

Sidecar vehicles: injecting liquidity and flexibility in a challenging fundraising environment

AUTHORS



Lauren Hulme



Marco Pontello



Natalie Miller

Fund sponsors continue to face a challenging fundraising market and many are sensitive to increasing investor demand for liquidity. Higher interest rates and public market dislocation continue to make capital-raising difficult, while decreased fund distributions are limiting capital available for new commitments, leading investors to prioritize liquidity and invest cautiously.

In this challenging environment, traditional add-on sources of capital are proving inadequate, with many fund sponsors turning to alternative forms of debt financing, such as private debt funds, to supplement traditional bank loans. Similarly, fund sponsors are continuing to arrange for co-investors to invest alongside main funds on a deal-by-deal basis, either directly in a portfolio company or through a special purpose vehicle. Accessing capital with private debt or co-investment equity can work splendidly (and both strategies remain popular and active); however, they do have certain drawbacks. For instance, debt servicing can be considered an unnecessary expense when investors could otherwise be an available source of capital, and deal-by-deal co-investment equity injections can be costly to negotiate and time-consuming to arrange for each investment opportunity.

As a result, fund sponsors have been increasingly broadening their interest in leveraging blind-pool/multi-investment sidecar vehicles to execute on their investment strategies.

What you need to know

- **Challenging market conditions are leading fund sponsors to seek alternative sources of investment capital.** As traditional add-on sources of capital prove increasingly inadequate, fund sponsors are broadening their interest in leveraging blind-pool/multi-investment sidecar vehicles to execute on their investment strategies.
- **Newer sidecar vehicles enable fund sponsors to seek flexible add-on capital without over-leveraging their portfolio.** While standard definitions for sidecar vehicles vary, blind-pool/multi-investment sidecars can be broken into the following categories:
 - *Overage (or “overflow”) funds*, which allow fund sponsors to raise capital concurrently with, but outside of, a main fund so that it can be deployed alongside the main fund.
 - *Annex funds*, which are raised and used post-investment and invite the existing main fund’s investors to re-up their capital commitments outside of the main fund.
 - *Top-up funds*, where the top-up vehicle and the main fund are raised and invest alongside one another during the investment period in new investment opportunities.

- **Anticipate the use of sidecar vehicles from the outset.** Regardless of when a sidecar vehicle is established, fund sponsors should consider their potential use from the outset of a main fund's fundraising so that the governing documents can be drafted accordingly.

Sidecar vehicles as the “right fit”

Sidecar vehicles can be a top choice for many fund sponsors seeking flexible add-on capital without over-leveraging their portfolios. This additional capital must be appropriate both in terms of the economics and with respect to the fund sponsor's relationships with the main fund's limited partners and the main fund's portfolio objectives. Different types of sidecar vehicles can fit varying sponsor and investor needs.

Distinguishing overage, annex and top-up funds

Single investment co-investment vehicles are the traditional type of “sidecars”, as they invest alongside the main fund in a given portfolio investment. However, the focus of this article is to address the newer types of “sidecar” vehicles that are less frequently discussed and which operate more as a blind-pool/multi-investment vehicle. We note that while these blind-pool/multi-investment vehicles have been picking up steam over the last handful of years, we see them as increasingly worthwhile tools given the challenges in today's fundraising environment.

Outside of the traditional deal-by-deal co-investment vehicle, there are three types of sidecar vehicles: overage funds, annex funds and top-up funds. A fund sponsor's choice of vehicle will primarily depend on the rationale behind the fund sponsor's request for additional capital outside the main fund. While it's worth noting that industry parlance on the various types of sidecar vehicles is somewhat inconsistent, this is how we view the universe of blind-pool/multi-investment sidecar vehicles.

1. **Overage funds.** Overage (or “overflow”) funds are used by fund sponsors seeking to pre-emptively increase the applicable main fund's investment capacity when there are constraints in the main fund's governing documents (such as investment restrictions relating to concentration limits). Overage funds allow fund sponsors to pool capital outside of a main fund so that it can be deployed alongside the main fund. It's worth bearing in mind that the investments made using overage funds must meet certain prescribed sector or investment criteria—for example, the investment might need to exceed a certain size.

As blind-pool vehicles that are established in advance of a specific investment opportunity, overage funds can provide fund sponsors with more discretion over investments and a greater agility to execute deals more quickly than traditional co-investment vehicles (which are negotiated on a deal-by-deal basis). Overage funds are typically offered, or at least contemplated, during the main fund's fundraising period and are generally raised side-by-side with the main fund. In addition to the preferred economics discussed below, investors can be attracted to overage funds as a means of increasing their exposure to portfolio investments.

2. **Annex funds.** Annex funds are typically used in the post-investment period, when a fund sponsor identifies a need for additional capital to make follow-on investments and invites the existing main fund's investors to re-up their capital commitments outside of the main fund. This is typically on a pro-rata basis, based on the portfolio's potential follow-on opportunities at the time (therefore, annex funds are only somewhat "blind-pool").

The fundraising success of an annex fund can largely depend on how investors view the existing investments in the main fund, and whether the fund requires follow-on capital (as opposed to investors believing that new investments in a new fund would be a more valuable use of their investment dollars). Pricing investment opportunities through an annex fund can be challenging for fund sponsors given that the general partner has a fiduciary duty to both the main fund and the annex fund—therefore, getting third-party valuation or fairness opinions can be a useful tool to mitigate the inherent conflicts of interest that arise from two vehicles sharing investment opportunities, but in different proportions and at different economic rates. Getting an annex fund over the line often requires an amendment to the main fund's limited partnership agreement, and generally at a high threshold of existing limited partner approval.

3. **Top-up funds.** Top-up funds are raised based on new market opportunities; for example, when a fund sponsor wants additional capital to take advantage of market dislocation and investors in the main fund agree that the new market opportunities merit additional capital commitments. This is accomplished through a top-up vehicle, where the top-up vehicle and the main fund invest alongside one another during the investment period in new investment opportunities. While top-up funds and annex funds are sometimes referred to interchangeably, top-up funds are generally viewed as vehicles that are raised and invested *during* the main fund's investment period, whereas annex funds are generally viewed as vehicles that are raised and invested *after* the main fund's investment period.

Sidecar economics: a win-win for fund sponsors and investors

Regardless of terms and strategy, a sidecar vehicle is only viable based on investor demand, which is generally shaped by interest in the strategy of the vehicle and the terms on which it is offered. In all cases, investors participating in such a vehicle believe that the main fund's investments are worthy of more of their capital commitment dollars rather than re-routing those dollars to an entirely new fund.

Preferential economic terms are usually used to make these opportunities attractive to investors while also providing additional economics to the fund sponsor. Sidecar vehicles typically charge investors carried interest at a reduced rate to that of the main fund—sometimes on a "back-ended" basis, where the fund sponsor receives carry only after investors have 100% of their capital returned together with their preferred return. Furthermore, sometimes fund sponsors integrate the waterfalls of the existing fund with the sidecar fund so that they are treated on a combined basis where all investors get their preferred returns before the fund sponsor hits carry in either vehicle.

Management fees and other fees are often waived or substantially reduced. Given that there is a possibility that not all (or any) of the sidecar fund's capital commitments will be deployed into investment opportunities, management fees are often charged based on a percentage of invested capital rather than on capital commitments (meaning the fund sponsor does not earn any management fees unless the sidecar vehicle actually has assets under management)—however, sidecar investors still take on the bearing of organizational and any ongoing expenses, even if the vehicle makes a limited number of (or no) investments.

In addition to preferred economics, main fund limited partners often view sidecar vehicles as an effective tool for obtaining additional exposure to main fund portfolio investments.

Who invests

In our experience, it is most often the case that there are no explicit requirements in a main fund's governing documents to offer sidecar interests solely to the existing limited partners of the main fund. However, from an investor relations perspective—and to mitigate potential conflicts of interest—we generally recommend that sidecar opportunities are offered to existing limited partners of the main fund (generally on a pro-rata basis) before soliciting interest from third parties.

In addition, we generally take the position that there should be no sponsor dollars in a sidecar vehicle unless the vehicle is investing in all portfolio investments of the main fund on a pro-rata basis. This is to ensure that the fund sponsor's "skin in the game" (i.e., sponsor commitment) is in the main fund from an alignment perspective, and to avoid cherry-picking.

When to add a sidecar

The point in time of a main fund's lifecycle often determines the type of sidecar vehicle a fund sponsor may look to form. As discussed above, overage funds are generally established during the fundraising period or the investment period to provide the greatest flexibility for the use of additional capital, top-up funds are often raised during the investment period in response to market opportunities, and annex funds tend to be established after the investment period to facilitate follow-on investments. These types of vehicles can provide fund sponsors with an accessible source of capital for fast-moving deals that are too large for the main fund.

These vehicles differ from a traditional single-investment co-investment vehicle, which is done on an *ad hoc* basis and needs to be negotiated with investors on a timeline linked to the execution of the underlying transaction.

Setting up fund documents for success

Regardless of when a sidecar vehicle is established, fund sponsors should consider its potential use from the outset of a main fund's fundraise so that the main fund's governing documents can be drafted accordingly. This is really no different from how the potential to do co-investments is frequently baked into main fund limited partnership agreements (including allocation rights and flexibilities) and investor side letters (including negotiated rights related to co-investment notice, participation and other rights).

The limited partnership agreements of sidecar vehicles often track the main fund's limited partnership agreements. With respect to overage funds in particular, it can be most efficient to concurrently share the governing agreements of both funds with investors during the fundraising processes.

Whether or not the existence or potential existence of a sidecar vehicle is explicitly contemplated in the main fund's limited partnership agreement, fund sponsors should still consider any permissions or restrictions that the main fund's documents place on their ability to raise a sidecar vehicle (whether generally or more specifically caught)—including, for instance, the timing and scope of any limited partner or limited partner advisory committee approval threshold.

Conflicts between the terms of the main fund's and sidecar vehicle's documents should also be considered during the drafting processes. Examples of potential conflicts include: (i) presentment provisions stipulating that on-strategy investment opportunities are owed exclusively to the main fund, provided it has the available capital and scope of investment permissions to invest; (ii) how any time and attention requirements of the key personnel will line up; (iii) whether the fund will be "tied at the hip" in regards to investing/divesting at substantially the same time and on substantially the same terms; (iv) how expense sharing will work; and (v) terms relating to any successor fund or similar restrictions.

To discuss these issues, please contact the author(s).

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