Private Equity in the United States: Frequently Asked Questions

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General Overview

Q 1. What are the general types of investments that fall within the private equity industry?

A Investments in the private equity industry generally fall into two categories: (i) investments in private equity funds and (ii) direct investments in companies.

A sophisticated investor may wish to invest in private equity funds, pooling its money with other sophisticated investors. The funds will in turn search out investments in specific types of companies or assets and subsequently manage these to make a profit for both the investor and the principals of the fund. These funds generally fall into the categories of buyout, venture capital, distressed debt, mezzanine, real estate, fund of funds or a hybrid of any of these.[1]

Funds with a buyout strategy generally acquire an undervalued company either in its entirety or a substantial part thereof, for the purpose of retooling it to cause the company's value to appreciate. On the other hand, venture capital funds generally invest in early-stage companies (often in the technology or life sciences industry), receiving shares or other equity interest in return; the purpose of such investment is to support the investee company's initiatives. Funds focused on distressed debt will likely target non-performing loans or distressed companies for the purpose of acquiring and disposing of the debt or underlying assets. Real estate funds focus on the acquisition of real property, either on a property-by-property basis or through the acquisition of existing real estate "portfolios". Fund of funds invest in any of the funds discussed above.

An investor may choose to invest directly in a company or in real estate, as distinguished from investing in private equity funds. These direct investments are often made side by side or as a "co-investment" with an investment or acquisition being led by a private equity fund. An investor in a private equity fund may obtain co-investment opportunities as a result of being an investor in one or more funds. A benefit of direct investments is that the investor receives direct equity holder rights and becomes a direct owner of the entity or property. A co-investor will also typically pay no fees or substantially reduced fees to the fund with which it has made a co-investment. Since direct investments or co-investments have significantly different characteristics from fund investments, these FAQs focus on investments in private equity funds (termed "funds" here).

Q 2. Please give an overview of the history of investments in private equity funds in the United States.

A Funds have a relatively short history. Traditionally, investment in private companies with the goal of re-selling them was the purview of a few wealthy families. The first big private equity firm came into existence in the late 1960s, and it was not until the 1980s that private equity investors attracted much attention, often as the groups behind that era's hostile takeovers.

1 Note that for purposes of these FAQs, we have omitted any discussion of hedge funds, which although arguably a subset of private equity funds, are governed by separate laws and regulations, and therefore are worthy of a separate discussion.

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In the late 1990s, funds raced to invest in startup companies with unproven business models, resulting in funds extending venture capital monies without the usual safeguards behind such deals – for example, a certain amount of control if the company fell on hard times; limited syndication of investments with other funds; and funds' joining investors in deals without performing adequate due diligence on the companies to be funded.

The increase in the popularity of private equity investment can be seen clearly in the growth of funds in the last three decades. The largest fund in 1980 stood at a value of $135 million. Twenty-five years later, many funds exceeded $1 billion in value (with several funds exceeding $10 billion).

Low interest rates in recent years have also made it easier for private equity buyers to borrow large amounts of cash to finance purchases. At the same time, funds are increasingly joining with other funds in "club deals" to make larger investments – a phenomenon that has resulted, in one case, in potential legal issues. On November 15, 2006, thirteen buyout funds were named as co-defendants in a class action lawsuit in which they were accused of violating federal antitrust laws. Primarily, the complaint alleges that collusion exists among the named funds, arguing that these funds no longer compete against each other for deals, but instead enter into club agreements among themselves or make agreements not to bid against each other in certain transactions. Many private equity professionals argue that there is lots of competition among the funds, particularly given the significant increase in the number of funds and the commitment size of funds raised.

3. What are the main advantages and disadvantages of investing in private equity funds?

Advantages

(a) **High returns:** Although there is a high risk in investing in funds, investors have the potential to receive high returns on their investments. For example, in Google's agreement to buy venture-backed YouTube for $1.65 billion, the successful venture capital fund, Sequoia Capital, will reportedly receive approximately $495 million in consideration for its 30% ownership stake in YouTube. Sequoia Capital invested a total of $11.5 million in two separate rounds and was the only venture capital fund invested in YouTube. Obviously, such returns are not the standard by which all funds and deals should be measured, but they illustrate the gains that are possible.

(b) **Safer long-term growth:** Funds typically are heavily involved in, and provide needed expertise to, the companies they buy or invest in. Generally, these investing funds will take control of, or at least maintain a presence on, an investee company's board of directors. At the same time, fund managers can deal with hiccups along the way without the distraction of public scrutiny or even intense scrutiny from investors. In addition, fund managers have extensive experience in accreting value in otherwise undervalued companies. Ultimately, this combination often offers a more attractive alternative than investors might otherwise have in the public markets.

(c) **Less regulatory scrutiny:** Funds do not normally face the same level of scrutiny as other investment vehicles (including hedge funds). Since February 2006, the U.S. Securities and Exchange Commission (SEC) has required certain private fund managers to register, so that the SEC can monitor them more closely. However, most managers do not fall within the SEC's definition of "private funds", which applies only to funds that allow investors to redeem their interests within two years of their investment (e.g., hedge funds). The term of investment in most funds extends well beyond the two-year mark.

(d) **Fewer internal resources and access to bigger deals:** If an investor were to attempt to build the capability to invest in buyout deals or make investments in venture capital companies and subsequently manage such companies or investments, an enormous amount of in-house resources would be required. For example, at a minimum, the investor would need someone to source the best deals out of the multitude available, someone to negotiate favorable terms regarding such investment, someone to manage the company or investment in an accretive manner (often by becoming involved in the day-to-day management) and someone to determine and expedite the most lucrative exit strategy. It is likely that several people would be required if the investor chose to follow more than one strategy (e.g., buyout deals and venture capital investments). Generally, investors do not want to use these significant internal resources when they can simply outsource such tasks to their choice of fund investment teams. In addition, given that investors are usually engaged in other types of business (and invest in funds as a way of enhancing their returns – e.g., investors may be pension plans or family trusts), they may not have access to the same amount of capital as funds. Accordingly, funds often have access to bigger deals that investors would not be able to participate in on their own.

Disadvantages

(a) **Less maneuverability:** Funds generally tie up investments over a term of approximately 10 years, not counting any term extensions. If an investment in a particular fund is going poorly, there are few practical or realistic opportunities for investors to exit the fund.

(b) **Control:** Investors in funds commit to invest specified amounts into a fund that is controlled by an investment team. The investor's money is then "called" on an as-needed basis by that team. Once the money is called, the investor has a period of days within which to provide the money and has no opportunity to review or comment on the proposed investment. The investor's primary protection is the inclusion of investment restrictions in the fund agreement (e.g., the limited partnership agreement or limited liability company agreement).

(c) **More competition:** While certainly an advantage, higher returns can be a double-edged sword. Funds increasingly find themselves competing with many other funds, as well as strategic investors, for fewer deals. In recent years, hedge funds and hybrid hedge/funds have become increasingly more active in private equity investments.

4. What have been the recent key trends in private equity fund formation?

Five of the most significant trends that we have seen over the last five years in fund formation are (i) restricted disclosure of information from the fund to its investors; (ii) inclusion in the fund agreement of a management fee waiver; (iii) inclusion of an investor giveback; (iv) increased availability of recycling of an investor's capital commitments; and (v) increase in overall size of funds.[2]

In response to various actions by newspapers and public advocacy groups, certain pension plans in the United States have been required to disclose information about the funds in which they invest, which previously would have been characterized as confidential. Funds are concerned about the scope of disclosure because (i) they do not want the terms under which they operate to become publicly known (and allow their competitors to undercut them), and (ii) they do not want investors reporting on aspects that are inherently subjective (e.g., valuations) and that therefore could have a detrimental effect on the investment in the marketplace. Investments made by the funds are generally held at cost unless the fund is permitted or required under the fund agreement to write down or write up such investments to reflect a change in the value, which is often in the fund's discretion. Additionally, an investor may calculate its expected rate of return differently than the fund would (e.g., the possibility exists that the investor would have a lower rate of return than the rate calculated by the fund). As a result, funds often limit the information that they will disclose to investors who are more likely to be required to publicly disclose such information. In addition, funds often protect their ability to withhold information from all investors if there is a concern of public disclosure (particularly with respect to confidential information concerning the fund's portfolio company investments).

As this is a currently developing area driven by actions brought by third parties, such as newspapers and advocacy groups, each fund agreement attempts to provide protection against future disclosures that may result.

Generally, the investment team is required to commit to the fund a certain amount of money (which varies from fund to fund) to demonstrate to the investors that the team has some "skin in the game". As a part of the terms of most investments in funds, investors are usually required to pay a management fee to the investment team. It has become increasingly common in U.S. buyout funds for the investment team to waive a portion of the management fee, instead directing the investors to contribute an equal amount to the fund on the team's behalf as a part of its capital commitment. Accordingly, the investment team is entitled to receive any profits generated from that contribution in accordance with the distribution "waterfall". This reduction in the management fee effectively permits the investment team to convert management fees (taxed at ordinary income rates) to capital contributions (taxed at more favorable capital gains rates).

Throughout the life of the fund, investors receive distributions upon the disposition of an investment by the fund. Accordingly, if a subsequent liability arises that the fund does not have sufficient assets to pay without a giveback obligation on the part of the investor, the investment team would be left to pay a

2 In addition to those trends listed, within the last year funds have begun to include provisions in their fund agreements allowing for the possibility of future public offerings with respect to entities above the fund that are wholly owned by the fund's investment team. We expect that this trend may continue with increased frequency depending upon the success of the Blackstone initial public offering.

disproportionate share of the liability. It has therefore become increasingly common, although arguably still controversial, to require investors to “refund” prior distributions if a subsequent liability arises. The terms of such refund will vary from fund to fund but generally include (i) a restriction based upon the time during which such refund can be required (e.g., two or three years after the date of the distribution or two or three years after the dissolution of the fund); (ii) a cap on the amount of such refund (e.g., all distributions made or a percentage thereof); and/or (iii) a restriction on the purpose for which such refund can be required (e.g., indemnification liabilities or all liabilities). Regardless, investors often insist that the fund look to its assets (including any unfunded capital commitments of investors) before seeking a refund from its investors.

The investment strategies of investors differ. When certain investors determine the amount of their investment, they want to ensure that this amount is their maximum exposure (other than for any refunds required, as discussed in the previous paragraph). Other investors would prefer that the amount of their investment represent the amount that is fully invested by the fund and that, therefore, fees and expenses be above that amount. The rationale for this latter approach is that the amount committed should be the full amount on which the investor earns a return and that fees and expenses should be separate. To comply with these differing viewpoints, funds will often be permitted to “recycle” certain distribution proceeds up to a specified cap. For example, if a fund makes an investment that is disposed of for a profit within 12 to 18 months of the date of the investment, the fund may then be able to reinvest the investors’ capital contributions for such investment (or, alternatively, the fund may be able to reinvest the proceeds realized on the investment that exceed the investors’ capital contributions). The rationale for this type of recycling is that since the money was not at work for a long period and the investor earned a profit, the fund should be entitled to put the money back to work. Another example of recycling would permit the fund to reinvest an amount equal to the capital contributions of the investors made for the purpose of fees and expenses. Alternatively, rather than specifying the type of distribution proceeds that can be recycled, there may be a cap on the total amount of distribution proceeds from capital commitments that can be reinvested (e.g., 110%–120%).

Practical and Legal Aspects of Private Equity Investment

Q 5. What legal entities may typically be used as vehicles for investments in private equity funds? What are the advantages and disadvantages of each?

A **Limited partnerships:** Most commonly, a limited partnership (typically formed in Delaware for U.S. funds) is the vehicle used in the formation of a fund. Its advantages include the protection of investors (as limited partners) from the liabilities of the fund so long as such investors do not participate in the management of the fund. Accordingly, the partnership agreements of most funds clearly specify which actions the limited partners may take regarding the oversight of the fund. In addition, a limited partnership is a flow-through entity for tax purposes. Fund investors’ chief realization of value is through a distribution. As such, a fund that is organized as a partnership will see distributions taxed only once, and often such distributions will be subject to the more favorable

long-term capital gains tax on the individual limited partners – a far more attractive option than the tax treatment funds would receive if organized as corporations. A disadvantage of this vehicle is that the limited partners must effectively hand over control of their investment to retain their limited liability.

Limited liability companies: An alternative vehicle used for the formation of a fund is a limited liability company (typically formed in Delaware for U.S. funds). It has similar advantages to the limited partnership vehicle because investors (as members) are protected from the liabilities of the fund. The members are not restricted from participating in the management of the fund. Like the limited partnership vehicle, it is a flow-through entity for tax purposes. A disadvantage of this vehicle is that it does not have the extensive case law as a fund formation vehicle that the limited partnership vehicle has. Given the relative newness of the LLC form and the lack of corporate formalities, courts may be more likely to pierce the corporate veil and therefore subject the investors to liability in a situation where members directly manage an LLC, a management structure that is not forbidden by the legislation. Use of an LLC may pose U.S. federal income tax issues for non-U.S. investors, depending on their jurisdiction of residence.

General partnership vehicles: Funds may choose to have a corporation serve as general partner of a limited partnership to avoid the potentially unlimited personal liability otherwise associated with the role of general partner in a limited partnership. Organizing the general partner as an S Corporation avoids the extra level of taxation generally associated with corporations. Limitations are imposed on an S Corporation, however – in particular, a restriction on the nationality of its shareholders and the requirement that it maintain only one class of stock; these limitations make it less favorable than other forms. More recently, funds have begun forming as limited partnerships in which the general partner is a Delaware limited liability company. The limited liability company general partner receives partnership-like tax treatment while removing the personal liability of the members and managers. The limited liability company also allows greater flexibility in its formation and particularly in its management, which need not follow traditional corporate formalities.

Q 6. What techniques are available to minimize tax liability? How do the positions of U.S. and non-U.S. investors differ in this regard?

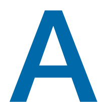
A A fund is generally classified as a partnership for U.S. federal income tax purposes. The income, gain, loss, deduction and credits of the fund pass through to, and generally retain their character in the hands of, the partners. Most of the income is long-term capital gain from the disposition of stock, which is taxed at a maximum rate of 15% for non-corporate investors (compared with rates of up to 35% for ordinary income).

The general partner is granted a “carried interest” entitling it to 20% (and sometimes more) of the cumulative profits of the fund. The carried interest is a “profits interest” for tax purposes. The general partner is taxed only when profits are allocated to it, not upon receipt of the profits interest at the inception of the fund. The general partner entity itself is usually classified as a partnership for U.S. federal income tax purposes, so allocations of long-term capital gain pass through to the individual members of the general partner and are taxed at the favorable 15% rate described above.

Non-U.S. limited partners generally are not subject to U.S. tax on gain derived upon the disposition of stock or debt securities of a U.S. corporation (other than stock of U.S. real property holding corporations). However, non-U.S. investors are taxed on income that is "effectively connected" to a trade or business conducted within the United States and are required to file a U.S. federal income tax return in any year in which they are deemed engaged in such a trade or business. In a fund, investments in operating partnerships or limited liability companies generate effectively connected income. To avoid direct imposition of tax and U.S. filing obligations on non-U.S. partners, most funds agree to structure investments of non-U.S. partners into an operating partnership or limited liability company through one or more "blocker corporations".

U.S. tax-exempt investors are subject to tax on "unrelated business taxable income" or "UBTI". In a fund, typical sources of UBTI are investments in operating partnerships and limited liability companies, as well as income from debt-financed property. Most funds agree to structure investments in a manner intended to minimize the likelihood of a tax-exempt investor's directly realizing UBTI, using blocker corporations or other holding vehicles.

7. (a) What are some applicable U.S. securities laws and other regulatory requirements relating to the promotion or management of a private equity fund?



In connection with the offering of interests of a fund to investors, funds generally rely on the exemption from registration under Rule 506 of Regulation D of the U.S. Securities Act of 1933, as amended. Under Rule 506, such offering transaction will be deemed private (and not public) so long as there are no more than 35 purchasers of the interests of the fund that are not "accredited investors". Each purchaser that is not an "accredited investor" must either alone or with a representative have the knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment; or the fund must reasonably believe, immediately prior to making the sale, that such purchaser comes within this description.

An "accredited investor" is defined to include (i) any corporation or partnership not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million; (ii) any director, executive officer or general partner of the issuer of the securities being offered or sold, or any director, executive officer or general partner of a general partner of that issuer; (iii) any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds $1 million; (iv) any natural person who had an individual income exceeding $200,000 in each of the two most recent years or joint income with that person's spouse exceeding $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; and (v) any entity in which all the equity owners are accredited investors.

The Investment Company Act of 1940, as amended, requires the following to register as investment companies: (i) issuers that engage (or propose to engage) primarily in the business of investing, reinvesting and trading in securities; (ii) issuers that engage (or propose to engage) primarily in the business of issuing face-amount certificates of the installment type; or (iii) issuers that engage in the

business of investing, reinvesting, owning, holding or trading in securities and own or propose to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets. The majority of funds rely on an exemption from registration under the Investment Company Act. See Q&A 7(b) for discussion.

The Investment Advisers Act of 1940, as amended, requires the following to register as investment advisers: (i) persons who, for compensation, engage in the business of advising others, either directly or indirectly or through publications or writings, regarding the value of securities or the advisability of investing in, purchasing or selling securities; or (ii) persons who, for compensation and as a part of a regular business, issue or promulgate analyses or reports concerning securities. The majority of funds take the position that their general partners, managers or other investment team members fall under the Investment Advisers Act's exception that such persons are not required to register as investment advisers if during the course of the preceding 12 months they have had fewer than 15 clients and do not hold themselves out generally to the public as investment advisers, nor act as investment advisers to any registered investment company or a company that has elected to be a business development company. For the purpose of determining the number of clients of an investment adviser, no shareholder, partner or beneficial owner of an investment fund will be deemed to be a client of the investment adviser unless the person is a client of such investment adviser separate and apart from his or her status as a shareholder, partner or beneficial owner.

The U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA), governs the investment of the assets of certain employee benefit plans that may be investors in a fund. Under ERISA and regulations issued by the Department of Labor (DOL), when a plan covered by ERISA acquires an equity interest (such as the interests of a fund) in an entity that is neither a "publicly offered security" nor a security issued by an investment company registered under the Investment Company Act, the assets of the ERISA plan generally include not only such equity interest but also an undivided interest in each of the underlying assets of such entity unless it is established that (i) ownership of each class of equity interest in an entity by "benefit plan investors" has a aggregate value of less than 25% of the total value of such class of equity interest outstanding at such time, determined on the date of the most recent acquisition of any equity interest in the entity; or (ii) the entity is a "venture capital operating company" as defined in the DOL regulations.

The USA PATRIOT Act (The Uniting and Strengthening America by Providing Appropriate Tools Required to Interrupt and Obstruct Terrorism Act of 2001) requires that financial institutions establish and maintain compliance programs to guard against money-laundering activities. The PATRIOT Act requires the Secretary of the U.S. Treasury Department to prescribe regulations to govern the anti-money-laundering policies of financial institutions. The Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury, has proposed regulations that would require certain pooled investment vehicles to follow anti-money-laundering policies or procedures. Although these regulations are not yet final, the final version adopted by FinCEN could possibly apply to funds. Moreover, legislation or regulations could be enacted to require funds or service providers to funds to share information with governmental authorities regarding investors in funds. Such legislation and/or regulations could also require funds to implement additional restrictions on the transfer of fund interests. Accordingly, funds generally require information from investors to verify, for any reason whatsoever, the identity of an investor and the

source of the payment of subscription monies, or to comply with any applicable customer identification programs required by FinCEN, the U.S. Securities and Exchange Commission (SEC) or other federal regulatory authority.

In addition, interests in funds may not be offered, sold, transferred or delivered, directly or indirectly, to certain persons, including (i) a person or entity who is a "specially designated national and blocked person" within the definitions set forth in the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) Regulations of the Treasury; (ii) a person acting on behalf of, or an entity owned or controlled by, any government against whom the United States maintains economic sanctions or embargoes under the OFAC Regulations; (iii) a person or entity who is within the scope of Executive Order 13224 – Blocking Property and Prohibiting Transactions with Persons who Commit, Threaten to Commit, or Support Terrorism, effective September 24, 2001; or (iv) a person or entity whose contributions to the fund will be derived from or related to, directly or indirectly, any illegal or illegitimate activities or any individual or organization identified as a terrorist or as a terrorist organization by the United Nations or the U.S. federal government.

Q

(b) Are private equity funds generally regarded as investment companies?

A

The majority of funds rely on exceptions under section 3(c)(1) or 3(c)(7) of the Investment Company Act from being required to register as an investment company under the Investment Company Act.

Under section 3(c)(1), a fund will not be deemed to be an investment company under the Investment Company Act if its outstanding securities are beneficially owned by not more than 100 persons and if it is not making and does not presently propose to make a public offering of its securities. Beneficial ownership by a person is deemed to be beneficial ownership by one person, except that if the person owns 10% or more of the outstanding voting securities of the fund and the person is or, but for the exception found in section 3(c)(1) or 3(c)(7) of the Investment Company Act, would be an investment company, beneficial ownership is deemed to be by the holders of such person's outstanding securities.

Under section 3(c)(7), a fund will not be deemed to be an investment company under the Investment Company Act if its outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers" and if it is not making and does not at that time propose to make a public offering of such securities. A "qualified purchaser" includes (i) a natural person who owns not less than $5 million in investments (as defined in the Investment Company Act) and (ii) any person, acting for its own account or the accounts of other qualified purchasers, who owns and invests on a discretionary basis not less than $25 million in investments.

Q 8. (a) **What is the impact of globalization upon investments in private equity funds?**

A Typically, when a fund is formed, the investment team is restricted from investing outside a specific geographical area. This is generally insisted upon by the investors who wish (i) to know where their money is being put to work, and (ii) to ensure that the investment team is capitalizing upon the strengths of its members and not being stretched too thinly. The primary impact of globalization on funds has been an increasing number of funds formed to invest in previously obscure geographical areas. For example, a fund focused on emerging markets may intend to invest primarily in India, Russia and China. Thus, investors are able to select funds that offer higher risk/reward investment profiles as well as gain exposure in previously inaccessible geographical areas.

Interestingly, the recent annual report of the UN Conference on Trade and Development indicated that there are signs of rising hostility from labor unions and politicians around the world toward fund managers, based largely upon the short time horizon of the investments and the fact that funds usually rely on job cuts to generate the increase in profitability and capital gains that they seek.

Q (b) **What legal issues may arise from investments by the fund in foreign jurisdictions?**

A Each jurisdiction brings its own particular set of issues. A common requirement among those investing in foreign jurisdictions is obtaining assurance that such investment would not lead to increased tax liability, create an obligation to file a tax return in a foreign jurisdiction and compromise an investor's limited liability. Often investors will negotiate for the fund agreement to contain protective language to prevent these negative effects.

Q (c) **What factors may be relevant to the decision of where to establish a private equity fund?**

A Generally, a fund is domiciled in the country where the investment team is domiciled. Other factors that are also taken into consideration are the primary location of investments, the primary location of investors, the familiarity of investors with the jurisdiction, the tax exposure and treaty benefits of the jurisdiction and the limited liability protection for investors. In the United States, funds are generally formed under to the laws of the State of Delaware, but often include parallel offshore vehicles for certain foreign investors.

Q 9. Why is due diligence so important in relation to investments in private equity funds?

A Investments in funds require a long-term commitment (e.g., a 10-year term with the possibility of extension). Generally, few exit options are available because the secondary market for investments in funds is limited, and transactions in that market require the consent of the investment team. In addition, the nature of investments in funds is that investors hire an investment team and give it a large amount of discretion to invest their money (subject to any applicable investment restrictions). Accordingly, it is important for investors to perform proper diligence on the investment team to ensure that its members are trustworthy; have a good reputation, good experience, good track record and extensive deal accessibility; and are people that the investors will want to be associated with for the foreseeable future.

It is also important for investors to perform proper diligence on the team's investment strategy and its historical performance, to attempt to determine the likelihood of the fund's success. Investors should understand the culture and values of the fund as well as its proposed market. In addition, investors should find out whether the fund follows a proper process to ensure that there is sufficient investment sourcing and analysis to seek out the best deals, that there are both an institutional approval process to review all deals and a clear method of identifying where value can be added and how investments will be managed. Ideally, investors should implement a diligence protocol that will enable them to approach each investment unemotionally. Key sources of information for the investors will likely include the following: material provided by the investment team, including presentations and interviews; informal and formal references from other investors and industry contacts; and other general industry information.

Q 10. (a) When considering an investment in private equity funds, what factors should an investor consider (e.g., business and legal)?

A The answer to this question will vary from investor to investor as the investment strategies of each will differ. For example, an insurance company or bank may invest in certain funds to benefit from exposure to certain members of the investment team or the opportunity to bid for other work. On the other hand, some investors may be motivated to invest in certain funds because of the opportunity to co-invest with such fund. Regardless of the reason for the investment or its strategy, investors should ensure that the fund's proposed investments correspond with their own investment strategy and risk tolerance. In addition, investors should ensure that (i) their limited liability is protected (e.g., investors should not be on the hook for the fund's general liabilities); (ii) they understand their tax filing obligations resulting from the investment (e.g., will they now have to file tax returns in a foreign jurisdiction because the fund will make its investments there?); and (iii) they are comfortable with the terms of the agreement for the foreseeable future and have some protection if things do not go according to plan.

Q (b) **How does the decision-making process to invest in a private equity fund differ from the process of investing in public securities?**

A Companies with public securities are obligated under applicable securities laws to disclose certain information to investors. In addition, regulators, including the relevant market administrators and the SEC, oversee the various filings of such companies to ensure compliance. As a result, investors benefit from increased disclosure and regulatory oversight. In investments in funds, access to information is generally more restricted because disclosure is only required in accordance with the fund agreement, and all offering documents are private.

Perhaps the most material difference relates to the consequences of investment. As discussed earlier, the exit opportunities for investments in funds are very limited compared with investments in public securities. So to limit their risk exposure, investors should spend extra time and effort in deciding whether to invest in a fund; they should also actively monitor their investments once in the funds.

Q 11. (a) **Over the course of an investment in a private equity fund, how will investors obtain sufficient information to monitor their investment and to enable the investors to make an informed decision when exercising their consent rights?**

A Investors generally negotiate for the fund to disclose certain information. Typically, investors attend formal annual meetings at which the investment team discusses both the fund's performance and the fund's portfolio. The investors may also be able to obtain information through informal discussions. Investors usually receive quarterly and annual financial statements and other disclosures regarding the fund (e.g., statement of the investor's capital account and unpaid capital commitments; identification of companies in the portfolio, including the cost and current value; statement of consummated transactions and summary of any significant decisions by the investors and/or the fund's advisory committee or any significant litigations or proceedings since the previous statement). Generally only annual financial statements are audited in accordance with applicable generally accepted accounting principles. Investors that have representatives on the fund's advisory committee may obtain additional information, depending on the terms of the fund agreement.

Q (b) **What impact have U.S. freedom of information laws had in this regard?**

A The U.S. Freedom of Information Act (FOIA) (and the various related lawsuits brought thereunder) may require certain investors to publicly disclose information about their investments in funds. Accordingly, funds are sensitive about the information that they are required to disclose to such investors and, with increased frequency now, funds (i) limit the information they are required to disclose to investors subject to FOIA or similar legislation; (ii) require investors to advise the fund of changes to their FOIA status; and (iii) retain the right to withhold information from any investor. See Q&A 4 for additional discussion.

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(c) What steps can be taken by an investor to protect its interest?

A

To attempt to protect its interest in a fund, an investor can negotiate to include in the fund agreement a combination of the following: (i) an excuse right that would relieve the investor from being obligated to make capital contributions to the fund if the investor's continued investment would violate the applicable laws or regulations; (ii) a right to remove the investment team with the consent of other investors (e.g., for "cause" – generally, fraud, willful misconduct or bad faith; for "no cause"; or if certain key members of the investment team are no longer involved in the fund's management); (iii) a right either to terminate the period within which the fund can make investments or to dissolve the fund (e.g., for cause; or for "no cause"; or if certain key members of the investment team are no longer involved in the fund's management); (iv) a right to transfer interests in the fund (a) to affiliates without the consent of the investment team and (b) to others with the consent of the investment team, which will not be unreasonably withheld; and (v) limitations on exculpation and indemnification provisions to ensure that indemnified members of the investment team will not be protected by the fund for bad acts or internal disputes.

To protect the dilution of its interest in a fund, an investor can negotiate that the fund agreement contain a cap on the aggregate amount of capital commitments. This cap, combined with a limitation on the length of time during which additional investors can be admitted to the fund, ensures that investors know the minimum interest that they will hold in the fund. These provisions also serve the purpose of ensuring (i) that the fund size does not become too large and therefore exceed what the investor determines to be the fund's capabilities, and (ii) that the investment team does not spend too much time raising capital (as opposed to investing it).

To prevent the investment team from taking actions that could adversely affect the interests of the investors, often investors will negotiate certain approval rights – for example, that amendments to the fund agreements cannot be made without the approval of a certain proportion of the investors (e.g., 50%, 66⅔% or unanimous). If the investment team has made substantial capital commitments to the fund, investors often request that approvals be made on a disinterested basis (e.g., by excluding the capital commitment of the investment team). This is particularly relevant in the area of conflicts.

Certain key economically significant amendments to the fund agreements, including altering the investors' commitments or reducing their share of distributions, generally require unanimous consent of the investors and the investment team. In addition, amendments to the provisions of the fund agreement that affect a certain class of investors (e.g., ERISA, tax-exempt investors or banks) generally require the unanimous approval of those investors. The fund agreements will also provide for investor approvals for certain actions not covered in the Advisory Committee approval provisions. These may include any of the following: waiving periodic fund meetings, terminating a suspension period after a key-person event, replacing the investment team following a cause or other disabling event, dissolving the fund after a cause event or on a no-fault basis, assigning/transferring the investment team's interest in the fund or making in-kind distributions of non-marketable securities or co-investments with sister funds to the fund.

Investors can also protect their interests in the fund by ensuring that the investment team does not receive distributions that exceed their entitlement under the fund agreement's waterfall provisions. The inclusion of a clawback mechanism ensures that if the investors have not received a preferred return (if applicable) or the investment team has received too much carried interest, the parties are "trued up" as of the clawback determination time. See Q&A 12 below for further discussion regarding distributions and clawbacks.

Performance of Investment

Q 12. (a) Which key provisions govern the relationship between an investor and a private equity fund?

A Fund agreements will vary from fund to fund; however, some of the more material legal provisions to consider are fees and expenses; waterfall distributions; clawbacks; Advisory Committee and investor approval rights; investment team duties to the fund and the investors; indemnification and investor giveback; and changes in governance.

The fund is generally responsible for picking up certain expenses, including the management fee. These expenses are then passed on to the investors by way of required capital contributions. In calculating the management fee, most funds pay the manager a fixed percentage (often 1.5%–2.5%) of capital commitments (some larger funds may reduce the percentage if capital commitments exceed certain breakpoints). There is often a reduction (based upon a reduced percentage and/or a reduced amount – e.g., invested capital contributions) following the expiration of the investment period or upon the investment team's raising of a successor fund.

The management fee is generally paid in advance quarterly or semi-annually and is offset by some percentage (e.g., between 50% and 100%) of ancillary fees generated by investments. These ancillary fees may include directors' fees received by the investment team as well as transaction fees and break-up fees (often to the extent that break-up expenses were borne by the fund). It has become increasingly common for a portion of the management fee to be waived and, in lieu thereof, for investors to be directed to contribute an equal amount to the fund on behalf of the investment team in the form of a capital contribution. As a result, the investment team will be entitled to receive any profits generated by such contribution according to the waterfall. This mechanism allows the investment team to gain a tax advantage by recharacterizing the management fee. See Q&A 4 for further discussion of the management fee waiver.

As a general principle, the fund bears the expenses of fund formation (e.g., organizational expenses such as legal and accounting expenses and fundraising expenses up to fixed cap); acquiring and holding investments; operating costs (e.g., audit expenses, tax-preparation expenses, reporting expenses, negotiation expenses, insurance costs, interests costs and Advisory Committee expenses); broken-deal expenses; and all other deal-related costs. On the other hand, the investment team typically bears office and employee expenses (e.g., overhead, salaries and benefits) and expenses incurred in sourcing deals for the fund (including travel and entertainment). Any placement agent fees

are generally ultimately borne by the investment team but, due to tax and timing considerations, may first be paid by the fund with a corresponding reduction to the management fee.

The waterfall determines how proceeds from the disposition of portfolio investments will be distributed to each partner and is thus heavily scrutinized and negotiated. It is typically calculated on a deal-by-deal basis or on an aggregate basis. See Q&A 12(b) for further discussion.

The inclusion of a clawback with respect to amounts received by the investment team resolves (i) the investors' concern that the investment team may get inflated returns under the premise that the "home run" investments may be sold early in the life of the fund, while the "dogs" may not be sold until the end of the life of the fund; and (ii) the desire of the investment team to share in the profits of the fund as soon as possible.

In its simplest form, the clawback causes the carried interest payment to be calculated at the end of the fund, aggregating all the disposed-of investments to ensure that the agreed-upon profit split is actually made. With the clawback, the investment team can be required to return (i) distributions received by the investment team that exceed the carried interest to which it is entitled; (ii) distributions received by the investment team that either exceed the carried interest to which it is entitled or are sufficient to cause the investors to receive a return of their capital contributions and a preferred return; or (iii) distributions received by the investment team that exceed what would have been distributed to the investment team as of a determination date if they had been made on an aggregate basis.

Generally, amounts required to be returned by the investment team (regardless of the clawback formulation) are calculated (i) net of taxes payable by the investment team (calculated at an assumed rate) plus (ii) net of distributions received in connection with the capital contributions of the investment team. The clawback obligations can be calculated at the end of the life of the fund and/or periodically before then (e.g., at the end of the investment period or at periodic intervals). Generally, investors require that the carried interest recipients in the investment team each guarantee that they will be liable for the amount of carried interest that they have received in the event of a clawback obligation. Investors may also consider requiring an escrow account to be established, in which a percentage of the carried interest distributions is required to be deposited.

Other key terms of fund agreements relate to investor consent rights and an Advisory Committee. An Advisory Committee is usually composed solely of investor nominees (generally, each of the investors with the largest capital commitments has the right to appoint a member to the Advisory Committee). The purpose of the Advisory Committee is to consent or otherwise deal with a variety of matters that are likely to arise during the life of the fund and to alleviate the administrative burden of rounding up investor consents.

Typical Advisory Committee powers include resolving conflicts of interest, reviewing and resolving valuations of investments, waiving certain investment restrictions in the fund agreement, substituting investment team members, terminating the investment period early in certain circumstances and settling indemnity claims. Most fund agreements provide that the fund will indemnify the members of the Advisory Committee and the investors that such members represent in connection with the administration of their duties. Investors often request that the fund agreement provide that members of the Advisory Committee do not owe a fiduciary duty to the fund or to the other investors in the fund,

but instead such members are permitted to act solely in the interests of the investors that they represent (or, alternatively, owe only a duty of good faith). As discussed in Q&A 11(c), certain approvals may require the investors' consent, not just the consent of the Advisory Committee. Generally, investor consent (rather than Advisory Committee approval) is required for certain amendments to the fund agreement, termination of the suspension period, removal of the investment team and/or dissolution of the fund.

Other key terms of fund agreements relate to the duties of the investment team to the investors and the fund (and corresponding indemnification of the investment team) and the ability of the team to require investors to return distributions previously made to them by the fund. With respect to duties of the investment team, the following or similar provisions may be contemplated for inclusion in the fund agreement: (i) a requirement that designated members of the investment team devote substantially all their business time to the fund until the end of the investment period, and thereafter, such time as deemed reasonably necessary to manage the affairs of the fund; (ii) a requirement that all investment opportunities within the scope of the fund strategy first be offered to the fund (alternatively, approval of the Advisory Committee is required if such opportunities are not to be first offered to the fund); (iii) a limitation that successor funds (e.g., funds that are substantially similar to the fund or, alternatively, any fund) cannot be raised by the investment team until a fixed percentage (e.g., 66⅔%–75%) of the fund's capital commitments have been invested; and (iv) a requirement that all non–third-party transactions be on an arm's-length basis and/or approved by the Advisory Committee.

Generally, provided that the investment team members do not act in material breach of the fund agreement or their acts (or omissions to act) do not constitute gross negligence, fraud or willful misconduct, the members will be exculpated and indemnified from liability. As discussed in greater detail in Q&A 4, if fund assets are inadequate to satisfy fund obligations, investors may be required to return prior distributions they received.

Finally, other key terms of funds relate to the investor exiting a fund. These provisions are discussed in greater detail in Q&A 11(c) and include the following: a key-person clause (e.g., if designated members of the investment team cease to devote the requisite time to the fund); a bad acts clause that allows investors to remove the investment team or take other action regarding the governance of the fund; and a no-fault clause that enables investors to either terminate the investment period or end the life of the fund.

Q **(b) How, typically, will the agreement provide for distributions to be made to the investors?**

A Fund agreements contain two general types of distribution waterfalls: deal-by-deal waterfalls and aggregate waterfalls.

In deal-by-deal waterfalls, distributions are generally made in the following order: first, to the investors and the investment team until they have received their capital contributions back with respect to the disposed-of investment (and any previously disposed-of investments, including capital contributions for any organizational expenses, fund expenses and management fees as allocated to the disposed

portfolio investment and any previously disposed-of portfolio investments); second, to the investors until they have received a preferred return on such disposed-of investments (calculated at a specified rate of return – often 8%, compounded annually); third, to the investment team until it receives a "catch-up" of its carried interest (e.g., 20%) on the distributions previously made to the investors as a preferred return (calculated commonly at a rate of 50%, 80% or 100% such that carried interest is calculated on the entire amount of profit, allowing the investment team to share in the profits at the first dollar and therefore catch up to the investors; by reducing the percentage under the catch-up provisions, investors receive their share of profits more quickly and are able to delay the time when the investment team shares in the fund's profits); and fourth, to the investment team at the carried interest rate and the remainder to the investors (e.g., 20%/80%). Many U.S. buyout and distressed debt funds have a deal-by-deal waterfall distribution scheme.

In deal-by-deal waterfalls, investors often request that a partial or complete writedown of a portfolio investment constitute a disposition event. The investment team may argue that writing down too frequently, without the ability to write up portfolio investments, can be an administrative burden. On the other hand, investors may want to ensure that valuations of portfolio investments are as accurate as possible for purposes of their reporting but also for determining when they should be eligible to receive a return of their capital contributions with respect to such investments.

In aggregate waterfalls, distributions of carried interest to the investment team are delayed until either all the portfolio investments have been disposed of or the investors have received back all their capital contributions (including capital contributions for any organizational expenses, fund expenses and management fees); distributions are then made to the investment team at the carried interest rate and the remainder to the investors. A variation on aggregate waterfalls is used in many venture capital and real estate funds, whereby investors and the investment team receive their capital contributions back with respect to the investment being disposed of and then remaining proceeds are distributed to the investment team at the carried interest rate and the remainder to the investors, so long as the capital accounts reflect a net asset value of at least 120% of unreturned capital contributions.

The fund agreement may have different rules regarding the disposition of bridge investments and temporary investments (e.g., the disposition proceeds may be distributed outside the waterfall provisions). Although there is often a higher risk associated with bridge investments, investors may choose to forgo their preferred return on these investments to prevent the investment team from receiving a carried interest on them, thereby reducing the investment team's incentive to make such investments. Proceeds from bridge investments may instead be distributed to investors and the investment team on the pro rata basis of their capital contributions, as is generally done with respect to temporary investments.

Q 13. (a) **Are the members of the investment teams subject to any legal duties?**

A Investors generally negotiate with the investment team to ensure that the fund agreements do not reduce the legal duties of the investment team to both the fund and the investors. Under Delaware law, any implied duties that members of the investment team may owe (e.g., duty of loyalty) may be modified by agreement except with respect to the duties of good faith and fair dealing. An aggressive investor may negotiate for the explicit inclusion of increased standard of care, whereas an aggressive fund may attempt to limit such standard of care by expressly stating that the investment team may act in its own interests in the management of the fund without considering the best interests of the fund or its investors.

Q (b) **What are common ways to align the interests of the investment team with the investors?**

A Investors argue that the more money that is contributed by the investment team, the more "skin" the investment team has in the game and therefore the increased likelihood that the investment team will act in the fund's best interests. In addition, the interests of the investment team and the investors are aligned with the (i) reduction of the management fee either at the end of the investment period or upon the raising of a successor fund (since the investment team's attention will not be as focused on the fund), and (ii) the offsetting of ancillary fees against the management fee (since these fees are earned as a result of the investors' investment in the fund and therefore the benefit, or a portion of the benefits, of such fees should arguably flow back to the investors).

Q (c) **What is the most common way to motivate the performance of the investment team?**

A The investment team is primarily motivated by its desire to return sufficient profits to the investors to ensure that it receives a portion of the profit under the applicable waterfall scheme (e.g., the investment team's "carried interest"). In addition, if the investment team is successful in returning profits to both the investors and to itself, there is an increased likelihood of successful fundraising to establish a successor fund once the current fund has been fully or substantially invested. We note that although the management fee was historically designed to cover the investment team's overhead expenses, given the recent substantial growth in the size of many funds, it is arguable whether the management fee in some funds is an additional way to put money into the hands of the investment team in excess of these expenses.

Q 14. What restrictions are likely to apply to the amount and period of investment, and to transferability of interests in private equity funds?

A The investment restrictions that may be included in fund agreements will vary dramatically according to the fund's strategies. Generally, there is a restriction on the amount that can be invested in one entity (e.g., 15%–20% of capital commitments), but this amount may be increased if bridge investments (which are also generally capped) are made or the Advisory Committee's approval is given; there may also be a maximum amount that may be invested outside the main strategy of the fund (e.g., if the fund's strategy is to invest in companies in the communications industry, the amount that may be invested outside that industry is capped). In addition, there may also be restrictions on the geographic areas where a fund may invest (e.g., only 15%–20% of capital commitments can be invested outside a specified region) and on the types of investments that a fund can make (e.g., investments in public securities, investments in "hostile" transactions or investments in other funds).

Moreover, a fund may be limited with respect to the amount of indebtedness that it can incur and its ability to invest in puts, calls, straddles or other derivative instruments. Depending upon the investors and other investment restrictions, the fund may also agree to restrictions on investing directly in oil or gas reserves, real estate or companies engaged primarily in the business of manufacturing or selling alcohol, tobacco or firearms.

The period in which the fund can make capital calls for investments is generally limited to the first four to six years of the fund. After this period, the fund can require investors to make capital contributions only for fees and expenses, with respect to investments in progress prior to the end of the investment period, investments subject to a written commitment or with respect to follow-on investments (e.g., subsequent investments made in existing portfolio companies or investments that are or will be under common control with existing portfolio companies).

As a general rule, investors' interests in the fund are not transferable without the consent of the investment team. An investor may be able to negotiate a transfer right regarding a desired transfer to its affiliate (e.g., an entity that is controlled by the investor, an entity that controls the investor or an entity that is under common control with the investor) whereby either the consent of the investment team is not required or such consent will not be unreasonably withheld. Generally, the investment team does not pre-approve any other transfers (including those to be made on the secondary market).

Exit

Q 15. What are common strategies to exit an investment in a private equity fund? What considerations need to be taken into account?

A There are three basic ways in which an investor can exit its investment in a fund: (i) through the secondary market; (ii) through the normal course exit at the end of the life of the fund; and (iii) through early termination of the fund, including by a vote of the investors to remove the investment team without replacing it.

During the life of the fund, an investor that wishes to liquidate its investment in the fund can attempt to find a buyer for its fund interest. If the fund is unsuccessful, the investor may be unable to find a buyer and/or may be required to accept a substantially discounted purchase price for its investment. As discussed in greater detail in Q&A 14, a sale on the secondary market will generally require the consent of the investment team. With such consent, the transferee would typically assume any obligations to make remaining unfunded capital commitments.

Each fund agreement provides for the disposition of investments at the end of the life of the fund (e.g., 10 years from the date of formation, which can be extended by the GP or with the consent of the Advisory Committee or the investors) and its subsequent liquidation. The fund may have the authority to distribute non-marketable securities to investors.

Finally, as discussed in greater detail in Q&A 11(c), investors often negotiate for the ability to exit the fund and/or cease making otherwise required capital contributions, including when (i) continued investment would violate applicable law; (ii) a certain proportion of the investors decide to remove the investment team and do not subsequently appoint a replacement investment team; or (iii) a certain proportion of the investors decide to dissolve the fund. In the cases of (ii) and (iii), the fund's assets would be liquidated and/or distributed in kind, thereby providing an exit for all the investors.

Thank you to Peter Keenan, Darren Baccus, Andrew Beck and Mark Tice for their contribution in answering these frequently asked questions. We also acknowledge Mondaq's contribution in providing the questions.