

Chapter 1

Introduction to Private Equity Funds

- § 1:1 A Brief History of Private Equity
 - § 1:1.1 Post World War II: American Research and Development
 - § 1:1.2 Small Business Administration
 - § 1:1.3 The Seventies: Favorable Legislation
 - § 1:1.4 The Eighties: Leveraged Buyouts
 - § 1:1.5 The Nineties: Technology Industry
 - § 1:1.6 The New Millennium: Securitization Market
 - § 1:1.7 The Subprime Mortgage Crisis
 - § 1:1.8 The European Sovereign Debt Crisis
 - § 1:1.9 The Investment Climate
- § 1:2 What Is a Private Equity Fund?
 - § 1:2.1 Overview
 - § 1:2.2 Typical Investments
 - [A] Diversified Portfolio
 - [B] Deal Structures
 - [C] Types of Investments
 - § 1:2.3 Organizational Structure
 - § 1:2.4 Private Placements
 - § 1:2.5 Key Players
 - [A] Fund Sponsors
 - [B] Investors
 - [C] Professional Advisors
 - [D] Placement Agents
- § 1:3 Types of Funds
 - § 1:3.1 Buyout Funds
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features
 - [C] Activist Funds
 - § 1:3.2 Venture Capital Funds
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features

PRIVATE EQUITY FUNDS

- § 1:3.3 **Mezzanine and Credit Opportunity Funds**
 - [A] Typical Investments
 - [A][1] Mezzanine Funds
 - [A][2] Credit Opportunity Funds
 - [B] Distinguishing Organizational Features
- § 1:3.4 **Distressed Debt Funds**
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features
- § 1:3.5 **Real Estate Funds**
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features
- § 1:3.6 **Funds of Funds**
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features
- § 1:3.7 **Structured Product Funds**
 - [A] Typical Investments
 - [B] Distinguishing Organizational Features
- § 1:3.8 **“Club” or “Pledge” Funds**
 - [A] Typical Investments
- § 1:4 **Other Investment Strategies in Private Equity**
 - § 1:4.1 **Private Investments in Public Equity (PIPEs)**
 - § 1:4.2 **Special Purpose Acquisition Companies (SPACs)**
 - [A] Investment Advantages
 - [B] Structural Considerations
 - [C] Investment Risks
 - § 1:4.3 **Mezzanine and Credit Opportunity Funds**
 - § 1:4.4 **Sovereign Wealth Funds (SWFs)**
 - [A] Foreign Policy Concerns with SWFs
 - § 1:4.5 **Secondaries**
 - § 1:4.6 **Distressed Funds**
 - § 1:4.7 **Seed Capital Funds**
 - § 1:4.8 **Permanent Capital**
 - § 1:4.9 **Status of Existing and New Deals Post Financial Crisis**
 - [A] Existing Deals
 - [B] New Deals
- § 1:5 **Current Trends in Fundraising**
 - § 1:5.1 **Overview**
 - § 1:5.2 **Other Sources of Capital; Co-Investors**
 - § 1:5.3 **Fund Terms—Bargaining Power of Limited Partners**
 - § 1:5.4 **Fundraising Periods**
- § 1:6 **Industry Convergence**
 - § 1:6.1 **Blurring the Line Between Private Equity and Hedge Funds**
 - [A] Strategic Differences
 - [B] Erosion of Differences Between Private Equity and Hedge Funds
 - [C] Advantages of Convergence
 - [D] Convergence Concerns

	[D][1]	Valuation of Fund Assets and Computation of Compensation
	[D][2]	Cultural Clash
	[D][3]	Marketing Issues
	[D][4]	Investor Expectations
§ 1:6.2		Hybrid Funds
§ 1:6.3		Private Equity Funds Versus Mutual Funds

§ 1:1 A Brief History of Private Equity

Some quip that the first private equity investment can be traced to Christopher Columbus, an undeterred young entrepreneur soliciting capital from the Spanish royalty with an overly ambitious business plan and a limited track record of success.¹ However, an analysis of the history of modern private equity—the industry of providing investment capital to a business in exchange for a share of the profits of the recipient entity—begins in New England in the years immediately following World War II.

§ 1:1.1 Post World War II: American Research and Development

For decades, wealthy individuals such as the Rockefellers and J.P. Morgan had been investing in private equity, but the tide was about to turn in the nature of the investments and the profile of the investor. The post-war years engendered a new type of private equity investor—a partnership built with investment capital from outside sources to be managed by individuals whose investment expertise (as well as capital) would substantially increase the growth of fledgling companies.

The transformation came as a result of a number of factors. In the early to mid twentieth century, industry in New England had slowed down considerably, particularly during the Great Depression. Many businessmen were rightly concerned that the economic revitalization that World War II had brought to the region would falter in the postwar years. Furthermore, due to wartime-related research and what was quickly becoming the frenetic race to be technologically superior to other nations, a number of exciting new technologies had been recently developed.² These technologies needed funds for development and marketing to the general public. A group of New England

-
1. Vishal Dixit, *Private Equity, Now in 3D*, STAN. BUS. REP. (June 4, 2007).
 2. Spencer E. Ante, *The Matchmaker of the Modern Economy*, HARV. BUS. SCH. WORKING KNOWLEDGE (Apr. 9, 2008), <http://hbswk.hbs.edu/item/5879.html>.

businessmen identified the promising nature of these technologies and discovered a major hurdle facing small development companies. In order to expand their business, they required either equity or long-term capital, but “the provision of such financing was outside the normal function of banks.”³ In order to capitalize on profits and growth, an entity that could provide this type of financing as well as management advice and experience to fledgling businesses would be invaluable.

Thus, American Research and Development (ARD), the first “modern” venture capital firm, was born. Started in 1946 by Georges Doriot, Ralph Flanders, Karl Compton and Merrill Griswold “as an organization with a novel mission,” ARD struggled to define itself and its purpose. Its innovative model was often misunderstood and risked comparisons with other more traditional investment companies. The difference, ARD argued, was not just the assumption of higher risk investments but the firm’s active participation in managing the investments that was critical to their philosophy and success.⁴ Doriot stressed the virtues of good management, “Always consider investing in a grade A man with a grade B idea. Never invest in a grade B man with a grade A idea.”⁵

§ 1:1.2 Small Business Administration

ARD changed the landscape of American business, moving away from large conglomerates toward fast-growing start-up companies. ARD was extremely profitable,⁶ and its success largely encouraged Congress to pass the Small Business Investment Act of 1958.⁷ Congress was interested in the ARD model for engendering growth and believed that a government partnership with venture capital

3. David H. Hsu & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946–1973*, 14 *INDUS. & CORP. CHANGE* 579 (2005).

4. See Elizabeth Cosenza, *Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights of First Refusal in the Venture Capital Context*, 55 *AM. U. L. REV.* 87, 144 (2006).

5. William D. Bygrave, *The Entrepreneurial Process*, in *THE PORTABLE MBA IN ENTREPRENEURSHIP* 12 (William D. Bygrave & Andrew Zacharakis eds., 3d ed. 2004).

6. Martin Kenney, *Note on “Venture Capital”* (The Berkeley Roundtable on the Int’l Economy, Working Paper No. 142, 2000) [hereinafter Kenney]. ARD’s investment of \$70,000 in Digital Equipment Corporation in 1958 grew to \$350 million in 1971. *Id.*

7. Small Business Investment Act of 1958, Pub. L. No. 85-699, 72 Stat. 689 (Aug. 21, 1958).

firms would flourish. Realizing that money for venture or risk investments is difficult for small firms to obtain, the Small Business Administration (SBA) enacted a program to provide financial assistance to Small Business Investment Companies (SBICs) to supplement the influx of private equity and long-term loan funds to new companies. In return, investment firms that participated in the SBIC program were able to borrow funds at favorable rates through the SBA's guarantee of SBIC debentures, which were ultimately sold to private investors.⁸

Prior SBA legislation allowed venture capital firms to obtain four dollars of government debt for each dollar of privately invested capital in the fund (now two-for-one). This cheap government money spurred a great deal of investment and caused people to leave the banking industry in droves for private equity jobs (a trend that would reoccur with the LBO frenzy of the 1980s, the Internet bubble in the 1990s and the housing/structured products boom of the 2000s).

By 1962, there were almost 600 SBICs, with many facing serious financial difficulties. By “democratizing finance,”⁹ ARD made the viability of making significant profits from venture capitalism seem possible for anyone. The problems were twofold: first, that the disciples of the ARD model failed to underscore the “management expertise” aspect of their equation (an ironic omission in that its founders distinguished themselves on that very nuance); and second, that the government did not understand the economies of scale associated with venture capital investments.¹⁰

Furthermore, the debt service requirements to maintain government debt were better suited for more mature companies and, as a result, investments in early-stage companies made with loans from the SBA faltered. Although government financing was cheap and easy to obtain, the SBA retained a great deal of oversight and required the companies so financed to reach certain government-created benchmarks in a specified amount of time.

By 1965, over 230 of the SBICs defaulted on their loan obligations, which resulted in the vast overshadowing of the SBIC program by the private venture capital industry. Government financing, which

8. Small Business Investment Company (SBIC) Program (Minority Bus. Dev. Agency Dec. 29, 2003).

9. Scott Kirsner, *Venture Capital's Grandfather*, BOS. GLOBE (Apr. 6, 2008), http://www.boston.com/business/articles/2008/04/06/venture_capitals_grandfather.

10. JONATHAN J. BEAN, *BIG GOVERNMENT AND AFFIRMATIVE ACTION: THE SCANDALOUS HISTORY OF THE SMALL BUSINESS ADMINISTRATION* 57–59 (2001).

offered only debt at favorable rates, was unable to compete with venture capital firms who offered equity to new companies.¹¹ Eventually, the federal government conceded that it was ill-equipped to finance this type of industry, ceased to provide financing,¹² and substantially revamped the SBIC program.

§ 1:1.3 *The Seventies: Favorable Legislation*

Following a number of years of minimal private equity-based financing, several pieces of legislation in the 1970s were enacted that encouraged the private equity industry and fostered its growth. Restrictions on institutional investing were relaxed. The 1978 Revenue Act¹³ reduced the long-term capital gains tax rate from 49.5% to 28%, creating incentives for both investors and entrepreneurs.

In 1979, capital commitments to private equity funds skyrocketed, representing a 1,000% increase over the previous year.¹⁴ Congress also rejected the limitations that the Investment Company Act of 1940, as amended (the "Investment Company Act"),¹⁵ placed on the regulation of a public vehicle in private equity. The restrictions prevented open-end investment companies from investing in young companies due to their inherent need for liquidity. Furthermore, the Investment Company Act's draconian limitations on compensation and effective borrowing precluded investment companies from providing financing to these new businesses.

Congress enacted the Small Business Investment Incentive Act of 1980¹⁶ to promote public investment in private companies and to remove the obstacles in obtaining capital sources through the use of an entity called the business development company (BDC), a closed-end investment company subject to the Investment Company Act. This type of investment vehicle had relaxed borrowing requirements and permitted a compensation structure that was in accordance with the current standard in the venture capital industry.

11. *Id.*

12. Kenney, *supra* note 6.

13. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (Nov. 6, 1978).

14. Andrew Carragher & Darren Kelly, *An Evaluative Comparison of the Canadian and American Private Equity Markets*, J. PRIV. EQUITY (Spring 1998).

15. Investment Company Act of 1940, Pub. L. No. 768, 54 Stat. 800 (Aug. 22, 1940).

16. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (Oct. 21, 1980).

Another investor incentive was the Economic Recovery Tax Act of 1981 (ERTA),¹⁷ which reduced the long-term capital gains tax rate from 28% to 20%, significantly benefiting large firms making considerable capital investments.¹⁸ This legislation encouraged private equity investments¹⁹ and set the stage for the explosive growth of the venture capital and leveraged buyout industry in the 1980s.

§ 1:1.4 The Eighties: Leveraged Buyouts

Between the years 1970 to 1987, investments in venture capital increased from \$427 million to \$4.4 billion.²⁰ However, the growth generated by leveraged buyouts (LBOs) during this period overshadowed early-stage investing. The twenty largest leveraged buyouts between the years 1983 and 1989 had a total purchase price of \$76.5 billion.²¹ Leveraged buyouts were profitable in the 1980s because of the high amount of both debt and equity incurred in a buyout, which provided a “carrot and stick mechanism.”²² The carrot aspect was that, after the transaction, managers generally received an increase in ownership, motivating the managers to pay off the debt and increase shareholder value. Prior to the transaction, management rarely owned stock or were given stock-related compensation. The ownership increase was an incentive for management to increase the value of the company. The “stick” was the debt incurred in an LBO; the buyout company management was under pressure to produce a sufficient, if not high, return on capital or face default on the loan.²³

The influx of institutional investors into the stock market increased both competition and prices. Firms were further encouraged by tax incentives that allowed them to deduct interest expenses from debt during a buyout.²⁴

-
17. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (Aug. 13, 1981).
 18. JOINT ECONOMIC COMMITTEE, 104TH CONG., REP. ON THE REAGAN TAX CUTS: LESSONS FOR TAX REFORM (1996).
 19. *Id.*
 20. Paul A. Gompers & Josh Lerner, *What Drives Venture Capital Fund-raising?* (Nat'l Bureau of Econ. Research, Working Paper No. 6906, 1999), <http://ssrn.com/abstract=57935>.
 21. Li Jin & Fiona Wand, *Leveraged Buyouts: Inception, Evolution, and Future Trends*, 3 PERSPECTIVES 6 (Sept. 30, 2002) [hereinafter Jin & Wand].
 22. *Id.*
 23. *Id.*
 24. MARK CARLSON, BD. OF GOVERNORS OF THE FED. RESERVE, A BRIEF HISTORY OF THE 1987 STOCK MARKET CRASH WITH A DISCUSSION OF THE FEDERAL RESERVE RESPONSE (2006) [hereinafter CARLSON], <http://www.federalreserve.gov/Pubs/feds/2007/200713/200713pap.pdf>.

Another factor in the popularity of LBOs was the increased attention to managerial improvements. Under a philosophy that echoed the ARD model of the 1950s, LBO sponsors actively monitored the companies they leveraged, as opposed to the level of monitoring provided by public company boards that generally consisted of a variety of outside investors with slight ownership interests. A post-LBO company board was small and consisted of sponsors who held significant equity in the company. This profitable and seemingly effective model caused some scholars to declare the “eclipse of the public corporation” by the more efficient LBO association.²⁵

But reports of the death of the public corporation had been greatly exaggerated. With concerns about inflation and the interest rate situation, the fervor surrounding LBOs began to subside. At this point, financing had become so excessively risky that there were no new creditors willing to accept the additional risk. Banks became subject to increased regulation and pressured to reduce their highly leveraged transaction exposures.²⁶ Banks were subsequently less likely to work with post-buyout firms that could not meet their debt service requirements.²⁷

With the situation tenuous at best, news that the House Ways and Means Committee filed legislation²⁸ to eliminate the tax benefits of financing mergers precipitated a turn of events that would call into serious question the seemingly omnipotent private equity industry. Interest rates shot up globally, while the U.S. dollar fell to dangerous lows.²⁹ As investors began unloading stock, the Dow Jones dropped 508 points (or 22.6%) on October 19, 1987, and panic ran rampant throughout the market.³⁰ From 1989 to 1990, there were \$4 billion worth of junk bond defaults and debt moratoriums, loans were failing to be syndicated, and corporate bankruptcies amounted to an aggregated \$27 billion in liabilities. By the end of 1991, at least twenty-six of eighty-three deals completed in the second half of the 1980s had defaulted. This, combined with a barrage of insider trading scandals, resulted in many investors struggling to find a way out of their

25. Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 235 (2008).

26. Sangkyun Park, *Explanations for the Increased Riskiness of Banks in the 1980s*, 76 FED. RES. BANK ST. LOUIS REV. 3 (July/Aug.1994), http://research.stlouisfed.org/publications/review/94/07/Explanations_Jul_Aug1994.pdf.

27. Jin & Wand, *supra* note 21.

28. See 26 U.S.C. § 469. Passive activity losses and credits limited.

29. CARLSON, *supra* note 24, at 6–7.

30. *Id.*

previously extolled high-risk ventures. The LBO market had declined so severely that many felt it would never rebound.³¹

§ 1:1.5 The Nineties: Technology Industry

In the early 1990s, the market began to settle as the capricious investors that had characterized the previous decade faded away. As the stock market increased in value, so, correspondingly, did purchase prices. Debt was increasingly more difficult to obtain. With the LBO market still on the wane, venture capitalism was enjoying a resurgence in interest as a direct result of revolutionary new technology companies and the individuals who were developing the technology. As the market for new investments heated up, investors feverishly competed to invest in these early-stage companies.³²

In 1996, technology companies received 60% of all venture capital investments.³³ Investors infused capital into the technology industry, providing financing to anyone, it seemed, with an idea and a URL address.³⁴ In what became a hallmark of the industry, the fervor of competing for new investments overshadowed adequate valuation and profit models.³⁵ In the early 1980s and 1990s, it took approximately three to five months to close an investment; by 1999, the average investment took only six weeks.³⁶ The Internet was a non-traditional industry to invest in and by valuing companies with traditional mechanisms, investors' expectations of profitability and returns were frequently unfulfilled.

The myth behind the true value of many of the Internet startups was further exemplified by the occasional use of stock options as the exclusive compensation for dot-com executives. Granting options was a favored tool for new growth technology companies who were able to attract and satisfy their employees without deflecting capital

-
31. *The Global Economic Impact of Private Equity* (World Econ. Forum, The Globalization of Alternative Investments Working Papers Vol. 1, 2008), http://www3.weforum.org/docs/WEF_IV_PrivateEquity_Report_2008.pdf.
 32. Laura M. Holson & Saul Hansell, *The Maniac Markets; The Making of a Market Bubble*, N.Y. TIMES (Apr. 23, 2000).
 33. Nicole R. Onorato, U.S. Small Business Administration Office of Advocacy, Trends in Venture Capital Funding in the 1990s (Aug. 1997), http://norcalsbdc.org/sites/default/files/trends_vc.pdf.
 34. Amy Cortese, *New Economy; Many Start-Ups Have Survived But Will Need Infusions of Venture Capital*, N.Y. TIMES (Mar. 25, 2002).
 35. Gary Rivlin, *Venture Capital Rediscovered the Consumer Internet*, N.Y. TIMES (June 10, 2005). "[A] Web site that drew millions of visitors had a hard time turning those visitors into profits." *Id.*
 36. David Kirsch & Brent Goldfarb, *Was There a Dot Com Bubble? Distinguishing Between Technological and Market Phenomena* (Univ. of Md. 2004) [hereinafter Kirsch & Goldfarb].

from the company.³⁷ As a result, the dot-com industry, like the LBO boards of the 1980s, had management with interests closely aligned to the investors. Now, management, more than ever, was concerned with profitability and growth. The majority of managers had created the technology from which their company profited. Due to the compensation packages referenced above, managers were both earnestly and fiscally invested in their company. Exemplifying the mystifying valuation techniques used during the late 1990s, some executives in technology companies were earning similar salaries to those in traditional sectors, with hundreds of millions more in sales.³⁸

When the bubble burst and dot-com companies lost value at a remarkable pace,³⁹ many blamed the venture capitalists for overvaluing businesses. Others blamed venture capital firms for being stretched across so many companies such that their “hands-on guidance” and management expertise could not be effectively utilized.⁴⁰

Also, the adoption in 1996 of section 3(c)(7) of the Investment Company Act⁴¹ enabled investment funds to increase their number of investors from 100 to a theoretically infinite level (with some obstacles at 500),⁴² provided that the investors targeted were sufficiently wealthy. As a result, investment banks and placement agents earned a more extensive role in the placement and development of funds, and an active fund of funds industry was spawned. In addition, the size of the typical private equity funds materially increased.

37. Reed Abelson, *Silicon Valley Aftershocks*, N.Y. TIMES (Apr. 4, 1999).

38. *Id.*

39. Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Market: Recent Trends and Developments*, J. PRIV. EQUITY (2003). At the close of the first quarter of 2001, forty-nine out of the “Fastest 50,” which are the fastest growing tech companies in the industry, had experienced significant losses in value. The majority had market cap declines of 80%. *Id.*

40. Kirsch & Goldfarb, *supra* note 36.

41. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (Aug. 22, 1940).

42. Although section 3(c)(7) of the Investment Company Act does not limit the number of investors in a fund, section 12(g) of the Exchange Act effectively limits the number of investors of a particular class to 1,999, by providing that every issuer engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, having more than \$10 million in total assets on the last day of its fiscal year, must register with the SEC any “class” of its equity securities “held of record” by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors. *See* 15 U.S.C. § 78l. Note that the \$10 million, 2,000-person and 500-person thresholds described above became effective on April 5, 2012, when President Obama signed into law the Jumpstart Our Business Startups Act (the “JOBS Act”).

§ 1:1.6 The New Millennium: Securitization Market

Investments in private equity heated up again in the early years of the new millennium, when the market for securitizations rapidly expanded.⁴³ In the first quarter of 2007, \$183 billion in leveraged loans were issued, marking a 20% increase from the previous quarter and a 366% increase in the amount issued in the first quarter of 2004.⁴⁴ The European leveraged loan market skyrocketed with a total volume of deals increasing from \$80 billion to \$200 billion in the years 2002–2006.⁴⁵ However, almost half of the debt issued in the first half of 2007 was rated below investment grade, which represented a 150% increase in these types of loans from 2004.⁴⁶

One of the major departures from past investing was the type of debt provider. Historically, debt had been issued mainly by banks. In 1995, banks represented over 70% of investors in loans, while in 2007 their share was only 13% of the market. In 2007, there were over 250 institutional investors, almost eight times the thirty-two that existed in 1995. Now, alternative investment vehicles are providing debt for buyouts.⁴⁷ This concept has grown very attractive to private equity firms because they are able to borrow more money at significantly more flexible and appealing terms.⁴⁸

By 2007, deals were larger and riskier than ever seen in the past. Investors found that with the influx of debt now available to them by non-traditional lenders, they were able to forge ahead with higher ambitions. In 2006, \$701.5 billion of LBOs had been announced—a number that many thought would only be exceeded in 2007. Buyouts in the range above \$500 million accounted for 91% of total deal value in 2007. However, although \$494 billion had been raised in 2007, \$398 billion of that had been raised in the first two fiscal quarters.

43. BRAD HAMNER, GE CAPITAL MARKETS, UPDATE ON THE LEVERAGED LOAN MARKET (May 2008).

44. Harvey R. Miller, *Commentary: Chapter 11 in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 378 (2007) [hereinafter Miller].

45. *Id.*

46. *Id.*

47. See ADAM GERŠL, ECON. RESEARCH AND FIN. STABILITY DEP'T, CZECH NAT'L BANK, PRIVATE EQUITY FROM THE PERSPECTIVE OF THE CENTRAL BANK: INSTITUTIONAL INVESTMENT INTO PRIVATE EQUITY (2007), http://www.docstoc.com/docs/25730373/01_CNB_Adam_Gersl.

48. Michael Flaherty, *LBO Industry Sees Profits in Debt It Created*, REUTERS (Aug. 15, 2007), <http://www.reuters.com/article/mergersNews/idUSN1526582820070815>.

§ 1:1.7 The Subprime Mortgage Crisis

In the summer of 2007, the private equity industry braced itself for the fallout from the collapse of the subprime mortgage industry. After several years of highly favorable lending, the credit markets began to tighten in mid 2007. Few in the private equity and hedge fund industry were surprised, as there was a prevailing opinion that lending terms had become unrealistic and unworkable.⁴⁹

Private equity investors were particularly susceptible to the credit crunch because many were heavily invested in (or reliant on leverage providers and counterparties who were themselves invested in) collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs).

In the early 2000s, new methods of packaging structured credit products distributed risk more evenly, enabling lenders to offer favorable borrowing terms.⁵⁰ In these types of transactions, the issuer (a financial intermediary, generally a bank) repackages debt securities or loans, which are then sold to investors (such as private equity funds) with various levels of claims on the collateral. The loans are mainly extended to highly leveraged companies and are therefore, low investment rated grade. The managers would then divide the loans into smaller pieces and sell them to other investors throughout the world, thereby reducing their exposure to the risk. This type of security proved to be extremely popular with long-term investors, whose purchase of CDOs and CLOs trickled down the market and provided the liquidity for extending the subprime loans to prospective home buyers.⁵¹

Simultaneously, home prices were rising and interest rates were dropping, making home ownership more attainable for many Americans.⁵² CDOs and CLOs were in such high demand by private equity and hedge funds that lenders could scarcely offer enough mortgages to people to keep up with the demand. However, some of these mortgages required little, if any, financial disclosure of the borrower's income.⁵³ As a result, home loans were extended to people with impaired credit histories or those who simply could not afford the

49. Mark O'Hare, *May You Live in Interesting Times*, in 2008 PREQIN GLOBAL PRIV. EQUITY REV. 6 (2008).

50. Miller, *supra* note 44.

51. Saskia Scholtes & Gillian Tett, *Does It All Add Up?*, FIN. TIMES (June 28, 2007) [hereinafter Scholtes & Tett], <http://www.ft.com/cms/s/0/d5f91f6e-2513-11dc-bf47-000b5df10621.html>.

52. See Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK OF ST. LOUIS REV. 31 (Jan./Feb. 2006), <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf>.

53. Scholtes & Tett, *supra* note 51.

home they were living in. Increasingly, these home owners began to default on their loans. By March 2007, one in five subprime home loans was either past due or in foreclosure.⁵⁴ As the major players in buying and selling CDOs and CLOs, private equity funds were particularly sensitive to the change in this market.

The subprime crisis drew particular attention to the hedge fund and private equity arena because of their investments in mortgage-backed securities. Unlike in earlier crises, such as the stock market crash of 1987 or the bursting of the dot-com bubble, many Americans, including those who had not been invested or even interested in private equity, were detrimentally affected. And the damage was not limited to those who were approved for subprime loans; even for well-qualified borrowers, jumbo loans were increasingly difficult to obtain and interest rates rose dramatically.⁵⁵ As the summer progressed, rampant uncertainty about the extent of the subprime problem spread through the financial industry and into other aspects of the credit market.⁵⁶ Depleted resources and decreased liquidity led a number of central banks to infuse capital into the market.⁵⁷

The tightening of credit presented a significant problem for many private equity firms, which sought to offer attractive returns despite reduced or, in some cases, no access to leverage. The massive buyouts that defined the industry during the boom years preceding the crisis gave way to more diverse strategies aimed at coping with lack of available credit. Unsurprisingly, as the global economy suffered, so too did the private equity industry, with decreased activity and returns through 2009. Nevertheless, since its slowing in 2009, the private equity world has seen improved growth and returns, with some markers indicating that the industry is seeing levels of investment and activity that have not been seen since 2007.

As a result of the crisis, the private equity industry faced increased political scrutiny as to such issues as government oversight, investor suitability, and the favored tax treatment afforded to performance-based allocations and sales proceeds achieved by fund sponsors. Subsequent legislation, including the Dodd-Frank Wall Street Reform and Consumer Protection Act and the rules adopted pursuant thereto, have significantly altered (and are expected to continue to alter) the regulatory landscape in which private equity firms operate.

54. Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall Street*, N.Y. TIMES (Aug. 10, 2007) [hereinafter Bajaj & Landler].

55. Nelson D. Schwartz, *One World, Taking Risks Together*, N.Y. TIMES (Oct. 21, 2007).

56. *Id.*

57. Bajaj & Landler, *supra* note 54.

§ 1:1.8 *The European Sovereign Debt Crisis*

In the fall of 2009, serious concerns began to spread regarding the rapidly ballooning debt of several European countries. Exacerbated by the global financial crisis, but rooted in easy access to credit in the years leading up to the crisis, trade imbalances, budget deficits, and a number of other complex factors, certain European Union member nations, most notably Greece, Portugal, Ireland and Spain, carried debts that far outweighed their capacities to repay. With such high ratios of debt to GDP, the countries risked defaulting on their debts, and accordingly had the ratings of their debts downgraded by credit rating agencies. Through austerity measures, bailouts, bond issuances, intense negotiations among European Union member nations and a substantial injection of funds into national banks by the European Central Bank, Eurozone officials were able to stave off default.⁵⁸ Nevertheless, the impact of the European debt crisis was felt throughout the global financial sector. European financial institutions drastically tightened credit, and funding avenues that had become increasingly reliable in Europe as the global financial crisis ebbed have only recently shown signs of opening up. European private equity firms eventually recovered, as the public markets and the availability of credit rebounded.⁵⁹ However, the vote in Great Britain in June 2016 to leave the European Union has introduced a new source of uncertainty in the European market.

§ 1:1.9 *The Investment Climate*

Private equity investing is attractive in part because it can offer returns that are not purely correlated to the public markets.⁶⁰ In pursuit of these returns, an expanding base of institutional and high-net-worth investors have allocated resources to the sector.⁶¹

58. Ralph Atkins, *Eurozone Will Survive Debt Crisis Intact*, FIN. TIMES (Dec. 11, 2012), <http://www.ft.com/intl/cms/s/0/93d6306e-4384-11e2-a48c-00144feabdc0.html>.

59. Dan Dunkley, *Private Equity's European Report Card*, WALL ST. J. (Dec. 31, 2013), <http://blogs.wsj.com/moneybeat/2013/12/31/private-equitys-european-report-card/>; PRICEWATERHOUSECOOPERS, PRIVATE EQUITY TREND REPORT 2017, RISING ABOVE UNCERTAINTY (Feb. 2017), https://www.pwc.de/de/finanzdienstleistungen/assets/41733_Studie_PETR_2017_170224_SCREEN.pdf.

60. Jerry Feigen, *Potential Exiting Through ADRs (and/or GDRs?) for International Private Equity Investors*, 13 AM. U. INT'L L. REV. 109, 112 (1997).

61. ULRICH GRABENWARTER & TOM WEIDIG, EXPOSED TO THE J-CURVE, UNDERSTANDING AND MANAGING PRIVATE EQUITY FUND INVESTMENTS 33-35 (2005).

However, the market volatility that has persisted since the global financial crisis has significantly impacted the industry. Recent estimates set the private equity industry's assets under management at approximately \$2.8 trillion.⁶² Because private equity funds have been slow to unload these investments, they have also been slow to return capital to investors, who then encounter their own liquidity issues, including the inability (or unwillingness) to invest further in private equity funds. Private equity funds are under pressure to invest their committed capital (also known as "dry powder").⁶³ As a result of the conditions described above, there are concerns that competition in the industry will intensify, which could apply upward pressure on deal prices and negatively impact fund returns.⁶⁴ Nevertheless, returns have been strong and the industry is on an upward trend with respect to capital raised, causing some commentators to declare this the "golden age of private equity investment."⁶⁵

§ 1:2 What Is a Private Equity Fund?

§ 1:2.1 Overview

There is no single method of defining what constitutes a private equity fund, and in fact, as described in more detail throughout this chapter, the term has evolved over time. In general, however, private equity funds are entities formed for the purpose of making investments in securities or other assets, typically equity and equity-related investments, that are not readily tradable or that are otherwise known as "illiquid" assets. The securities of these funds are typically offered to sophisticated investors through private placement offering exemptions available under the Securities Act of 1933, as amended (the "Securities Act").⁶⁶ The structure and terms of the funds themselves are dictated, in part, usually by the desire to avoid registration as a "registered investment company" in the United States and, in part, by tax considerations applicable to different types of investors. Terms are also dictated, in part, by the constraints of managing assets that are, pending disposition, difficult to value, and are time-consuming to liquidate. Additionally, fund terms are dictated

62. 2018 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT (Preqin Ltd. 2018).

63. As of early 2018, the value of dry powder was estimated to be in excess of \$1 trillion. *Id.*

64. *Id.*

65. Antoine Drean, *10 Predictions for Private Equity in 2018*, FORBES (Jan. 24, 2018).

66. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (May 27, 1933).

by market conventions that have developed in the space, as varied by negotiations between the parties. These forces do not produce a uniformity of terms, but do narrow the possibilities.

§ 1:2.2 Typical Investments

[A] Diversified Portfolio

A fund (private equity or not) is referred to as a “pooled investment vehicle” because it generally acquires a diversified group of investments. The managers of a fund receive a disproportionately greater share of profits of a fund for identifying, completing, and disposing of investments. The profits and losses of a fund’s numerous investments are netted against one another to generate an overall return that is shared among the fund’s investors and manager.

Pooled investment vehicles offer investors a diversity of investments and generally permit investors to make a greater number of smaller investments, thereby reducing their risk exposure with respect to a single investment. Pooled investment vehicles also provide investors with access to larger transactions in which they could not have participated individually as investors.

The nature of a private equity fund’s diversified portfolio is dictated by its partnership agreement or other governing documents. A fund’s governing documents typically contain investment restrictions that limit the amount that the fund can invest in a single company, in geographic areas, in industry sectors, and in types of transactions. A hostile tender offer is one such type of transaction often prohibited by a fund’s governing documents. Other investment restrictions are included to address tax characteristics of investors, such as a prohibition or limitations on the investment in U.S. real estate by funds whose non-U.S. investors want to eliminate or reduce U.S. net income tax. The riskier the investment strategy of a private equity fund, the more likely that such fund will be required to follow greater diversity guidelines. As a result, venture capital funds typically do not invest more than 10% of their investors’ capital in a single company, while buyout funds may be permitted to invest as much as 30% of their investors’ capital in a single company.

[B] Deal Structures

The private equity fund may be comprised of multiple “parallel investment vehicles” that are structured to efficiently manage tax, regulatory, legal, and similar concerns for different types of investors.

Alternative investment vehicles may be created to address tax and regulatory structuring issues for particular fund investments. When an alternative investment vehicle holds an investment outside a private equity fund, its investment is generally treated as if having been

made by the fund for purposes of calculating the returns that are shared among the fund's investors and manager.

Co-investment vehicles also may be formed (on a one-off or blind-pool basis) in conjunction with private equity funds. Co-investment vehicles allow investors (including existing investors in a private equity fund) to participate in an investment only to the extent that a fund does not elect to pursue an entire transaction.

Parallel investment vehicles participate on a pro rata basis (in accordance with capital of the parallel and main funds) in all investments made by the main fund. Certain co-investment vehicles participate in more than one transaction made by a single fund, and are referred to as "overline funds." Overline funds are given the first opportunity to make co-investments with a fund before the manager can offer other parties the right to co-invest with the fund. The economic terms of parallel funds are generally the same as those of the main fund; however, the economic terms of co-investment vehicles vary greatly and do not necessarily follow the economic terms of the main fund.

Feeder funds. Feeder funds are generally formed to become limited partners of a fund, and are formed to accommodate the needs of various types of investors. Some feeder funds are structured as corporations in order to efficiently structure investments for potential adverse tax, legal or regulatory attributes of particular investments for particular types of investors.

Special purpose vehicles (SPVs). SPVs are used to allow numerous investors to acquire a single investment. While investors have exposure to a single investment through an SPV, they receive the potential benefit of participating in a larger transaction.

[C] Types of Investments

The term "private equity fund" encompasses a wide variety of vehicles that pursue different investment strategies. As discussed in more detail below, there are a few widely known categories of private equity funds—including venture capital funds, buyout funds, mezzanine funds, real estate funds, distressed funds and funds of funds.

Historically, private equity funds only invested in equity and equity-related securities of operating companies whose securities were not publicly traded. Today, investment vehicles may be referred to as "private equity funds" even if they invest in non-equity securities, and even if a portion of their target investments are publicly traded. It is no longer unusual for a private equity fund to acquire debt securities, real estate, derivatives, or contract claims.

The common denominator among investments made by private equity funds is the fact that these investments are substantially illiquid. The securities held by private equity funds typically do not have a defined market. As a result, their investors cannot voluntarily

withdraw from the fund (other than for very narrow reasons, such as a regulatory problem), and the general partner of the fund shares in distributions of proceeds only when the investors in such fund receive distributions. The general partner is expected to structure investments in a manner that allows the fund to obtain liquidity through negotiated sales of investments, public offerings of securities, or other restructurings of companies or assets.

§ 1:2.3 **Organizational Structure**

The appropriate organizational structure of a private equity fund is dictated by tax and regulatory considerations.⁶⁷ The most common structure is the limited partnership, although other types of vehicles, including limited liability companies, may be used.⁶⁸

§ 1:2.4 **Private Placements**

Private equity funds obtain capital from investors by selling unregistered securities in such funds (typically partnership interests) to qualified investors pursuant to private placement exemptions from the registration requirements of the Securities Act.⁶⁹ Private equity funds generally acquire securities as well in private placements, although funds are frequently permitted to use a stated portion of investors' capital to acquire some assets that are publicly sold. Typically, a private equity fund is not permitted to acquire publicly traded securities (other than very thinly traded issuances in some cases) with an aggregate cost to the fund of more than 5%–15% of investors' committed capital. Investments in companies that go public after an investment is made would not count toward this restriction. Funds may have a separate limitation on "private investment in public equity" (PIPE) securities.

§ 1:2.5 **Key Players**

The key players involved in the formation and operation of a private equity fund include:

- (a) the fund sponsors (usually the owners of the "general partner" and/or "manager");
- (b) investors;

67. See chapter 5, Organizational Options for Funds and Their Sponsors.

68. During the period beginning on August 1, 2015, and ending on July 31, 2016, issuers identified themselves as private equity funds on 1,900 initial Form D filings. Of these filings, 1,396 (or 73%) identified the issuer as a limited partnership.

69. For an extensive discussion, see chapter 14, ERISA.

- (c) professional advisors; and
- (d) placement agents.

[A] Fund Sponsors

When a fund is sponsored in the United States generally there is a separation between the fund's general partner and its investment manager or management company. The fund's general partner controls the fund, but has no employees or overhead. The fund's investment manager or management company provides management services, personnel, and office space, and, unlike the general partner, is treated as being engaged in a "trade or business" for U.S. federal tax purposes. A fund's "sponsors" refer to the individuals or entities that own the general partner or the investment manager of the fund. Sponsors are responsible for organizing and managing private equity funds (including raising capital alone or with placement agents).

In the course of obtaining capital commitments from investors, sponsors participate in the preparation of marketing documents, including the "pitch book" or "flip book," the fund's private placement offering memorandum, the partnership agreement of the fund, investor side letters, and organizational documentation governing the general partner and the investment manager.

The formation process can last well over a year. Once the fund holds its initial closing on (that is, accepts) capital commitments from investors, its final closing typically occurs no later than twelve to eighteen months after such initial closing.

In addition to formation responsibilities, fund sponsors select and oversee investments, determine the manner in which investments are disposed of, and make decisions regarding the fund's ongoing relationships with investors. These actions include negotiation of investment documentation, serving on the board of directors of portfolio companies, and ongoing communications with investors. In addition, fund sponsors control the admission and termination of participants in the general partner and manager.

The fund sponsors' interest in the general partner offers them the opportunity to participate in the management of the fund and to receive a share of profits (variously referred to as "carried interest," "incentive allocation" (or fee), and "performance allocation" (or fee)). An interest in the management company offers the sponsor the opportunity to participate in the profits of the management company (either by receipt of management fees or sale of equity of the manager, which is a more recent phenomenon). While the economics of the general partner and the manager are separate (one receives the performance-based allocations based on profits, while the other receives a management fee based on the amount of capital or value of assets

managed), their management functions are often blurred, especially because the same people generally have interests in both the general partner and the management company.

The general partner does not have employees. Rather, the management company employs all personnel participating in the operations of the fund. The management company also pays for overhead costs, such as office space and equipment, salaries and benefits for personnel, and other ongoing operating costs. It has become more common for the management company to enter into employment arrangements with senior investment professionals. These professionals receive severance arrangements and are bound by restrictive covenants (such as non-disclosure, non-competition, and non-solicitation) similar to those found in agreements for executives of operating companies.

From time to time, fund sponsors delegate or share their management authority with sub-advisers. Investment authority also may be shared within the general partner through the use of investment committees. Entities that provide start-up or “seed” capital to the sponsor group often are given veto rights over major decisions at the sponsor level, and may have input into certain fund decisions.⁷⁰ However, since investors require the key persons to be actively involved in the business of a private equity fund, complete delegation of the core investment function does not occur frequently.

[B] Investors

Investors provide a substantial portion of the capital to a private equity fund in exchange for an interest in the fund. Historically, investors often provided as much as 99% of the capital of a private equity fund in exchange for 80% of the profits. Today, the managers of a fund regularly provide much more than 1% of the capital to the fund in order to align their economic interests more fully with investors. Investors generally do not participate in the management of a fund, although they do negotiate restrictive covenants to protect their investment while having no liquidity rights other than the right to receive distributions after investments are sold.

Institutional investors are the largest group of investors in private equity funds. Institutional investors include sovereign wealth funds, private and public pension funds, university and foundation endowments, financial institutions, large corporations, and funds of funds. Investments by wealthy individuals have become more common in private equity funds; however, as funds get larger, institutional investors have remained forceful negotiators of the terms of private equity

70. See chapter 16, Seed Investors and Other Strategic Investors.

funds. Occasionally, high-net-worth investors act through asset managers who play the role of an institutional investor.

Investors' demands are often driven by their tax status. Tax-exempt U.S. investors may wish to avoid investments in funds that generate unrelated business taxable income (UBTI), including funds that borrow to make investments and investments in "pass-through" vehicles that generate UBTI. Non-U.S. investors may require restrictive covenants from private equity funds to ensure, among other things, that they will not be treated as engaged in a "U.S. trade or business" subject to U.S. net income tax. Investors generally do not wish to become subject to tax on a net basis in any jurisdiction in which they are not already taxpayers by reason of being investors in funds. It is not always possible to achieve this goal, and investors may be willing to incur some additional tax if the potential for returns is sufficiently compelling. However, investors' tax requirements play a fundamental role in the structuring of a fund and its investments.

[C] Professional Advisors

Advisors to private equity funds include attorneys, accountants, auditors, consultants, and more recently, administrators and custodians.

Legal advisors provide services in the formation and operation of private equity funds. Fund formation lawyers work closely with tax, ERISA, employment, and other specialized attorneys. Attorneys first assist in the marketing and formation of the private equity fund by reviewing and preparing marketing materials, including the fund's private placement memorandum. They then draft and negotiate the following key documents that govern a private equity fund:

- the limited partnership agreement or other organizational document, as applicable;
- the subscription agreement, which typically includes an investor suitability questionnaire;
- side letters;
- legal opinions; and
- "upper tier" agreements for the general partner and the management company.

Attorneys guide fund sponsors through compliance with laws governing securities offerings, regulation of investment companies, and regulation of investment managers. Fund attorneys advise on permitted fund investments and other operations and changes to the management teams of funds.

Accounting firms assist in the preparation of financial statements and advise on tax, accounting, and valuation issues.

Auditors audit the fund's financial statements (typically annually). Administrators, when used, assist with investor communications, record-keeping, capital calls, and distributions.

[D] Placement Agents

Although some fund sponsors handle the offering of their funds without assistance, many retain placement agents to assist in the formation of private equity funds and to raise capital for the fund. In addition to locating investors, placement agents can play a key role in decisions relating to a fund's structure and terms, and assist in drafting the fund's marketing materials. When retained, the placement agent enters into a placement agreement with the fund, the general partner, or manager. The compensation paid to placement agents is often tied to a percentage of the capital raised from investors that invest in the fund and who were introduced by the placement agent to the fund. Placement agents also seek fees for investments in successor funds.

In general, investors (other than in some "retail" funds) are not willing to bear the fees of the placement agent, although some placement-related expenses may be borne by the investor.

§ 1:3 Types of Funds

§ 1:3.1 Buyout Funds

[A] Typical Investments

Buyout funds acquire significant or controlling interests in existing private companies or public companies that are taken private.

Buyout funds normally pursue transactions of the largest size among all private equity funds, and typically invest a larger amount of money in a single company than other types of private equity funds. It would not be unusual for a buyout fund to invest up to 25% of its capital commitments in a single portfolio company.

The term "leveraged buyout fund" refers to a buyout fund that pursues acquisitions and investments with the use of leverage. This does not mean that the fund itself borrows money. Rather, a subsidiary acquisition vehicle formed to make the investment incurs debt that, together with equity provided by the private equity fund, provides the cash that allows such subsidiary acquisition vehicle to consummate the transaction.

Buyout funds often acquire existing public companies (and take them private). Occasionally, these funds buy smaller “toe hold” positions in public companies.

[B] Distinguishing Organizational Features

Larger private equity fund vehicle. The terms of a buyout fund typically reflect the fact that they are much larger vehicles than other types of private equity funds. For instance, the management fee that a large buyout fund is permitted to charge is often smaller (as a percentage of assets managed or committed capital) than that charged by a venture capital private equity fund.

Low risk for larger businesses; higher risk for medium-sized businesses. Since investments by buyout funds are made in businesses with substantial operating history and reliable financial statements, they are considered one of the less risky types of private equity funds. However, the term “buyout fund” is also used in the context of a “middle market” investment business. This means that a fund invests in medium-sized businesses, which are often considered riskier than larger businesses with significant market presence. The structure of middle market buyout funds does not fundamentally vary from that of large, late-stage buyout funds apart from the fact that the size of these funds tends to be smaller and, correspondingly, the deals they pursue are smaller. One might also expect a middle market buyout fund to do a slightly larger number of deals. It would be unusual for a middle market buyout fund to have a concentration cap that would permit more than 20% to be invested in a single company. Transactions of middle market buyout funds are also typically less leveraged.

Parallel investment partnerships. For tax, regulatory and legal reasons relating to particular types of investors or to investment in multiple jurisdictions, buyout funds often involve the formation of one or more parallel investment partnerships.⁷¹

[C] Activist Funds

Activist funds are related to buyout funds, but they only buy stock of public companies. Their goal in buying this stock is to promote change at the public company and then sell their stakes once the stock price has improved as a result of their efforts. Because this strategy involves assets the value of which can be marked to market, the terms of an activist fund typically incorporate hedge fund elements.

71. For a discussion of these tax considerations, see chapter 5, Organizational Options for Funds and Their Sponsors.

Often, activist managers operate private equity structures and hedge fund structures side by side.

§ 1:3.2 **Venture Capital Funds**

[A] Typical Investments

Venture capital funds are formed for the purpose of investing in early-stage businesses. “Early-stage” business can mean generally anything from an entity with nothing more than an idea (or business plan), or perhaps some technology rights (or business plan), to an entity that has operated over a period of time without revenues. Common industries in which venture funds invest include technology (including “clean tech”), biotech/healthcare (life sciences, pharma, medical devices), and retail.

“Angel” venture capital funds invest in the earliest-stage businesses. They are known to invest in brand new companies that have been formed just prior to the venture capital investment, with nothing more than senior management and ownership of the basic business assets. Obviously, these investments are deemed the riskiest of all private equity investments.

Venture capital funds also may make investments in businesses that have had ongoing operations. One benchmark for calling an investment a “venture capital” investment is whether the target company has either recognized any revenues or, more unusually, any profits prior to the period of the venture capital investment.

Investment in preferred stock. Investments made by venture capital funds typically consist of the preferred stock of a private company. When additional capital is needed by the company, additional preferred stock is purchased by the venture capital fund, with each new round of investment receiving special rights as to preferences on liquidation and dividends, and special rights to receive repayment in liquidation.

A venture capital fund routinely holds portions of its investments when its portfolio companies go public. IPOs became less common following the global financial crisis of 2008; more recently, IPO activity has increased. After the public offering concludes and the applicable “lock-up” period expires, the venture capital fund disposes of the investment in increments into the public market. Venture capital funds may distribute shares of companies to investors once they go public. These in-kind distributions permit the general partner and investors to decide when they wish to sell the shares they receive “in kind” from the fund.

Distributions in-kind have resulted in difficulties. Investors are often not able to sell the shares distributed to them at as high a price as that at which the fund deemed the shares distributed (which price,

in turn, determines how many shares the general partner receives as its carried interest and how many shares the investors receive). In addition, many institutional investors have the right to require the general partner to sell securities otherwise to be distributed in-kind to such investors (whether or not the investors have legal impediments to receiving distributions in-kind).

[B] Distinguishing Organizational Features

High-risk. Venture capital funds are generally considered high-risk investment vehicles. Therefore, the partnership agreement of a venture capital fund contains substantial restrictions on the general partner's ability to operate the fund so as to mitigate risk of an investment in such funds. For instance, the diversification requirements of a venture capital fund typically prohibit investment of more than 10% of the fund's capital commitments in a single company. Unless a venture capital fund was specifically formed for the purpose of doing non-U.S. investments, investors do not expect the fund to make a material amount of non-U.S. investments. Because investments made by venture capital funds are in businesses with no means to support repayment of debt, there is rarely any leverage involved in making a venture capital investment. Venture capital funds typically negotiate more restrictions on the activities of their portfolio companies than buyout funds. These restrictions are in place to address the fact that more control is needed from the investor at the beginning stages of any business to assure that the nascent business has the best opportunity to develop into a profitable business. Management fees of venture funds may also be higher than those of other private equity funds.

Limited partnerships. Like buyout funds, venture capital funds are typically limited partnerships formed either under the laws of Delaware or the Cayman Islands. Unlike buyout funds, venture capital funds are less likely to use alternative investment vehicles or parallel investment vehicles.

Long-term investment. The term of venture capital funds is relatively longer than any other type of private equity fund (other than infrastructure funds), as it is expected that the investments made by a venture capital fund will take longer to develop into a security that can be sold or registered in the public markets. It is typical for a venture capital fund to have a term of up to twelve years with permitted extensions.

§ 1:3.3 Mezzanine and Credit Opportunity Funds**[A] Typical Investments****[A][1] Mezzanine Funds**

Mezzanine funds pursue investments that consist primarily of subordinated loans, often with an accompanying equity-type investment (typically, warrants). Because investments made by mezzanine funds involve debt instruments, the target companies are later-stage businesses that are expected to have the ability to pay interest on the mezzanine loans made by the fund on a current basis. Portfolio companies of mezzanine funds are considered less risky, given the stage of the typical portfolio company (that is, a developed business). Mezzanine loans vary in terms of maturity dates and interest rates, but because they are riskier than senior loans and typically unsecured, the interest rate on a mezzanine loan is higher than that paid on a senior secured loan. Like venture capital funds, a mezzanine fund makes multiple mezzanine loans to multiple issuers to achieve risk diversification. There is often a much smaller concentration cap in a mezzanine fund than a buyout fund because of the riskiness of the loan repayments.

Mezzanine financing⁷² is most attractive to companies who are unable to secure financing from financial institutions due to a lack of collateral, short operating history, or other factors. The mezzanine debt market is mostly geared toward “middle-market” companies with specific financing requirements, such as acquisitions, capital expenditures, or recapitalizations.⁷³

[A][2] Credit Opportunity Funds

In times of credit-tightening, mezzanine funds may be replaced by “credit opportunity” funds, which seek to profit from the purchase or refinancing of existing loans at distressed prices, as well as from the origination of loans to borrowers who are otherwise having difficulty obtaining financing. The risk and return profile of a credit opportunity fund is more aggressive than that of a mezzanine fund, and its terms will be adjusted accordingly. Because the tightening of credit (for example, as occurred during the global financial crisis of

72. See JENNIFER J. BURLEIGH, DEBEVOISE & PLIMPTON, *MEZZANINE FUNDS: IN THE SPOTLIGHT* (2003), <http://www.altassets.net/knowledge-bank/mezzanine-funds-in-the-spotlight.html>. Mezzanine debt represents the layer of financing between a company’s senior debt and equity, and is relatively low risk in comparison with other private equity investments. *Id.*

73. Jerry Abejo, *Why Mezz May Experience a Strong Resurgence*, CAPITAL EYES, BANK OF AMERICA BUSINESS CAPITAL E-NEWSLETTER (May/June 2008).

2008) is viewed by many to present a buying opportunity with a relatively short time horizon, credit opportunity funds often have shorter investment and holding periods than other types of private equity funds.

[B] Distinguishing Organizational Features

Since the income derived from mezzanine funds consists in large part of interest payments from portfolio companies, the distributions made by mezzanine funds take one of two typical forms:

- (1) distributions are performance-based allocations from a portion of the interest payments received from portfolio companies, without regard to whether the principal amount of the corresponding loan has been repaid, so long as the overall value of investment in the fund would otherwise satisfy the fund's preferred return hurdle;⁷⁴ or
- (2) distributions are made to the partners using the same methodology as other types of private equity funds, which is that a mezzanine fund would return the principal on any loan made to a portfolio company to investors before beginning to make performance-based allocations to the general partner.

Generally, these two alternatives represent a difference only in the timing of distributions, as the clawback owed by the general partner at the end of the life of the fund⁷⁵ will require the general partner to have received no more than 20% of such interest payments on any investment (as well as 20% of the profits on any equity-related investments made by the fund), and a return on its invested capital. With that said, investors prefer the latter approach because the general partner's maximum clawback obligation is typically capped as an "after tax obligation" (that is, the clawback will not exceed total carry net of any taxes payable in respect of the carry). Management fees tend to be lower in mezzanine and credit opportunity funds.

§ 1:3.4 Distressed Debt Funds

[A] Typical Investments

Distressed debt funds are private equity vehicles that acquire securities, obligations, assets, trade claims, and businesses of, or relating to, financially distressed companies, typically with the objective of obtaining control or substantial influence over such companies. Such

74. For a more extensive discussion of distributions, see *infra* section 4:7.

75. *Id.*

securities or other assets often consist of loans, but may also consist of the equity of these businesses.

[B] Distinguishing Organizational Features

Shorter-term investment. Like credit opportunity funds, distressed funds may have shorter terms and shorter investment periods than other types of private equity funds. It is generally expected that the sponsor will be able to locate investments more quickly and should therefore be able to dispose of the funds' overall portfolio during a period that ends earlier than a typical ten-year term of a buyout fund.

Restrictive investment policies because of high risk. Distressed funds often invest in both publicly traded securities as well as privately placed securities, so it would be unusual to have a restriction in the partnership agreement limiting investments acquired on the open market. Because distressed funds are considered relatively risky investments, like venture capital funds, there are significant restrictions on the investment activities of these funds. In addition to limits on the amount that can be invested in a single portfolio company, other typical restrictions include limits on investing in real estate and limits on investing in a particular country or industry.

§ 1:3.5 Real Estate Funds

[A] Typical Investments

Real estate funds are those formed for the purpose of investing in some aspect of real estate. In addition to physical real property, target assets may include loans secured by real property, interests in businesses (such as hotels or retail stores) substantially reliant on real property, businesses (such as real property development, management, or brokerage) that relate to real property but do not hold it, and debt or equity securities of these businesses.

Real estate funds sometimes focus their investment strategy on particular geographic locations. However, other typical investment strategies of real estate funds could be based on residential versus commercial properties, development versus developed properties, and investments in more liquid securities such as real estate investment trusts (REITs).

[B] Distinguishing Organizational Features

Complex structuring. Real estate funds, particularly those formed to make investments outside the United States, often involve significant structuring through the formation of one or several layers of subsidiaries in order to achieve the most efficient results for investors. Accordingly, it may be necessary to have several parallel entities

as well as several levels of subsidiaries formed to make a single real estate investment.

Short-term investment, higher preferred return. Other common characteristics of real estate funds include a shorter investment period, shorter term, and (in some cases) a higher preferred return than are typical of buyout or most other types of private equity funds.

Leverage incurred. Real estate funds generally incur leverage in order to make investments. Unlike private equity buyout funds, where the leverage is often incurred by a C Corp beneath the partnership, real estate funds generally incur leverage at subsidiary levels by partnerships or other “pass-through” entities. Tax-exempt U.S. investors who are either pension plans or educational institutions may require real estate funds to seek to comply with the “fractions rule” requirements of section 514(c)(9) of the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), which may permit income from such real estate funds that use leverage to exclude such income from the computation of unrelated business taxable income (UBTI) for such investors. Real estate funds also typically have caps on the amount of leverage they are allowed to incur, often expressed as a percentage of the aggregate cost of the portfolio.

Management fees based on debt and equity invested in properties. Unlike the private equity fund model in which management fees are charged as a percentage of committed capital during the investment period and invested capital thereafter, real estate funds may charge management fees based on the debt and equity invested in properties, rather than committed investor capital. More recently, many real estate funds have charged management fees using a buyout fund model.

Also, real estate funds are often formed by sponsors who are otherwise engaged in some aspect of the real estate business. For instance, a real estate developer or asset manager may form a real estate fund. In that case, in addition to management fees charged to the fund by the management company, the asset manager in charge of managing the day-to-day real estate investments may also earn income from the fund’s investments. There is generally no offset to the management fee charged to the fund for the real estate property management fees charged to the property and paid to an affiliate of this type of general partner. The theory behind this is that these are the types of services the fund would otherwise have to pay a third party to provide.

§ 1:3.6 Funds of Funds

[A] Typical Investments

A fund of funds is formed to invest in other funds. Private equity funds of funds invest in other private equity funds, which may

include buyout, venture capital, distressed, real estate, mezzanine, credit opportunities, or a combination of these funds.

Funds of funds often have co-investment rights with the funds in which they invest, thereby allowing the sponsor of the fund of funds to gain access to other investment opportunities in the target companies of its underlying private equity funds. Funds of funds serve a useful purpose, given the increase in size of most private equity funds and the corresponding increase in the minimum investment they require from investors. Funds of funds also offer an additional layer of diversification. Some funds of funds are limited to a particular underlying strategy (for example, real estate), while others also diversify across strategies. In either case, with the exception of funds of funds formed by a sponsor to invest in its own underlying funds, a fund of funds will typically invest in funds offered by multiple underlying managers, reducing reliance on a particular sponsor.

[B] Distinguishing Organizational Features

Smaller management fees and carried interests. Funds of funds' economic terms vary greatly from those of a typical private equity fund. Because the sponsor's management fee and carried interest are in addition to that charged by the underlying funds in which it invests, the management fees and carried interest in funds of funds are substantially smaller.

Provisions that allow recall of distributions. Since private equity funds often have provisions that require investors to return some or all of their distributions (in order to cover liabilities of the private equity fund), funds of funds that invest in private equity funds must be careful to provide that they are able to recall distributions from their own investors.

Long-term investment. The term of the fund of funds is often much longer (and its investment period is often shorter) than that of private equity funds. The fund of funds will make its initial commitments to underlying funds over a period of years, and has an ongoing obligation to honor its commitment to underlying funds, which may itself go on for as long as ten years after the initial commitment is made by the fund of funds to a private equity fund.

§ 1:3.7 Structured Product Funds

[A] Typical Investments

Investments made by asset-backed securities (ABS), mortgage-backed securities (MBS), and collateralization loan obligation (CLO) funds consist of securities that are secured by, represent an equity interest in, or receive payments from a portfolio of financial assets consisting primarily of corporate debt securities, loans, securitized

receivables, ABS, CDO securities, or other financial assets and/or credit default swaps referencing any of the foregoing.

A collateralized debt obligation (CDO) is a special purpose vehicle that typically issues several tranches of debt and equity securities pursuant to an indenture (or trust agreement or similar agreement) and a preference share paying agency agreement (or fiscal agency agreement or similar agreement), and invests the net proceeds thereof primarily in a portfolio of financial assets. The portfolio of financial assets that secures the debt securities issued by the CDO may include any combination of bonds, loans, securitized receivables, asset-backed securities, CDO securities, or other financial assets and/or credit default swaps referencing any of the foregoing. The equity securities issued by a CDO typically are unsecured.

A “synthetic” CDO is a CDO that obtains credit exposure to companies or asset-backed securities primarily by entering into credit default swaps or total return swaps (and a security issued by it is referred to as a “Synthetic CDO Obligation”).

A “cash” CDO is a CDO that primarily invests in loans or securities in order to obtain credit exposure to companies, asset-backed securities, CDO securities, or other financial instruments.

[B] Distinguishing Organizational Features

“Managed” versus “static” CDOs. A “managed” CDO is a CDO with an underlying portfolio of assets (or, in the case of synthetic CDOs, an underlying portfolio of reference entities and/or reference obligations) that is actively managed by a collateral manager or portfolio manager.

A “static” CDO is a CDO with an underlying portfolio of assets (or, in the case of synthetic CDOs, an underlying portfolio of reference entities and/or reference obligations) that is not actively managed by a collateral manager or portfolio manager, and in which new assets generally cannot be added after the closing (or a brief ramp-up period thereafter).

The collateral or portfolio manager of a managed CDO generally has the ability to do the following:

- (i) buy and sell assets (or, in the case of a synthetic CDO, add and remove reference obligations and/or reference entities) for the CDO based on predetermined guidelines, and
- (ii) in the case of a cash CDO, reinvest certain cash flows received by the CDO in additional assets for a specified period of time.

CDO structure. The indenture (or other governing document) pursuant to which CDO securities are issued will limit the types of assets that the CDO may purchase. In general, the cash flows received by

a CDO in respect of its portfolio of assets that are not used to purchase additional assets during the applicable reinvestment period (net of the administrative expenses of such CDO) are used as follows: first, to make payments to the holders of the related CDO senior tranche; second, to make payments to the holders of the related CDO mezzanine tranches; and finally, to make payments to the holders of the related CDO equity. However, almost all CDOs (whether synthetic or cash, or managed or static) are structured such that, in certain circumstances (for example, if predetermined overcollateralization tests or interest coverage tests are not satisfied), cash flows that otherwise would have been paid to the holders of the CDO mezzanine tranches and the CDO equity tranches will be used to redeem the related CDO senior tranches. Such structural features enhance the credit quality of the CDO senior tranches at the expense of the credit quality of the related CDO mezzanine tranches and CDO equity tranches.

“Cash flow” versus “market value” CDOs. CDOs may be characterized either as one of the following:

- (i) *“cash flow” CDOs*, which have overcollateralization tests based on the relationship between the principal amount (or *“par coverage”*) of the CDO collateral securing the related CDO securities and interest coverage tests (but no tests based on the market value of the CDO collateral), or
- (ii) *“market value” CDOs*, which have overcollateralization tests that take into account the market value of the CDO collateral.

As a result of the global financial crisis of 2008, the issuance of new CDOs collapsed⁷⁶ and many private equity funds that held these instruments incurred substantial losses. However, in the wake of the financial crisis, a number of *“credit opportunity”* funds were formed to purchase CDO securities, or the underlying assets of CDOs at distressed prices.

§ 1:3.8 “Club” or “Pledge” Funds

[A] Typical Investments

“Club” or *“pledge”* funds are private equity funds that permit investors to opt in or out of individual investments, rather than investing on a *“blind pool”* basis in whatever the sponsor selects. Investors in club funds typically pay a management fee for the privilege of receiving a first look at investments, and can be removed from the club

76. Nicole Bullock & Paul J. Davies, *CDO Volumes Take Big Hammering*, FIN. TIMES, July 11, 2008.

if they veto too many investments meeting the fund's investment parameters.

Club funds are often used by managers who do not yet have a sufficient track record to be able to raise a blind-pool fund to pursue their objectives, or who want to take advantage of immediate market opportunities instead of going through the waiting period necessary when raising a blind-pool fund. The track record from the club fund can be helpful to the manager when later raising a blind pool; however, if the club fund includes members who themselves have substantial investment experience in the area, then the track record generated may appear to be a collaborative effort.

Club funds tend to attract strategic investor-types, rather than purely passive financial investors. In order to take advantage of the club feature, the investor must be able to independently evaluate each investment opportunity. The club offers an investor a guaranteed first look at investment opportunities generated by the manager. Investors in club funds are often industry players who already have a history of co-investing with the manager on individual deals, and who are looking to formalize this arrangement. In addition, the club fund also typically provides uniform, pre-negotiated documentation and fee terms for each deal, which enables transactions to be completed more quickly.

§ 1:4 Other Investment Strategies in Private Equity

§ 1:4.1 Private Investments in Public Equity (PIPEs)

One of the investment strategies in the private equity field is private investments in issuers whose securities are already publicly traded, otherwise known as Private Investments in Public Equity (PIPEs). PIPEs provide financing to public companies through a private placement (as opposed to a registered public offering). PIPEs may consist either of preferred equity or debt that is convertible to stock.⁷⁷ This is significantly different from a traditional private equity investment, not only because funds that make PIPEs target public companies, but also because the time period for holding this type of investment is typically much shorter. Additionally, a PIPE investor generally is not

77. Megan Davies, *DEALTALK—In credit crunch, private equity turns to PIPEs*, REUTERS (Dec. 6, 2007), <http://www.reuters.com/article/mergers/News/idUSN0663716720071206?sp=true>. They are typically smaller than leveraged buyouts and rarely rely on leverage, thus making them almost immune to financial markets. *Id.*

interested in the management and direction of a company, and often does not offer assistance in running the company.⁷⁸

Although PIPEs have been a part of the private equity landscape for some time,⁷⁹ the global financial crisis of 2008 refocused private equity firms' interest in using them. Indeed, 2015 saw a spike in PIPE transactions involving private equity and venture capital investors.⁸⁰ PIPEs are advantageous for companies that need to raise money quickly without the expense of an underwritten secondary offering, as well as for investors who receive discount shares and warrants in the transaction.⁸¹ Lately, with the staggering amount of capital raised, funds are searching for investments that do not rely on large loans. In a market where it may be difficult to secure financing for control of a company, use of PIPEs is increasingly seen as a promising strategy.

However, an important consideration is that private equity funds are ultimately passive investors in PIPEs and do not control the board of directors. Private equity funds must reconcile this shift away from their traditional investment strategy in order for PIPEs to be a viable option.

§ 1:4.2 Special Purpose Acquisition Companies (SPACs)

SPACs are blank check public companies with no current operations that are formed for the purpose of consummating an acquisition of a to-be-identified business in the future. In a number of instances, SPACs have been formed by institutional fund managers. The promoters of many of the more recent SPACs are extremely well-known names from the buyout and alternative asset management communities.

SPACs are different from traditional private equity funds in several significant respects. First, interests in SPACs are publicly offered and

78. Joseph Kuzneski & Ron Landen, *Looking Through the PIPE—Opportunities for Private Equity Investors*, PRIV. EQUITY ALERT (Weil, Gotshal & Manges LLP, New York, NY May 2006), <http://www.weil.com/~media/files/pdfs/PEAMay06.pdf>.

79. From the years 2006–2007, according to Sagient Research Systems, the average deal size for PIPEs more than doubled from \$21 million to \$45 million, <http://www.sagientresearch.com/pt/GStats.cfm?Type=6>.

80. Angelo Bonvino, Matthew W. Abbott, Justin G. Hamil & Frank Lamicella, *Key Considerations for PE Investors in Growing PIPE Market*, LAW360 (May 5, 2016), <http://www.law360.com/articles/792567/key-considerations-for-pe-investors-in-growing-pipe-market>.

81. *Interview with Christopher S. Auguste, Kramer Levin Naftalis & Frankel LLP: SPACs and PIPEs: A User's Guide*, METRO. CORP. COUNS. (Feb. 1, 2008), <http://www.metrocorpcounsel.com/current.php?artType=view&artMonth=February&artYear=2008&EntryNo=7873> [hereinafter Auguste Interview].

consist of common stock and warrants, rather than privately placed limited partnership interests. Second, all of the investor capital is paid in at completion of the SPAC's initial public offering, rather than over time via capital calls. Most significantly, unlike a private equity fund, which is established to make multiple investments, the SPAC structure is designed for a single initial investment, although many SPACs seek to pursue a roll-up strategy after they complete their initial business combination. Some SPACs are focused on specific industries or geographic areas of the world, while others take a more generalist approach.

[A] Investment Advantages

SPACs can be attractive to investors as they not only allow for greater liquidity than traditional private equity funds, but also give institutional investors more “control” over the types of private equity investments in which they choose to invest. SPACs provide private equity sponsors with an adjunct opportunity to make acquisitions. An initial business combination with a SPAC also may be attractive to a target that would not be interested in a traditional sale to a private equity fund, since a transaction with a SPAC will enable the owners of the private target to monetize a piece of their ownership interest while still preserving the possibility for additional public market appreciation. SPACs may play a more significant role in providing exit opportunities to sponsors. SPACs are attractive to private companies because they allow a private company to become public in less time and at a lower cost than would be required if the company conducted its own initial public offering.

Traditionally, SPACs were unattractive because they require shareholder approval for all acquisitions. Following the global financial crises of 2008, when both credit and exit opportunities for private equity sponsors have been more limited, SPACs have become an attractive option.⁸² As they grow in popularity and use, their structure has changed to reflect the concerns of the U.S. Securities and Exchange Commission (SEC), investors, and management.

[B] Structural Considerations

SPACs raise a number of structural considerations not often faced by other more traditional private equity offerings.

Potential conflicts of interest must be carefully analyzed. Existing business activities raise both disclosure and, in some cases, consent

82. Bill Meagher, *Another Way to Invest with the Smart Money: SPACs*, LDNews (Aug. 12, 2016), <http://business-news.thestreet.com/ld-news/story/another-way-to-invest-with-the-smart-money-spacs/1367387?page=1>.

issues, especially for fund sponsors. On the flip side, the SPAC must be structured to mesh with future business activities, including future permanent capital vehicles. These considerations are further complicated if the sponsor wishes to sponsor multiple SPACs.

Fund sponsors often prefer a holding company structure for holding the carried interest and making their real equity investment. Structure will be dictated by co-investment considerations and who will receive an interest in the carried interest.

Given their cash resources, fund sponsors often wish to make a larger co-investment in the SPAC, and are more amenable to a 10b5-1 repurchase component,⁸³ both of which raise additional structural considerations.

As a public company, a SPAC is subject to periodic public company reporting. The reporting regimen generally is not as complicated as for an operating company, although there are a few twists. Many fund sponsors need to build out their financial reporting and/or legal compliance function in order to adequately handle public company compliance for the SPAC. In many cases, this will require a great amount of lead time prior to the SPAC offering.

Finally, SPACs raise Investment Company Act considerations for fund sponsors. All sponsors, whether or not registered as investment advisers with the SEC, must be mindful of the issues raised by the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”).

[C] Investment Risks

For a fund sponsor, the major structural limitation of a SPAC is that shareholder approval of an initial business combination is required. In addition, shareholders who oppose a proposed transaction can convert their shares into cash and, if more than a specified percentage (typically between 20% and 40%) of the public shares exercise redemption rights, the SPAC will be prohibited from consummating the transaction.⁸⁴ Furthermore, the transaction value must equal at least 80% of the SPAC’s trust account.⁸⁵

83. Rule 10b5-1, Securities Exchange Act of 1934.

84. See Carol Boyer & Glenn Baigent, *SPACs As Alternative Investments: An Examination of Performance and Factors That Drive Prices*, 11 J. PRIV. EQUITY 8 (2008). Because the founders of SPACs are generally required to vote in accordance with the public shareholders, they have little influence. *Id.*

85. McDermott Will & Emery, Corporate Practice Group, *Overview of SPACs and Latest Trends: Special-Purpose Acquisition Companies*, NAT’L L. REV. (Oct. 22, 2015), <http://www.natlawreview.com/article/overview-spacs-and-latest-trends-special-purpose-acquisition-companies>.

SPACs have a limited time frame (generally eighteen to thirty-six months) in which to complete an initial business combination.⁸⁶ If the transaction is not consummated in the time allocated, the SPAC must liquidate and return its IPO proceeds to the shareholders.⁸⁷

§ 1:4.3 Mezzanine and Credit Opportunity Funds

The global financial crisis of 2008 fostered a number of credit opportunity funds.⁸⁸ In particular, these funds pursue opportunities in CDOs, CLOs and related assets. The catalyst for the surge of mezzanine funds was the tightening of the credit markets in 2007.⁸⁹ With commercial banks imposing more conservative lending standards and restrictive terms, private mezzanine securities are frequently used in weak economic environments as a more flexible alternative to traditional financing. Because mezzanine investors generally follow a “buy and hold” investment strategy, they are less susceptible to market fluctuations.⁹⁰ Ultimately, mezzanine debt is more expensive than other lending sources because it is available even in times of economic turmoil⁹¹ and because it functions as a mechanism of last resort to raise capital before a company must start selling its equity.

§ 1:4.4 Sovereign Wealth Funds (SWFs)

Another current trend in the private equity industry is the prevalence of sovereign wealth funds (SWFs), which are government-funded investment funds composed of financial assets such as stocks, bonds, property, or other financial instruments. While SWFs have been in existence for over fifty years, their recent rapid growth, both fiscally and geographically, is stirring up interest. SWFs are funded by money derived from a country's reserves that are diverted into the fund for

86. This short time period not only puts a great deal of pressure on management (and gives the target company a significant advantage), but can be unrealistic given the proxy and regulatory issues associated with acquiring companies in certain industries or foreign countries. See Kit R. Roane, *Business Buffet: When hungry investors want to make a meal of a company, they can pool their millions in something called a SPAC*, U.S. NEWS & WORLD REP., Jan. 30, 2006, at 1.

87. An emerging trend is to extend the twenty-four-month term, which can generally be accomplished with a signed letter of intent or an acquisition agreement before the end of the time period. See Auguste Interview, *supra* note 81.

88. See *supra* section 1:3.3.

89. *Id.*

90. Miller, *supra* note 44.

91. Nicolette Davey, *Mezzanine Makes Comeback As Market Suffers Fundraising Squeeze*, FIN. NEWS ONLINE (Feb. 4, 2008), <http://www.efinancialnews.com/investmentbanking/peoplemoves/content/2449714905>.

the benefit of the country's economy and citizens. This can involve either investments of the central bank's reserves in foreign treasuries, or funds that the government earns through exports, such as natural resources.⁹² Countries that export large quantities of oil tend to have larger SWFs.

The financial resources of SWFs vary by nation, but represent a substantial amount of capital in the world market.⁹³ The estimated value of the SWF industry as of June 2018 was approximately \$7.82 trillion.⁹⁴ To put the composition of this number in perspective, ten SWFs control 75% of these assets.⁹⁵ The SWFs are significant by virtue of the assets they control. In comparison with the alternative investment industry, the total assets of SWFs surpass the \$3.55 trillion managed by hedge funds worldwide,⁹⁶ but global institutional pension fund assets in twenty-two major markets is valued at \$41 trillion.⁹⁷

A SWF's investments are limited by the needs of its country. Nations that are more concerned with liquidity tend to shy away from investing in private equity. This money frequently is instead invested directly in foreign companies and financial institutions, which generally welcome not only the influx of capital but the confidentiality and speed typical of SWFs.⁹⁸ In the United States, some contend that SWFs were an indispensable component of preventing the global

-
92. *Sovereign Wealth Funds: Foreign Policy Consequences in an Era of New Money*: Hearing Before the S. Comm. on Foreign Relations, 110th Cong. (June 11, 2008), <https://www.gpo.gov/fdsys/pkg/CHRG-110shrg48061/html/CHRG-110shrg48061.htm> (statement of Jagdish Bhagwati, Senior Fellow in Int'l Econ. Council on Foreign Relations, and Prof. of Econ. and Law, Columbia Univ.).
93. WILLIAM MIRACKY ET AL., MONITOR GRP., *ASSESSING THE RISKS: THE BEHAVIOR OF SOVEREIGN WEALTH FUNDS IN THE GLOBAL ECONOMY* (June 2008).
94. SWF INSTITUTE, *SOVEREIGN WEALTH FUND RANKINGS* (Aug. 2018), <http://www.swfinstitute.org/sovereign-wealth-fund-rankings/> [hereinafter SWF INST. SOVEREIGN WEALTH FUND RANKINGS].
95. The seven funds with the largest amount of assets under their control are Norway's Government Pension Fund Global (\$1 trillion), China's China Investment Corporation (\$941 billion), the United Arab Emirates' Abu Dhabi Investment Authority (\$683 billion), Kuwait's Kuwait Investment Authority (\$592 billion), Hong Kong's Hong Kong Monetary Authority Investment Portfolio (\$522 billion), Saudi Arabia's SAMA Foreign Holdings (\$515 billion), and China's SAFE Investment Company (\$441 billion). SWF INST. SOVEREIGN WEALTH FUND RANKINGS, *supra* note 94.
96. 2018 PREQIN GLOBAL HEDGE FUND REPORT.
97. WILLIS TOWERS WATSON GLOBAL PENSION ASSETS STUDY 2018.
98. Ahmed A. Elewa, *Standard Chartered Invites UAE Funds to Buy Stake*, GULF NEWS (Jan. 31, 2008), http://www.gulfnews.com/business/Banking_and_Finance/10186074.html.

financial crisis of 2008 from worsening by infusing a large amount of liquidity into the market.⁹⁹

[A] Foreign Policy Concerns with SWFs

Although some feel that SWFs are a stabilizing force in the world economy due to their unleveraged and long-term status, others argue that SWFs are a potential foreign policy issue and have advocated protectionist policies against their activities.¹⁰⁰ Because SWFs are a financial vehicle of the state, some critics have expressed the concern that SWFs may invest in foreign industries that are developing technology in order to appropriate the technology to their own country. Also, some of the most considerable SWFs are affiliated with non-democratic governments. This bestows an enormous amount of investing power, and consequently, a meaningful influence on the global market, in the hands of a few. There is some concern in the industry that this type of situation could set the stage for an investment program that concentrates not solely on economic gain, but also on furtherance of the nation's political goals and aspirations.¹⁰¹

To address these concerns, the International Monetary Fund (IMF) held talks in the fall of 2008 to develop a set of principles aimed to ensure that investments by SWFs were, among other things, commercially motivated.¹⁰² The International Working Group of Sovereign Wealth Funds (comprised of twenty-six IMF member countries with SWFs) agreed on a set of principles while meeting in Santiago, Chile (known as the "Santiago Principles").¹⁰³ Published in October 2008, the Santiago Principles set out twenty-four voluntary guidelines intended to "contribute to the stability of the global financial system, reduce protectionist pressures, and help maintain an open and stable investment climate."¹⁰⁴

99. Lee Hudson Teslik, *Sovereign Wealth Funds*, COUNCIL ON FOREIGN RELATIONS (Jan. 28, 2009), http://www.cfr.org/publication/15251/sovereign_wealth_funds.html?breadcrumb=%2Fbios%2F12286%2Flee_hudson_teslik.

100. *Sovereign Wealth Funds Draw Scrutiny*, OXFORD ANALYTICA (Mar. 3, 2008), <http://www.oxan.com/display.aspx?ItemID=DB140996?ItemID=DB140996>.

101. Bhagwati Testimony, *supra* note 92.

102. Elewa, *supra* note 98.

103. IWG, SOVEREIGN WEALTH FUNDS, GENERALLY ACCEPTED PRINCIPLES AND PRACTICES, SANTIAGO PRINCIPLES (2008), <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>.

104. *Id.*

§ 1:4.5 **Secondaries**

Secondary funds have experienced rapid growth due to the interest of investors in the purchase of existing interests in existing private equity funds, frequently sold at substantial discounts. Secondary purchases involve the assumption by a purchaser of the selling investors' unfunded commitments to a private equity fund and the existing underlying investments in such fund's portfolio.

The growth of a secondary market serves a number of purposes for investors. First of all, the secondary market offers investors the ability to exit their private equity fund investments before the funds make distributions to investors. This liquidity may be attractive for a variety of reasons that are not necessarily correlated to the attractiveness of the investment being sold: the investor may need cash, its investment strategies may have changed, or it may need to rebalance its portfolio.¹⁰⁵ Secondaries are particularly popular in a fluctuating and uncertain market because investors may be able to avoid the long-term commitment of private equity fund investments. For example, if an investor wanted to invest in a fund for half the time of the fund's specified term, it could buy an original interest and then sell it before the term was up. Conversely, an investor could find a private equity fund nearing the middle or end of its life and buy the original investor's interest.¹⁰⁶

Historically, buyers in the secondary market were able to purchase interests at a highly discounted rate to their net asset value. Notably, during the Internet boom of the 1990s, the secondary market grew rapidly after the investors were forced to liquidate their private equity portfolio.¹⁰⁷ By 2006, however, with the massive amount of capital in the market, secondaries had become less purely a buyer's market.¹⁰⁸ The competition for deals in the primary market overflowed to the secondaries market and the discounts previously offered substantially

105. William Alden, *A Boom in Private Equity's Secondary Market*, N.Y. TIMES (Feb. 18, 2015), http://dealbook.nytimes.com/2015/02/18/a-boom-in-private-equitys-secondary-market/?_r=0.

106. Cesar Estrada, *The Emergence of Private Equity's Secondary Market*, INSTITUTIONAL INV'R (June 18, 2016), <http://www.institutionalinvestor.com/gmtl/3563232/The-Emergence-of-Private-Equitys-Secondary-Market.html#.V7XSx9Lrt9A>.

107. Rob Marks & Bart Walker, *Pros and Cons of Secondary Private Equity Buyouts*, ALTASSETS (Dec. 5, 2007) [hereinafter Marks & Walker], <http://www.altassets.net/casefor/sectors/2007/nz12293.php>.

108. ALTASSETS, PRIVATE EQUITY AND VENTURE CAPITAL GLOSSARY OF TERMS, <http://www.altassets.net/private-equity-and-venture-capital-glossary-of-terms> (last visited Apr. 28, 2015).

declined.¹⁰⁹ However, the global financial crisis of 2008 once again created a buyer's market for most illiquid investments, including secondaries. As private equity investors saw their investments shrink, their need for liquidity increased and many saw the secondary market as the solution to their liquidity problems. Offers of secondary interests flooded the market, resulting in significant discounts.¹¹⁰ In 2010, following the recession in the United States, discounts reduced¹¹¹ as the market cycle moved once again to improve sellers' prospects. Nonetheless, as a result of the larger number of players in the secondary space, there continues to be a significant market for secondary interests. In fact, the volume of secondary transactions in 2017 hit \$52 billion, setting a new record.¹¹²

The development of a secondary market speaks to the robustness of private equity funds as an asset class.¹¹³ The secondary market provides investors both with liquidity in an extremely illiquid market and flexibility by allowing investors to modify their investment strategies, respond to changes in public markets, and more ably manage their liquidity.

§ 1:4.6 Distressed Funds

Historically, traditional private equity sponsors in the United States were not focused on buying distressed companies because of a number of concerns. First, managers were apprehensive of their ability to conduct operational turnarounds. Second, there was a perception that buying financially distressed companies was a long and complicated process that was best left to specialists in distressed or special situation funds. Third, private equity fund managers also feared that they would face competition with a management-sponsored plan of reorganization. And finally, distressed funds have existed for some time, but they traditionally were not sponsored by the same players seen in the buyout area.

109. Stephen Harris, *Overlooking Private Equity Partnerships Can Be Costly Mistake Secondary Market Offers Liquidity for Limited Partners*, J. CORP. RENEWAL (Nov. 2006), <http://www.turnaround.org/publications/articles.aspx?objectID=6735>.

110. Sabrina Willmer & Gillian Wee, *Harvard Said to Seek Sale of \$1.5 Billion in Private-Equity*, BLOOMBERG BUSINESSWEEK (Nov. 25, 2011), <http://www.bloomberg.com/news/articles/2011-11-14/harvard-said-to-seek-sale-of-1-5-billion-in-private-equity-stakes>.

111. In October 2010, discounts on the secondary market averaged approximately 8%, compared with 35% in early 2009. See Anita Raghavan, *Stronger Secondary Market in Private Equity*, N.Y. TIMES (Dec. 9, 2010).

112. *The Private Equity Secondary Market*, COLLIER CAPITAL (2018).

113. Marks & Walker, *supra* note 107.

However, the changing dynamics of the market as a whole suggested that investments in distressed debt could be extremely lucrative.¹¹⁴ Prior to the financial crisis of 2008, many companies with extensive leverage had little difficulty refinancing their debt. Post financial crisis of 2008, “given the unprecedented market dislocation,”¹¹⁵ such companies turned to private equity for liquidity. This provided an entry opportunity for private equity funds that do not usually specialize in distressed companies.¹¹⁶ In 2008, forty-nine distressed private equity funds raised \$54.7 billion. As the global economy has improved in the years following 2008, the number of funds and amount raised per year have generally been lower than the highs seen in 2008, and fundraising for distressed private equity funds is expected to remain challenging (except for funds focused on the energy sector, which has presented managers with opportunities fueled by the collapse of oil prices).¹¹⁷ However, some managers are attracting investors once again to distressed strategies with the belief that a corporate default cycle may be approaching.¹¹⁸

§ 1:4.7 Seed Capital Funds

Increasingly, institutional investors and new fund sponsors looking to form private equity funds are entering into arrangements known as “seed” investments whereby institutional investors make a “seed” investment in a new fund sponsor’s private equity fund in exchange for an equity or profit sharing stake in the management entities and general partner established by the fund sponsor and/or the right to invest in future fund products formed by the fund sponsor. The fund sponsor benefits by gaining initial capital required to sustain its operations during the initial phase of its business, while the institutional investor gains access to talented investment personnel and new investment opportunities in which its own clients may be interested to invest.

-
114. Richard Widows, *Look Here to Invest in Distressed Assets*, THESTREET (June 20, 2008), <http://www.thestreet.com/story/10422276/1/look-here-to-invest-in-distressed-assets.html>.
115. Marti Murray, *Babson Plans Mortgage Fund Launch*, ALTERNATIVE INV. NEWS at 3 (May 5, 2008), <http://www.ialternatives.com/pdf/AIN050508.pdf>.
116. Daniel Holzman, *Shopping for Distressed Companies*, ALTASSETS, Dec. 12, 2007, <http://www.altassets.net/casefor/sectors/2007/nz12275.php>.
117. 2016 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT (Preqin Ltd. 2016).
118. Devin Banerjee, *KKR Gets \$3.35 Billion for Distressed Fund as Defaults Loom*, BLOOMBERG (Apr. 5, 2016), <http://www.bloomberg.com/news/articles/2016-04-05/kkr-said-to-get-3-3-billion-for-distressed-fund-passing-target>.

In a related development, institutional investors are also increasingly making investments in the funds and management entities of more well-established fund sponsors. These later-stage strategic investments allow the fund sponsor to “monetize” some of the profits generated in managing its fund products, while giving the strategic investor access to talented investment professionals.¹¹⁹

§ 1:4.8 Permanent Capital

In recent years, fund sponsors have sought to form funds designed to achieve “permanent capital” for themselves by offering liquidity exclusively through secondary market transactions (that is, transfers of fund interests to new or existing investors) in funds with a potentially indefinite life. These vehicles may be formed as “business development companies” under U.S. law, or structured as listed public vehicles in non-U.S. jurisdictions, which, to avoid falling under the laws applicable to U.S.-registered mutual funds, are offered in the United States only through private placements to qualified investors.

In 2005, several prominent private equity managers successfully formed multi-billion-dollar private equity-style funds focused on fund of funds investing and co-investments. However, there has been less interest in creating these funds in recent years. These funds seem, like many U.S.-registered closed-end funds, to trade at substantial discounts and to bear such a significant, non-scalable additional expense load (when compared to a traditionally structured private equity fund) that the structure is only viable for funds of a very large size.

From an investor’s standpoint, its investments in permanent capital vehicles are favorable because they can be resold in smaller pieces, permitting access by retail investors, in the United States and beyond, who may not otherwise have access to private equity fund products. In the future, retailization could occur; however, press coverage in connection with the recent round of permanent capital launches suggests that the initial holders were a small number of large institutional investors, who are well able to access the best private equity funds through more traditional means.

119. A more in-depth discussion of “seed” investments and later-stage strategic acquisitions can be found in chapter 16, Seed Investors and Other Strategic Investors.

§ 1:4.9 Status of Existing and New Deals Post Financial Crisis

[A] Existing Deals

During the global financial crisis, private equity funds had to evaluate the performance of the deals already in their portfolio. Unlike the value of investments in liquid funds with readily ascertainable market values, the value of investments in most types of private equity funds is not easily determined. However, indicators such as unmet performance targets, loss of significant customers and revenues, and data on the price of comparable investments may lead a private equity fund to write down an investment. Write-downs may affect management fees paid by a fund and, if the fund has other profitable realizations, will reduce the general partner's performance-based allocation.

In order to support an investment, fund sponsors may need to seek additional capital for follow-on investments, including rescue financings. These situations can create great unease. If the fund has available capital, it will be deployed, but if diversity limits have been met, then such capital must be sourced from third parties. Cooperation of investors at different levels of the capital structure of a portfolio company is required. Ultimately, if investor capital is not available, the portfolio company will look for third-party sources of capital. During a period of economic downturn, leverage can be expensive or simply unavailable, and other sources of rescue financing can shrivel. This makes it more likely that the fund sponsor will have to turn to existing investors to add capital to rescue existing deals.

[B] New Deals

During the global financial crisis, buyout and other funds that rely on debt, such as real estate funds, had virtually been precluded from proceeding with deals and drove down the prices at which transactions were accomplished. Funds that relied less on debt, such as venture capital funds, were likely to pursue deals at a much slower pace. Like the dot-com era, managers of funds derive benefits in showing investors that they are extremely careful in selecting deals so as to avoid future losses. Funds that cease to make investments typically receive pressure to reduce management fees, as the manager is deemed less than fully engaged and investors do not want to pay fees on capital that never gets deployed.

In the downturn of 2008–2010, distressed debt funds and “credit opportunity” funds seemed to have the greatest popularity. Managers seized opportunities to purchase debt instruments and related securities at enormous discounts to face value. These funds are also more likely to offer a degree of liquidity, either by their own terms

or (because their assets are easier to value than most other types of private equity investments) through the secondary markets. The investment periods and terms of these funds are often shorter, and, as discussed below, investors may be more comfortable with the impression of earlier releases from private equity funds.

As a result of constrained investment opportunities of private equity funds, we have observed a trend of shifting investment strategies from equity to debt. Buyout fund managers who have determined that distressed debt investments are more attractive than many equity investments may seek this shift in strategy in order to provide returns to investors—even in challenging economic times. It is highly advisable that the sponsor obtain the requisite consent of investors to pursue such a strategy absent sufficient and specific authority in the fund's partnership agreement. Investors objecting to such a shift in strategy could argue that the general partner, absent consent from investors, would not have the authority to implement such a fundamental change to the fund.

On the equity side, activism is growing in popularity as an investment strategy. Like distressed investing, activism is a method of extracting value from mature assets that are currently not optimized using the skill of the manager.

§ 1:5 Current Trends in Fundraising

§ 1:5.1 Overview

Private equity funds continue to navigate the adverse consequences of recent global financial crises, which have dramatically changed the private equity landscape and the way that fund sponsors, investors, and their attorneys view their respective roles. Investors have continued to expand their demands on sponsors before committing to a fund, with a particular focus on fees.¹²⁰ Nevertheless, aggregate capital raised each year since the financial crisis has generally been increasing, with larger, more established managers favored over smaller, emerging managers.¹²¹

§ 1:5.2 Other Sources of Capital; Co-Investors

Fund managers must use a broad array of strategies for sourcing capital. In addition to capital sourced through placement agents, sponsors have also looked to seed arrangements with investors to

120. PREQUIN LTD., PREQUIN INVESTOR OUTLOOK: ALTERNATIVE ASSETS H1 2015, NEW CHALLENGES OF A GROWING ASSET CLASS 9 (2015).

121. PREQUIN LTD., THE PREQUIN QUARTERLY UPDATE: PRIVATE EQUITY, Q3 2014 (2014).

secure capital. As further discussed in chapter 16, in seed deals, investors will often receive an equity interest in the general partner in exchange for a large investment. Although a seed investor will often receive substantially better terms and concessions, the arrangement provides the general partner with a much-needed inflow of capital both for investment by the fund and often for working capital of the manager of the fund.

Reliance on co-investors has remained an important means for private equity funds to pursue investments, particularly where a fund has achieved a smaller than expected amount of committed capital. From an investor's perspective, the investor can have a base commitment to a private equity fund and the flexibility to increase its exposure to certain of that fund's deals as a co-investor. The co-investment capital is often invested at reduced fees and carried interest (or none at all). Therefore, general partners often find that their investors are willing to make additional capital available for co-investments.

The concept of co-investment capital has developed into a more noticeable fund category—often referred to as an “add-on fund” or a “spillover fund.” These vehicles obtain committed capital from investors that, in turn, co-invest with an existing private equity fund under management by the same sponsor. Add-on funds are relatively easier to raise because they call for a smaller amount of capital, and often provide for lower fees (frequently charged on actively invested capital rather than based on committed capital) and carry. However, due to conflict and valuation issues, these funds are rarely permitted to make investments in existing portfolio companies of the existing fund.

§ 1:5.3 Fund Terms—Bargaining Power of Limited Partners

In the current fundraising environment, general partners continue to brace themselves against demands for terms that are more favorable to investors. Unimpressive past performance has exposed some sponsors to pressure to negotiate terms, even if the poor performance combined with competition for capital is more indicative of the industry as a whole rather than of the sponsor. Despite the uptick in fundraising activity, limited partner demands on partnership agreement terms have not let up. Due to the heightened risk of default by some limited partners, and the difficulty in obtaining funding from banks, private equity fund sponsors find themselves in the unenviable position of searching for new sources of capital. As a result, the new or altered terms of fund documentation currently reflect a shift in favor of limited partners (for all but the most successful managers and strategies).

Pressures on management fees are noticeable, while the carried interest does not seem to have been reduced. Unlike profits of a fund, management fees are paid regardless of the fund's success and, in that respect, misalign the manager with its investors. Investors prefer that the general partners have an incentive to generate profitable returns on investments. In fact, very early private equity funds paid management fees in accordance with budgets approved by investors—no frills allowed. Offsets to management fees arising from transaction fees have been heavily negotiated following the financial crisis, with many funds being forced to accept demands for 100% offsets for transaction fees.¹²² Many funds now use back-end-loaded “total capital return” waterfalls (meaning that the carried interest is distributed only once the investors receive a total return of their invested capital). In addition, to address investor concerns about the availability of sufficient monies to satisfy potential clawback obligations, more sponsors are agreeing to personal guarantees and interim clawbacks. Zombie funds have paved the way for limits on management fees beyond stated dates.

Beyond basic economic terms, and as a corollary to the sponsor's desire to expand its fundraising ability, investors seem to be focusing on fund terms that give them greater flexibility in terms of exit rights in a private equity fund. As discussed in chapter 4, these rights may include a “no fault” dissolution right and/or a “no fault” right to terminate the investment period of the fund.¹²³ Simply, with a relatively high level of votes (greater than that needed for simple amendments) investors may elect to dissolve the fund or terminate the investment period without any reason. These rights have existed in many funds over many economic cycles but are becoming increasingly prevalent. General partners may also choose to offer a shorter investment period and a shorter term for newer funds. However, while these features from a marketing perspective give the appearance that an investor will not be tied up for as extensive a period as was historically associated with private equity funds, there is no certainty that a private equity fund will actually be able to dispose of its investments within the stated term of the fund.

In 2011, the Institutional Limited Partners Association (ILPA) released an updated version of its “Private Equity Principles,” referred to as the “ILPA” principles (the “ILPA letter”), to express their current view as to the best practices governing the General Partner–Limited

122. See *infra* section 4:8.2[D][1].

123. One of the more frequent requests in the past few years by limited partners has been the addition of a “no fault” removal provision for the general partner, although these requests have almost exclusively been rejected.

Partner relationship.¹²⁴ Although groups representing limited partners have been present throughout the years, only during the economic climate of the past few years have limited partners been in a position to demand these rights or principles. In the past, groups that have focused on discussing what the fund industry should be like and what the appropriate terms of a fund should be have often been viewed as engaging in an academic exercise. The ILPA letter, by contrast, originally released in 2009, has been frequently cited in negotiations by limited partners requesting changes in fund documentation. Many, but certainly not all, of the principles espoused by ILPA are already common in private equity funds, such as the back-ended carry model of distributing the carried interest and mechanisms to ensure clawback repayment. Although there has been a great deal of pressure on the general partners to lower management fees and to adopt a more investor-friendly approach to the distribution waterfall (that is, the back-end-loaded “total capital return” waterfall), the ILPA letter also advocates for more protections on non-financial terms, such as tightened key-man provisions, greater transparency in fund reporting, and a stronger role for the Advisory Committee.

More favorable investor terms may give certain private equity funds a fundraising advantage over competitors. However, granting overly favorable terms to limited partners may prove dangerous to general partners in looking toward the future. It is generally anticipated that many limited partners in their current funds will also invest in their future funds, and it is likely that such limited partners will not easily relinquish the concessions in the current fund.

General partners may consider forming a single investor account or managed account for a large investor to avoid setting a precedent for the terms of future funds for other investors. A single investor fund is basically a private equity fund tailored to one investor. Investors in these types of funds, like managed accounts, have the ability to control the advisory committee role and can have more rights over the decision-making process in terms of investments. Investors can also obtain greater portfolio transparency and more flexibility on terms. There are a number of differences in the tax treatment of the carried interest in funds as opposed to managed accounts (as more fully discussed in chapter 4). The benefits to the investor of a managed account or single investor vehicle pose a corresponding deterrent to the sponsor in many respects, including the lack of certainty as to the continued availability of capital and fees. In a single investor fund/managed account context, the general partner can generally be

124. INSTITUTIONAL LTD. PARTNERS ASS’N, PRIVATE EQUITY PRINCIPLES (2011) [hereinafter ILPA Letter]. See *infra* Appendix R.

removed, or the arrangement terminated, by the single investor. If a general partner is building out overhead for the account and the investor terminates the account, then the general partner is not only left without any cash flow from the account in order to make the proposed investments, but has also expended resources on the overhead of the account.

Another issue to consider in forming managed accounts and single investor funds is the ability of the parties to terminate the investment advisory agreement. In a no-action letter related to termination of contracts at will,¹²⁵ the SEC concluded that advisory agreements that are only annually terminable breach the adviser's fiduciary duties to its client, as well as section 206(2) of the Investment Advisers Act. If this determination were extended to sophisticated investors in managed accounts, the manager would be more at risk of termination than in a pooled fund context, where the fund is the investor and is controlled by the manager. This risk may also apply by analogy to single investor funds.

§ 1:5.4 Fundraising Periods

The provisions of partnership agreements that address the timing of new investor admissions may also be modified to take into account the pressures of locating investors. As stated in chapter 4 (Terms of Private Equity Funds), the fund sponsor typically is afforded a twelve-to-eighteen-month window to raise the capital for a single fund. It is not unusual for the sponsor to request an amendment (or several) to extend its fundraising period. Investors rarely oppose these extensions if requested judiciously and under the assumption that the extension will not enable new investors to dilute existing investors at a price below the current market value of the portfolio, although investors may require the existing investment period and fund term to remain unchanged. For example, investors would typically approve a request from the general partner to extend the marketing period by three months with respect to prospective investors that were already engaged in discussions with the general partner as of the end of the existing marketing period. General partners may also find it prudent to seek to include an extended marketing period in the originally negotiated partnership agreement, although such extensions are frequently subject to advisory committee approval. Sponsors of funds with portfolios that are likely to demonstrate material appreciation during the offering period (for example, distressed funds and funds investing in fixed-income investments) may find it easier to justify

125. Robert D. Brown Investment Counsel, Inc., SEC No-Action Letter, NAFT WSB File No. 102284013 (July 19, 1984).

an extended offering period if subsequent closings are priced at net asset value (NAV) rather than on a cost-plus basis, as discussed below. Notably, investors may agree to extend the marketing period, but will not necessarily extend the investment period or term of the fund.

Longer fundraising periods during economic downturns increase the likelihood that values of portfolio investments made while the sponsor is fundraising will significantly decrease during such periods. While many private equity fund partnership agreements grant general partners the discretion to permit investors that come in at a subsequent close to participate in existing investments at a valuation other than cost, it is expected that these provisions will be utilized by general partners with increasing frequency.

§ 1:6 Industry Convergence

§ 1:6.1 *Blurring the Line Between Private Equity and Hedge Funds*

“Convergence” is a term commonly used to describe the distinction between the hedge fund and private equity industries. Historically, private equity and hedge funds represented two entirely different investment options. Since 2000, however, hedge funds and certain private equity funds have taken on a number of the other’s characteristics, and the same sponsors increasingly manage both hedge funds and private equity funds or hybrids between them. Although this trend has transformed hedge funds by the use of “gates,” allocation of assets into “side pockets,” and creation of “synthetic side pockets” in response to the global financial crisis of 2008, many investors resisted the forces of convergence. Private fund structures are expected to continue to evolve, shaped by the needs of investors, the needs of sponsors, and the bargaining power of each.

[A] Strategic Differences

Traditionally, the difference between private equity and hedge funds was starkly defined. Hedge funds invested in publicly traded securities with easily discernible values that could be liquidated at those values in relatively short periods of time. Hedge funds did not seek to play active roles in company management or to hold illiquid assets in the hope that liquidity would develop in the future. Instead, strategies relied on selecting attractively priced securities (and, possibly, hedging by selling overpriced securities “short”), and selling them once the market recognized their value.

Hedge fund terms reflect this strategic difference. Unlike private equity funds, hedge funds charge or allocate annual incentive compensation and quarterly management fees based on the net asset value

(NAV) of their portfolios. Investors subscribe at NAV throughout the life of the fund, rather than buying in at cost plus an interest factor as they typically do in private equity, and investors can redeem at NAV as well. Subscriptions are often accepted monthly, and redemptions occur when the investor so chooses, subject to specified lock-ups (which traditionally permitted monthly, quarterly, or semiannual redemptions after a perhaps one- or two-year lockup) and notice periods. Unless an investor redeems, proceeds from investment sales are automatically reinvested, and uninvested amounts are held by the fund in cash rather than being drawn down as needed. The fund itself has a potentially unlimited life, although the identity of its investors may change.

[B] Erosion of Differences Between Private Equity and Hedge Funds

The distinction between private equity and hedge strategies, and the corresponding difference in fund terms, has considerably eroded. Hedge fund sponsors have increasingly ventured into the following traditional private equity strategies:

- distressed investment in both public and non-public securities;
- loan origination;
- activist investing; and
- investment in illiquid assets, including private company debt and equity.

Sometimes, the illiquid nature of certain assets requires that they be held in “side pockets,” which mimic private equity fund characteristics in the following ways:

- new investors in the hedge fund do not dilute the side pocket investments of existing investors;
- incentive allocations on the side pocket are not made until the underlying asset is realized; and
- an investor who elects to redeem from the hedge fund must nonetheless stay invested in the side pocket until its sale.

In other cases, less liquid assets are held in the hedge fund’s main portfolio, and are subject to redemption, dilution, and fees charged at NAV. However, the frequency with which investors may redeem is substantially reduced in hedge funds pursuing less liquid strategies, and redemptions may be staggered or subject to “gates” (that is, caps on the aggregate amount that may be withdrawn in a given period) in order to maintain stability.

The investment strategies of both types of funds have historically caused a greater separation than currently seen in the market. While both funds seek to capitalize on inefficiencies, hedge funds tend to look to, for example, short-term price movements or pricing anomalies in the market. Private equity funds also seek inefficiency in the market, but their traditional goal is not to exploit the inefficiency, but rather to create value by improving or replacing management and policies. Restructuring a business can often take an extended period of time, while profits can be made from public securities in a very short period of time. Traditional private equity funds, having longer hold periods, are very interested in the strategic direction of the companies and industries in which they invest. As such, private equity firms engage in a significant amount of research regarding both the targeted company and the industry in which it operates. On the other hand, hedge funds assess target companies' strategies but traditionally are more focused on company and industry hedging strategies. Today, a number of hedge funds are seeking to influence management decisions made by companies in which they have invested.

[C] Advantages of Convergence

The concept of industry convergence is manifested by a hedge fund engaging in private equity-like investments (often through the use of side pockets¹²⁶) and vice versa. The current climate of the industry is increasingly competitive, and funds are becoming larger. As hedge funds compete for investments, hedge fund managers are forced into new trading strategies and investments to produce the absolute returns that they seek every year.¹²⁷ Private equity investing affords new opportunities, leading to greater diversification of portfolios, and illiquid investments can often provide higher returns.¹²⁸ Conversely, private equity funds can benefit from hedging strategies. Because private equity investments are held for longer periods of time, it can often take ten years or more before profits on the investments are fully realized and flow through to the investors. There are currently a number of private equity firms that also operate hedge funds in order to capitalize on the opportunities, and in order to find a way to generate cash flow and deploy capital at times when immediate private equity opportunities are not available.

126. See discussion in chapter 4, Terms of Private Equity Funds.

127. Mark Hulbert, *Just How Contagious Is That Hedge Fund?*, N.Y. TIMES (Aug. 26, 2007).

128. *But see* Nicole M. Boyson, Christof W. Stahel & René M.M. Stulz, *Is There Hedge Fund Contagion?* (Nat'l Bureau of Econ. Research, Working Paper No. W12090, Mar. 13, 2007), <http://ssrn.com/abstract=884202>.

Yet another incentive for private equity and hedge funds to converge is basic efficiency. By managing funds that offer wide-ranging and innovative opportunities, these funds are able to attract better talent to work in such funds. And precisely because they gain exposure to both sectors, the employees are educated in the mechanics and nuances of both types of investing and are, therefore, better equipped to understand the market as a whole. Also, the fact that hedge funds charge or allocate annual performance compensation on unrealized gains, typically without a hurdle or a clawback, makes their compensation structure attractive to employees.

[D] Convergence Concerns

[D][1] Valuation of Fund Assets and Computation of Compensation

Possibly the most conspicuous issue relating to convergence is with valuation of the fund's assets and computation of compensation. As mentioned previously, hedge funds are structured to provide frequent liquidity so that they may accept new investors and redeem existing investors at scheduled intervals. If the fund's portfolio consists largely of illiquid securities, the fund may find itself fiscally ill-equipped to redeem investors' subscriptions, and may discover that the marks at which it carries its portfolio are not achievable on sale.

Furthermore, attempting to value a private company in order to ascertain net asset value is highly subjective because the manager may be forced to estimate the value of such assets without an objective standard. Because hedge fund investors pay performance compensation based on the value of the assets in the fund's portfolio, investors may object to relying solely on the manager's opinion.

[D][2] Cultural Clash

There is a cultural clash inherent in a merger between hedge funds and private equity funds. Private equity employees are management-focused and are concerned with efficiently running a company. Private equity investments are generally complex and require protracted organizational and planning skills. These transactions may require a focus that is both long-term and patient. In contrast, hedge funds are often managed by traders from investment banks who are experienced in more short-term investing strategies and used to relying entirely on public data to evaluate opportunities. They may not possess the skill set to understand and improve upon the inner workings of a company. These two very different types of personalities may not necessarily work well together.

[D][3] Marketing Issues

A firm that conducts private equity and hedging strategies may face difficulties with marketing the performance of one of these models to investors interested in the other structure. Although certainly there may be some commonality in their investments, success in the private equity realm does not indicate that the same firm will be similarly successful running a hedge fund. An established private equity firm launching a hybrid fund may find itself similarly situated, in this respect, as a new firm.

[D][4] Investor Expectations

Another issue presented by convergence is that private equity investors and hedge investors are themselves different cultures with different expectations, even when they are parts of the same investing entity. Private equity investors expect to be able to negotiate the fund's documentation and terms, and are used to receiving extensive side letters. By contrast, hedge fund investors must often take the documents that are presented as-is, and rely for control on their right to withdraw. Meanwhile, institutional investors often place investments in "buckets," allocating their assets across strategies before evaluating the relative attractiveness of managers in each strategy. A private equity manager who opens a hedge fund will likely find that fund in a new "bucket," being evaluated by different personnel and on different criteria than were used for private equity vehicles, even when the investor is an existing client of the firm. Hybrid funds that mix private equity and hedge terms in the same vehicle may find themselves outside both the investor's hedge and private equity "buckets," adding to the fundraising challenge.

Hedge funds that pursue the types of illiquid strategies traditionally pursued by private equity funds may be asked by investors to include the types of protection typically included in private equity funds, including such terms as third-party verification of valuations, fund size caps, exclusivity undertakings, and more extensive side letters. These demands reflect the erosion of the traditional compact between the hedge fund sponsor and its investors, in which the sponsor was given substantial latitude to opportunistically invest, while the investor was given the ability to "vote with its feet" if the sponsor's performance failed to satisfy. In the newer hedge fund model, investors may be unable to withdraw all or a portion of their investment for multiple years, and the constraints on sponsors have correspondingly tightened.

Despite this convergence, hedge fund terms continue to differ materially from those of private equity funds, and the two structures occupy different places in institutional portfolios. It is not uncommon

for the same sponsor to run hedge funds and private equity funds side by side, with similar portfolios and strategies but differing terms; it is not clear which structure is better for the sponsor and which structure is better for investors. Investors in hedge funds typically give up a number of private equity protections, including realization-based compensation, hurdle rates, clawbacks, and limitations on dilution. On the other hand, hedge fund investors gain the ability to control (within limits) the length of their commitment to the fund sponsor, which can be highly valued. In addition, the ability of hedge funds to accept additional cash at all times can make them more nimble in exploiting investment opportunities as they arise.¹²⁹

As investors become familiar with both hedge and private equity structures, and as the differences in their strategies and terms diminish, documentation is beginning to converge. Increasingly, hedge fund investors are demanding side letter protections and standards of liability long ago adopted by private equity fund managers. Negotiation of hedge fund documentation is becoming more common, especially where the hedge fund imposes long lockups and permits illiquid investments. In some cases, traditional private equity terms such as bundle rates, clawbacks, and key person provisions are finding their way into hedge fund documents. Conversely, private equity-style funds that include public markets investments are rethinking the basis on which subsequent investors are admitted, and the viability of giving investment transparency on a real-time basis.

Ultimately, the history of modern private equity has proven it to be a highly resilient and evolving industry, focused on growth and innovation. Whether the industry embraces or rejects the current trends is uncertain. Undeniably, however, the potential for new types of investing is infinite, as it continues its constant search for and development of new strategies, models, and vehicles.

§ 1:6.2 Hybrid Funds

“Hybrid funds” are those perceived as combining hedge and private equity fund characteristics in a single vehicle. This perception can have marketing implications, particularly in attracting institutional investors who have “hedge” and “private equity” buckets, and no allocation dedicated to products that cannot be classified.

It is hard to say exactly where to draw the line between hybrid funds and their more traditional counterparts, especially as the terms of private equity and hedge funds are already converging:¹³⁰

129. For a comparison between private equity terms and hedge fund terms, see Appendix R.

130. *Id.*

- hedge funds with multi-year lockups may no longer be considered “hybrid”;
- side pockets had become not uncommon in the years leading up to the financial crisis, although they have been increasingly disfavored in the period since then;
- some hedge funds draw down capital over time;
- some private equity funds (particularly those formed to exploit “credit dislocation”) have shortened their investment periods and holding periods to the point where they are substantially in line with those of hedge funds with longer lockups; and
- the underlying assets purchased by funds considered “hedge” and those considered “private equity” are ever harder to distinguish.

That said, there continue to be boundaries, albeit moving ones, in what terms are considered standard for each type of fund, and a fund that crosses these boundaries will be viewed as a hybrid product. At the time of this writing, the outer edges of a traditional “hedge” fund are as follows:

- an outside cap of 10%–25% on “side pockets,”
- an outside cap of three years on initial lockup on capital, and
- rolling lockups not exceeding one to three years thereafter.

Funds that cross these boundaries may face a harder sell.

Hedge funds of funds, which constitute a material component of the hedge fund investor base, often offer annual liquidity to their investors and generally do not have side pockets. A hedge fund constructed to conduct less liquid strategies may lose access to these investors (although some fund of funds sponsors are beginning to build out new platforms with reduced liquidity and side pockets to access less liquid hedge funds).

On the other hand, it can also be difficult to sell and later on to manage a fund with terms that are not well-matched to the realities of the manager’s strategy. For example, frequent redemption dates may seem protective of investors, but if the underlying portfolio is too illiquid to facilitate satisfaction of those redemptions in cash, then the fund may be forced to suspend redemptions, or to liquidate the more liquid portion of an existing portfolio while leaving existing investors concentrated in more illiquid assets. Similarly, a manager who tries to protect against this outcome by tilting the portfolio in favor of liquid assets and cash may be foregoing the opportunity for higher returns.

When the sponsor's investment strategy is itself a mix between private equity and hedge, a corresponding hybridization of fund terms may be the best course, even if it creates an additional marketing hurdle. However, managers should think carefully about the difference between the latitude they actually need to effectively manage their strategy, and terms that seem appealing simply because they add flexibility. It is easy to imagine the best mix of fund terms from a sponsor's perspective—combining the long lockups and resulting capital stability of a private equity fund with the more favorable compensation terms (no hurdles, no clawbacks, mark-to-market carry) and freedom from investment limitations, exclusivity undertakings and fundraising limits offered by hedge structures. It is more difficult to sell this mixture to investors.

Also, investors have recently become more resistant to liquidity constraints in funds that have investment programs that could support greater liquidity. As a result, in the current market for hedge funds it can be helpful to avoid the use of long lock-up periods and side pockets, if possible. This trend has pushed fund sponsors toward the use of co-investment vehicles or true private equity funds, rather than hybrid vehicles that combine liquid and illiquid assets in a single portfolio.

§ 1:6.3 Private Equity Funds Versus Mutual Funds

Private equity funds are almost invariably privately offered, and do not rely on the special tax and regulatory regime offered to mutual funds. There are a variety of reasons for this, including the incompatibility of the mutual fund regime with such concepts as drawdowns, realization-based fees, affiliate party transactions and disclosure limits on information regarding underlying portfolio investments, as well as a perception that the illiquidity and risk profile of private equity funds is not well suited to a retail client base.

