

Chapter 2

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§ 2:1 Overview

Establishing the terms of a private equity fund is a collaborative effort between fund sponsors and investors, and typically involves detailed negotiations between these two groups. As the private equity fund industry has matured, fund sponsors and investors have become increasingly sophisticated with regard to the considerations and safeguards needed to protect their respective interests. This chapter will survey some of the most commonly used key terms of private equity funds and several variations on such terms.

At the outset, it should be noted that negotiating the parameters of a fund is influenced by numerous factors, including:

- (1) the size of the fund;
- (2) the fund's investment strategy;
- (3) the intended maturity of the fund;
- (4) whether the fund is a stand-alone enterprise or one of many different funds offered by a larger single organization;
- (5) the jurisdiction in which the fund will operate and the classifications of its investors (for example, taxable U.S. investors, tax-exempt U.S. investors, non-U.S. investors, and ERISA limited partners); and
- (6) the experience and success of its manager.

For these and other historical reasons, it is not possible to create a single private equity fund template or to generalize about appropriate private equity fund terms. Investors and managers may differ as to the importance placed on certain fund terms, and a final negotiated fund agreement will reflect the importance and priority of the various issues raised. For example, a manager who is unwilling to commit a material amount of his or her personal capital to the fund may compensate by offering less aggressive compensation terms. Alternatively, a manager who is unwilling to cap the size of his or her fund to assure investors that opportunities will not be spread too thinly may make a larger personal investment in the fund. The manager may also offer promises of a large personal time commitment to reassure investors that their interests are aligned. Economic terms may also be negotiated. For example, a high management fee may be counterbalanced by generous transaction-fee sharing arrangements. Often, many of the terms offered by a fund sponsor are open to negotiation. The resulting changes depend on which issues are most crucial to the majority of investors. Further concessions may be made at subsequent closings as additional investors with new concerns join the offering.

The most commonly used terms in a private equity offering will ultimately be embodied in a combination of the following documents:

- the fund's offering memorandum;¹
- the fund's governing documents (typically a Delaware limited partnership agreement, but potentially including other vehicles such as a Cayman Islands partnership or a limited liability company, corporation or trust);²
- subscription documentation;³ and
- side letters.⁴

§ 2:1.1 Fund Size

Within the private equity fund industry, there are a small number of multi-billion-dollar funds run by established managers that are sometimes referred to as "super funds," "jumbo funds," or "mega funds." In these funds, it is common to have elaborate tax and regulatory structures, and carefully negotiated investor terms. Super funds are commonly structured to meet the needs of sophisticated investors of various regulatory and tax classifications, including benefit plan investors, bank-regulated investors, non-U.S. investors facing various tax regimes and treaty eligibilities, foundations, endowments, and foreign governments.

From the perspective of the fund sponsor of a super fund, it is prudent to include provisions addressing the specific conflict issues faced by larger organizations that are simultaneously operating multiple funds. It may also be necessary to include sophisticated structures in order to operate the fund in a tax-efficient manner.

Although super funds control a significant portion of the capital invested in the private equity industry, the majority of private equity funds are smaller funds in which the managers focus on a single fund investment strategy or a few closely related fund investment strategies. The regulatory considerations and sophistication described for investors in super funds above may not necessarily all be applicable to investors in smaller funds. These funds may instead be comprised principally of high-net-worth individuals and smaller institutions, resulting in less fully negotiated and more varied fund terms. In some cases, lack of negotiation may favor the manager. On the other hand, a large seed investor in these smaller funds may, by virtue of the investor's

1. See section 6:2.
2. See section 6:3.
3. See section 6:4.1.
4. See *infra* section 2:19.

significance to the fund, be able to dramatically improve economic terms for all investors, assurances of future capacity, and possible participation in the economics of other aspects of the sponsor's business over what would be viewed as "market" for a more established fund.

§ 2:1.2 Fund Investment Strategy

The nature of the private equity fund's investment strategy is also determinative of how fund terms are negotiated. For example, real estate funds are typically more focused on the treatment of current income (particularly on mature properties with rental income streams) than other types of private equity funds. Current income is also important for distressed and fixed-income (for example, mezzanine) funds. Real estate funds may also contain special allocation provisions designed to bring them into compliance with the "fractions rule" under section 514(c)(9) of the Internal Revenue Code,⁵ which provides relief to certain pension plans and educational institutions from tax on "debt-financed income."

Venture capital funds also contain provisions that differ from those of classic buyout funds. During the venture capital boom of the mid to late 1990s, venture capital funds commonly had carried interest provisions that entitled the manager to receive more than 20% of the fund's profits. This was often achieved through a tiered waterfall structure with higher levels of carry once set profit levels were met. Venture capital funds frequently tie their economics to the allocation provisions of their operating agreements, whereas other funds use distribution-based formulas. Venture funds have been more likely than other types of funds to share 100% of portfolio company fees (that is, transaction, monitoring and directors fees) because such fees are paid so rarely in venture deals. However, recently investors have pressured general partners of most types of funds to share more (if not all) of such fees with them than has historically been the case.

§ 2:1.3 Fund Maturity

First-time funds (and, interestingly, super funds, which have to address the detailed concerns of sophisticated, well-represented investors whose level of individual investment justifies a rigorous level of negotiation) are also more likely than smaller yet more mature funds to offer investors liberal protection in areas such as no-fault removal of the general partner, no-fault dissolution of the fund and a key-person provision tied to a single individual. However, the management fees charged by smaller funds may actually be higher (in percentage terms)

5. 26 U.S.C. § 514(c)(9).

than those charged by larger funds, because fund management benefits from economies of scale.

§ 2:1.4 *Single Fund or Cluster of Parallel Funds*

Another relevant consideration affecting fund terms is whether the fund is a stand-alone enterprise or one of many funds offered by a larger organization. For more entrepreneurial sponsors, it is typical to promise that the manager will market only a single fund at any one time (or a cluster of parallel funds formed simultaneously), forming successor funds only when existing funds are substantially (typically 75%) invested, committed for investment or reserved, or have completed their investment periods. These types of restrictions will not work with, for example, a private equity fund sponsored by an investment bank that sponsors multiple investment platforms, or a private equity fund run alongside existing (or contemplated future) hedge funds, collateralized loan obligations (CLOs), and other investment vehicles with partially or entirely overlapping investment objectives. Funds sponsored by institutions also must address other issues unique to their particular arrangements, including the possibility that the institution may be retained to provide other services to the fund for its portfolio companies (for example, providing investment banking advice, brokerage, lending, or loan servicing), and the possibility that the institution's proprietary trading activities may overlap with investments made on behalf of the fund.

§ 2:1.5 *Fund Jurisdiction*

Other important considerations affecting fund terms are the jurisdiction in which the fund will conduct its investment activities and the location from which the manager will operate. Funds investing in or from jurisdictions outside the United States must confront complex tax and potential regulatory constraints. Typically, local counsel are engaged in the relevant jurisdictions, together with international tax accountants, to advise on appropriate structures for the fund and its investments. In order to best address the tax and regulatory considerations of different categories of investments and investors, these types of funds may require multiple parallel vehicles formed under different legal structures and possibly in different jurisdictions.

§ 2:1.6 *Fund Manager Experience*

A fund sponsor whose first fund performed well may find itself negotiating with many of the same investors in subsequent funds. Although the initial fund documents form the basis of such negotiations, it is not uncommon for managers to try to improve a successor

fund's terms applicable to the manager. As the manager becomes more established and potentially oversubscribed, it typically seeks to improve its compensation levels and to reduce certain investor protections, although then-current economic conditions may dictate otherwise. Conversely, investors may seek to add investor-favorable provisions that have become more "market" in the intervening years.

Additionally, new investors may insist on concessions that were not raised by existing investors or were successfully resisted by the manager in the original fund.

As we explore these terms, it is important to note that many of the restrictions investors seek to impose on private equity fund sponsors can be seen as alternative ways to achieve the same objective. Therefore, it is often not necessary to utilize all of the restrictions described below, but rather to obtain a combination of protections that address the issues presented by a particular fund. Similarly, from the manager's perspective, it may be possible to retain flexibility in areas that are important to the manager while reassuring investors that incentives between the manager and the investors will be aligned and the fund will operate as anticipated.

§ 2:1.7 Investor Fund Term Negotiation Objectives

The main objectives investors seek to achieve in their negotiation of fund terms include the following:

1. *Aligning the interests of the manager and the investors in ensuring performance of the fund.* Methods used to achieve this include the following:
 - ensuring that compensation terms are within market norms for comparable products;
 - requiring a sizable capital contribution by the manager and active senior personnel;
 - ensuring that a significant portion of the compensation paid or allocated to the manager reach the active management team as opposed to passive investors at the manager level;
 - recouping excess carried interest, with a final, and possibly interim, clawback;
 - ensuring that management fees are not a profit center so that the manager remains focused on the performance of the fund's investments;
 - creating an escape hatch from unsatisfactory management through use of for-cause (and in some cases also no-fault) general partner removal clauses;

- no-fault dissolution or commitment-period termination provisions to ensure that investors have a voice in the manager's future conduct of the fund; and
 - reduction or elimination of conflicts through provisions such as investment opportunity allocation requirements, limitations on the formation of competing funds, transaction fee sharing, and advisory committee approval requirements regarding conflict transactions.
2. *Ensuring that the investment program will conform to expectations.* Methods used to achieve this include the following:
- setting limits on the fund's purpose;
 - restricting the type, size, number, geographic range, risk profile, and leverage of investments;
 - requiring frequent reporting regarding fund investments; and
 - permitting investors to remove the manager, to stop new investments, or to dissolve the fund.
3. *Ensuring that there is continuity of the management team.* Provisions to address this may include the following:
- providing provisions (known as "key person" provisions) allowing investors to terminate investing or to dissolve the fund if certain personnel leave;
 - paying attention to the portion of compensation being shared with key members of the management team;
 - at the diligence level, focusing on the vesting and forfeiture provisions to which team members are subject (in the case of seed investors, this may also include attaching provisions to subsequent funds run by the same manager); and
 - requiring minimum ownership of the general partner and management company by investment professionals (as opposed to outside investors).
4. *Avoiding dilution of interests in existing investments at less than fair value.* Provisions to address this include the following:
- setting an outside date by which new investors in the existing funds must be admitted;
 - providing an interest charge in favor of early investors;
 - providing for the possibility of a mark-to-market adjustment of the fund's portfolio for purposes of admitting new investors in appropriate cases; and

- considering the terms on which assets may be moved among funds managed by the same sponsor.
5. *Obtaining certainty regarding capital deployment.* Methods used to achieve this include the following:
- setting end dates for investment of capital in new deals or companies;
 - reinvestment of capital and recall of prior distributions;
 - imposing possible caps on the percentage of capital commitment that may be drawn in a particular period;
 - imposing caps and floors on fund size; and
 - restricting the allocation of investment opportunities away from the fund.
6. *Obtaining some form of safety valve if things go wrong.* The clearest way to achieve this is through provisions allowing removal of the general partner, dissolution of the fund or, at the very least, requiring the general partner to stop making new investments. Another option is to impose consent rights regarding investments or other significant actions (although these rights are less typical in the context of blind-pool funds than they are in the club fund context).

The remainder of this chapter will discuss related fund terms in greater detail.

§ 2:2 Fund Size

Depending on a fund's strategy, and the depth and breadth of a fund's management team, investors may be concerned about ensuring that the fund does not fall below an agreed-upon minimum size and/or exceed a maximum size. Investors may also demand that the fund's first closing achieve a certain minimum size, in case additional closings do not occur.

§ 2:2.1 Excessively Small Funds

There are a number of concerns with an excessively small fund. Investors may fear that the portion of their capital that will be used to pay expenses (as opposed to being invested) will be excessively large as compared to capital used for investing if the fund does not reach a certain minimum size. In addition, a very small fund may lack sufficient capital to pursue its intended investment strategy. If the fund's management team does not make a sufficient profit, they may not be motivated to manage the fund or to support a robust back office.

As a result, the fund may not attract and retain the number and level of sophistication of management personnel that it requires. Finally, there is a concern that the fund may be overly dependent on the views and providence of its largest investor. Many institutional investors are unwilling to constitute more than a minority percentage of the fund's investment base for regulatory or policy reasons. For these reasons, investors may insist either that a minimum level of commitment be obtained or, in the alternative, may agree to invest (but do not permit their capital to be drawn on or management fees to be charged) until the desired minimum fund size has been achieved.

§ 2:2.2 Excessively Large Funds

Excessively large funds also raise investor concerns. Investors may worry that the sponsor does not have the staff necessary to locate and manage the large number of investments required to deploy the fund's capital commitments, or that there will be insufficient attractive opportunities available to the sponsor in the space in which the fund operates. Delay in locating suitable investments is an investor concern because, until investor capital is drawn by a fund, capital that will potentially be required to fund capital commitments must often be held by the investor in shorter-term, low-yielding investments that can be liquidated to satisfy capital calls. While some delay in deploying capital is a necessity and even a desirable attribute of private equity funds (because risk can be increased if all investments of a given fund are made in an unreasonably short time period without adequate diligence), investors do not want to commit more to a manager than the manager will be realistically able to spend, nor do investors want the manager to reach for less attractive investment opportunities to avoid holding undeployed commitments. Investors may also seek an alignment of interests between themselves and the management team, and are sometimes concerned that the management compensation stream from an excessively large fund may be so large that managers are more incentivized to gather assets than to maximize returns on the assets they have already obtained.

§ 2:2.3 Fund Size Caps or Floors

To address the foregoing concerns, some funds offer firm caps or floors on fund size. Many other funds do not include firm caps or floors, but instead articulate a "target" that may be increased or decreased at the manager's discretion. Private equity funds range from small funds of several million dollars to those that invest tens of billions of dollars. There is no one model size for a private equity fund. Each fund differs based on the strategies pursued and the depth of the bench of portfolio managers pursuing them.

Larger fund groups may simultaneously run multiple funds with completely diverse, partially diverse, or overlapping investment management teams and strategies. Often, these funds include different business models. For example, a number of managers who focus on distressed investments operate private equity funds and hedge funds side-by-side. In those cases, investors in the hedge funds have greater liquidity; portfolio positions are accordingly less concentrated and more liquid than in corresponding private equity funds. Recently, a few large managers have begun to explore “permanent capital vehicles” that invest in or alongside private equity funds.

It is important to consider the investor’s objective when considering whether to ask for a cap on fund size and, if so, what size is appropriate. If the goal is to ensure that the core investment team for the fund product is adequately focused on the performance of a manageable amount of assets, it may not matter that the sponsor group has other products run by other management teams. If, on the other hand, the investor is concerned that the strategy will not yield a sufficient number of attractive investment opportunities, other funds run by the sponsor group that have partially or completely overlapping investment objectives will become relevant, as will the question of allocation policies and information flow across these products.

Similarly, when an investor considers whether to require a minimum fund size, it is important to consider what other means the manager has to achieve the desired diversification and size of investments, and, if the particular fund is too small, to incentivize the management team. For example, a small blind pool private equity fund may nonetheless be able to access a diversified pool of attractive investment opportunities if the manager has access to willing co-investors. If the manager is able to charge fees to those co-investors, the management team will have greater incentive to stay at the firm and ensure the performance of these investments than would be the case if the only cash flow came from the small, blind-pool fund.

A manager who has agreed to a firm cap or floor on fund size may renegotiate that number depending on the success (or lack thereof) of the marketing process. In the case of an increase in the fund size cap, investors may require a reduction in management fees if they are concerned that a larger fund size may otherwise make the management compensation stream a disproportionate profit center.

§ 2:3 Investment Programs

Private equity funds utilize a variety of investment strategies, including leveraged buyouts (LBOs), venture capital, real estate, mezzanine debt, distressed investing, and other liquid asset classes.

Private equity funds may have multiple investment strategies, and there are private equity funds of funds that invest in multiple private equity funds.

Within these broad strategy groupings, significant differences exist in the way individual managers may approach investments. Some managers hold highly concentrated positions, while others seek to be diversified across such criteria as number of issuers, types of issuers, geography, and industry. Certain managers may use substantial leverage, while others may use little or no leverage, and some underlying investment classes may have leverage already embedded in them, as is the case in collateralized loan obligations (CLOs). Some managers may engage in relatively rapid purchases and sales of securities, while others hold investments with a longer-term view; and some managers may be actively involved in the operations of portfolio companies, while others rely more heavily on external market forces to generate returns.

Depending on these different approaches, two funds in the same broad strategy grouping may have very different risk/return characteristics and portfolios. For example, a private equity real estate fund that focuses on purchasing and managing mature office buildings with creditworthy tenants is a very different product than a real estate private equity fund focused on developing raw land. Similarly, an activist buyout fund that will engage in hostile proxy fights and tender offers is a very different product than a buyout fund that cooperates with managers of private companies and seeks to bring about operational improvements.

§ 2:3.1 Fund Investment Approach Stated in Offering Memorandum

Accurate articulation of a fund's investment approach in the offering memorandum (and, to a lesser extent, the other governing documents) of a private equity fund is important both to managers and to investors. Investors want fund documents to describe the manager's intended investment approach with sufficient specificity so that they can ensure that the investment approach sold will in fact be followed. Managers also seek this specificity because it protects them later against investor claims in the event that the contemplated investment program results in losses.

On the other hand, an excessively specific investment program can expose the manager to potential liability. It is important to remember that managers who lose money for investors while following the program they have articulated are often not sued, while managers who incur losses in deviating from an expressed program are far more exposed.

The investment program articulated in the offering memorandum of a private equity fund will typically include the following information:

- a description of the types of investments that are expected to comprise the manager's primary portfolio;
- a description of other types of permitted investments;
- an indication of expected concentrations;
- leverage limits, geographic diversification and other relevant portfolio characteristics; and
- a discussion of the manager's approach to selecting, managing, and exiting investments and some indication of the typical time frames over which investments are expected to be held.

When describing a fund investment program, it is important to distinguish between firm guidelines and softer expectations. It is also important to focus on location of restrictions on the investment program. Investment program covenants contained in a fund's limited partnership agreement may require an amendment with investor consent, while descriptions of contemplated investment program characteristics that are limited to the fund's offering memorandum may be less rigidly binding, especially if market conditions change. More commonly, restrictions on investments are contained in the partnership agreement.

Other documents may also contain descriptions of the fund's investment program, including due diligence memoranda, flip books (also called "pitch books"), side letters, and correspondence with investors. It is important for managers (ideally with the advice of counsel) to review these documents for consistency. Investors should also be kept current in the event that a fund investment approach changes from what was originally articulated. Often, this can be done through the periodic letters sent to investors regarding fund performance. However, if the deviation exceeds permitted limits in a fund's operative documents, including, but not limited to, violation of specific investment restrictions contained in the fund's governing documents, then investor consent to an amendment will be needed.

Now that most managers of private equity funds have become registered investment advisers, the SEC, as part of its examination process, can scrutinize the information in the marketing materials of private equity funds, including the descriptions of investment programs, to evaluate whether information provided to investors is misleading. As a result, managers are more focused on ensuring that all materials that could be viewed as advertising or offering materials, including flip books, due diligence questionnaires, and materials made available in data rooms, are reviewed for regulatory compliance, accuracy, and consistency.

§ 2:3.2 Investment Guidelines and Restrictions

Investment guidelines are the binding and nonbinding restrictions that a manager follows in managing a fund's investment strategy. Typical investment guidelines include the following:

- indications of maximum position size (as a percentage of a fund's committed capital);
- restrictions on leverage (potentially including restrictions on recourse or cross-collateralized leverage); and
- prohibition of types of investments investors view as problematic, such as hostile tender offers, investments in raw land, investments in disfavored industries such as alcohol, tobacco, weapons, and gaming, investments outside an agreed geographic region, and investments in situations that contain inherent conflict (such as assets owned outside the fund by the manager, assets purchased from other funds of the manager, and investments in other funds and vehicles that will impose an additional layer of fees).

Investment guidelines also often include restrictions on types of activity that will create adverse tax consequences for particular categories of investors. For example, non-U.S. investors may be concerned about the tax implications of equity investments in U.S. real estate, and the tax implications of activities, such as loan origination, that could constitute a U.S. trade or business. Investors may also be concerned about the possibility that foreign investments will create tax or regulatory issues for them, including a potential loss of limited liability.

When investment guidelines are expressed as restrictive covenants rather than precatory expectations, it is important to focus on the method by which they may be waived or varied. Certain guidelines may be waivable by advisory committee consent, while others may require formal amendments by investors. In some cases, such as the purchase or sale of securities between the fund and the manager, it may be desirable to require that an independent party approve the transaction. In the case of investments that raise potential adverse tax or regulatory consequences, it may be sufficient for the funds to obtain a legal opinion or even informal legal advice addressing the issue.

Often, investors in private equity funds require some level of assurance as to the types of investments that will be allocated exclusively to them versus the types of investments that the manager may share with other funds and managed accounts, or may invest in proprietarily. A restriction on a particular type of investment in one fund may actually assist the manager in allocating certain investments to another product. For example, a manager who runs multiple real estate funds may wish to manage a fund with a global investment

approach, as well as other funds focused on a particular geographic area. In that case, investors can be geographically focused and may insist on receiving priority with respect to all or a portion of the investment in the target geographic location. This is more easily accomplished if those investments are carved out of the permitted investments of the global fund. (Alternatively, both funds may be permitted to make these investments and the investment guidelines may include an indication of the way in which investments appropriate for multiple funds will be allocated among them.)

Although there are certain themes that recur in the investment guidelines of many funds (such as restrictions on transactions that place the manager in a conflict position), there is no uniformity of investment restrictions even among funds with the same general investment program. A smaller fund may not be able to promise the same diversification level as a larger fund would expect to achieve. Some funds may contemplate higher levels of leverage in exchange for riskier, but potentially higher, returns. A restriction on hostile tender offers would not be appropriate for an activist fund that is dedicated to an adversarial approach.

In the course of negotiations, a manager will often be asked to add to or modify initially proposed investment guidelines and restrictions. Sometimes these modifications amount to little more than articulation of detail of the investment approach the manager would follow nonetheless (for example, a request that a manager may not trade in weaponry). In other cases, the request may cut closer to the heart of an investment program (for example, a request that the manager forgo investments that could generate unrelated business taxable income (UBTI) or that involve leverage). In the former case, it may be possible to accommodate the investment restriction through a side letter with the requesting investor. However, this approach should not be followed where the changes to the investment program are likely to be material to other investors. In that case, the restrictions should be disclosed to all investors through the offering materials of the fund. If the issue arises after the fund's initial closing, then it may also be necessary to obtain investor consent.

As a fallback for investors, the fund's partnership agreement may allow an investor to be excused from participating in an investment due to legal, tax, regulatory, policy, or other investment constraints applicable to it.

In addition to articulating what types of investments a fund will make, the fund's offering memorandum should articulate which parties or individuals have investment-making authority. Often, the general partner of the fund will form an investment committee of key professionals that is responsible for making these decisions. The biographies

of these key professionals will be included in the offering memorandum. Sometimes, the fund is managed through a joint venture of multiple parties, in which case that arrangement, and the respective duties of those parties, will be outlined.

The fund's advisory committee is often asked to approve investment decisions that involve a conflict of interest for the sponsor, for example, the purchase or sale of securities to or from the sponsor, or the investment by a successor fund in a predecessor fund's existing portfolio company, or the retention of the sponsor or an affiliate to provide services to a portfolio company. The advisory committee is typically comprised of representatives of select investors, who typically act through a "one person, one vote" methodology.⁶ It should be noted, however, that these representatives will not necessarily be well versed in the evaluation of investment opportunities, and that advisory committee representatives may be unwilling for this reason as well as concerns about potential fiduciary liability to take an overly active role in the investment evaluation process. Therefore, it can be difficult to convince advisory committee members to assume responsibility for the valuation of transactions with the sponsor group or other approvals requiring specialized expertise. To address these concerns in situations in which there will frequently be transactions with the sponsor group, an expert is sometimes retained to act as the independent representative of the investors.

§ 2:4 Life of a Fund

The life cycle of a private equity fund is typically divided into several distinct stages. First, there is an offering period of indeterminate length preceding the first closing. Once the first closing has occurred (which happens when the general partner determines that the minimum amount of investor commitments has been achieved to commence operation), there is an additional offering period, typically twelve months (although recently, as long as eighteen months), during which additional interests in the fund may be sold (in one or more subsequent closings) to new investors. From the first closing until a date typically three to five years following the first (or sometimes following the final) closing, the fund has an "investment" or "commitment" period during which investments in new or existing issuers may be made.⁷ Thereafter, the fund typically has a period of perhaps five to seven years to develop, manage, and harvest investments and may make "follow-on investments," that is, investments in

6. See *infra* section 2:12.

7. Over 53% of funds have an investment period of five years, according to Preqin Ltd., a data provider.

existing issuers of securities held in the fund's portfolio. Once the harvest period has elapsed, the fund will terminate and distribute remaining investments in cash or, possibly, in-kind to its investors.

The appropriate length for each of these stages (aside from the marketing period) will vary depending on the investment program of the fund.⁸ Funds that invest in relatively liquid or rapidly maturing investments, such as funds that focus on the acquisition of distressed securities in the secondary market or the making of mezzanine loans, may find that a shorter investment and holding period is appropriate. By contrast, a fund that develops raw land or invests in private companies in emerging markets will likely have a longer investment horizon. Often, the decision of which time period to select for each stage of the fund's life cycle is dictated in part by marketing considerations, which means evaluating the fund against competitors in the same investment space. It may be easier to market a fund that promises a relatively short investment horizon and overall term, because investors can expect to see a return of their capital sooner. However, if the time allotted to invest and develop investments is too short for the strategy, then sophisticated investors will correctly be dubious. The ideal time for each stage of the fund's life cycle is one which will permit the manager to maximize returns from the underlying investments while balancing the investors' desire to see their capital returned as soon as practicable.

§ 2:4.1 Marketing Period

The marketing of a private equity fund often can be accomplished in a few months, in the case of a successor fund with an existing investor base and a successful performance record, or may take several years, as in the case of many first-time funds. The long, uncertain path between quitting a secure prior job and taking in a private equity fund's first investor dollars can be challenging for a sponsor. During that time period, unless the manager has found someone to provide seed capital, there will be no outside source of cash to pay rents, salaries, travel expenses, and the like. Additionally, there will be no cash to make investments.

[A] First-Time Funds

Typically, first-time entrepreneurial sponsors of a private equity fund attempt to manage their cash flow requirements during the marketing period by delaying hiring all but the most essential core team members and by operating from temporary space or even from

8. Information furnished by Preqin Ltd.

home. The fund's legal counsel, accountants, and placement agents may be asked to wait until the first closing has occurred to receive payment. A "short form" offering memorandum may be prepared to gauge the level of investor interest before the production of more costly long-form documentation. Senior-level employees also may be asked to wait to receive payment, especially if they will ultimately receive equity or profit interests in the general partner and management company. These steps may reduce the economic burden on the first-time fund sponsor. However, these measures do not fully address the fact that the sponsor will earn no income until the fund has held its first closing, unless the sponsor is able to retain his or her prior job during that period (which is often not practicable unless the other form of employment is itself entrepreneurial or the fund is being marketed with the support of the prior employer, for example, in the case of a portfolio manager who will be seeded by the asset manager she is leaving).

In addition, there is a real risk that a first-time fund will fail to attract sufficient investor capital to make it a viable business, or that the portfolio manager will abandon the effort to raise the fund without ever achieving a first closing. In that case, the service providers who have waited to be paid will need to be satisfied from the sponsor's personal resources (albeit possibly at a discounted rate reflecting the failed deal status of the project).

Sometimes, first-time managers are able to attract one or more seed capital providers to reduce these risks. In addition to making a substantial investment in the fund, those providers will typically offer sufficient capital to defray all or a portion of the organizational expenses incurred prior to the fund's first closing, including some level of compensation to the founder, in exchange for a slice of the business going forward. Seed capital providers may consist of financial or strategic investors, possibly including the sponsor's prior employer. Seed capital financing may take the form of a recourse or non-recourse loan, or may be equity that bears the risk that the fund fails to launch.

[B] Development of Fund Terms and Initial Offering Materials

The tasks facing the sponsor during the marketing period may make having another occupation impractical. Service providers such as lawyers, accountants, administrators, placement agents, custodians, and prime brokers must be interviewed and retained. The fund's name must be selected, researched, and reserved. Employees must be interviewed, retained, and documented. Temporary and permanent office space must be found, furniture must be leased, equipment must be obtained, and so forth.

Once counsel has been selected, the sponsor must work with counsel (as well as with placement agents, if applicable) to determine the terms of the proposed fund and to develop initial offering materials. This process can be time-consuming—requiring industry knowledge about the terms of competitors and a determination of the manager’s investment philosophy. If the sponsor has a portable track record, then the process of obtaining and sizing the relevant data can also be time-consuming, which may include clearing the use of confidential information with prior employers and retaining accountants or other experts to convert the data to relevant usable form.

As discussed above, initial indications of interest are often sought from investors using short-form offering materials. These may consist of a fund term sheet, a summary of investment approach and track record, and a short description of risks. Ultimately, however, the fund will require full documentation.⁹ A first-time fund sponsor should expect to spend several months reviewing and refining its documentation. This reality can be hard to balance against the understandable desire to avoid incurring legal fees until investors are in hand.

[C] Warehousing Investments

One issue that managers face during the marketing period is whether it is worthwhile to investigate and possibly even to “warehouse” investments in anticipation of a first closing rather than wait to make the investments once the fund is formed. Warehousing involves the purchase of an investment (usually by an affiliate of a fund in formation) with the expectation that such investment will be transferred to the fund once it is formed. There are pros and cons to both of these approaches.¹⁰

On the plus side, investors often worry that a manager will not be able to deploy capital quickly enough following the first closing, forcing them to wait for capital calls while remaining invested in low-yield, short-term investments. Investors may also wonder whether the manager will be capable of finding sufficient investment opportunities before the fund’s investment period lapses, or whether they will commit to a fund that leaves a portion of their commitments uninvested. By showing investors a pipeline of reviewed investments under active consideration and/or a collection of investments that have already been purchased by the sponsor group with the expectation that they will be transferred to the fund once it closes, a sponsor can allay investor concerns about these issues.

9. See chapter 6, Fund Documentation.

10. See *infra* section 2:23.

On the other hand, it takes time and money to review, negotiate, and make investments. This activity is distracting when the sponsor is simultaneously trying to focus on documenting and raising a fund. Also, it may be difficult to convince counterparties to take a sponsor's interest in potential investment seriously if the sponsor lacks the capital to make a firm commitment, resulting in difficulties developing a dedicated pipeline on which the manager may have exclusive rights.

Even if the manager is able to find sufficient capital to purchase and warehouse investments (perhaps through seed capital, or because the sponsor is institutional and has proprietary capital available), these warehoused investments can sometimes backfire, creating more issues than they were intended to solve. For example, if warehoused investments fare poorly, they will represent discouraging track record information, and investors may be unwilling to buy into the warehoused portfolio at a non-discounted price. On the other hand, if the warehoused investments do well, the manager may be unwilling to part with them at cost plus interest. If warehoused investments are instead sold to the fund at fair value, then that value will need to be verified to investors, which may require an appraisal, especially if significant time has elapsed since the investments were purchased. For this reason, warehoused investments are typically sold at cost to a fund and are not permitted to be purchased by a fund. And of course, if the fund fails to close, or to attract sufficient capital to justify the size of the warehoused portfolio, the sponsor will be forced to retain the warehoused portfolio proprietarily or to resell it (possibly at a discount) in the secondary market.

[D] Closings

A first closing can be held once a manager has identified investors ready to commit sufficient capital to effectuate the fund's investment program. At that point, investors may be asked to begin to meet capital calls for purposes of contributing to pay organizational expenses and management fees and making initial investments.

Once the first closing has occurred, subsequent closings are typically held over a defined period of time (the marketing period) of approximately twelve months (and currently even longer periods of up to eighteen months). The manager would prefer that the marketing period be as long as possible, in order to permit maximum flexibility in raising further capital; however, investors may resist this flexibility because additional investors in the private equity funds typically buy into the existing portfolio at cost plus an interest factor. As a result, existing investors may be unwilling to have their interests in the portfolio diluted once sufficient time has passed for the portfolio to have shifted measurably in value.

Also, once commitments have been made, investors wish the manager to devote its efforts to deals rather than fundraising.

[E] Admission of Subsequent Investors

In private equity funds, subsequent investors are typically treated as if they had essentially borrowed money from first closers to participate in the fund from day one. The method of addressing the admission of subsequent investors to private equity funds differs from the approach followed by hedge and mutual funds, in which new investors buy into funds at a marked-to-market value. Thus, the new investors to a private equity fund pay into the fund their share of the cost of investments made (and expenses paid) by the funds to date, and a corresponding amount is refunded to the existing investors. Additionally, the new investors will pay interest on that amount to the old investors. Finally, the new investors generally will pay a management fee on their own commitments retroactive to the first closing, together with an interest factor payable to the manager. The net intended result of these mechanics is that the new and old investors will participate *pro rata* in all investments and (with the exception of investments already realized prior to the subsequent closing, which are typically not shared) will have the same ratio of committed to uncommitted capital as one another.¹¹

There are imperfections and variations to this approach. A minority of funds exclude new investors from existing investments, or from a subset of existing investments such as those that have been held for a particularly long period of time prior to the subsequent closing or that have otherwise experienced significant events such as realizations or other demonstrated changes in values. Private equity funds may also provide for the possibility of charging a premium to incoming investors with respect to investments that have materially increased in value. (It is more difficult, though not impossible, to convince private equity investors to permit the manager to sell new interests in the fund to incoming investors at a discount to reflect losses.) These alternative approaches may be more equitable in terms of causing investors to buy into investments at fair value; however, they can add significant accounting complexity to the funds.

A minority of funds provide that the interest paid by the incoming investors is payable to the fund rather than to existing investors. This approach slightly benefits the manager because the interest paid will itself count as profits of the funds, potentially resulting in additional carried interest. However, it is intellectually difficult to justify why the

11. For a sample provision that relates to the “catch-up” payments that investors admitted in subsequent closings will make in order to participate *pro rata* in investments already made by the fund, see Appendix L.

incoming investor pays a portion of the interest on its “borrowing” to itself rather than to the investors whose capital has in fact been at risk.

Investors often seek to limit the amount of dilution they can suffer by providing a cap on the size of the funds. Additionally, some investors may negotiate the right to continue to capitalize a fund in subsequent closings so as not to dilute their own percentage interests, which is most typically seen in instances in which an investor faces a regulatory or policy limit on the percentage of the fund it can represent. For example, an investor that is a bank may be limited to holding less than 25% of the total interest in the fund, and a fund may limit the percentage of its aggregate interests that can be held by “benefit plan investors” subject to ERISA. Investors held back by these restrictions may negotiate the rights to add capital as additional third-party funds are raised.

A manager may also have a “dry” closing. A “dry” closing firmly commits investors, but no capital is called until a later date, which may be when a fund reaches a particular size. Commitments may expire if the size target is not met within a set timeframe. Sometimes, investments may be made and only management fees are delayed pending achievement of the size targets.

§ 2:4.2 Investment Period

The “investment period” or “commitment period” of a private equity fund is the period during which the general partner is permitted to make investments on behalf of the fund in newly identified deals (as opposed to “follow-on” investments in existing issuers or projects). The appropriate length of the commitment period will vary depending on the investment strategy of the fund, with a time period of three to five years being typical for many strategies. Sometimes, the manager has the unilateral right to extend the investment period one or two additional years, or such extension may be permitted with the approval of the advisory committee. Often, the fund documents do not provide for such extension, in which case a formal amendment for extension would be required. The approval for such amendments must be carefully evaluated, as certain partnership agreements inadvertently require 100% investor approval for such amendments due to limits on increasing investor “liability.”

During the investment period, the manager may draw down capital to buy investments, and, if the fund partnership agreement permits reinvestment, the manager may use the proceeds from the operation or disposition of investments to purchase additional assets. Often, only the return of a capital portion of disposition proceeds, as opposed to the profit portion, may be reinvested, so that investors do not have amounts at risk in excess of what they originally committed. Other funds permit reinvestment of both capital and profits. (This approach is often used in distressed funds, where the purchase of fixed income

instruments at a discount adds complexity to attempts to distinguish between capital and profits.)

[A] Recall of Capital

Among funds that permit reinvestment, there is a further distinction as to whether distributed capital may be recalled or whether, instead, the manager may only reinvest capital if it does not distribute it first. Recall of capital is resisted by some investors because it denies them the certainty of investing the capital elsewhere. On the other hand, if the manager is forced to retain capital in order to reinvest it, that can create inefficiencies in the short-term investment of that capital. Additionally, if the manager is required to retain uninvested capital in the fund as a reserve for future investments or expenses, this will increase the amount of preferred return to which the investors are entitled. For this reason, managers often prefer to return proceeds as soon as possible with the right to reinvest them later. (Other managers address the issue by providing that the preferred return only runs against capital actually deployed in investments or used to pay expenses, and does not run against cash held by the fund in temporary investments, that is, cash and cash equivalents.) Sometimes, a compromise is reached whereby there are limits on the ability of the manager to recall capital. For example, the manager may be permitted to recall capital only within a set time period after it is distributed, only capital resulting from flipping an existing investment within a short time period (that is, thirteen months or less), or only in the case of a bridge financing that is being replaced with a longer-term investment.

[B] Management Fees and Expenses

During the investment period, the manager of the private equity fund will typically charge management fees based on a percentage of committed capital. Once the commitment period has expired (or, in some cases, at such earlier time as a successor fund has been raised), management fees are typically charged instead on a percentage of capital that remains invested. For jumbo funds, this percentage may be lower than the rate at which management fees were charged during the investment period, while for smaller funds the percentage used does not change.

Less commonly, some funds charge management fees (always or at least after the commitment period) on the cost of investments, and others charge management fees on the net asset value of investments. These formulations can help solve what can otherwise be odd fee results whereby the same investment is subject to different levels of management fees depending on whether it is purchased with capital or with debt.

Most private equity funds permit managers to draw capital for expenses and liabilities that do not relate to the purchase of investments both during and after the expiration of the commitment period. Thus, undrawn commitments will continue to be available to pay such expenses as management fees, operating expenses, indemnity liability, and repayments of credit facilities. A minority of funds require that some or all of these expenses be satisfied exclusively through reserves, or operating and disposition proceeds from investments. While some investors may prefer the comfort that their capital is no longer callable, there is an offsetting cost in that the fund will likely need to hold large reserves invested in low-yielding short-term instruments.

[C] Post-Investment Period Investments

Following the investment period, the manager is typically permitted to make additional investments only in limited circumstances, including follow-on investments necessary or desirable to protect or enhance the value of investments already made, and completion of investments committed to or actively under consideration at the time the commitment period ended. There typically is a cap on the percentage of capital that can be expended on follow-on investments. Also, the fund may be permitted to make investments that were “in process” at the end of the commitment period, so long as they are completed within six months to one year after the investment period. Investments subject to binding obligations may also be made after the investment period. The appropriate cap on the amount of follow-on investments will depend on the nature of the fund’s investment strategy. For example, a fund that engages in real estate development will likely need to make sizable follow-on investments, and a distressed fund may need to continue to invest in the same issuer in order to build a controlling position, while a fund that passively invests in fixed income securities purchased in the secondary market will rarely need to do so. Similarly, depending on the nature of the fund, it may be more or less likely that there are transactions under active negotiation that will take unexpected additional time periods to close. For these reasons, the extent of post-investment period investments may vary substantially across funds.

[D] Investment Period Extensions

If the market for a particular strategy is not strong, the sponsor may seek investor consent to extend the investment period in order to deploy unused capital. Some fund documents permit the general partner to unilaterally impose an initial extension.

§ 2:4.3 Holding Period

Once the investment period has expired, private equity funds are typically permitted to hold investments for an additional time period of perhaps five to seven years in order to harvest their value (the time period is shorter in the case of some strategies including some credit opportunity funds, and longer in the case of funds of funds for which harvest periods will depend on corresponding harvest by underlying portfolio funds). Investments will likely be sold piecemeal throughout this period (and indeed, some investments will be fully realized during the investment period). As described above, additional limited investments are permitted during this stage of the fund life, and the management fee base typically declines as investments are sold.

If unsold investments remain following expiration of the holding period, the manager of the private equity fund may be permitted to extend the fund term for another one to two years, either unilaterally or with advisory committee or investor consents. If that time period is insufficient, remaining assets may be distributed in-kind or, perhaps, placed into a liquidating trust. In any event, after the term of a fund expires, the fund must engage in an orderly liquidation.

In practice, if a private equity fund is successful, it is likely that successor funds will have been formed by the time its investment period elapses. In that case, the new fund will sometimes purchase the unsold investments of the prior funds. This type of arrangement often raises conflict issues, and it is typical to require consent of the advisory committees of both funds, or perhaps even the investors, plus, in some cases, validation through appraisal or other review by third parties, to the terms of the transfer.

Often, investors negotiate that the manager may not distribute illiquid investments in-kind prior to termination of the funds. However, this limitation typically does not apply to liquidating distributions. Investors who are concerned about receiving illiquid assets may negotiate that the manager will use commercially reasonable efforts to sell these assets on their behalf.

§ 2:5 Capital Commitments and Capital Contributions**§ 2:5.1 Capital Commitments**

Investors in private equity funds typically subscribe for their interests in exchange for a promise to make capital contributions to the fund, that is, “capital commitments” that may be drawn by the manager over time. As discussed above, these commitments may be used to purchase investments, or to fund partnership expenses and to cover liabilities, subject to certain limitations.

If an investor fails to fund its capital call when called for, the manager is typically permitted to impose a variety of draconian default remedies.¹² Sometimes, these remedies can only be exercised after an additional notice and opportunity to cure, although a high interest rate may be imposed immediately on the late payment.

§ 2:5.2 Capital Contributions

The portion of the capital commitment of an investor that has been funded is referred to as that investor's "capital contributions." Typically, capital contributions are made in proportion to each investor's undrawn capital commitment to the fund. This is to ensure that, to the extent possible, investors participate proportionally in each investment and liability of the fund.

Often, this perfect proportionality is not achievable for various reasons. For example, if certain investors are paying lower fees or are not paying management fees at all, and management fees are being paid from (rather than in addition to) capital commitments, the undrawn capital commitments of the investors receiving such waivers will become higher, over time, than the undrawn capital commitments of investors paying full fees. Similarly, if an investor is excused from making a particular investment for tax, regulatory, or other reasons, the ratio of drawn to undrawn capital commitments will be thrown out of whack.

Sometimes, a private equity fund may provide that capital will be drawn from investors based on their total capital commitments rather than their unused capital commitments. In that case, to the extent that there are investors who have received fee waivers or have been excused from investments, a portion of their capital commitments will never be used.

§ 2:5.3 General Partner Commitment

Typically, a general partner of a private equity fund will make a capital commitment to the fund that will be drawn at the same time and for the same reasons as capital is drawn from investors. In order to ensure that the general partner is treated as a true partner for tax purposes, a certain minimum capital commitment is recommended. For marketing reasons, the sponsor group will typically be expected to contribute a larger aggregate commitment than that recommended for tax purposes, either as a general partner or through the purchase of investor interests.

12. See *infra* section 2:5.6.

[A] Incremental Liability Exposure

In theory, there is some incremental liability exposure for the portion of the general partner's capital commitments that is made as a general partner rather than as a limited partner. This is the case because, in the event that the fund becomes insolvent, the general partner has liability for its obligations. Under most circumstances, this liability exposure is unlikely to have practical consequences, because the fund itself will have sufficient assets to satisfy its obligations and will have indemnified the general partner and its principals for liabilities in the absence of their gross (or sometimes ordinary) negligence, and funds also often obtain insurance. Therefore, most liabilities will be covered by other sources and will not reach the general partner absent the general partner's own misconduct (in which case the sponsors may have liability regardless of whether they invested as general partners or investors, because the liability in question may reach them personally for the misconduct they committed). Nonetheless, the general partner could have incremental liability exposure if, for example, the liability were to arise or become known only after the fund had dissolved and distributed assets, as might be the case if there was a breach of a representation made in connection with a sale by the fund of assets. Additionally, the general partner could have liability for its misconduct even though such conduct related to actions by certain of the owners of the general partner, in which case the remaining owners could have exposure they would not otherwise have. For all of these reasons, sponsors often choose to make the bulk of their capital contributions to the fund as limited partners, and ensure that the general partner entity is a shell that does not have other assets and associated businesses. In most cases, a new general partner entity also will be created for each successor fund, to shield the carry streams from one fund to exposure to the possible failure of another.

[B] Sponsor Commitments

Another issue that arises in connection with general partner commitments is whether, for marketing purposes, investors will accept a sponsor commitment that includes contributions from other funds (for example, funds of funds) managed by the sponsors. Some investors resist the inclusion on the grounds that their goal in requiring a minimum sponsor commitment is to ensure that the sponsor has an alignment of interests with the investors, a goal which may not be equally obtained if third-party money is used to satisfy the contribution obligation.

By contrast, it is typically viewed as acceptable and even as desirable that a portion of the sponsor commitments come from other employees who will be actively involved in managing the funds. If those

employees are not eligible to invest in the fund directly, parallel vehicles may be built to accommodate them.¹³

The founding partners or institutional sponsor may extend loans to lesser employees to enable them to meet their capital contribution obligations to the fund. These arrangements can be accompanied by vesting and forfeiture provisions that increase the “golden handcuffs” to which these employees are subject. For example, loans extended for the purpose of meeting capital contribution obligations may become recourse in the event that an employee is a “bad leaver” and be non-recourse otherwise.¹⁴

§ 2:5.4 Drawdowns and Notices

[A] Draw Period

Private equity funds typically provide that investors must fund their unused capital commitments in increments on a specified number of days’ prior notice as demanded by the general partner. For many funds, funding is required within ten business or calendar days, and significant default penalties are imposed if an investor fails to meet its obligation.

Sometimes, a shorter draw period may be mandated in emergency situations, such as when an investor has defaulted or opted out of an investment for regulatory reasons, and other investors are required to fund the shortfall. Similarly, a fund may provide for a shorter draw period if a capital call request must be revised upward to address the fact that an investment requires a slightly larger contribution amount than was initially anticipated.

For most institutional investors, agreeing to fund on relatively short notice is not problematic. However, these mechanics can be less manageable if the fund is comprised of high-net-worth individuals (or fund of funds with investors who are individuals), where individuals could be on vacation or otherwise unavailable when the capital call notice arrives. In that instance, some funds may agree to provide for longer notice, or may draw capital down in tranches of a certain minimum size. Alternatively, investors may be given the option or be required to have capital available from a ready source such as an escrow account or a prime brokerage account at the fund sponsor. These types of arrangements are most common in funds of funds managed by institutional sponsors that already manage brokerage accounts for their investors.

13. See chapter 3, Organizational Options for Funds and Their Sponsors.

14. See chapter 4, Ownership and Compensation Arrangements for Fund Sponsors.

[B] Capital Call Notice

Investors also sometimes negotiate the amount of their capital commitment that can be drawn within a particular period. These limits can enable investors to manage their own cash flow timing expectations.

In general, the capital call notice issued by a private equity fund sponsor will include an indication of the use to which the proceeds will be put. If the proceeds are needed for an investment, that investment will be described and investors will often be given the opportunity to be excused from investments that create particular tax or regulatory issues for them.

It should be noted that certain types of strategy do not lend themselves to this approach. For example, a private equity fund that follows a distressed investing strategy may take “toehold” positions in a public company and may not wish to disclose the identity of those investments in connection with the capital call. Additionally, this type of fund will likely want to draw capital in advance of investments in order to have a pool of trading capital available to take advantage of opportunities (often in the public markets) immediately as they arise. Related issues will arise in any other type of fund that follows a hybrid strategy in which a portion of the investment may be made in the public markets. Similarly, a private equity fund of funds may be designed to draw capital in tranches to cover contemplated capital calls from underlying funds, because neither the sponsor nor investors will wish to address a new capital call every time an underlying fund asks for money, and because, in order to meet the deadline for capital contributions at the underlying fund level, the fund of funds would otherwise need to impose a shorter deadline on its own investors.

Typically, private equity funds include a provision that prohibits third-party beneficiaries from relying on the obligation of partners to fund their capital commitments. This provision can be an important protection to investors if issues arise with creditors of the funds. However, if a fund obtains a credit line at the fund (as opposed to portfolio company) level, it is common for the lender to seek assurance that it can enforce the obligation of partners to make capital contributions. These lender protections may include the rights to step into the general partner’s shoes in demanding capital contributions, as well as a pledge of the investors’ interests in the partnership.

[C] Capital Contribution Notice

Capital contribution notices are typically given through the same mechanism in which notices are given by the partnership generally. Some investors may request additional notice protection, such as email confirmation for sending copies of capital call notices to additional

parties such as counsel. In any case, fund documents often provide that an investor can not be treated as a defaulting partner by virtue of failure to make capital contributions unless a further notice of that default has been given with a short opportunity to cure.

§ 2:5.5 Minimum Commitment

Private equity sponsors typically set a minimum capital commitment that they will accept from fund investors, while reserving the right to waive that minimum in their discretion. In large part, the setting of a minimum capital commitment level is a marketing decision intended to indicate to prospective investors the level of capital contribution a sponsor is likely to accept. If the fund is oversubscribed, this minimum is likely to be rigidly observed with the exception of employees, friends, and family. In funds that are more needy for capital, additional exceptions are likely.

For funds managed by registered investment advisers whose investors are “qualified purchasers,” the minimum commitment requirements do not have regulatory significance. Instead, investor suitability will depend on the investor’s overall net worth, aggregate level of financial investments, and sophistication.¹⁵ If a fund is domiciled outside the United States, there may be regulatory reasons for a non-waivable minimum investment size in order to avoid incremental regulation, which, for example, is the case in the Cayman Islands (where the relevant minimum investment size is \$100,000).

From a back-office standpoint, a manager would typically prefer to have a few large investors rather than dealing with the administrative burdens imposed by a larger number of smaller investors, each of whom must receive financial statements, tax reports, capital call notices, and the like. On the other hand, larger investors can impose their own issues, because they are likely to have more bargaining power and the inclination to renegotiate fund terms. Additionally, if a fund is held in a few hands, it is more likely that dissatisfied investors can take action such as removing the general partner or terminating the commitment period. Larger investors can also sometimes create additional regulatory burdens depending on the nature of underlying investments.

Many managers attempt to identify one or a few “lead” investors with whom to negotiate a fund’s document, and to convince smaller investors to accept the results. This approach can save time and money, especially if the lead investors are sophisticated and are identified early enough in the process.

15. See chapter 8, Securities Act of 1933, and chapter 9, Investment Company Act of 1940.

As mentioned above, the minimum capital commitment requirements will typically be waived for lesser employees. Similarly, smaller capital commitments may be acceptable from other investors who add perceived strategic value to the fund.

§ 2:5.6 Defaults on Capital Contributions

[A] Remedies

In the event that an investor defaults in its capital contribution obligations, private equity funds typically offer the general partner broad flexibility in choosing from a laundry list of remedies. Delaware law (and the laws of many other jurisdictions) permits a fund to impose as stringent a remedy as complete forfeiture of a defaulting partner's interests, if desired. Many funds provide for this possibility, while others choose a lesser but still potentially punitive forfeiture level (for example, forfeiture of 50%). However, under Cayman law, remedies cannot be punitive.

Other remedies typically include the following:

- the ability to draw additional capital from non-defaulting investors,
- the right to charge high interest on late payments,
- the right to force a sale of the defaulting partner's interest at a price determined by the general partner,
- the right to continue to charge losses and expenses to the defaulting partners while cutting off their interest in future profits, and
- the right to take any other action permitted at law or in equity.

The goal of these onerous and flexible provisions is to maximize the chances that the general partner will be able to enforce capital contribution obligations or, if that is not successful, to be able to replace the lost capital with capital from other investors or third-party sources to allow the fund to successfully pursue its investment program. Often, the best remedy in a given situation will be highly fact-specific. For example, if an investor is unable to meet its capital contribution obligations, remedies involving the sale of that partner's interest at a discount or the acquisition of additional capital from other investors will be more effective than certain other remedies. On the other hand, a solvent investor who has become disenchanted with the fund's investment program and is trying to avoid making payments will be disincentivized from this approach by the fact that the manager can haircut or eliminate their interest in existing investments and still hold them liable for their contribution obligations.

Similarly, high interest rates for late payments and the forfeiture of voting rights can discourage solvent investors from refusing to fund.

Remedies involving forfeiture of an investor's existing interest in the fund generally become more effective as the fund becomes more substantially invested, and do not in themselves provide incentive against default if little capital has been spent. In these circumstances, the ability to sue to enforce continuing capital contribution obligations is essential.

In the general partnership context, the Delaware case of *Hindman v. Salt Pond Associates*¹⁶ determined that if a partner failed to make an additional capital contribution within ninety days from the date it was approved, such partner's interests would be transferred to the partnership and the defaulting partner would forfeit all rights as a partner, including the right to future income from the partnership. The court, confronting the issue of whether forfeiture provisions contravened public policy, indicated that deference would be given to the intent of contracting parties, holding that if the partnership agreement provided for a forfeiture provision, courts should enforce such provision as a form of liquidated damages.

There is relatively little case law on defaults in the private equity funds context. As a result, it is not clear when and whether a court would find that a general partner's use of one remedy forecloses the possibility of the imposition of additional, subsequent remedies. Common sense would suggest that some remedies cannot be used in tandem (for example, if damages are sought as a remedy, they would presumably be reduced by the amount of a partner's interest in the fund that had been forfeited). However, there is little clear guidance in this area. Regardless, it would be prudent for private equity sponsors to include forfeiture provisions in partnership agreements.

[B] Defaulting Partner's Interest

Another area in which there is less guidance than would be desirable is the question of whether amounts salvaged in respect of a defaulting partner's interest should be shared with that partner or belong instead to remaining partners in the partnership. For example, if a partner's interest in the partnership is forfeited and then resold to a new investor, should the proceeds from that resale be shared with the defaulting partner? Delaware law suggests that no fiduciary duty is owed to the defaulting partner, and a general partner does (to the extent not contractually waived) owe fiduciary duties to non-defaulting partners, which might suggest that the payment made by the transferee belongs to non-defaulting partners only. Nonetheless, sponsors

16. *Hindman v. Salt Pond Assocs.*, C.A. No. 1536, 1992 WL 396304 (Del. Ch. Dec. 21, 1992), *aff'd*, 633 A.2d 370 (Del. 1993).

faced with this issue sometimes choose to share a portion of the windfall with the defaulting partner, particularly where the default occurs because of hardship rather than willful renunciation.

In practice, if a fund is doing well, there will likely be willing buyers of a defaulting partner's interest, and a partner who expects to be unwilling or unable to fund future capital calls will be able to reach out to the fund sponsor for help in finding a transferee before the default occurs. That transferee may well be an existing investor in the fund, because existing investors are already familiar with the fund and do not have to engage in diligence to make the additional purchase, or may be an investor the sponsor has been cultivating but who has been unable to gain access to the fund because it was already closed or oversubscribed. Alternatively, the buyer may be one of the small number of prominent secondary buyers who seek opportunities in this area, in which case it is likely that the buyer will expect to pay a discounted price but a less significant discount than the levels of forfeiture imposed on the fund's defaulting investors.

[C] Investor Default Due to Loss of Confidence in Fund Sponsor

The issue of defaulting investors is of more significance where investors generally have lost confidence in the ability of the general partner to manage the fund or in the values of existing investments (or where general economic conditions have made capital-raising difficult), because in those instances it will be more difficult for the manager to replace the lost capital. Sometimes, the presence of a growing number of defaulting investors can itself indicate that investors have lost confidence in the general partner. In that case, investors may wish to exercise remedies, if available to them, such as voting to terminate the investment period, replace the manager, or require dissolution of the funds.¹⁷ Some investors provide in their side letters that the general partner must notify them of defaults by other investors. Absent such a provision, it is not clear whether the general partner has a duty to do so.

Typically, one of the remedies available to the general partner in the event of a default by an investor is that the defaulting investor will lose voting rights, so decisions such as those relating to termination of the manager and the length of investment period, among others, will be made by investors not currently in default. In extreme situations, there are delicate timing issues regarding whether investors have succeeded in removing the manager and rescinding capital calls, or whether, instead, their failure to fund capital calls by the controversial

17. See *infra* section 2:15.2.

manager is itself a default that eliminates their voting rights. These situations may arise where the manager is seeking capital contributions from investors to fund indemnity payments for misconduct of the manager and the investors wish to replace the manager, or where investors are being asked to make additional contributions into a fund that they believe has been the victim of manager fraud.

[D] Consequences of Investor Default

The extent of the damage suffered by a fund due to defaulting investors will often depend on the fund's strategy. For a private equity fund of funds (assuming it has not been able to put a revolving credit facility in place to avoid this result), the consequence of investor defaults could be that the fund is unable to meet its capital call obligations to underlying funds, which could result in imposition of forfeiture remedies against the fund of funds by the underlying fund sponsor. To avoid this outcome, a fund of funds may be forced to sell its underlying fund holdings in the secondary market, potentially at a discount and likely involving sale of the more attractive of its investments. (Many funds of funds seek to limit the exercise of default remedies by an underlying portfolio fund so that only the portion of the fund of fund's interest in the underlying fund that corresponds to the departing investor at the fund of funds level is affected. That cost is then passed on to the departing investor only.) For a buyout fund, the immediate consequence of an investor default may be that the fund is in default under its purchase agreement with respect to a particular asset, and the longer-term consequences may be that the fund has insufficient assets to achieve the diversification of its portfolio and payment of fund expenses. Funds that have an existing credit line or that permit additional draws from other partners on short notice will be better able to avoid short-term adverse consequences of a default. Where there is no immediate crisis, negotiations with the defaulting investor may continue for a significant period of time, raising the issue of whether and when to notify other investors that a default situation is ongoing. Typically, private equity fund documents do not include a specific obligation to notify remaining investors that a default has occurred, but such notification could be advisable if the default has become material to the fund.

[E] Trends in Investor Defaults

Limited partner default rates vary depending on economic conditions. For example, defaults on making capital contributions became more prevalent during the global financial crisis of 2008. While historically the safeguards afforded by accredited investor and/or qualified purchaser representations provided comfort that limited

partners would have the fiscal fortitude to meet capital calls, the global financial crisis of 2008 weakened this assumption. Furthermore, institutions often rely on distributions from funds in which they were already invested to fund new capital commitments. During the financial crisis, these distributions slowed, which adversely impacted the ability of some limited partners to meet capital calls. This dynamic led some investors to try to obtain relief from existing funding obligations. In some cases, these attempts rose to the level of threatening funding default.

Defaults result in penalties on the investor, and may create the impression that a fund is in distress. During periods of economic distress, sponsors may be more willing to make accommodations to address an investor's financial plight. However, under general principles of duties owed to limited partners, the general partner may be concerned about the implications of failing to impose default remedies absent a justifiable business reason that is in the best interest of the partnership. This duty becomes particularly significant when financial pressures make it likely that multiple investors will request relief from their capital commitments.

General partners of funds rarely sue their investors for defaults on capital calls, as lawsuits are viewed as an extreme step in lieu of exercising remedies in the partnership agreements. Nevertheless, investors should not assume that they will be able to walk away from a private equity fund.

§ 2:5.7 Transfers

The better and more common means to address an investor's goal of reducing its capital contributions to a fund is for the investor to transfer all or a portion of its investment. Of course, this assumes that there are buyers available to pay acceptable prices to sellers. Buyers could be existing investors in the fund or other strategic investors. General partners (or their affiliates) may find themselves as the buyers of interests in their own funds. Their decision to buy could be one of desperation, but could also reflect the general partner's confidence in its own fund. General partners should consider whether they are establishing a precedent, that is, whether buying out one investor will lead other investors to look to the general partner to buy out their limited partner interests. Absent an express duty to do so, one would not expect investors to have the right to require the general partner to purchase their interests as well. The general partner should arrange to have the selling investor acknowledge that the general partner (or its affiliate buyer) may not be paying the actual value of the interest being transferred, and the general partner may have information about the fund and its investments that the selling investor does not possess.

The buyer of the interest would, at a minimum, be required to assume the transferring investor's unfunded commitment (or portion thereof being transferred). Sponsors may assist in finding buyers, but rarely take on liability (such as making representations to a buyer) in order to effect a transfer. In such situations, the purchase price of the interest is rarely correlative with the actual value of the interest, as the seller is in a less-than-optimal bargaining position. Typically, the buyer pays some discounted amount of the seller's capital account, although when the value of the portfolio is in great question, or the position of commitments already drawn is small, buyers are known to pay nothing for the existing portfolio investments. The question arises whether the general partner has a fiduciary duty to the fund to offer the defaulting limited partner's interest to the other limited partners. While the authors feel that it is unlikely that such a duty exists absent specific rights of first offer or first refusal in the partnership agreement, it is worthwhile for general partners to consider the issue as a business relations matter, if not a legal one.

During the financial crisis, a number of investors approached general partners requesting that their capital commitment to the private equity fund be reduced simply due to the investor's financial duress. Under Delaware limited partnership laws, the general partner has the right to permit such a reduction only if the general partner is given such authority in the fund's partnership agreement or if all partners consent to such reduction.¹⁸ Most private equity fund partnership agreements do not give the general partner the discretion to allow a limited partner to reduce its capital commitment. Therefore, it may be necessary to amend the partnership agreement to permit such reduction. This is more likely to be pursued when a relatively large investor makes such a request.

The consent needed to amend a partnership agreement to allow for commitments to be reduced is the subject of the case *In re LJM2 Co-Investment, L.P.*,¹⁹ and an amendment to the Delaware limited partnership law in response to the holding of that case. In *In re LJM2 Co-Investment, L.P.*, the court found that, because the limited partnership agreement did not expressly provide for the amendment of provisions related to the contribution obligation of a partner, the default rule of unanimous consent should be deemed part of the partnership agreement and, due to the operation of a provision of the partnership agreement that required amendments to be approved by the particular vote required for the relevant investor action

18. DEL. CODE ANN. tit. 6, § 17-502(b)(1).

19. *In re LJM2 Co-Investment, L.P.*, 866 A.2d 762 (Del. Ch. 2004).

(a “supermajority amendment provision”),²⁰ any amendment related to the contribution obligation of a partner requires unanimous consent. In response to the decision of *In re LJM2 Co-Investment, L.P.*, the Delaware limited partnership law was amended to clarify that, unless otherwise provided in a partnership agreement, a supermajority amendment provision applies only to provisions expressly included in the agreement (not default rules in the Delaware limited partnership law).²¹

In some cases, the limited partner may not have the cash available to fund a drawdown, but there are also examples of “soft defaults,” that is, where limited partners who have the capacity to meet their capital calls choose not to do so. Limited partners may refuse to fund capital calls for a variety of reasons, including their opinion that the general partner is not making appropriate investment decisions or that the current state of the market is not optimal for such investments. Other investors may cite the general partner’s past conduct in investing as a rationale for refusing to fund a capital call.

The effectiveness of limited partner mutiny is mixed. In considering a response, it is important for general partners to balance the long-term goals of retaining investors for their future funds, as well as the short-term goals of profiting from their investments. Wanting to keep the good will of investors is understandable, and necessary, to raise future funds, but that is not a valid reason to disregard the best interests of existing non-defaulting investors (as discussed above)—it is not permissible to forgive commitments under Delaware law assuming that other investors object.

Fiduciary duties must be considered when taking action that has the de facto effect of reducing commitments, such as assuring investors that no new investments will be made even though the investment period has not ended by its terms. The general partner must determine that it is in the best interest of the partnership to take this type of action. For example, determining that it is unlikely that the general partner will be able to identify investments at the pace or volume originally intended for the fund’s operations would likely be an acceptable reason. General partners must reconcile appeasing their investors while believing in

20. The amended Delaware Revised Uniform Limited Partnership Act section 17-302(f) defines a “supermajority amendment provision” as “any amendment provision . . . requiring that an amendment to a provision . . . be adopted by no less than the vote or consent required to take action under such latter provision.” For example, if a section of a partnership agreement reads that “75% in interest of the limited partners must consent to any investment in a non-U.S. company,” then 75% in interest of the limited partners would be required to consent to an amendment to such clause.

21. DEL. CODE ANN. tit. 6, § 17-302(f).

their ability to make appropriate investment decisions for the fund. General partners sometimes will agree to stop making new investments if a large investor or a group of investors representing a large share of the fund refuse to fund the capital calls.

Another concern facing general partners with regard to default is the possibility of limited partners filing for bankruptcy. The bankruptcy of a limited partner will make the implementation of default remedies and transfers more difficult, due to the automatic stay against exercising creditor rights against an insolvent counterparty. One issue presented in these situations is whether the investor itself is bankrupt, or whether it is an affiliate of the investor who is insolvent. For example, bankruptcy of the general partner of an investor that is a fund of funds does not in itself provide relief for the investor.

§ 2:5.8 Follow-On and Pending Investments

Following the commitment period of a private equity fund, the general partner is typically not permitted to make additional capital calls for new investments (meaning an investment or project in which the fund had not previously invested). However, an exception is often made for “follow-on investments” and for investments that are in process (including investments that a fund has obligated itself to make), but not yet closed, when the commitment period ends.

[A] Follow-On Investments

Follow-on investments are investments that are necessary to protect the value of, or to enhance, an existing investment. For example, a real estate private equity fund might need to make repairs and capital improvements to existing properties. A buyout fund or venture capital fund might need to add capital to an underlying portfolio company to support the company’s growth. A debt fund might need to make an additional loan to an existing borrower experiencing a cash-flow crisis. A distressed or activist fund might need to add capital to an existing toehold position in an attempt to gain control over an issuer or a creditors’ committee. These types of investments are generally permitted throughout the life of the fund, notwithstanding that the commitment period has otherwise ended.

Private equity fund documents often restrict the aggregate amounts of capital that can be expended on follow-on investments once the commitment period has elapsed. This limit is intended to avoid a situation where follow-on investments are so large compared to the initial investment that, in essence, they constitute new investments rather than a necessary enhancement of an existing portfolio position. A cap of 10%–25% of remaining commitments is a common limitation, but a higher cap may be appropriate if the strategy is likely to

involve significant and unpredictable follow-ons. For example, a venture capital fund is more likely to need more follow-on capital than a mezzanine fund.

Sometimes private equity fund documents permit the advisory committee to waive the cap on follow-on investments if viewed as justified in a particular case. If this provision is not included in the fund documents, waiver would be achievable only through amendment, typically requiring investor consent.

[B] Pending Investments

Private equity fund documents almost always permit the manager to complete investments that were in process as the commitment period ended. There is some play in the precise language used for this, such as whether the investment must already be subject to a binding contract, or whether a nonbinding letter of intent or active negotiations will suffice. Additionally, there is frequently an outside date of perhaps a few months to one year during which these pending investments must be completed. As with the size cap on follow-on investments, the time period for completion of pending investments may be extendable by the advisory committee, or an investor vote, to amend the fund documents, may be required.

[C] Drawing Capital for Follow-On and Pending Investments

Often, the limitations on follow-on investments and pending investments relate only to the general partner's right to call capital from investors and not to the general partner's right to engage in these activities using already available capital (such as proceeds from investments permitted to be invested). As a result, the general partner can plan for anticipated follow-on investments and completion of pending deals by drawing down capital and reserving it before the commitment period ends. This resolution has a price, however, because the holding of large reserves will depress the fund's reported performance (an important issue when developing a track record for subsequent funds) and may also result in lower carry to the general partner as a result of the need to pay higher preferred returns to investors. For these reasons, managers generally prefer to avoid holding large reserves inside their funds.

A minority of funds do not permit any draws of capital to be made after the investment period, even with respect to expenses and liabilities. Instead, fund documents require that these obligations be satisfied through reserves or through recycling of operating income and disposition proceeds. This type of restriction is obviously unfavorable to the manager, for the reasons articulated above. Its feasibility will also depend on the timing of expected cash from investments.

Cash flow from operating assets and from dispositions will generally be available to satisfy fund expenses and liabilities, and many funds do not cap the portion of such cash flow that can be used for follow-on investments. For certain types of funds, such as debt funds or real estate funds that operate mature properties, cash flows are significant and predictable through the fund's life cycle. For most strategies, however, the vast bulk of income will be achieved only upon disposition of assets toward the end of the fund's term. As a result, it is important to the manager to have the flexibility to call capital even after the commitment period has ended.

§ 2:5.9 Recall and Reinvestment; Limited Partner Clawback

[A] Reinvestment and Recall of Capital

Many private equity funds permit the manager to reinvest and/or recall previously drawn capital under a variety of circumstances. Those circumstances may include any of the following:

1. Recall of capital contributions drawn down for an expected investment or expense item, but ultimately not needed for that purpose and returned to investors (often required to be returned by a set time such as a requirement that amounts be returned within forty-five days of the date drawn);
2. Recall of capital contributions returned to existing investors in connection with the admission of new investors to the fund at a subsequent closing;
3. Reinvestment of capital drawn for an investment that is sold during the investment period (sometimes with additional restrictions, including the requirement that the investment be sold within a year or two of its purchase, that the investment be a bridge investment intended to be replaced with a more permanent investment in the same issuer, or that the sold investment achieve its target minimum level of return);
4. Reinvestment of the capital and profit component achieved on existing investments in order to allow the fund to invest a stated percentage of commitments (such as 100%–115% of commitments); or
5. Recall of amounts previously distributed to the investors to satisfy the fund's indemnity obligations and, sometimes, other fund liabilities and expenses ("limited partner clawback").

Provisions regarding reinvestment and recall of capital are often the subject of extensive negotiation between the manager and investors,

although their interests are not completely misaligned. Investors often have several goals in minimizing the general partner's rights to reinvest capital, including ensuring that the amount they have at risk in the fund does not exceed the amount they originally allocated to it, and discouraging premature dispositions of investments. Investors are often even more sensitive to the possibility of recalling capital distributions previously made to them, because this practice raises the issue that they will be forced to continue to manage their own investments in low-return liquid assets held outside the fund with the goal of having cash available for future potential capital calls. Provisions that permit recall of capital also enable the manager to avoid incurring additional preferred return obligations by instead recycling capital quickly to and from investors.

Reinvestment of profits (as opposed to reinvestment of return of capital) is sometimes permitted, but this practice raises certain accounting complexities in connection with the fund's distribution waterfall. Since the reinvested amounts will include the general partner's carried interest, the general partner's interest in assets purchased with reinvested carry will be larger than its capital percentage in the partnership as a whole. Similar distortion will occur for any investor paying reduced or no carry and/or management fees.

Some investors view reinvestment as desirable because it ensures that the manager will continue to actively manage capital throughout the investment period even if early investments have been quickly recouped. From their point of view, they have committed to have the services of the manager for the term of the funds, and reinvestment increases the amount of services they will receive. Similarly, investors may become comfortable with recall of capital as an alternative to having money reserved by the general partner for future cash needs and locked up in low-returning short-term investments at the fund level.

If a fund permits reinvestment, the disposition proceeds to be reinvested should nonetheless run through the fund's distribution waterfall and be allocated between the general partner and the investors. Occasionally, the strategy of the private equity fund is such that it is not practical to make this calculation every time an investment is sold, such as in the case of a distressed fund or another fund actively trading on a daily basis in the public market. In that case, the fund documentation may provide for a grouping of these investments and a periodic true-up, but the ultimate economic results should be the same as if calculations were made contemporaneously on an investment-by-investment basis.

[B] Limited Partner Clawback

A limited partner clawback is a mechanism whereby distributions previously made to limited partners can be recalled by the general

partner to satisfy indemnification claims against the general partner and its affiliates or, sometimes, other liabilities of the fund. Not all private equity funds include a limited partner clawback, and fund sponsors that seek to include this provision often find that details of the clawback are heavily negotiated. This provision is particularly difficult to introduce in successor funds. Issues at stake include the following:

- whether all or merely a portion of the distributions received by investors are subject to recall;
- how long after those distributions are made may they be recalled (this issue is sometimes tied to the date on which the distribution was made, while other funds permit recall until a period of years after fund dissolution);
- whether the general partner must return a portion of its carried interest alongside a recall from investors; and
- whether the recall is limited to the purpose of satisfying the fund's indemnity obligations to the general partner and its affiliates, or is more broadly available to satisfy fund liabilities, even where the fund has other assets available to pay them.

The importance of a limited partner clawback will vary depending on the investment purpose of the fund. Buyout funds and real estate funds are particularly sensitive to this issue, because there is a real possibility that the representations made to buyers of the fund's assets toward the end of its life cycle will result in liability exposure later. Funds of private equity funds also are likely to need a limited partner clawback in order to satisfy their corresponding obligations to underlying funds. Funds that make loans are less likely to have late-breaking liabilities, and this issue may accordingly be less significant for them.

If a fund sponsor is unable to obtain a sufficient limited partner clawback, it may be forced to create significant reserves, potentially continuing even after the fund is already dissolved. For this reason, it can be in the best interest of investors as well as the manager to ensure that the possibility of clawback is allowed for.

Certain investors (notably governmental entities and some pension plans) have statutory or policy restrictions on their ability to agree to clawback provisions. Where this is the case, it may be necessary to rely instead on reserves.

§ 2:6 Closings

§ 2:6.1 Initial Closing; Offering Period

Private equity funds typically hold an initial closing once they have raised the minimum amount they view as necessary to conduct their

investment program, and hold one or more subsequent closings over a set time period (often somewhere between six and eighteen months) thereafter as necessary to achieve their maximum desired size. The outside date for subsequent closing is important to investors, because the assets of a private equity fund are typically not readily marked to market. As a result, new investors will dilute existing investors in the unknown and unrealized appreciation of existing investments. This is an acceptable risk during the early months of the fund, when investments may not even have been made and in any case typically will not have shown demonstrable returns. After a while, however, dilution by new investors creates an unacceptable free look in their favor. As a result, it is necessary either to end the offering period or, less commonly, to exclude new investors from existing investments or to charge them on a mark-to-market basis for embedded appreciation.

§ 2:7 Distributions

§ 2:7.1 Timing of Distributions

Private equity funds typically distribute net cash flow as received, subject to reduction for expenses and reserves. Often, a distinction is made between disposition proceeds, which are distributed promptly upon receipt subject to potential reinvestment,²² and recurring current income such as interest, dividends, loan coupon repayments, rental receipts, and the like, which may be bundled and distributed on a periodic (often quarterly) basis.

The relative amounts and timing of current income and disposition proceeds will vary depending upon the investment strategy of the fund. Funds such as debt funds, real estate funds managing mature properties, and funds holding significantly more liquid assets will likely have relatively large amounts of current income to distribute over the life of the fund. Leveraged buyout and venture capital funds, as well as real estate funds involved in property development, will likely pursue a buy and hold strategy—generating little current income. When considering the appropriate provisions regarding timing of distributions and calculation of the carried interest distributable to the general partner,²³ it is important to be sensitive to these timing differences.

§ 2:7.2 Distributions In-Kind

In general, private equity funds make distributions prior to liquidation in cash. However, sponsors reserve the right to make distributions

22. See *supra* section 2:5.8[A].

23. See *infra* section 2:8.1.

in-kind (for example, to distribute securities and other assets to investors). Typically, investors negotiate restrictions on the ability of the general partner to make in-kind distributions. Those restrictions will likely include (1) a prohibition against making in-kind distributions of non-marketable securities or other assets prior to fund dissolution; (2) a requirement that any in-kind distributions be made *pro rata* among investors and the general partner; and (3) a requirement that in-kind distributions (especially of non-marketable securities) be subject to some form of valuation review, either as a matter of course or upon the demand of the advisory committee or investors.

[A] Marketable Securities

The definition of what constitutes a marketable security varies among funds and is the subject of negotiation. Issues include:

- whether the security in question must be listed on a U.S. stock exchange or whether an international exchange is acceptable;
- whether FINRAAQ listing or active over-the-counter markets are sufficient;
- whether the security in question must be free of all trading restrictions, including volume restrictions under Rule 144A of the Securities Act,²⁴ and
- whether a certain minimum level of trading volume must have been achieved.

In posing these restrictions, investors' goals are to ensure that they do not receive assets that will be difficult for them to liquidate, and that the assets distributed have been fairly valued. The latter is an especially important concern because the claimed value of the distributed securities and assets form the basis of the carried interest allocation owed to the general partner.

Some funds provide that the price set for marketable securities distributed in-kind must take into account the trading price of those securities for a period (for example, ten days) following their distribution to investors. This mechanism helps protect investors against the risk that they will receive large volumes of a given (thinly traded) security and, through their own actions in liquidating it, incur losses not reflected in the price at which securities were valued upon their distribution by the fund.

24. Securities Act of 1933, 48 Stat. 74 (May 27, 1933) (codified at 15 U.S.C. § 77a).

[B] Tax Advantages of Distributions In-Kind

Distributions in-kind can be advantageous to taxable U.S. investors if they wish to continue to hold the security distributed. In that case, they may be able to avoid the earlier recognition of gain that would occur if the fund sold the security and distributed the proceeds. Often, the general partner is itself comprised of taxable U.S. individuals who may wish to achieve this benefit. In that case, the general partner may choose to receive securities in-kind even if investors would prefer to receive a distribution in cash.

[C] Sale of Securities Instead of Distributions In-Kind

Often, certain investors negotiate for the right to require the general partner to sell securities for them rather than delivering a distribution in-kind, particularly where they would otherwise face regulatory restrictions against holding the security directly. For example, a benefit plan investor subject to ERISA may be unable to hold certain assets directly because of “prohibited transaction” restrictions; a bank holding company investor may be unable to directly hold securities of banks; direct holding of securities of companies in different tax jurisdictions may impose tax liability in those jurisdictions; and so forth. If this type of provision is included for particular investors rather than for the benefit of investors in the fund as a whole, the cost of liquidating the securities will likely be borne by the investors requesting this accommodation.

[D] Residual Assets

Upon liquidation of the fund, it is no longer realistic to restrict distributions to marketable securities, because the possibility exists that the fund will still hold various illiquid assets that it has been unwilling or unable to sell. Fund documents typically permit the general partner to distribute illiquid assets at that point, subject to investors’ right to request a sale on their behalf as described above. In practice, whatever the fund documentation provides, decisions regarding the treatment of residual assets lingering upon expiration of the fund’s otherwise scheduled term are made on an *ad hoc* basis considering the nature and size of the assets involved, the level of continuing management they will require, and the best interests of investors. Residual assets may be: (1) distributed in-kind directly or through participations; (2) deposited into a liquidating trust; (3) sold (typically with advisory committee or investor approval because of the conflict involved) to a successor fund run by the sponsor or even to the sponsor itself; or (4) held even after the fund’s scheduled term, if the fund term may be

extended (perhaps with a modification or elimination of compensation going forward) for the period necessary to bring these residual assets to maturity. Sometimes, the approach followed may vary across investors, as some investors seek to manage their share of residual assets directly while others need the continued assistance of the manager.

If residual assets are to be managed by the sponsor in some form, reserves for associated expenses will likely be held back from distribution proceeds on the fund liquidation.

§ 2:7.3 Tax Distributions

Most private equity funds include a provision that allows the fund to make tax distributions either to all partners or, depending in part on the carried interest structure,²⁵ just to the general partner. Tax distributions are intended to cover the amount by which the tax liability of the relevant partner resulting from the partnership's activities exceeds the cash distributions made to them during or shortly after the same period. Typically, tax distribution provisions just allow the general partner to distribute amounts attributable to tax liabilities as a result of the carry and nothing more.

Tax distributions can be especially important in funds that generate "phantom income," that is, tax liabilities that are not linked to sales of an asset and resulting receipts of sales proceeds. The types of investment programs that generate this issue go beyond the scope of this book, and should be addressed with tax practitioners when structuring the relevant fund. Tax distributions are also important for general partners of funds that have back-end-loaded carry, because profits on realized investments will be paid to the limited partners to repay capital still invested in unrealized deals, yet the general partner will owe taxes currently on the share of those profits expected to be distributable as carry at the end of the fund.

Tax-exempt and non-U.S. investors often constitute the majority of a private equity fund's investor base and do not typically require tax distributions. Even taxable U.S. investors who are wealthy and have multiple sources of taxable gains and losses to offset may not be sensitive to phantom income. Therefore, even where tax distributions are to be made to all partners, it is typically the general partner and its equity owners who want them most.

If tax distributions are made to the general partner only, they are typically treated as an advance against future carried interest distributions to the general partner and will reduce those distributions. Accordingly, upon liquidation of the fund, tax distributions previously made

25. See *infra* section 2:8.1.

will factor into the clawback payment potentially due from the general partner.²⁶

If the fund's investment strategy will generate significant phantom income, investors may negotiate to limit the ability of the general partner to draw capital from investors to make tax distributions to the general partner. Instead, they may require that a tax distribution be made only from operating income of the partnership.

§ 2:7.4 Tax Withholding

Private equity partnership documentation typically includes provisions addressing the possibility that the general partner will be required to withhold a portion of the distributions otherwise payable to certain partners to address tax withholding obligations. For example, a U.S.-domiciled fund may be required to withhold tax against non-U.S. partners. Similar issues may arise in other tax jurisdictions or with respect to the activities of a U.S.-domiciled partnership in other jurisdictions. Partners will typically also be asked to indemnify the fund and the general partner if, by virtue of their misrepresentations, the requisite withholding is not made, and fund documentation generally provides that amounts withheld with respect to a partner will be deemed distributed to such partner.

Sometimes, investors may be eligible to receive refunds of some of the amounts withheld, and fund documentation may include provisions requiring the general partner to offer reasonable assistance in obtaining any available tax refund.

Certain provisions of the Hiring Incentives to Restore Employment Act (the "HIRE Act"),²⁷ generally referred to as FATCA (the "Foreign Account Tax Compliance Act"), were enacted to enforce reporting on U.S. persons investing through non-U.S. investment vehicles (including certain holding companies formed in connection with or availed of by a fund). In order to avoid a U.S. withholding tax of 30% on certain payments (including payments of gross proceeds) made with respect to certain actual and deemed U.S. investments, certain non-U.S. investment vehicles will generally be required to timely register with the Internal Revenue Service and agree to identify, and report information with respect to, certain direct and indirect U.S. account holders (including debtholders and equityholders). A non-U.S. investor in such non-U.S. investment vehicle will generally be required to provide to such non-U.S. investment vehicle information that identifies its direct and indirect U.S. ownership. A non-U.S. investor that is a "foreign

26. See *infra* section 2:8.1[G].

27. Pub L. No. 111-147, 124 Stat. 71 (2010).

financial institution” within the meaning of section 1471(d)(4) of the Code will generally also be required to timely register with the Internal Revenue Service and agree to identify, and report information with respect to, certain of its own direct and indirect U.S. account holders (including debtholders and equityholders). A non-U.S. investor who fails to provide such information to such non-U.S. investment vehicle, or timely register and agree to identify, and report information with respect to, such account holders (as applicable); may be subject to the 30% withholding tax with respect to its share of any such payments attributable to actual and deemed U.S. investments of such non-U.S. investment vehicle. Further, U.S. investment vehicles may be required to withhold on certain payments made unless they have the appropriate information from their investors. The types of investors and investment vehicles that may be subject to these rules is beyond the scope of this book, and should be addressed with tax practitioners when investing in or structuring such investment vehicles.

§ 2:8 Fees and Allocations

§ 2:8.1 Carried Interest

[A] Overview

The amount, timing, and calculation methodology of the carried interest payable (or allocable and distributable, in the case of allocations in funds structured as partnerships for U.S. tax purposes) to the general partner of a private equity fund is one of the most complex and significant issues presented by private equity fund documentation. Almost all elements of this calculation are subject to individual negotiation, and the appropriate resolution of the issues presented will vary based on, among other things, the following:

- the relative bargaining strength of the investor and manager;
- the investment strategy of the fund; the fund’s expected returns; market conditions at the time the fund is raised;
- whether the fund is a first-time or successor fund;
- whether the sponsor group consists of not yet wealthy individuals who want to receive carried interest payments quickly to support their lifestyles, or established sponsor groups and institutions that are less sensitive to the timing of cash flows; and
- the trade-off against other economic issues such as the level of management fee and sharing arrangements regarding transaction and other economic benefits.

For these reasons, it is impossible to summarize all the possible carry structures. However, in the remainder of this section we will attempt to address typical structures.

[B] Deal-by-Deal Carry

When private equity funds were first structured, the typical compensation structure was “deal-by-deal.” In this structure, the general partner received carry (typically at the rate of 20% of profits subject to variation as discussed below) on profitable deals without regard to losses on unsuccessful deals.

This structure is uncommon today in “blind pool” funds, in which the manager retains discretion over the selection of investments, because it is viewed as an overly manager-favorable term that does not align the interests of the manager and investors, and instead encourages the manager to gamble on risky investments knowing that potential gains on the winning deals will outweigh its exposure to losses. To the extent that the concept of pure “deal-by-deal” carry is still current, it is typically seen only in “club” funds (or “pledge” funds) that permit investors to individually veto particular deals or to decide whether they will participate in a particular deal.

[C] Deal-by-Deal with Loss Carryforward

The more common version of deal-by-deal carry that appears in contemporary funds involves two modifications over the earlier pure deal-by-deal structure. First, carry is calculated taking into consideration any previously realized losses on deals that have been disposed of, and any “write-offs” and “write-downs” (that is, permanent impairments of value) experienced by assets not yet sold. Second, to the extent that there are losses on subsequent deals after carry has been taken on earlier dispositions, the general partner must return the excess through a payment known as a “clawback.”²⁸

Unlike the earlier version of deal-by-deal carry, this modified approach does not permit the general partner to receive carry on winning deals while avoiding recoupment of losses to investors on losing deals. However, if losing deals are sold after winning deals have been the subject of disposition, it is possible that the general partner will receive carry on the early deals and not be obligated to restore the windfall until the dissolution of the fund.

Private equity funds typically offer investors a preferred return on their investment capital, followed by a “catch up” to the general partner, then followed by a carry split on profits going forward. Each

28. See *infra* section 2:8.1[G].

of these terms is negotiable. Below is an example of a “plain vanilla” deal-by-deal distribution waterfall with loss carryforward under current market conditions.

Example 2-1 Modified Deal-By-Deal Waterfall

Net available cash flow will first be divided among the partners based on their respective Percentage Interests (that is, how much each of them contributed) in the relevant investment (or, if such net available cash flow does not relate to any investments, then based on their respective Percentage Interests, that is, their overall capital commitments, in the Partnership). The share of such net cash flow apportioned to the general partner will be distributed to the general partner. Each investor’s share of such net available cash flow will then be further divided and distributed as between each investor and the general partner as follows:

- (i) first (or sometimes second—see below), to the investor until the investor has received a return of its invested capital in the investments to which such distribution relates, if any, plus its unreturned invested capital in any prior investments that have been the subject of dispositions, plus any write-downs, plus the allocable share of the investor’s unrecouped expenses relating thereto;
 - (ii) second (or sometimes first), to the investor until the investor has received a cumulative compounded rate of return of [8 to 10 percent, typically] percent on the amounts distributed under clause (i) above [the “hurdle” or “preferred return”];
 - (iii) third, [50% to 100%, typically] to the general partner and the remainder to the investor [if the “catch-up” is less than 100% to the general partner] until the amount distributed to the general partner pursuant to this clause (iii) equals [20%] of the amount distributed to the general partner and the investor pursuant to clause (ii) above and this clause (iii) [the “catch-up”]; and
 - (iv) thereafter, [20%] to the general partner and [80%] to the investor.
-

[C][1] Principal Issues and Variations

There are many issues embedded in this formulation, each of which may be the subject of intensive negotiation, and which may have significant effects on the overall economic splits between the general partner and the investors. The principal issues and variations include the following:

- (1) *Whether the preferential return precedes or follows the return of capital in the waterfall.* If the preferred return is paid after the capital is returned, there will be a compounding of preferred return on preferred return, resulting in a higher overall preferred return to the investors.
- (2) *Whether (and if so, how frequently) the preferred return is compounded.* It typically is compounded.
- (3) *Whether the preferred return is payable on all amounts expended by the investors or whether preferred return is only paid on amounts invested in investments.* Some funds do not pay preferred return on fund-related expenses. Some funds pay preferred return on investment-related expenses but not on non-investment-related expenses such as organizational and offering costs and fund overhead. Most funds pay preferred return on all expenses.
- (4) *How expenses are allocated across investments for waterfall purposes.* Some fund waterfalls require that investors recoup their share of all expenses incurred through the date of the distribution. Often, however, expenses are instead allocated across the fund's investments using a formula that spreads expenses accrued to date across investments made to date. To appreciate the impact of such a formula, consider the following example:

Example 2-2

- (i) The private equity fund has made five investments, each of which costs \$20.
- (ii) In year three, the fund has paid management fees and other non-investment-related expenses aggregating \$5.
- (iii) The fund sells one of its investments for \$25.

If no expense allocation formula is used, the investor will be entitled to receive a return of the \$20 cost basis of the sold investments plus a full \$5 of non-investment-related expenses, and the manager will receive nothing. By contrast, under the typical allocation formula, the \$5 of accrued expenses would be allocated *pro rata* across the five deals made to date by the fund, in which case the investor would only be entitled to receive a return of \$1 of expenses in connection with this distribution. Similarly, the preferred return due to the investor would be based on \$21 rather than \$25 of expended capital. As a result, the general partner would receive some carry at this point.

- (iv) In year four, the fund has incurred an additional \$2 of management fees and non-investment-related expenses.
- (v) The fund sells a second investment for \$25.

If no expense allocation formula is used, the investor will be entitled to receive a return of the \$20 cost basis of the sold investment plus the remaining \$2 of newly accrued expenses, together with the preferred return on these amounts, after which the general partner will receive carry.

Under the typical expense allocation formula, by contrast, the investor would still be owed \$4 of unrecouped expenses from prior periods plus the newly accrued \$2 of additional expense, for a total of \$6 of expenses to be spread across four remaining investments. Thus, \$1.50 of expense would need to be recouped in connection with the disposition of the second investment.

Assuming that expenses continue to accrue throughout the life of the fund while investments stop being made after the first few years, the effect of the typical expense allocation formula is to push the largest portion of expenses toward the deals that are sold last. This formulation enables the general partner to receive carry on early dispositions notwithstanding that a portion of the fund's expenses have been borne and not yet recouped by investors.

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- (5) *The level of general partner catch-up.* Most private equity funds permit the general partner to “catch up” on the preferred return distributions made to investors. The consequence of this arrangement is that, for example, if the carried interest level is ultimately 20% of profits, then the general partner will receive a special allocation of more than 20% of profits until it has caught up with respect to amounts allocated to the investors, that is,

until it has received 20% of the total profit distributed. Depending on the level of catch-up, the general partner will achieve its goal of receiving 20% of fund profits at different breakpoints.

Example 2-3

For example, if the preferred return payable to investors is 8% and the general partner receives 100% of the next profits as a catch-up, then the general partner will be fully caught up once the fund has achieved a 10% rate of return. At that point, the general partner will have received 20% of the total profits. By contrast, if the catch-up percentage is only 50%, then, after the investors receive their 8% preferred return, the next 2% of return will be split 50/50 between the general partner and the investors, in which case, at a 10% rate of return, the general partner will have received only 10% of total profits. In order for the general partner to fully catch up to a 20% profit level in a 50% catch-up scenario, the fund would need to earn in excess of a 12% rate of return.

Drafting Tip: The catch-up should be calculated including both the preferred return paid to investors and the catch-up distributions being made to the general partner. Otherwise, the general partner will never fully catch up.

A minority of private equity funds offer the general partner no catch-up at all. In that case, the general partner never truly achieves a 20% profit share.

- (6) *Whether there are multiple hurdles.* Some private equity funds provide for more complicated waterfalls with multiple levels of breakpoints and catch-ups. For example, during the venture capital boom of the early 1990s, it was not uncommon for a general partner to receive as much as a 30% carry on incremental profits once the rate of return on the fund as a whole exceeded a benchmark. At the other end of the spectrum, some sponsors of startup funds may be forced to offer a lower-than-20% carry rate unless certain minimum profit thresholds have been achieved.
- (7) *The time period for which capital is determined to be outstanding for purposes of calculating the preferred return.* Some private equity funds accrue preferred return on all capital that has not yet been returned to investors. Others may adopt

conventions that limit the preferred return to a return on amounts truly at risk in those funds, in which case preferred return does not accrue on capital that has been drawn down until it has actually been invested or expended, and similarly, preferred return does not accrue during the period between the time the fund receives disposition proceeds from an investment and the time those proceeds are distributed to investors.

- (8) *Whether there is a separate waterfall for current income as opposed to disposition proceeds.* Some private equity fund strategies generate significant amounts of current income. For example, a real estate fund with mature operating properties will generate significant rental income. A fund holding fixed income instruments may receive significant interest payments. In some cases, the fund's documents may permit the general partner to take carry on these current income amounts without first applying the amounts toward repayments of the cost basis of the investment to which they relate and/or on the recouped cost basis of other deals. This type of current income waterfall can increase the speed at which the general partner receives carry.
- (9) *Treatment of short-term investment proceeds.* Private equity funds can expect to earn some level of return on capital held in bank accounts or other short-term investments pending use for portfolio investment and expenses. Earnings on short-term investments typically do not bear carry, unless they are generated from proceeds on dispositions on investments. If temporary income is not run through the carry waterfall, amounts held as temporary investments should not accrue preferred return and vice versa.
- (10) *Write-downs.* Investors typically require that general partners treat assets that have suffered a permanent impairment of value as if they have been partially or fully disposed of for purposes of carry calculation. Otherwise, a general partner could avoid recognizing a loss until a clawback payment is due on dissolution of the funds. There is significant variation in the way write-down language is crafted. Issues include whether it is within the general partner's sole discretion to determine the write-down amounts or whether the investors and/or the advisory committee can become involved in the process; whether unrealized gains can be offset against unrealized losses; whether partial write-downs or only full write-offs trigger the provision; and whether investors can require third-party appraisals or other similar valuation mechanics to verify values.

- (11) *Coverage ratio requirements.* The general partner of a private equity fund is typically required to agree to a “clawback” whereby the general partner refunds to the investors the excess of the carried interest received over the carried interest it would have received if the profitability of the fund portfolio were considered on an aggregate basis capped at the amount of carried interest received less taxes on such amount.²⁹ Often, the clawback occurs only at the end of the life of the fund, but more frequently, investors require clawbacks on an interim basis. Sometimes, however, investors may insist that the general partner reduce or delay receipt of carry during the life of the fund to the extent that valuation calculations made on the portfolio remaining to be sold do not provide adequate assurance to investors that a clawback will not be required. The amounts foregone by the general partner may be placed into an escrow to secure the clawback or may be paid as accelerated distributions to the investors.

Drafting Tip: When crafting interim clawback provisions, it is important to ensure that you do not inadvertently create the possibility that excess distributions will be made to the investors, as they typically do not face a clawback obligation for this in favor of the general partner.

[D] Back-End-Loaded Carry

Some private equity funds do not permit the general partner to receive carry as individual deals are disposed of, but rather require that the investors receive a return of their full invested capital in the fund, plus their full preferred return, before the general partner receives any carry at all. A basic example of this formulation follows.

Example 2-4

Net available cash flow will first be divided among the Partners based on their respective Percentage Interests in the relevant investment (or, if such net available cash flow does not relate to any investments, then based on their respective Percentage Interests in the Partnership). Each investor’s share of such net

29. See *infra* section 2:8.1[G].

available cash flow will then be further divided as between such investor and the general partner as follows:

- (i) first [or sometimes second—see below], to the investor until the investor has received, on a cumulative basis, an amount equal to such investor's aggregated capital contributions to the partnership;
 - (ii) second [or sometimes first], to the investor until the investor has received an [internal rate of return] [cumulative compounded rate of return] of [8 to 10 percent, typically] thereon [the "hurdle" or "preferred return"];
 - (iii) [third, [50% to 100%, typically] to the general partner and the remainder to the investor until the amount allocated to the general partner pursuant to this clause (iii) equals [20%] of the amount allocated to the general partner and the investor pursuant to clause (ii) and this clause (iii) [the "catch-up"]]; and
 - (iv) thereafter, [20%] to the general partner and [80%] to the investor.
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[D][1] Delay in Receipt of Carry

A back-end-loaded carry formulation substantially delays the receipt of carry by the general partner. Assuming that the private equity fund expects to make multiple investments during its investment period, and to hold most or all of them for a period of years thereafter, the general partner may well have to wait until the tail end of the life of the fund to receive any carry.

The exact length of this delay depends on the strategy and term of the fund. For example, a fund that invests in distressed securities or secondary market income securities may have a relatively short investment period and holding period, while a conventional buyout, venture capital, or real estate fund may have an investment horizon of more than a decade.

[D][2] Advantages to Investor

The back-end-loaded carry arrangement is more favorable to investors and, as a result, is most commonly seen in first-time funds or other funds where capital-raising is difficult. Even managers that once commanded a deal-by-deal waterfall may find it necessary to revert to a back-ended waterfall in a difficult fundraising environment. This arrangement solves a number of problems investors otherwise face, including the following:

- greatly reducing the possibility that the general partner will receive excessive carry that must later be recouped through clawback, and reducing the need to rely on escrow or personnel guarantees to support the clawback payment;
- reducing the possibility that the general partner will delay recognition of unrealized losses by procrastinating in disposing of losing investments;
- obviating any need to value assets and determine write-downs;
- avoiding the need to determine which amounts constitute disposition proceeds as opposed to current income (an issue which can become complex in the context, for example, of distressed income instruments); and
- avoiding the need to determine how to allocate fund expenses across investments.

[D][3] Advantages to Fund Sponsor

Back-ended carry arrangements can also offer some advantages to fund sponsors. First, if the general partner is otherwise planning to share the carried interest with individual employees, who will in turn be obligated to fund their share of clawback liabilities,³⁰ then the general partner may find it necessary in any case to escrow much of the carried interest the employees will receive to ensure that they can fund their share of the clawback. Such escrow arrangements may also be desirable for purposes of enforcing non-competes and discouraging employee turnover. Employees often forfeit all or a portion of the carried interest if they voluntarily quit or violate employee covenants.³¹ Assuming that carry will be in an escrow account rather than being available to employees for their personal use, the earlier receipt of carry offered by a modified deal-by-deal carried structure is not necessarily doing the sponsor much good. The escrow will likely be held in safe, short-term investments that do not yield a significant return. For sponsors in this situation, the back-end-loaded carry structure may impose little real cost.

Sometimes, investors can be persuaded to forgo a clawback requirement if the fund has a back-end-loaded carry structure. Foregoing the clawback, however, is not free of risk because it is possible for a fund to return all invested capital and then lose capital subsequently on reinvestment, or to invest fully, return a portion of the capital while

30. See chapter 4, Ownership and Compensation Arrangements for Fund Sponsors.

31. *Id.*

subsequently investing, and then lose the remainder later. These risks are relatively small compared to the risk that a clawback will be required in a modified deal-by-deal carry structure, especially if the general partner is not permitted to distribute carry to itself until the investment period has expired. If investors will agree to forego the right to clawback, the back-end-loaded carry structure may actually enable the manager to distribute carry sooner to its employees.

The general partner may also be glad to avoid the need to document write-downs, distinguish between current income versus disposition proceeds, and analyze the appropriate allocation of expenses across investments. Overall, the back-end-loaded carry structure simplifies fund accounting.

Finally, to the extent that the general partner intends to report rates of return achieved by investors (as opposed to overall rates of return achieved by the fund) for purposes of track record presentation when marketing subsequent funds, the back-end-loaded carry structure can improve performance numbers.

[D][4] Special Tax Distributions to General Partners

General partners who offer back-end-loaded carry structures typically rely on a special tax distribution to themselves to cover the “phantom income” produced by these arrangements, assuming that the general partner group is comprised of U.S. taxpayers. “Phantom income” results from the fact that, in a back-end-loaded carry structure, amounts that constitute income and gains for U.S. income tax purposes get diverted to repay the unrecouped cost basis of the investors. Since the general partner will ultimately be entitled to its carry share of income and gains, for tax purposes the general partner allocated (and will owe tax on) these amounts, but the investors will receive the cash. To correct this mismatch, a special tax distribution is made to the general partner to cover the resulting tax liability of the general partner and its owners. The tax distribution is treated as an advance against future amounts of carry otherwise distributable to the general partner.

Tax distributions may not be necessary if the sponsor is not a U.S. taxpayer, or if the sponsor is an institution that does not face cash flow issues as a result of the receipt of phantom income tax liability.

[E] Hybrid Carry Arrangements

Some private equity funds may utilize distribution waterfalls that constitute a hybrid between the deal-by-deal and back-end-loaded models. For example, a private equity fund may generally use a back-end-loaded carry model, but permit advances of carry in the event that certain asset coverage tests are met based on expected sales proceeds from the remainder of the portfolio.

[F] Waivers and Reductions of Carry

Typically, the general partner does not bear carry on its own investment in a fund, and similarly, employees and partners of the sponsor group are typically exempt from carry. Exceptions do exist, however, including where the sponsor group is comprised of multiple joint venture partners or where the sponsor institution has agreed to pay carry to the employees running the portfolio.

From the general partner's point of view, it is preferable to preserve maximum flexibility to waive or reduce carry for any investor. Many offering documents do contain this level of flexibility. However, some general partners find that reserving a broad power to modify carry results in additional negotiations with investors who may view the compensation terms described in the offering documents as aspirational rather than definitive. As a result, some general partners choose to limit their rights to waive or reduce carry for a limited list of investors such as the general partner and its affiliates.

Investors who seek "most favored nation" rights through side letters will typically seek to receive the benefits of any compensation waivers or reductions given to other investors (or, at least, those given to other investors of their same or smaller size).³² In this context, it is important to carve out categories of investors, such as affiliates of the sponsor group, employees, and strategic investors, whose more favorable compensation terms will not trigger a most favored nation right.

Sometimes, larger investors are able to negotiate a reduced level of carry or management fee. These arrangements may apply to the full amount of the large investor's commitment, or only to the portion of the commitment that exceeds a set threshold.

Sometimes, a compensation reduction threshold is instead set for the fund as a whole, and all investors receive the benefits of a reduced compensation level to the extent that the fund size exceeds a specified amount. These types of arrangements reflect investors' awareness that if a fund is large, then compensation is more likely to be a profit center. Sometimes the reduction in compensation above a set level is conceded by a sponsor in the course of marketing in exchange for waivers by investors of the insistence on a previously set fund size cap.

In addition to offering reduced compensation levels to large investors, sponsors may attract large investors by offering them a slice of the general partner and/or management company, permitting them to participate in a portion of the compensation generated by other investors. This type of arrangement typically is not captured by a standard "most favored nation" clause, which addresses concessions at the fund level only. However, admitting an investor to the sponsor's

32. See *infra* section 2:19.3[A].

upper-tier entities raises a number of additional issues, including fiduciary concerns and possible adverse tax consequences (for example, a tax-exempt investor may find that participating in management fees constitutes UBTI; additionally, admitting a corporate investor to an upper-tier entity can force that entity to follow the accrual method rather than the cash method of accounting).

Compensation reductions can also raise issues in connection with placement arrangements. Sometimes, a placement agent agrees to accept a set percentage of the compensation earned by the manager, but in other cases, the placement agent insists on receiving a set absolute percentage of monies raised. If the latter approach is followed, the manager may be forced to unilaterally bear the burden of any compensation reductions. (Capital commitments of the sponsor group and its affiliates are typically excluded from the base on which placement fees are calculated, so this issue arises more frequently in the context of unaffiliated third-party investors.) A related issue is whether the placement agent can require a sponsor to accept capital commitments from investors who are eligible to receive compensation reductions.

[G] General Partner Clawback

As discussed above, any performance compensation arrangement that permits the general partner to take a slice of profits before dissolution of the funds raises the possibility that the general partner will, as a result of vagaries of timing, receive more carry than the general partner would be entitled to receive if the profits and losses of the fund were instead distributed on an aggregate basis. This inequity can result from many possible scenarios, including:

- early sale of profitable investments followed by delayed recognition of losses generated by unprofitable investments;
- reinvestment of the proceeds of successful investments followed by subsequent loss of that reinvested capital;
- build-up of expenses in the fund's later years, including management fees, follow-on investment expenses and expenses relating to the operation of existing investments or the fund itself;
- unexpected liabilities such as claims made by buyers of fund assets or other types of claims for which the sponsor group is entitled to be indemnified; and
- a slow-down in the profitability of the fund in later years so that, even if losses are not incurred, the preferred return owed to investors builds and the ultimate level of return achieved by the fund is not sufficient to entitle the sponsor group to receive full carry.

These issues are particularly acute in a fund that utilizes a modified deal-by-deal carry arrangement,³³ and are comparatively remote in a fund that follows a back-end-loaded carry model³⁴ requiring investors to receive all of their capital plus their preferred return before the general partner begins to take carry. However, the theoretical risk that the general partner will have received excess carry exists even in back-end-loaded carry funds.

Investors typically address this risk by requiring that the general partner agree to “claw back” excess profits and return them to the fund (and through the fund to its investors) based on a “true-up” calculation made upon dissolution and windup of the fund (or, in some cases, also calculated and paid at periodic intervals during the fund’s life—this latter concept being known as “interim clawback”).

Issues raised by clawback provisions include (1) how the clawback is calculated; (2) when the clawback is payable; (3) who is liable for repayments of the clawback; (4) what deductions may be taken in calculating the clawback; and (5) what security is given to ensure repayment. We will consider each of these issues in turn.

[G][1] Calculation of the Clawback

There are a number of possible variations to the phrasing of a clawback obligation.³⁵ In general, a comprehensive clawback provision will include two concepts, with the investor receiving the benefits of whichever of the two concepts yields the larger clawback:

- (i) To the extent that the investor has not received all of its capital plus preferred return, the general partner must return the full carry (subject to a cap as discussed below); and
- (ii) To the extent that the general partner has received a larger percentage of the carried interest than its ultimate carry percentage would justify, the general partner must return the excess (again subject to a cap as discussed below).

Some funds include only a single prong of the clawback calculation. However, this can short-change the investor. To see the issues, it is easiest to work through an example.

33. See *supra* section 2:8.1[C].

34. See *supra* section 2:8.1[D].

35. Some samples are included in Appendix L.

Example 2-5 Clawback Calculation

Assume the fund has a modified deal-by-deal carry structure in which the investor receives its invested capital on the sold deals plus an 8% preferred return, after which the general partner receives 100% catch-up on next profits and 20% of profits as a carried interest going forward. Assume that, due to early sales of profitable deals, the general partner received 25% of the aggregate profits of the fund, but the investor was paid enough to return its capital plus preferred return. In this scenario, the second prong of the carried interest clawback calculation would kick in, requiring a general partner to return carry so that it had received 20%, rather than 25%, of aggregate profits.

In this same scenario, assume the general partner received only 18% of the aggregate profits of the fund, but the fund generated only a 6% return overall, and as a result, the investor did not receive its full preferred return. In that case, the first prong of the clawback calculation would require the general partner to return the full amount of the carried interest it received, notwithstanding that it had not taken more than 20% of the profits.

Rather than spelling out these two prongs, some fund documents provide looser language to the effect that the general partner will be required to return carry to the extent that it has received more carry than it would be entitled to receive if all investments of the funds had been sold on a single date. This language is generally understood to achieve the same result, but the spelling out of the two prongs can offer more precise guidance to the people charged with calculating the carry, and avoid confusion (which can be clarified with additional language) over the timing of assumed capital contributions and distributions for purposes of calculating the preferred return.

Sometimes the looser formulation will be necessary, particularly where the distribution waterfall is more complex than that described above. For example, if the waterfall provides for increasing levels of carry as various return thresholds are achieved, with catch-up in some cases and perhaps not in others, it can become extremely complex to draft a clawback provision using the prong method. In that case, broader language along the lines of the prior paragraph may be preferable. Alternatively, some funds simply attempt to use the clawback to bring the parties into parity for the first portion of their

waterfall and do not attempt to resolve for all possible inequity. For example, if the fund provides for terms along the lines of those described above, but further provides that the general partner's carry may be increased to 25% if the fund has achieved an aggregate internal rate of return (IRR) of 20%, the clawback may be based on a 25% carry level without including the IRR condition. In that case, it is possible that the general partner may be permitted to keep carry taken at a 25% level even if subsequent losses mean that the 20% IRR has not been achieved.

[G][2] When the Clawback Is Payable

Typically, clawback is calculated and payable only upon dissolution and winding up of the fund. At that point, all cash flows are theoretically known and it is possible to bring the parties into their equitable positions through a single calculation and adjustment.

It is now common for investors to insist that they should not wait until the end of the fund's winding up to receive a clawback payment, particularly if they have significant concern over the general partner's ability to repay the clawback obligation. In many cases, investors now require that interim clawback payments be made, based on analysis of cash flows to date and the expected recoveries on the remainder of the portfolio. Occasionally, investors may require the general partner to delay withdrawing carry in the first place until it is clear that no clawback will be due (typically at the end of the investment period).

Even where the clawback is calculated upon liquidation of the fund, there is some risk that a later adjustment may need to be made if the fund incurs subsequent liabilities relating to, for example, breach of representations made to counterparties on sold deals or other events that cause the general partner to have the right to seek indemnification. Where fund documents provide for investors to satisfy such a clawback, fund documents typically provide that the general partner must return a corresponding portion of its carry so that the aggregate clawback is equitable.

[G][3] Who Is Liable for Repayments of the Clawback

Typically, the general partner of a private equity fund is a special-purpose entity that does not have other material assets in excess of its right to receive carry from the fund. As a result, investors generally expect to see some additional assurance that the clawback obligation will be funded.

Early private equity funds tended to address this issue by providing elaborate escrow formulations that required the general partner to hold portions of its carry aside based on various asset coverage tests. The idea of these formulations was to permit the general partner to

withdraw some carry on a current basis, while making it unlikely that the escrow would be insufficient to cover the general partner's ultimate clawback liability under reasonable investment assumptions. Often, these provisions permitted the general partner to withdraw carry assuming that, even if the remainder of the portfolio were sold at a moderate discount to cost, no clawback liability would be incurred.

These types of formulae are still sometimes seen, and they may exist within the general partner in respect of the rights of owners of the general partner to withdraw carry even where similar escrow provisions are not in place at the fund level. However, most current private equity funds rely on personal undertakings from the upstream owners of the general partner instead of (or sometimes in addition to) these types of escrow provisions.

Many fund managers (especially in the venture area) include a provision in the fund's partnership agreement that allows (or requires) the general partner to forego distributions of the carried interest in order to manage overall distributions in a manner that will not result in any clawback obligation. These provisions allow the general partner to defer distributions of carried interest until such time as the general partner has greater confidence that its portfolio will be profitable.

From the investor's perspective, personal undertakings have the advantage of providing direct recourse against the ultimate recipients of the fund's carried interest and offering the greatest chance of recovery. The general partner is normally a special purpose vehicle that would be expected to distribute its carried interest to its members upon receipt. Without any other assets, the general partner would be judgment-proof with respect to a claim regarding the clawback. Personal undertakings also may benefit the individual managers of a fund, who care about maintaining a good reputation and recognize that, if they wish to obtain new capital commitments from prior investors, they must ensure that their colleagues honor their shares of the clawback obligation incurred by the general partner. It would be difficult for these members to raise a new fund from their former investors following a default on a guarantee of a clawback obligation. Where the promise is not enough (for example, where employees who are not portfolio managers share in carry, and it may be difficult to pursue them if they leave), the personal guarantee may be secured by an escrow at the general partner level.

Individual member guarantees on a several basis. The individual members of the general partner who are required to guarantee payment of the clawback typically do so on a several basis, and not on a joint and several basis (although senior founding members of the team and any institutional sponsor may sometimes be asked to share the liability for carry distributed to more junior employees). Each member's share of the clawback obligation is based on such member's share

of total carried interest distributions made to the general partner by the fund and in turn distributed by the general partner to such member. If a member of the general partner assigns a portion of his or her share of the carried interest to an estate planning vehicle, such member typically remains responsible for the obligation of such vehicle to contribute toward the clawback.

Member shares based on investment roles. The limited liability company agreements governing the general partner of a private equity fund often provide that the members of such general partner do not participate equally in the carried interest with respect to each investment made by the fund, but rather share based on their respective roles in each investment. These arrangements make calculation of the individuals' responsibility of any clawback obligation more difficult to calculate in a fair manner among such members.

Example 2-6 Clawback Responsibility Calculation

Assume that a fund makes only two investments, the first of which is profitable and the second of which is sold at a complete loss. Also assume that member "A" of the general partner only has an interest in the first investment and member "B" of the general partner only has an interest in the second investment. If the first investment is sold before the second investment, member "A" will receive the entire carried interest distributable with respect to such first investment. Assuming that the loss on the second investment completely reverses the profits realized from the first investment, there will be a clawback owing to the fund equal to the total carried interest distributed to member "A" less taxes on such carried interest. However, even though member "A" has no interest in the second investment (which generated the loss and therefore generated a clawback), member "A" would be required to cover the entire clawback, a loss that was intended to be borne by member "B" of the general partner. As a result, member "A" will not receive the true benefit of the deal-by-deal allocations of the carried interest. To avoid this result, the general partner documents may provide for an equitable adjustment among these two partners—but note that it is not possible to prevent member "A" from funding the clawback without requiring member "B" to go out-of-pocket to fund the shortfall.

Institutional sponsor guarantees. Clawback obligations may also be guaranteed by institutions that are the sponsors of a private equity fund. In such case, the institution would deliver a guarantee of the entire clawback to the investors. Such guarantor would be expected to have a sufficient net worth to assure investors that its guarantee was backed by a creditworthy entity. The internal documents governing the general partner would nevertheless typically require the individual employees of such institution receiving carried interest to return to the institution their several share of any clawback. When the institution provides a guarantee of the entire clawback, it is common to establish escrow accounts for the carried interest at the general partner level (as opposed to an escrow required by investors) so that the employer can assure itself that it will not be responsible for the entire clawback. These escrows can also be used as “golden handcuffs” subject to forfeiture in the event the employee quits or competes. Often, employees are required to escrow their full remaining carry once they leave, even if the escrow for employees still at the firm is only a fraction of the carried interest they receive.

[G][4] What Deductions May Be Taken in Calculating the Clawback

Clawback obligations typically are calculated taking into account tax liabilities of the members of the general partner with respect to their income generated by receipt of the carried interest, the parties ultimately responsible for payment of the clawback. There are three methods for calculation of such tax liabilities. First, and most commonly, the aggregate clawback obligation is limited by the total amount of carried interest distributions made by the fund to the general partner, less tax liabilities with respect to the total amount of allocations related to carried interest distributions. The second manner in which tax liabilities are applied to reduce clawback obligations is one in which the actual clawback obligation (rather than simply the maximum possible clawback) is reduced by an amount equal to taxes paid on such obligation. This is a much more general partner-favorable manner for calculating the clawback, because investors are not made whole even where the general partner has received net carry after taxes, and is rarely accepted by investors today. The third method of taking tax liabilities into account in calculating clawback obligations involves adding back the amount of any tax benefits received by the members of the general partner for payments of the clawback obligation. This is an equitable resolution, but is often resisted by general partners because it involves an analysis of personal tax returns.

Example 2-7 Tax Deductions in Calculating Clawback

Assume the clawback obligation was \$100, total carried interest distributions were \$110 and taxes on all such \$110 were \$40.

Under the first example above, the total clawback obligation could not exceed \$70 (that is, \$110 less \$40 of taxes). Therefore, the general partner would be required to return only \$70, and not the full \$110.

Under the second example of the clawback calculation, the general partner would be required to return the \$100 less taxes on such \$100 (assuming the 36% tax rate applied on the \$110 as described above, \$36 of taxes), resulting in a total clawback obligation of \$64. This second method is rarely accepted by investors since it is viewed as giving the general partner a windfall of the extra \$6 that it could have paid without having gone out-of-pocket based on the total carried interest paid to it net of taxes on the total carried interest.

Under the third example, the general partner's \$100 clawback would have been payable in full unless such \$100 exceeds (a) \$110 less (b) \$40 plus (c) tax benefits received for paying the \$100. It is difficult and personally intrusive (because personal tax returns must be analyzed) to calculate such tax benefits, and general partners seek to avoid this method, or at least to require limited partners to accept the general partner's good-faith estimate of the tax benefits received without performing independent analysis. If an offsetting tax benefit provision is included, under current tax laws, losses derived from making a clawback payment can be utilized on a carry-forward basis. Therefore, partnership agreements typically provide that such loss is measured for the year in which the clawback payment is made and for up to three years thereafter. One assumes that such tax benefit will approach the \$40 tax liability referred to above and that the clawback will also approach the full \$100 amount.

[G][5] What Security Is Given to Ensure Repayment

Security for payment of a clawback obligation is given in a variety of ways. The best security is avoiding clawback obligations completely by preventing the general partner from receiving carried interest. The typical distribution waterfall in a partnership agreement is designed for just such purpose. For instance, a partnership agreement will

require prior realized losses (or, in the case of back-end-loaded carry, all funded capital contributions, including those relating to unrealized deals) to be made up before the general partner is allowed to receive distributions of the carried interest. Similarly, write-downs (or, less commonly, write-downs, net of write-ups of investments) are also required to be distributed to investors before the general partner receives distributions of the carried interest. Occasionally, the general partner is able to receive a distribution of the carried interest only if the amount of total distributions plus the value of the remaining portfolio exceeds a designated percentage (typically, 125%) of the then-aggregate cumulative capital contributions of investors to the fund.

The personal guarantee of the members of the general partner is the most common form of security for payment of the clawback. As discussed above, investors do not generally require any further assurance from the general partner as to the commitment of its members to honor a clawback. The members of the general partner also commit to cover their share of the clawback to one another within the general partner's limited liability company agreement. Therefore, if one member does not contribute his or her share of clawback, the other members of the general partner may bring a claim against such breaching member. Sometimes, the general partner covenants to investors that this type of commitment exists at the general partner level and that it will seek to enforce it, rather than offering direct guarantees from the individuals to the investors. This arrangement is often resisted by investors on the grounds that it is more difficult for them to enforce.

In addition to personal guarantees, the establishment of escrow accounts into which carried interest distributions are deposited presents a highly desirable form of security to ensure payment of any clawback obligation. Such deposits are made net of tax liabilities in order to permit the members of the general partner to have adequate cash for their tax liabilities. Escrow deposits are released when a formula confirms that there have been sufficient distributions to the partners such that the clawback will not be payable. The timing of such release could occur when investors receive distributions of their entire contributed capital to the fund, although such timing does not offer adequate protection when subsequent capital contributions are made and subsequent losses occur. If the release is made at this time, investors may require the general partner to do an interim clawback calculation and to hold back amounts that take into account write-downs of investments. It is more likely that such a release will occur after investors receive distributions equal to their total committed capital to the fund. In such case, it would be nearly impossible (barring reinvestment or subsequent incurrence of liabilities such as indemnity claims) for the general partner to owe any clawback.

Escrow requirements at the fund level are relatively uncommon. Investors who are concerned about whether the general partner will make good on a clawback obligation generally insist on back-end-loaded carry, which allows them to receive the funds that would otherwise be deposited in an escrow account and therefore not benefit either the general partner or the investors while in such account. On the other hand, as discussed above, it is fairly common for the general partner to retain in escrow a portfolio of the funds that are received by the general partner on behalf of non-founding members of the general partner to ensure that they will pay their share of the clawback obligation when due. The escrowed amount is generally retained until the completion of the liquidation of the fund, at which point the general partner can determine how much of the carried interest should be distributed to its members and how much might be owing as clawback obligation.

[H] Proposed Carried Interest Tax Legislation

Legislation related to the taxation of carried interest that was previously proposed, and expected by many to be passed, has yet to be enacted. Under such proposed legislation, certain income derived with respect to an “investment services partnership” would be taxed as ordinary income, as opposed to capital gains. Although such carried interest legislation failed to pass, practitioners have not ruled out the possibility of such legislation being adopted.

§ 2:8.2 Management Fees

[A] Overview

In addition to distributions of the carried interest, the management team of a private equity fund is compensated by receipt of management fees that the fund pays to an entity designated as the “investment manager,” “investment advisor” or simply the “manager” of its fund. This entity typically does not make investment decisions for a fund. Rather, it provides investment advice to the fund and the fund’s general partner. Management fees are used to cover the overhead costs of a fund’s operations. They cover the salary of all management company personnel, including investment professionals, health benefits, rent, day-to-day costs of operations, and costs of monitoring existing investments.

Management fees and carried interest comprise the most important economic features of the compensation received by sponsors of private equity funds. Yet, they differ greatly. Management fees are paid in regular intervals, whether or not an investment has been sold at the time of payment. Conversely, the timing of carried interest distributions is unpredictable as these distributions are completely dependent

on the profitability of investments and are made after expenses of the fund, including management fees, are returned to investors.

Management fees are taxed as ordinary income. Under current tax laws, the taxation of carried interest depends on the characteristics and timing of realization of the income giving rise to the payment of the carried interest, and carried interest is often taxable at capital gains tax rates. Managers of first-time funds often rely on management fees as their sole source of income pending dispositions of investments. Therefore, the amount of these fees can be a decisive factor in whether a fund is formed.

[B] How Management Fees Are Calculated

[B][1] Typical Structure

The market rate for management fees of private equity funds is approximately 1.5%–2% of the fund's aggregate capital commitments during the fund's investment period (meaning the first three to five years of a fund during which it is allowed to invest in new portfolio companies), whether or not drawn by the fund, and approximately 2% of the "net invested capital" of the fund thereafter. Typically, the fee is paid until the complete liquidation of the fund, but if that period extends significantly beyond the fund's initially stated term, investors may negotiate for scale-backs of the management fee during an extended winding-down phase in exchange for consenting to extend the term. Management fee is typically funded out of capital commitments or operating cash flows. Occasionally, management fees are instead charged to investors over and above their stated committed capital to a private equity fund. This may occur, for example, when the fund is a special purpose vehicle formed to make a single investment. In such a case, it may be easier to describe to investors that their capital commitment is being used for the purpose of making an investment in an underlying target investment, over and above which they will be charged a management fee of 2% of such invested amount.

[B][2] Deviation from the Typical Market Structure

Management fee calculations deviate from the basic 1.5%–2% market structure under many circumstances. The fee is often reduced for larger funds and for funds where the perceived investment strategy does not require the same type of oversight and monitoring requirements as a pure private equity fund (where board representation and significant interaction with management is assumed). Historically, mezzanine funds have charged management fees of 1.5%. Smaller, first-time funds (often venture capital funds) may be permitted to pay management fees of up to 2.5%, but this has become increasingly rare. Further, investors may require the fee base to be stepped down after the

investment period. For example, management fees might be 2% of committed capital during the fund's investment period and 1.5% of net invested capital thereafter. In real estate funds, it would not be unusual to charge management fees based on the capital and leverage actually deployed for investment properties. If the general partner forms a side-by-side vehicle to invest with a principal fund, investors in the co-investment entity would be charged a management fee of less than 2%. Finally, fund managers may simply elect to forego market rate management fees in order to convey the message that they are motivated by profits, not fee income, in running a particular fund (which presumably only happens when the fee income from other investment vehicles under management is significant enough to cover overhead costs).

[B][3] Investor Scrutiny of Management Fees

Historically, management fees were intended to permit the manager to cover its overhead, including reasonable salaries for the investment team—but nothing more. Today, with multiple funds under management and fund size having no apparent limit, investors do have a concern that fee income earned by managers could outweigh the incentive to earn profits from investments. Thus, investors are more likely to scrutinize the amount of management fees paid by a private equity fund. It would not be unusual for management fees of an existing fund to be reduced by reason of the formation of a successor fund.

[B][4] Net Invested Capital

The term “net invested capital” should be carefully defined in a partnership agreement. The term refers to the cost of investments of the fund still held on the date of payment of management fees (or the immediately preceding day). If an investment has been written down (or written-off) (meaning a permanent impairment of value as determined by the general partner, not a normal market value fluctuation), then the amount of such write-down is deemed to reduce the cost of the investment so held by the fund. Occasionally, the management company will be permitted to offset write-ups of investments against write-downs and, therefore, negate the reduction of management fees triggered by individual write-downs in a portfolio.

[B][5] Different Management Fees for Different Investors

It is possible for different investors in the same fund to be charged different management fees. For instance, larger investors may require reduced management fees. In addition, affiliates or other employees of

the investment manager who are investors of the fund are typically not charged any management fees. Having different management fees (other than with respect to insiders) can make it more difficult to market a fund, especially a fund where investors receive “most favored nations” rights.

[C] Timing of Management Fee Payments

Management fees are usually paid either quarterly or semi-annually in advance, and accrue from the first closing of a fund. As investors are admitted to a private equity fund at later closings, they typically are charged management fees as if they had been admitted at the first third-party investor closing, together with interest on the retroactive fees. Occasionally, management fees accrue from a date that precedes the first third-party investor closing. This can occur when an investment has closed prior to the first closing (referred to as a “warehoused” investment)³⁶ that has been managed by the investment manager pending the closing. Conversely, in funds that exclude investors from participating in investments made prior to their admission, the management fee to subsequent closers may not be retroactive.

[D] Reduction to Management Fees

Management fees are subject to reduction based on two principal events: (1) receipt by the investment manager and its affiliates of income from portfolio companies or proposed portfolio companies, such as deal fees, monitoring fees, break-up fees, and directors’ fees (collectively, transaction fees);³⁷ and (2) payment by the fund of placement agent fees.

[D][1] Transaction Fees

Management fee offsets arising from payment of transaction fees to the investment manager and its officers, directors, and affiliates³⁸ are one of the most important features of a partnership agreement of a private equity fund. Investors consider transaction fees paid to managers from portfolio companies to create a misalignment of the economic interest between the general partner/manager and investors, and an avoidable inflation of management fees paid to the management team. Investors generally prefer that the management team be motivated by the profits derived from the carried interest distributions. Accordingly, management fees are routinely reduced by 80%–100% of transaction fees, net of out-of-pocket expenses incurred by the recipient of such transaction fees that were incurred in connection with

36. See *infra* section 2:23.

37. See *infra* section 2:8.3.

38. Described in more detail in *infra* section 2:8.3.

the transaction giving rise to the payment of such fees. Reduction of less than 80% of transaction fees would be considered a very favorable term to the investment manager in a partnership agreement. Note, however, that the SEC has suggested that, if management fees are not reduced by 100% of transaction fees, the investment manager may be required to register as a broker under section 15(a) of the Exchange Act.³⁹

Venture capital funds. Since transaction fees are rarely paid by portfolio companies of venture capital funds, the partnership agreement of a venture capital fund typically provides for a 100% management fee offset provision. However, portfolio companies of venture capital funds frequently issue options to their directors. The value of these options would be included in the calculation of transaction fees. Such value is determined in one of two ways. First, one might value options granted to a director on the date of grant. Such value is likely to be extremely low and therefore would result in little, if any, offset to management fees. As a result, investors are more likely to value options based on the income recognized by the director at the time the option is exercised (and the underlying shares sold).

Exemption from management fee offset of certain transaction fees. If the transaction fee is paid to an affiliate of the manager in the ordinary course of the affiliate's business, then investors may be willing to forgo any offset to management fees for such income. For example, a commission received by an underwriter that is paid in connection with a public offering of securities by a portfolio company of a fund that is managed by an affiliate of such underwriter could be excused from the management fee offset requirements. As the number of distressed debt funds has grown (or funds referred to as "credit opportunity funds"), their managers have recognized the need to retain parties for debt servicing services. If these services are provided by affiliates of the general partner, arguably the fees paid for such services might not reduce management fees if the debt servicing activities constitute a separate business from the investment management of the fund. Further, it has become more common for employees of an investment manager to serve as transitional employees of portfolio

39. See *infra* section 11:1.1. In a speech by David Blass, Chief Counsel of the SEC Division of Trading and Markets, he stated that, "To the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns." See David Blass, Chief Counsel of the SEC Division of Trading and Markets, Remarks to the American Bar Association, Trading and Markets Subcommittee: A Few Observations in the Private Fund Space (Apr. 5, 2013), available at www.sec.gov/News/Speech/Detail/Speech/1365171515178#.U3UAuXZRqVI.

companies. The salaries and fees paid to such transitional employees would not generate management fee offsets (on the assumption that the portfolio company would be paying these amounts to a person anyway).

Partnership agreements often provide that management fees are offset only by income received by the investment manager, its officers, directors, and affiliates. Therefore, fund managers sometimes conclude that income paid to their employees who are not senior executives or to consultants would not result in offsets to management fees. This may be an unsupportable position for the fund manager to take, as an investor might argue that the income paid to such employees or consultants could have just as easily been paid by the portfolio company directly to the investment manager, and in turn paid by the investment manager to such employees or consultants.

Co-investment by affiliated funds; apportionment of transaction fees. Calculations of management fee offsets must take into account co-investments by affiliated funds or affiliated in the same portfolio company that pays transaction fees to an investment manager. In order to afford offsets of the same amount for each of the affiliated funds, the limited partnership agreement of a private equity fund provides that the transaction fee received by such private equity fund will be apportioned among its affiliated coinvestors. Further, since management fees are not necessarily charged to all partners of a private equity fund, the amount of transaction fees paid by a portfolio company to the investment manager will be apportioned among only those investors who are charged management fees.

Example 2-8

If the investment manager receives a \$10,000 closing fee, but only 95% of the fund's partners are charged management fees, then only \$9,500 is taken into account under offset provision and multiplied by the management fee of a percentage (for example, 80%). (It is not typical to adjust for different management fee rates paid by different investors, however.)

Tax consequences. Because transaction fees are handled as an offset to management fees rather than being payable to the fund for activities conducted by the fund, it is expected that they will not cause the fund to be treated as engaged in an active trade or business that would be taxable to non-U.S. investors, even if the transaction fee results from the manager's engagement in an active trade or business.

Nonetheless, there is a possibility that reductions to management fees arising out of the receipt of certain transaction fees by fund managers could result in the fund being deemed to have received such transaction fees directly. Therefore, tax-exempt U.S. investors could be treated as having recognized “unrelated taxable business income,” and non-U.S. investors could be deemed engaged in a U.S. trade or business. Notwithstanding this risk, investors typically require reductions to management fees arising out of the receipt of transaction fees by fund managers.

Regulatory consequences. Certain types of transaction fees can present the issue of whether the recipient is required to be registered as a broker-dealer.⁴⁰

[D][2] Waiver of Management Fees Relating to Payment of Placement Agent Fees

Sponsors of private equity funds regularly retain placement agents in connection with the sale of limited partnership interests in the fund. Investors are not accustomed to paying for placement fees. On the other hand, placement fees are often not tax deductible by a general partner, making the general partner reluctant to bear such fees directly. The typical solution is for the fund to bear the placement fee, but require an offset against management fees of 100% of any placement agent fees paid by such fund. Since non-corporate taxable U.S. investors may have a limit on the deductibility of investment expenses (including the management fee), the tax benefit to the general partner of this structure is not offset by an adverse effect on such investors.

Management fee offsets typically are not required in the case of placement agent or finder’s fees paid by a fund to identify an investment to be made by the fund. Such finder’s fees are considered a necessary cost of running a private equity fund, and are economically borne by investors.

Also, the expenses (as opposed to fees) that a private equity fund pays to reimburse a placement agent for the sale of interests in a fund are not subject to management fee offsets. If a private equity fund does cover the expenses of placement agents for selling interests in the fund, such expenses would be included in a fund’s organizational expenses, and subject to the cap provided in the partnership agreement.

[E] Source of Payment for Management Fees

Management fees are paid from two principal sources: (1) capital contributions from investors, and (2) proceeds from investments.

40. See *infra* section 11:1.

In the early years of a fund, management fees are generally paid out of capital contributions from investors since investments take some time to be sold and the timing of investment proceeds is not predictable. As investors make capital contributions to the fund to cover management fees, there is a reduction in their unfunded capital commitment available to make investments. It has become more common for funds to have the right to recall distributions in amounts representing prior capital contributions that were used to cover fund expenses, including management fees, in order to deploy all committed capital for investments. In later years of a fund, proceeds from investments are expected to be available and can be used for fund expenses, including management fees. Management fees typically are paid out of capital commitments (as opposed to being in excess of commitments); and capital contributions for management fees will therefore typically reduce unfunded capital commitments. However, in certain circumstances there can be advantages to charging a management fee in excess of capital commitments. If a fund is charging different amounts of fees to different investors, fund accounting will be simplified if the management fee does not reduce capital commitments, because it will be possible to give all investors the same proportions of each investment and expense rather than having the relative unused capital commitments of investors paying lower management fees become misaligned with those of higher fee payers over time.

§ 2:8.3 Other Fees

In addition to the compensation paid or allocated directly by a fund to the investment manager in the form of management fees and distributions of the carried interest, managers and their affiliates also from time to time receive other income directly from portfolio companies or third parties that relate to an investment in portfolio companies (referred to above as transaction fees).⁴¹ This income typically falls under one of the following categories: Break-Up Fees; Directors Fees; Advisory Fees; Acquisition/Disposition Fees; and Affiliate Service Fees.

Notably, many private equity funds do not invest in companies or assets that are likely to pay this additional fee income. For instance, other than income derived from the receipt of directors options, venture capital fund managers do not generally receive income from portfolio companies. Similarly, managers of funds that invest in distressed debt securities or funds of funds would not be expected to receive these fees. Nonetheless, because of the perceived misalignment

41. See *supra* section 2:8.2[D][1].

of interest between the manager and the investors arising out of the receipt of income outside the partnership, it would be unusual for the partnership agreement of any type of private equity fund to omit “sharing” arrangements with respect to such income with investors through the management fee offset provisions discussed above.⁴²

[A] Break-Up Fees

Break-up fees are paid by a target company of a buyout fund when the target company wishes to terminate the purchase agreement between itself and the fund in order to accept a higher purchase price from another party. Break-up fees are viewed in part as compensation to the fund managers for devoting their time and attention to structuring and documenting an investment. Because of this effort, the offset provisions in a partnership agreement may allow the investment manager to keep a greater percentage of break-up fees than they do of other transactional fees, but it is highly unlikely that such fee would be reduced below 50%.

[B] Directors Fees

Directors fees are paid by portfolio companies to their directors, including representatives of private equity funds serving on the board of directors of those companies. Having board seats is a key method of allowing a private equity fund to operate under the permitted “venture capital operating company” (VCOC) exception under ERISA, which is necessary if the ownership by “benefit plan investors” of any class of securities of the fund is 25% or more.⁴³ Board representation is also an important method for a fund to monitor its investment. Nearly all venture capital funds and buyout funds obtain board representation. Real estate funds, distressed and fixed income funds, and funds of funds rarely face this issue.

Directors fees can be paid in the form of cash or options. Cash fees paid by private companies are rarely substantial. Options, however, are commonly granted. The fund’s investors require management fees to be reduced by the value of directors’ options. It has become industry practice to ascertain such value at the time of exercise or disposition of the option, and to measure such value based on the income recognized by the director. If the option has not been exercised by the time of liquidation of the fund, it will be subject to valuation under basic valuation guidelines in the fund’s partnership agreement. Some

42. *Id.*

43. For a more in-depth discussion of venture capital operating companies, see chapter 12, ERISA.

investors may request that the fund acquire from the director any options granted as directors fees. This cannot be accomplished for two principal reasons. First, the plans under which such options are granted do not generally permit anyone other than the director to hold such options. This feature is driven by provisions of the Exchange Act,⁴⁴ which do not treat an option plan as a “qualified option plan” entitled to certain benefits under the Exchange Act if the options are transferable. Secondly, if the fund actually acquires the option directly, it may be required to report any income derived from such option as “unrelated business taxable income” or “effectively connected income,” creating adverse tax consequences for tax-exempt U.S. investors and non-U.S. investors.

[C] Advisory and Similar Fees

Advisory fees, or monitoring fees, are paid to a fund’s investment manager for providing ongoing consulting services to a portfolio company. While these fees are generally paid by the portfolio company, occasionally such fees will be paid by a co-investor to the recipient. These fees are paid over a number of years, and are often subject to limits on amounts by investors as it is not always clear that the advisory services performed under these arrangements would not have been provided as part of the investment manager’s general duty to monitor investments for a fund.

The types of advisory and similar fees relevant to a fund will depend on its strategy and on the other business lines of its sponsor. For example, the sponsor of a real estate fund may offer property management or development services, the sponsor of a distressed fund may offer loan servicing, and an institutional sponsor may offer underwriting, administrative, or investment banking services. If these services are of a type that would otherwise be provided by third parties, the sponsor may not offer a fee offset against them, and may instead covenant that such arrangements will be on arm’s-length terms, subject perhaps to advisory committee approval.

Private equity funds typically restrict investments in other collective investment vehicles unless, of course, they are funds of funds themselves. Buyout funds often include transactions in which the manager receives a transaction fee from the portfolio company, which is typically shared in whole or in part with investors. The percentage of the transaction fee that is required to be offset is a significant negotiated term of the buyout partnership agreement. By contrast,

44. Securities Exchange Act of 1934, 48 Stat. 881 (June 6, 1934) (codified at 15 U.S.C. § 78a).

venture capital funds typically do not invest in companies that pay any form of transaction fees. Accordingly, management fee offsets for transaction fees are generally 100%. Distressed funds may invest in companies that from time to time pay transaction or monitoring fees. Thus, like buyout funds, the level of management fee offset is extremely important and follows the typical terms of a buyout fund.

[D] Acquisition/Disposition Fees

Acquisition and disposition fees may be charged by fund managers to funds or to portfolio companies for structuring and negotiating documentation of investments. These fees were common in the early days of private equity funds, but are less common now. Where they do appear, investors often view them as, in effect, additional management fees and negotiate the aggregate fee level accordingly. If the fee is payable by the portfolio company, it may be addressed by management fee offsets, as discussed above.

[E] Affiliate Service Fees

Private equity funds may, in the ordinary course of their business, utilize the services of affiliates of the general partner if those affiliates engage in businesses of a type for which the fund would otherwise retain third parties. These services may include, among others, placement agent services, underwriting services, consulting services, and debt servicing. Normally, the members of the general partner do not benefit directly from these fees, although their parent institution does. Nonetheless, investors scrutinize the nature and amount of these fees to determine whether they should be entitled to share the benefit of the fund's payment of such fees through a management fee offset.

§ 2:9 Expenses

§ 2:9.1 Overview

The expenses incurred in operating a private equity fund are apportioned among the fund, its general partner, and its investment manager. Permitted fund expenses, as described below, can be paid out of investors' capital contributions or investment proceeds. By contrast, investors' capital contributions and deal proceeds cannot be used to cover expenses required to be borne by the general partner or the investment manager. Since capital contributions that are used to cover fund expenses are required to be returned to investors before the general partner is entitled to earn its carried interest, the economic interest of investors, and that of the general partner and its investment manager in a profitable fund are ultimately aligned.

§ 2:9.2 Fund Expenses**[A] Types of Expenses Incurred by Funds**

Permitted fund expenses include all costs and expenses incurred in connection with the operation of the fund, generally including the following types of expenses:

- management fees;
- costs incurred in connection with the acquisition, holding, and disposition of investments (including broken deal expenses), finder's fees, and investment banking expenses (and most costs are generally paid by the fund independent of whether an investment is consummated);
- organizational expenses;
- fees and expenses of service providers, including attorneys, consultants, custodians, administrators, and accountants;
- extraordinary expenses, such as litigation expenses, and indemnification costs and expenses;
- costs of partners meetings; and
- entity-level taxes.

[A][1] Management Fees

As a key economic component of the fund's operations, management fees are specified in the limited partnership agreement and are addressed above.

[A][2] Costs in Acquiring, Holding, and Disposition of Investments

Costs incurred by a fund in the acquisition, holding, and disposition of investments can be sizable, but are often subject to reimbursement by the issuer of portfolio securities. Occasionally, investors seek to limit the amount of broken deal expenses that a private equity fund is allowed to incur. General partners strongly argue against such a restriction, as it creates an unnecessary incentive for the general partner to consummate investments on behalf of a fund that might not otherwise have been concluded. Finder's fees are typically paid in cash; however, if such fees are paid in the form of securities (as a co-investment with the fund), such non-cash fees may raise the following investor issues: (1) the general partner may have a concern that it is giving away an investment opportunity that should have otherwise been directed to the fund; and (2) the general partner may wish to restrict the finder's ability to take action with respect to the

shared investment. Therefore, the general partner may request a proxy with respect to shares, or some other form of shareholder agreement in which the general partner can restrict the transfer of such co-investment and require the finder to sell its securities at the same time as the fund.

Costs of “holding” investments should not be confused with expenses that the investment manager is required to bear. “Holding” costs generally refer to costs associated with third-party service providers and contractually required expenses relating to investments during the holding period of an investment. They do not, however, cover the cost of monitoring an investment, which is required to be borne by the investment manager and therefore paid out of management fees. The extent of investment-related travel expenses that can be passed through to the fund as permitted fund expenses also varies. Some funds cover travel expenses that are incurred either as part of the acquisition or disposition of an investment, but not those incurred in connection with monitoring investments.

[A][3] Organizational Expenses

Organizational expenses borne by the fund (as opposed to the manager) are in nearly all cases capped by the fund’s partnership agreement. These expenses include the costs of attorneys, accountants, and fund managers incurred in raising and forming the fund and in forming the general partner and its investment manager. Funds typically do not cover the fees of placement agents, but do cover the placement-related expenses (for example, travel, printers costs, etc.) incurred by the placement agent. If the fund does pay for the fees of a placement agent, its management fees typically would be reduced by a like amount of the placement agent fees.

Organizational expenses of private equity funds have risen significantly in the last twenty years. These expenses are driven by heavily negotiated documentation both between the general partner and investors, and complex fund structures, including the use of multiple parallel investment vehicles and subsidiary investment vehicles. The costs of preparing marketing documents has also risen as a result of the increased number of entities comprising an investment fund’s operations, greater regulatory scrutiny, and difficulties in describing the track record of many individuals. In theory, the size of the fund should correlate with the amount of organizational expenses that it incurs. Factually, however, this is not the case, because many organizational expenses (including legal costs of preparing and, to some extent, negotiating the fund’s offering memorandum governing documents and listings) are not scalable. Accordingly, although the organizational expense cap of a larger fund will be somewhat larger than that of a smaller one in recognition of the larger number and size of investors and

the likelihood that more extensive negotiations may be required, investors regularly agree to organizational expenses of \$500,000 or more for relatively small funds.

As arrangements among the members of the general partner and the investment manager have become more complex, the formation of the internal entities of private equity funds (that is, the general partner, the investment manager, and other control entities) has become almost as costly as those incurred to document agreements with investors (that is, fund partnership agents, side letters, and subscription documents). This complexity is reflected by provisions, among others, that allocate gains on a deal-by-deal basis, provide for non-competition agreements, and include clawback escrows and vesting arrangements. Adding to the complexity are the number of professionals and, possibly, seed and strategic investors, who may be granted ownership interests in the general partner and the investment manager, resulting in negotiations that can be more extensive than investor negotiations. The less senior professionals are subject to more restrictions in these documents. Lastly, separate employment agreements have become customary for senior investment professionals.

[A][4] Service Provider Costs

Legal costs make up the bulk of service provider costs prior to fund launch. Costs of auditors also have risen significantly, especially as institutional investors regularly require a fund to use a “big four” firm to perform a fund’s audit. More private equity funds also are retaining the services of custodians and administrators, which has historically been an expense incurred by hedge funds and not private equity funds. As hedge fund managers have branched into the private equity fund business, they have expanded the role of their current administrators and custodians to address the private equity fund’s operations.

[A][5] Extraordinary Expenses

Extraordinary expenses incurred by a fund (for example, indemnity obligations and litigation costs) can substantially impair its performance. As a result, the extent to which a fund may be obligated to indemnify its managers has been curtailed significantly over the past twenty years.⁴⁵

[A][6] Partner Meeting Expenses; Reporting

A fund can incur substantial costs for its annual partner meetings, but these meetings are considered an important part of fund communications. Costs of special investor meetings and trips, however,

45. A description of indemnification provisions appears *infra* section 2:13.2.

should not be charged to the fund. Reporting to investors has grown significantly. Accordingly, costs of such reports are typically borne by the fund.

[A][7] Taxes

Funds are typically structured as limited partnerships, limited liability companies, or offshore vehicles that generally do not pay entity-level U.S. federal income taxes. However, funds can have tax liability under state, local, or foreign laws, and may use taxable blocker corporations to hold certain investments. Additionally, a fund may need to withhold amounts from certain partners to address tax liabilities of those partners (for example, ECI or FIRPTA). Fund documents should be drafted so that tax liabilities of a particular partner are borne by that partner only. Also, if taxes will be incurred by the blocker entities, it is important to consider whether carry will be calculated gross or net of these amounts.

[B] Sources of Cash to Cover Expenses

A fund covers its expenses out of capital contributions from investors, proceeds from investments, and interest earned on cash pending use or distribution of such cash. Until dispositions occur, obviously, the likely source for expense coverage is investor capital contributions.

§ 2:9.3 Investment Manager Expenses

[A] Types of Expenses Incurred by the Investment Manager

The investment manager is required to cover the overhead expenses of the fund, including payment of salaries, benefits, rent, health insurance, and other similar expenses, and the cost of fund-related hardware and software. The investment manager may also be required to bear travel and entertainment expenses for monitoring investments, and fees for consultants for specialized or technical services related to the business of issuers of securities held by the partnership. In certain cases, the investment manager may be required to bear broken deal expenses, but those are usually expenses of the fund.

Some of the expenses that were historically borne by the manager in monitoring investments have recently been shifted to the fund. Specifically, funds now cover the costs of administrators and custodians. Some of the services that these companies provide to funds could be provided by an experienced management team. Funds are also more likely than before to bear the costs of third-party providers of diligence services relating to investments.

[B] Sources of Cash to Cover Expenses

The investment manager covers the majority of its expenses out of the payment of management fees. As the size and number of funds managed by a single investment manager (or related group of investment managers) grow, the management fee income may actually exceed the manager's overhead costs. As a result, investors sometimes negotiate reduced management fee payments for management groups in an effort to keep investor and general partner economic interests aligned.

Transaction fees may also provide enormous sources of expense coverage. While the management fees paid by the fund are reduced by some or all of the transaction fees paid directly to the investment manager,⁴⁶ the amount of transaction fees actually retained by fund managers may significantly exceed the management fee. If the general partner bears failed deal costs, it will often be permitted to offset these against transaction fees earned in that same period or possibly also other transactions before the net amount remaining is shared with other investors.

§ 2:9.4 General Partner Expenses**[A] Types of Expenses Incurred by the General Partner**

Expenses incurred by the general partner outside of the fund are generally limited. The general partner does not have employees, and therefore does not bear overhead-type expenses other than auditing and legal expenses. Furthermore, the general partner will (absent violation of its agreed standard of care) generally be able to look to the fund indemnity to cover litigation or extraordinary expenses insofar as they arise from fund activities.

[B] Sources of Cash to Cover Expenses

The general partner's source of cash to cover its expenses is limited to distributions it receives from the fund and in some cases capital contributions from its partners. Since the timing of such distributions are unpredictable and not likely to coincide with the payment of expenses, the investment manager (or its principals, in their capacity as equity owners of the general partner) is likely to advance the payment of the general partner's expenses with the expectation that such payments will be reimbursed.

46. See *supra* section 2:8.2[D][1].

§ 2:10 Management Company; General Partner**§ 2:10.1 In General**

As discussed earlier, a private equity fund that is organized as a limited partnership is established with two separate entities that function in a managerial capacity: the first entity is referred to as the “management company,” “investment manager,” or the “manager”; and the second entity is known as the “general partner.” In most cases, these two management entities are owned and operated by the same individuals, and their separate existence is driven primarily by legal and tax structuring issues.

A private equity fund that is established as a limited liability company is governed by its managing member, instead of having a general partner.

Funds rarely have more than one general partner or more than one management company, although this can occur in funds managed by multiple joint venture partners or in funds whose management teams operate from multiple jurisdictions. Sometimes a management company also may sub-contract for services from one or more sub-advisors, including sub-advisors that are affiliated with the actual management company. These arrangements with affiliates often serve to allocate income to a particular jurisdiction.

§ 2:10.2 Duties and Powers of the General Partner

The management and operation of a private equity fund and the formulation of investment policy of such fund are vested exclusively in its general partner. The general partner is generally empowered to exercise the powers of the fund established under the fund’s limited partnership agreement as may be necessary or advisable to carry out the purposes of the fund. If the general partner is itself a limited partnership, its general partner exercises the powers of the funds. Often, the general partner is a limited liability company. In such case, its managers or managing members exercise the powers of the fund. The general partner generally receives the special profits interest from the fund variously known as the “carried interest,” “carry,” “incentive allocation,” or “performance allocation.”

Examples of the powers and authority of the general partner typically include, but are not limited to the right to:

1. secure the necessary goods and services required in performing the general partner’s duties for the partnership or the partnership’s duties or obligations in respect of any affiliate, any alternative investment vehicle, or any other asset in which the partnership has a direct or indirect interest from time to time;

2. set aside funds for reserves, including for anticipated capital expenditures, contingencies and working capital, in such amounts as are reasonable for the requirements and obligations of the partnership;
3. cause the partnership, any affiliate, or any alternative investment vehicle to carry such indemnification insurance in an amount and at a cost as the general partner deems necessary and reasonable under the circumstances to protect it and any other person entitled to indemnification by the partnership;
4. cause the fund to invest in securities, on margin or otherwise, purchase or sell, or contract to purchase or sell, or purchase or sell options to purchase or sell direct or indirect equity interests, debt, or other financial instruments (or obligations and instruments, or evidences of indebtedness of whatever kind or nature of any type of entity or person), or other interests in the name or for the account of the partnership, or enter into any contract in the name or for the account of the partnership with respect to any investments, interests in any affiliate, or in any alternative investment vehicle, or in any other manner bind the partnership to purchase or sell any investments (including through joint ventures and other collective investment vehicles) or interests in any affiliate or in any alternative investment vehicle on such terms as the general partner shall determine and to otherwise deal in any manner with the assets of the fund;
5. cause the fund to open, maintain, and close accounts, including margin and custodial accounts, with brokers, including brokers affiliated with the general partner, which power shall include the authority to issue all instructions and authorizations to brokers regarding securities and/or money therein; to pay, or authorize the payment and reimbursement of, brokerage commissions that may be in excess of the lowest rates available that are paid to brokers who execute transactions for the account of the fund or any affiliate, and who supply or pay for the cost of brokerage, research, or execution services utilized by the fund, or any affiliate;
6. cause the fund to enter into futures contracts (and options thereon), swaps, options, warrants, caps, collars, floors and forward rate agreements, spot and forward currency transactions, and agreements relating to or securing such transactions and any other derivative instruments, including for hedging purposes and to leverage the fund's investment return;

7. cause the fund to acquire a long position or a short position with respect to any security, and to make purchases or sales increasing, decreasing, or liquidating such position, or changing from a long position to a short position or from a short position to a long position, without any limitation as to the frequency of the fluctuation in such positions or as to the frequency of the changes in the nature of such positions;
8. cause the fund to lend, either with or without security, any securities, funds, or other properties of the fund, including by entering into reverse repurchase agreements and, from time to time, without limit as to amount;
9. cause the fund to borrow money on market terms on behalf of the fund or any affiliate from any source, including one or more of the partners, upon such terms and conditions as the general partner may deem advisable and proper, to execute guarantees, promissory notes, drafts, bills of exchange, and other instruments and evidences of indebtedness or credit enhancements, and to secure the payment thereof by mortgage, pledge, or assignment of or security interest in all or any part of property then owned or thereafter acquired by the fund (including the capital commitments of the partners to the fund) or by any affiliate, and to refinance, recast, modify, extend, or memorialize any of the obligations of the fund, or any affiliate, and to execute instruments and agreements evidencing and securing those obligations. Without limitation, the general partner shall exercise all powers of the fund, on behalf of the fund, in connection with the financing or refinancing of any assets owned by the fund, or by any affiliate, or the other incurrence of debt by the fund, or by any affiliate;
10. cause the fund to employ, retain, or otherwise secure or enter into contracts, agreements, and other undertakings on market terms with persons or firms in connection with the management and operation of the fund's business, including attorneys, accountants, consultants, investment bankers, and other agents, and to enter into contracts, agreements or other undertakings and transactions on market terms with the general partner, any limited partner, or any affiliate of the general partner or any limited partner, and to make arrangements with insurance companies through brokers, all on such terms and for such consideration as the general partner deems advisable;
11. cause the fund to retain the management company on terms consistent with the fund's partnership agreement, for the

provision of certain management and administrative services to the fund (including origination, structuring, and recommending investments to the fund, sourcing capital to finance investments, monitoring the performance of the fund's investments, and making recommendations regarding disposition of investments), and to cause the fund to pay the management fee to the management company for such services;

12. cause the fund to retain an administrator to perform administrative, certain registrar, and other services on behalf of the fund;
13. enter into partnership agreements on behalf of the fund and to take any and all actions incident to the fund's serving as general partner or investing as a limited partner in other general or limited partnerships, and to enter into organizational agreements (for organizations other than partnerships) on behalf of the fund, and to take any and all actions incident to the fund's investment or participation in such organizations, the business of which is related to mining and minerals;
14. open, maintain, and close bank accounts, and to draw checks and other orders for the payment of money;
15. take any and all action that is permitted under applicable law and the fund's partnership agreement, and which is customary or reasonably related to the business of the fund or expressly provided for in the fund's partnership agreement, including the purchase for its own account of interests in the fund;
16. make all elections for the fund that are permitted under tax or other applicable laws;
17. bring or defend, pay, collect, compromise, arbitrate, resort to legal action, or otherwise adjust claims or demands of or against the fund or any affiliate;
18. deposit, withdraw, invest, pay, retain, and distribute the fund's available cash in a manner consistent with the provisions of the fund's partnership agreement;
19. take all actions that may be necessary or appropriate for the continuation of the fund's valid existence as a limited partnership under applicable laws and of each other jurisdiction in which such existence is necessary to protect the limited liability of the limited partners or to enable the fund to conduct the business in which it is engaged;

20. cause the fund or any affiliate to make or acquire loans secured, directly or indirectly, by interests in real property, upon such terms and conditions as the general partner may deem advisable and proper;
21. exercise, on behalf of the fund, all powers and rights of the fund in respect of any affiliate;
22. execute and deliver any and all instruments as are necessary to carry out the intentions and purposes of the above duties and powers; and
23. engage in all other activities and to do all further acts desirable or necessary to, in connection with, or related or incidental to, any of the foregoing.

The general partner is required to exercise its authority under the fund's partnership agreement in good faith and in what it believes to be the best interests of the fund, including with respect to the allocation of co-investment opportunities. Under most limited partnership laws, the general partner may delegate any part of its authority to its investment manager, but the general partner remains liable to its partners for the ultimate control and management of the fund.⁴⁷

Courts have interpreted several fiduciary duties that have their genesis in corporate law to apply in the partnership context, including the duties of loyalty and candor (often referred to as the duty of disclosure).⁴⁸ Furthermore, the corporate law business judgment rule has been applied with respect to the duty of care in partnership contexts,⁴⁹ with model acts applying a similar standard.⁵⁰ Unless the partnership agreement provides otherwise, such corporate law concepts will similarly apply to limited partnerships.⁵¹

An issue that arises frequently in private equity funds in connection with the duty of loyalty is conflict of interests. The allocation of investment opportunities and manager time divided between entities will present conflicts, as will purchases and sales of assets among

47. *But see* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. Super. Ct. 2002); *Sonet v. Timerber*, 722 A.2d 319, 323 (Del. Ch. 1998) (stating in dicta that the Delaware Court of Chancery permits an LPA to eliminate fiduciary duties).

48. *Meinhard v. Salmon*, 249 N.Y. 458, 468 (1928).

49. *Levine v. Levine*, 184 A.D.2d 53, 590 N.Y.S.2d 439 (1st Dep't 1992).

50. *See* UNIF. PARTNERSHIP ACT (UPA) § 21; REVISED UNIF. PARTNERSHIP ACT (RUPA) § 404. Under RUPA, fiduciary duties include the duty to account for property, profits, or benefits, the duty to refrain from dealing with the partnership on behalf of a party having an adverse interest, and the duty to refrain from competing with the partnership. *Id.*

51. *See* UPA § 6(2); RUPA § 1105.

funds or between funds and affiliates of the sponsors. Additional conflicts may arise from other services provided by the sponsor and its affiliates to funds and their portfolio companies, and the fees paid for these services. It may be prudent to include a provision in the partnership agreement that permits the general partner to balance the interests of the various parties, to require a vote of the independent directors of the corporate general partner, or to create a committee of the investor to resolve the conflicts. Each firm should have its own conflict-of-interest policy with protocol to be followed in these situations. The same issues arise in limited liability companies as with limited partnerships.

In addition to common-law fiduciary duties, the general partner and management company owe fiduciary duties to the fund under the Advisers Act.⁵² Although there is no private right of action under the Advisers Act, its application can potentially subject the investment adviser to a higher non-waivable standard of care and also impact the investment advisor's ability to engage in activities that present a conflict of interests. Also, it should be noted that in the fund context, the relationship between passive investors and a fund manager—who drafted the documents and is being paid to manage the business is very different from the relationship between co-owners of an investment firm—who likely have been on equal footing in negotiating their documents. Therefore, to avoid activities that could be viewed as detrimental to investors, it is especially important to be clear and specific about the activities in which a fund manager may engage.

§ 2:10.3 *Duties and Powers of the Management Company*

The general partner retains the services of the management company on behalf of the fund with respect to ongoing investment activities, in exchange for which the management fee is paid to the management company. The management company does not generally have investment discretion with respect to the fund's investments (this power instead resides in the general partner). However, in the case of offshore private equity funds whose general partners are managed by locally appointed directors, or funds structured as corporations, business trusts, or other entities without general partners, the management company may actually be given investment authority with respect to the fund's operations, and in any case the personnel responsible for analyzing and making investment decisions on behalf of the general partner are typically employed by the management company.

52. See chapter 10, Investment Advisers Act of 1940.

The management company's services include portfolio analysis. It provides assistance to the general partner in respect of the general partner's management and supervision of the business and affairs of the fund. Such services may include, without limitation, the obligation to:

- (a) seek suitable investment opportunities and make recommendations with respect to the investment policy of the fund;
- (b) arrange for the performance of day-to-day administrative operations for the fund;
- (c) act as investment adviser for the fund in connection with investment decisions;
- (d) prepare all reports to the partners required by the fund agreement;
- (e) monitor the performance of the fund's investments; and
- (f) make recommendations regarding disposition of investments.

§ 2:10.4 *Restrictions on Fund Managers*

[A] *Time Commitment*

In making a decision to invest in a private equity fund, investors evaluate the identity of the management team and the obligation of that team to devote their time to the fund's business. Ideally from an investor's viewpoint, the managing members of the general partner, or an identified group of senior managers, will commit to spend substantially all their business time managing the business of the fund being marketed. However, as funds under management by a single management group continue to grow, this covenant is drafted to allow the managing members of the general partner to spend substantially all their business time during the investment period of the fund operating such fund's business, the business of all affiliated funds then in existence (that is, funds under common management), and the business of successor funds managed by such group. After the investment period expires, the time commitment covenant is typically reduced to the amount of time that is reasonably necessary to devote to the fund. The partnership agreement does not normally apportion the amount of time that an individual must devote to a particular fund under common management, but investors may require this in some cases.

As fund groups mature, it would not be unusual for more senior members to seek a lower time commitment to new funds. Thus, one may see the senior members' time commitments drafted as a "meaningful portion of such person's business time" or a "majority" test.

Occasionally, as groups deviate from the “substantially all” test, they use actual percentages. For example, Mr. X will devote no less than 60% of his business time to the conduct of ABC Partnership and its affiliates. The percentage approach is difficult to monitor, and theoretically requires policing of how many actual days a professional will spend in the office.

Restrictions on the formation of successor funds is an important mechanism that is intended to ensure investors that managers are devoting sufficient time to a fund’s business. The philosophy of “lock-up” provisions is to prevent managers from forming new funds until the capital of their existing fund is substantially invested.⁵³

[B] Allocation of Investment Opportunities and Aggregation of Trades

An investment adviser’s fiduciary obligations to its client may be violated if the adviser favors one client account over another, and does not allocate securities and advisory recommendations among clients in a fair and equitable manner. There is no statute or SEC rule that specifically requires an adviser to adopt a purely objective or even formulaic approach to trade allocation or allocation of investment opportunities among advisory clients. However, an adviser’s best defense against claims that an adviser unfairly favored certain advisory clients over others is the implementation of a trade or investment allocation policy that is objective, consistently applied, and demonstrably fair and equitable to clients.

The primary SEC no-action letter addressing the adequacy of trade allocation policies is *SMC Capital, Inc.*,⁵⁴ under which the SEC staff permitted the aggregation of orders for advisory clients if the following conditions were satisfied: (i) all advisory clients would be treated equally (that is, no client would be favored over another), (ii) clients would participate in an aggregated order at the average share price, with transaction costs shared *pro rata*, (iii) aggregation policies would be disclosed to the adviser’s clients, (iv) a written aggregation statement would be prepared prior to entering the order specifying the clients that would participate and the method of allocation, (v) partial fills would be allocated *pro rata* based on the written aggregation statement, (vi) if an order is allocated in a manner different from that specified in the written statement, then all clients would be treated fairly and equitably and a written rationale for the departure would be approved by the firm’s chief compliance officer, (vii) the adviser would

53. See *infra* section 2:10.4[E].

54. SMC Capital, Inc., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,049 (Sept. 5, 1995).

seek best execution, and (viii) the books and records of the adviser would separately reflect, for each account whose orders are aggregated, the securities held by, and bought and sold for, each account.

The SEC staff indicated in *SMC Capital* that the procedures set forth in that no-action letter were not necessarily the only appropriate means to allocate trades. Nonetheless, these types of procedures are adopted by many investment advisers in their allocation policies in order to remain consistent with procedures that the SEC staff has deemed appropriate.

There has been informal recent commentary from the SEC staff about whether fund investors have a right to priority in allocation of co-investment opportunities. As a result, the authors recommend that fund sponsors include specific disclosure in fund documents regarding allocation of these opportunities, especially where some limited partners (or non-limited partners) may be given priority over limited partners generally.

[C] Conflict Transactions

The partnership agreement of a private equity fund is intended to restrict the manager and general partner from engaging in self-dealing transactions. Examples of typical interested-party transactions that are restricted in a partnership agreement (absent investor or in some cases advisory committee consent) include:

- (a) The partnership's acquisition of investments from, and sale of investments to, the management company, the general partner, any of their respective affiliates, or any entity in which any of the foregoing holds an equity ownership position or is in a position to directly control the management of the entity. This type of restriction would prevent affiliated funds from buying and selling investments to one another.
- (b) The acquisition by the general partner and its managing members of securities of any company in which the fund then holds an investment or in which the fund had actively considered making an investment, other than certain publicly traded securities.
- (c) The acquisition by the fund of securities of any company in which the general partner or its managing members or their affiliates holds any direct or indirect interest.
- (d) The sale by the fund of assets to any company in which the general partner or its managing members or their affiliates hold any direct or indirect interest.

The above transactions may be pursued with appropriate authorization. Such authorization is generally granted by the fund's advisory

committee. Absent appropriate consent from the advisory committee, the general partner would be advised to seek a consent from the investors generally to allow for the transaction. In post-Enron times, advisory committee members have become less willing to approve interested-party transactions, particularly if they involve complex analysis of deal structures and pricing terms. Even if the committee members are willing to act on a request, it is equally important to ensure that the advisory committee members have been given adequate information regarding the conflict situations. If material information is omitted or misstated, any consent of the advisory committee could be rendered invalid.

[D] Duty to Make Investment Opportunities Available to Funds; Deal Exclusivity

The general partner and its affiliates typically agree to offer to a private equity fund any investment opportunities they receive that are of a kind suitable for investment by the fund. This obligation generally terminates at the end of the investment period, or if earlier, the initial closing of a successor fund. Numerous exceptions may apply to the above duty, such as:

- (a) investments that would be precluded or materially limited by the investment limitations or other requirements of the fund's partnership agreement, applicable law or regulation, and investments that are too large, too small, or have the wrong return characteristics;
- (b) investments by predecessor funds to the extent necessary to complete the investment of available capital of such funds;
- (c) permitted co-investments made with the fund where, for example, an investment is too large for the fund to consummate alone, or strategic investors can add value; and
- (d) specific carveouts to address other current or active business lines in which the sponsors wish to engage either through the general partner or in their personal capacities.

The advisory committee typically has the power to allow the general partner and its affiliates to pursue an investment outside the fund.

The general partner may be permitted to share investment opportunities among other related parties, but disclosure of the manner in which such allocation is to occur is generally disclosed to investors. Allocations of investment opportunities are most simply accomplished by apportioning investments among investment vehicles based on the relative capital available for investment by each such vehicle in the applicable investment. Sometimes, differences between funds,

such as partially but not fully overlapping investment objectives, different existing portfolios, differences in remaining fund terms, and differing tax or regulatory considerations, will require a non-pro rata allocation of opportunities. Investors may ask to be told of these adjustments to be sure the general partner is not abusing its discretion. This is more a concern if apparent investment opportunities are expected to be scarce and of limited size.⁵⁵

[E] Subsequent Funds

The general partner and its affiliates typically are restricted from organizing or sponsoring an investment vehicle with investment objectives that are substantially similar to those of the particular fund until the earlier of: (i) the end of the investment period, and (ii) such time as a stated percentage (usually between 65% and 75%) of aggregate capital commitments of the fund have been invested, actually expended for fund expenses, committed to investment, or reserved for fund expenses or to make follow-on investments. The advisory committee may be given the right to approve the formation of a successor fund earlier than the above date. In the case of a more heavily negotiated agreement, investors may not be tolerant of a restriction that allows for the formation of a new fund even if it involves a different investment strategy, because this can divert the principals' time and energy.

[F] Other Activities

As long as the general partner, the management company and their affiliates comply with the restrictions generally outlined above, they will not be prevented from engaging in or possessing an interest in other business ventures for their own account, independently or with others, whether or not such other enterprises are in competition with the activities of the fund. A partner in a private equity fund would not obtain any right in such other activities by virtue of its investment in a fund or being a party to the limited partnership agreement of the fund.

[G] Non-Competition

The partnership agreements of a private equity fund do not generally contain provisions in which the general partner's members are bound by non-competition agreements (instead, this issue is handled through requirements not to invest away from the fund, key person provisions, and restrictions on formation of additional funds). However, these arrangements have become more common among members of the general partner, and the documents governing the general partner would contain such provisions.

55. See *supra* section 2:10.4[B].

§ 2:11 Limited Partners**§ 2:11.1 Limited Liability**

The investors of a private equity fund typically provide most, if not substantially all, of the capital to be invested by the fund, in exchange for a share of profits of the fund. Like a shareholder of a corporation, a limited partner expects to have limited liability for the fund's operations that extends no further than such investor's capital paid into the fund and the amount of such partner's unfunded capital commitment to the fund.

A limited partner may be required to return distributions received from the fund if the distributions violate local limited partnership (or other applicable governing) laws. Such laws typically involve distributions that violate creditors' rights, such as insolvency rules. Further, a fund's partnership agreement may contain limited partner "clawback" provisions requiring its investors to return distributions under certain circumstances. While these return mechanisms may have the appearance of giving rise to liability that exceeds a partner's capital commitment, and indeed many such provisions are not limited to a partner's capital commitment to the fund, the partner's obligation is almost always capped at an amount no higher than its unpaid capital commitment plus the distributions it has received.

Even though limited partnership law would structurally limit an investor's liability with respect to the private equity fund, investors often seek to limit their liability contractually. Such limits may also include exculpatory provisions in which it is provided that no investor will owe any fiduciary duty, or any other duty or liability (except as expressly provided in the partnership agreement) to the fund or any partner of the fund.

Certain sovereign investors, such as governmental pension plans, require an acknowledgment of their sovereign status, including applicable protection under the Eleventh Amendment to the U.S. Constitution, in partnership documents. In such cases, an investor would reserve all immunities, defenses, rights, or actions arising out of its sovereign status (including its status under the Eleventh Amendment to the U.S. Constitution), and would be afforded the opportunity to state that any waiver of such immunities, defenses, rights, or actions shall not be implied or otherwise deemed to exist by such investor's investment in the partnership, or its execution and delivery of the partnership agreement. In response to these provisions, the general partner should require the sovereign investor to acknowledge that such reservation will not in any way compromise or otherwise limit the obligations of such investor under the partnership's documents, including, but not limited to, such investor's obligations to make required capital contributions to the fund.

§ 2:11.2 No Participation in Management

Under limited partnership laws, a limited partner is afforded limited liability because it is not actively engaged in the management of the limited partnership. Conversely, the general partner has the statutory authority to control and to manage the limited partnership, and has unlimited liability for the debts and obligations of a limited partnership to the extent that the assets of the limited partnership are insufficient to satisfy such debts and obligations.

The rights afforded to investors in partnership agreements may give an investor concern that such protective provisions constitute active engagement by the limited partner of the business of a fund. Under Delaware limited partnership law,⁵⁶ however, it is expressly provided that the following acts are not considered to constitute such engagement:

- To be an independent contractor for or to transact business with, including being a contractor for, or to be an agent or employee of, the limited partnership or a general partner, or to be an officer, director, or stockholder of a corporate general partner, or to be a partner of a partnership that is a general partner of the limited partnership, or to be a trustee, administrator, executor, custodian, or other fiduciary or beneficiary of an estate or trust that is a general partner, or to be a trustee, officer, advisor, stockholder, or beneficiary of a business trust or a statutory trust that is a general partner or to be a member, manager, agent, or employee of a limited liability company that is a general partner;
- To consult with or advise a general partner or any other person with respect to any matter, including the business of the limited partnership, or to act or cause a general partner or any other person to take or refrain from taking any action, including by proposing, approving, consenting or disapproving, by voting or otherwise, with respect to any matter, including the business of the limited partnership;
- To act as surety, guarantor, or endorser for the limited partnership or a general partner, to guaranty or assume one or more obligations of the limited partnership or a general partner, to borrow money from the limited partnership or a general partner, to lend money to the limited partnership or a general partner, or to provide collateral for the limited partnership or a general partner;
- To call, request, attend, or participate at a meeting of the partners or the investors;

56. DEL. CODE ANN. tit. 6, § 17.

- To wind up a limited partnership;
- To take any action required or permitted by law to bring, pursue or settle or otherwise terminate a derivative action in the right of the limited partnership;
- To serve on a committee of the limited partnership, the investors, or partners, or to appoint, elect, or otherwise participate in the choice of a representative or another person to serve on any such committee, and to act as a member of any such committee directly, by, or through any such representative or other person; and
- To act or cause the taking or refraining from the taking of any action, including by proposing, approving, consenting, or disapproving, by voting or otherwise, with respect to one or more of the following matters:
 - the dissolution and winding up of the limited partnership, or an election to continue the limited partnership, or an election to continue the business of the limited partnership;
 - the sale, exchange, lease, mortgage, assignment, pledge, or other transfer of, or granting of a security interest in, any asset or assets of the limited partnership;
 - the incurrence, renewal, refinancing, payment, or other discharge of indebtedness by the limited partnership;
 - a change in the nature of the business;
 - the admission, removal, or retention of a general partner;
 - the admission, removal, or retention of a limited partner;
 - a transaction or other matter involving an actual or potential conflict of interest;
 - an amendment to the partnership agreement or certificate of limited partnership;
 - the merger or consolidation of a limited partnership;
 - in respect of a limited partnership that is registered as an investment company under the Investment Company Act,⁵⁷ any matter required by the Investment Company Act, or the rules and regulations of the SEC thereunder, to be approved by the holders of beneficial interests in an investment company, including the electing of directors or trustees of the investment company, the approving or terminating of

57. Investment Company Act of 1940, Pub. L. No. 76-768 (Aug. 22, 1940), 54 Stat. 789 (codified at 15 U.S.C. § 80a-1–80a-64).

investment advisory or underwriting contracts, and the approving of auditors;

- the indemnification of any partner or other person;
- the making of, or calling for, or the making of other determinations in connection with, contributions;
- the making of, or the making of other determinations in connection with or concerning, investments, including investments in property, whether real, personal, or mixed, either directly or indirectly, by the limited partnership;
- the nomination, appointment, election, or other manner of selection or removal of an independent contractor for, or an agent or employee of, the limited partnership or a general partner, or an officer, director, or stockholder of a corporate general partner, or a partner of a partnership that is a general partner, or a trustee, administrator, executor, custodian or other fiduciary or beneficiary of an estate or trust that is a general partner, or a trustee, officer, advisor, stockholder or beneficiary of a business trust or a statutory trust that is a general partner, or a member or manager of a limited liability company that is a general partner, or a member of a governing body of, or a fiduciary for, any person, whether domestic or foreign, that is a general partner; or
- such other matters as are stated in the partnership agreement or in any other agreement or in writing;
- to serve on the board of directors or a committee of, to consult with or advise, to be an officer, director, stockholder, partner, member, manager, trustee, agent, or employee of, or to be a fiduciary or contractor for, any person in which the limited partnership has an interest or any person providing management, consulting, advisory, custody, or other services or products for, to, or on behalf of, or otherwise having a business or other relationship with, the limited partnership or a general partner of the limited partnership; and
- any other right or power granted or permitted to investors under the Delaware limited partnership law.

Further, a limited partner does not participate in the control of the business of the Delaware limited partnership by virtue of the fact that all or any part of the name of such investor is included in the name of the limited partnership. A limited partner also is not deemed to participate in the control of the business regardless of the nature, extent, scope, number or frequency of the investor's possessing or, regardless of whether or not the investor has the rights or powers, exercising or

attempting to exercise one or more of the rights or powers or having or, regardless of whether or not the investor has the rights or powers, by acting or attempting to act in one or more of the capacities that are permitted under the list of permitted activities set forth above.⁵⁸ A limited partner should not, of course, expect to be protected from limited liability if in fact it holds itself out as a general partner of a fund. Also, if the fund is formed in another jurisdiction, the laws of that jurisdiction should be analyzed to confirm that investors do not incur unlimited liability; in that context, it should be noted that states may offer a non-owner list of safe powers other than those permitted by Delaware.

§ 2:11.3 Additional Limited Partners; Increased Commitments

A limited partner's principal role in the fund's operations is to provide investment capital. Each occasion on which a fund accepts new capital commitments from investors is referred to as a "closing."

The ability of the fund to accept additional investors and increased capital commitments (including increased capital commitments from existing investors) is generally restricted by the fund's partnership agreement. The general partner typically has the ability over the course of six to eighteen months to seek capital commitments from investors and to admit new investors.

Investors subscribing for new capital commitments are generally expected to participate in all investments made by a fund, even if such investments have been made during the initial offering period. At closings held after the first closing, a newly admitted investor (or investor increasing its capital commitment) will be required to make capital contributions equal to: (i) its *pro rata* share of the cost of any existing portfolio investments (to the extent not previously realized); (ii) its *pro rata* share of expenses already incurred (including organizational expenses plus the management fee on such investor's capital commitment calculated retroactive to the first closing date); and (iii) an additional sum equal to interest on such amounts from the date on which previously admitted investors made their capital contributions, to the closing date for the new partners or partners increasing its capital commitment. For this purpose, pre-existing investments will generally be valued at cost, although the general partner may have the authority to require additional capital contributions from newly subscribing investors if it determines that a material change (such as a material change in value of an investment or a significant event specifically relating to a pre-existing investment) would justify a different valuation.

58. DEL. CODE ANN. tit. 6, § 17-303.

Investors often require the size of a fund (that is, the maximum amount of capital to be contributed to the fund) to be capped. Such cap is driven by several factors. First, investors seek assurance that the managers of the fund will be able to deploy their committed capital, as they are setting aside such commitments from other potential investment pursuits. Investors also have concerns that individual deals or investments match the investment strategy of the fund. The maximum size of a deal that can be made by the fund is determined as a percentage of total capital commitments. The larger the fund, the larger the maximum permitted individual deal size is likely to be. However, many deals are not scalable and investors will try to ensure that the fund is not too large to locate and manage opportunities that meet its investment objectives. For example, the right size of a buyout fund will typically be larger than that of a venture fund focusing on smaller investments. Lastly, a larger fund requires more personnel and more infrastructure. Therefore, investors may place restrictions on the size of the fund when they do not believe that the size of the management team can support the capital to be invested.

§ 2:12 Advisory Committee

Private equity funds generally form investor committees (also referred to as advisory committees), unless there is an extremely small number of investors. These committees are created primarily to clear conflict-of-interest situations. They may also be used to review or to approve general partner valuation decisions, and to grant approvals or to provide consents as are expressly required or permitted to be granted pursuant to the terms of the partnership agreement. It is extremely common for the advisory committee to have the power to modify restrictive covenants in the partnership agreement. Lastly, the advisory committee serves to provide advice and counsel on such fund matters and investments, as may be requested by the general partner.

The general partner usually appoints and has the power to remove advisory committee members. The committee typically consists of less than three and not more than eight individuals. Large investors often negotiate for a side letter right to be able to appoint a representative to the advisory committee and may require that their designee not be subject to removal.

Advisory committees typically vote on a per capita basis rather than based on the size of investors' commitments, and it is rare for any investor to receive more than a single seat. As a result, the voting dynamic of the advisory committee may differ from that which would prevail if a matter were instead subjected to a vote of the investors.

Advisory committees meet at regular intervals (generally not more often than quarterly, and often annually), although special meetings

can be called by the general partner for unanticipated events requiring advisory committee consents. The fund typically covers the expense of such meetings (which may be held in person or via telephone conference), but members do not receive fees for serving on the committee. Investors may request disclosure of actions taken at advisory committee meetings.

As more actions have arisen against managers of funds, investor committee members have become increasingly reluctant to approve conflict-of-interest transactions between the fund and the general partner or the general partner's affiliates. This reluctance reflects a concern that investors will bring an action against investor committee members for a breach of duty by the investor committee members to the other partners or the fund for approving a conflict transaction. Therefore, the limited partnership agreement of a fund will generally provide that advisory committee members have no duty to the fund or the partners of a fund, other than a duty to act in good faith (or, perhaps, imposing the same gross negligence standard applied to the general partner). Similarly, the fund agreement will provide for an indemnification obligation in favor of advisory committee members unless they fail to act in good faith.

The contractual protection of advisory committee members serves to encourage them to respond to general partner requests for approvals permitted to be granted under the limited partnership agreement. The general partner also tends to favor the use of advisory committees as a means to seek such approval, as it is more efficient (and therefore could be easier) to seek the consent of a limited number of investor representatives than to solicit the consent of all investors as a group. However, as is the case in seeking any consent, the information that the general partner provides to the advisory committee must include all material information necessary to make an informed decision, and the absence of any such information will render any such consent invalid.

§ 2:13 Exculpation and Indemnification

§ 2:13.1 Exculpation

Exculpation is the concept of contractually relieving a party of liability to another party. A fund's partnership agreement customarily provides that none of the general partner, the manager, their respective affiliates, any of their respective members, managers, officers, directors, shareholders, partners, employees, any member of the advisory committee, or anyone who serves at the request of the general partner on behalf of the partnership as an officer, director, partner, or employee (the covered parties) will be liable to any partner of such fund or the fund for any

claims, liabilities, costs, loss, damages or expenses, including legal fees, judgments, and amounts paid in settlement to which they may be or may become subject to arising out of or incidental to the business of such fund or its activities, except to the extent arising from types of negligence or misconduct enumerated in the fund's partnership agreement.

[A] Misconduct

The definition of the types of misconduct that are not subject to indemnification and exculpation varies in fund agreements, but generally includes any conduct determined to have been made in bad faith, conduct that was grossly negligent, or willful misconduct. Other common definitions of misconduct include the commission of a crime, fraud, or violations of securities laws (which are all arguably acts of willful misconduct). Some funds do not separately provide that a material violation of the provisions of the fund's partnership agreement constitutes misconduct that would subject the general partner to liability to its investors. In the absence of stating that a material breach of the partnership agreement would be deemed misconduct, a party may be covered under the exculpation clause for such conduct unless the violation of the partnership agreement also constituted an act of bad faith, gross negligence, or willful misconduct.

[B] Delaware Law

Under Delaware law, a partner can be contractually relieved of the fiduciary duties owed to its partners, except for the duty of good faith and fair dealing. Therefore, it is typical to provide that the exculpation clause in a Delaware limited partnership agreement replaces the duty that a partner would otherwise have at law, unless investors insist on a fiduciary duty liability standard. In fact, there has been a recent trend of institutional investors requiring general partners to accept liability for breaches of fiduciary duty. Absent clear intent as to the replacement of duties under law, a general partner could be held liable to its investors under Delaware law for a breach of fiduciary duties owed to its investors. Such duties include the duty of loyalty, the duty of care, and the duty of good faith and fair dealing.

[C] Standard of Liability

The consequence of the typical exculpation clause is to move the standard of liability from ordinary negligence to gross negligence (a higher standard involving reckless indifference rather than simply careless error), and to limit the general partner's obligations with respect to such matters as allocation of investment opportunities, dedication of time, and engagement in other businesses, to the express restrictions negotiated in the partnership agreement of the fund.

Some investors are able to negotiate for an ordinary negligence standard, as opposed to a gross negligence standard, either explicitly or through indirect language such as that requiring the exculpated party to have “reasonably believed” an action to be in the best interest of the partnership, or to be permitted to rely on advice of counsel only if “selected and monitored with reasonable care.” If the sponsor’s intention is to be protected under a gross negligence standard of liability, it is important not to allow these types of provisions to inadvertently undercut that expectation.

Even if a gross negligence standard of liability is selected, there is an argument that securities laws require a higher standard for certain actions. To address this, exculpation provisions typically include a carveout, such as: “Except to the extent otherwise required under applicable securities laws . . .” Note, however, that securities laws do not necessarily provide investors with a private right of action.

§ 2:13.2 Indemnification

The corollary of a covered party being exculpated under a fund’s partnership agreement is the right to be indemnified by the fund for losses that do not constitute misconduct (which is defined using the same standard described in the exculpation clause in most cases, although funds occasionally exculpate on a gross negligence standard and indemnify using an ordinary negligence standard), if such losses are incurred in connection with the fund’s business. Covered parties include, in addition to the general partner, a number of persons who are not themselves parties to the partnership agreement. Some parties providing services to the partnership (for example, placement agents, administrators, and prime brokers) may be covered by separately negotiated agreements that they have entered into with the partnership. These agreements need not provide the same indemnity standards and other terms as the partnership agreement. However, if the indemnity is given to someone affiliated with the general partner (for example, an affiliated placement agent), then the contractual provisions regarding investor approval of affiliated party transactions may apply.

Investors seek to reduce a fund’s indemnification obligations in various ways. For instance, if there are other sources of coverage for a party’s losses, such as indemnification from a portfolio company or liability insurance, it would be expected that such source would be utilized before the fund makes an indemnification payment. If the members or other affiliates of the general partner are bringing claims against one another, investors typically no longer will permit the fund to indemnify such parties for their losses, even if no misconduct is ultimately deemed to have been committed by the party seeking the indemnity payment.

A covered party generally will be permitted to have its expenses (including legal and other professional fees and disbursements) advanced by the fund prior to any determination that such party is entitled to be indemnified. However, the covered party must agree in advance to return such expenses in connection with a determination that it is not entitled to be indemnified by the fund under the terms of the partnership agreement. Some investors require that there be no advancement of expenses in the event of a claim by a sufficient number of investors against the general partner, in order not to cover the defense costs of a party they are suing.

The partners' capital commitments to a fund are available to satisfy the reimbursement, indemnity, and contribution obligations of such fund. In addition, the general partner may utilize proceeds from investments to cover indemnification obligations. Fund agreements frequently require partners to return distributions to cover indemnification obligations—a feature that is referred to as the “limited partner clawback.”⁵⁹ The obligation to return distributions is generally limited in time (for example, to a claim made no later than the third anniversary of the fund's date of dissolution, or, with respect to claims and proceedings initiated prior to such third anniversary, until the final disposition of such claim or proceeding), or limited to a period of years following the date on which the applicable distribution was made to the investors. The aggregate amount of a partner's re-contribution (or payment) obligation is also typically limited. For example, this obligation might be capped at the lesser of 50% of the aggregate distributions, and 50% of a limited partner's capital commitment to the fund.

§ 2:14 Withdrawal of Interests

§ 2:14.1 Mandatory Withdrawals

Private equity funds generally provide for mandatory withdrawal of a limited partner only in the case where the continued participation by a limited partner in a fund would give rise to a regulatory or legal violation by the investor or the fund (or the general partner and its affiliates). Even then, it is often possible to address the regulatory issue by excusing the investor from particular investments while leaving them otherwise in the fund. Excusal from investments is easier to implement than withdrawal; the latter forces the fund to value the investor's holdings and to come up with cash or another acceptable payment method (such as a promissory note).

59. *See supra* section 2:5.8.

§ 2:14.2 Optional Withdrawals

The most common reason for allowing withdrawals from private equity funds arises in the case of an ERISA violation where there is a substantial likelihood that the assets of the fund would be treated as “plan assets” of any ERISA partner for purposes of Title I of ERISA or section 4975 of the Internal Revenue Code.⁶⁰ Thereafter, unless the general partner is able to cure such situation, an ERISA limited partner would be entitled to elect to withdraw from the fund.

In addition to ERISA regulatory issues, investors may be permitted to withdraw from a fund if their continued participation as a partner of such fund would cause a legal or regulatory problem. Similarly, foundation investors may be permitted to withdraw from a private equity fund if the income allocated to such foundation partner would become taxable by the Internal Revenue Service.

The withdrawal by an investor from a fund should be distinguished from an “opt-out” with respect to investments. Opt-out rights allow an investor to be excused (or allow the general partner to exclude an investor) from an investment on a case-by-case basis. It is far simpler for funds to grant opt-out rights with respect to future investments than it is to find a buyer (or otherwise create liquidity) of an investor’s entire interest in the fund. As a result, the right to withdraw from the fund is typically provided only as a last resort. The investor would remain a limited partner of the fund notwithstanding the exercise of an “opt out” right.

§ 2:14.3 Rights Upon Withdrawal

Unlike funds with liquid securities that can be sold in a public market in order to permit a withdrawing partner to receive a return of its investment (typically in the amount of its capital account balance at the time of withdrawal), private equity funds would not be expected to own securities that can be readily disposed of. Therefore, the withdrawal rights of investors do not necessarily result in the requirement for a fund to dispose of investments. Frequently, the fund would obligate itself by delivery of a promissory note to the withdrawing partner to pay the withdrawal amount under which payments will be made as distributions to the remaining partners of the fund, or by helping to find a transferee to buy the partner’s interest. Which of these methods is selected will depend on the particular law otherwise being violated. In some cases (for example, the Bank Holding Company Act⁶¹), problems

60. 26 U.S.C. § 4975.

61. Bank Holding Company Act of 1956, 12 U.S.C. § 1841.

may be addressed by converting the investor to a non-voting interest or by selling down a portion of their investment so that the remainder meets regulatory position limits.

§ 2:15 Key Person Events

§ 2:15.1 Nature of Key Person Events

A “Key Person Event” is triggered by the departure of a designated number of the named “key persons” in a fund’s partnership agreement, and results in the exercise of one or more rights afforded to investors in the partnership agreement. For example, a typical fund agreement provision may name five individuals as key persons; and a key person event may be triggered when there are less than three of such five individuals working for the firm. A key person event may also be triggered when the requisite key persons are not devoting a sufficient amount of time to the fund; however, the time commitment requirement is more difficult to measure. Many partnership agreements contain different key person events. For example, the departure of one of the two founding partners may in and of itself be a key person event, in addition to another test whereby four or more of the junior partners may leave.

While key person event provisions are designed to protect investors from the potential ill effects of the departure of a fund’s investment professionals, investors recognize that professionals could nevertheless leave. A fund’s partnership agreement would not be expected to contain any form of non-compete provision that applies to a departed manager, although the agreement governing the relationship among the fund’s investment professionals is likely to contain such restrictions.

Key persons are typically the senior managers of the fund. The partnership agreement often allows additional individuals to be approved by the fund’s investors or its advisory committee as key persons. The addition of parties as key persons allows more people to leave before a key person event is triggered. For instance, if three of the five named individuals leave the firm (not necessarily at the same time), a key person event will have occurred after the departure of the third person. If, however, there are six named key persons, then there would not be a key person event until the fourth such departure.

In order to avoid key person events, it is beneficial to provide in the fund’s partnership agreement that the advisory committee can approve a replacement key person. Practically, these replacement persons are investment professionals who have already worked with the senior key persons and are generally known to the investor conflicts committee. In such cases, approval of a replacement key person is expected to be obtained without great hardship.

§ 2:15.2 Remedies Following Key Person Events

If a key person event occurs, investors are typically afforded one or more of the following remedies:

1. the right to terminate the investment period of the fund;
2. the right to dissolve the fund; or
3. the right to replace the general partner and manager of the fund.

[A] Termination of Investment Period

The right to terminate the investment period is the most common remedy of investors following a key person event. Such remedy typically results in an automatic suspension period of the investment period (for ninety to 120 days), unless investors consent otherwise during that period. If investors do not elect to terminate the commitment period prior to the expiration of such suspension period, then the commitment period would automatically resume upon such expiration. However, the inertia may be reversed with a provision for automatic termination of the investment period unless the investors vote otherwise. The exercise of the foregoing remedies ordinarily requires the same vote as that required to amend the fund's partnership agreement—a "super majority" vote is not required.

[B] Dissolution of Fund

Investors may also be given the right to dissolve the fund if a key person event occurs (as well as following other events, such as for "cause" or under a "no-fault" clause). The right to dissolve the fund does not in itself remove the existing general partner. Rather, it requires the general partner to liquidate the assets of the fund in an orderly manner. This process may take place over months or years, and in that sense, dissolution is not radically different than termination of the investment period. The main difference is that the holding period of existing investments will be reduced. General partners typically prefer termination of the investment period, to avoid liquidating investments before their originally planned maturity. Whether this makes sense for the fund will depend on who is still available at the general partner to manage the existing portfolio.

[C] Replacement of General Partner and Manager

Removal of the general partner is a more extreme remedy, and general partners try to avoid offering this right based on a key person violation (although they will likely concede it if there are grounds to remove the general partner for "cause," and investors are sometimes

successful in negotiating a no-fault (without “cause”) removal right). Removal means that the general partner loses control of the portfolio, and may be asked to forego some or all carry in order to motivate a successor. Even where removal provisions are included, it can be difficult and expensive for investors to find a replacement general partner with the expertise to manage the portfolio.

[D] Required Vote and Treatment of Carry

Typically, the level of investor vote required to remove a general partner for a key person event is typically a majority or 66²/₃% in interest vote. A vote to remove the general partner without “cause” is higher than that required to remove the general partner for “cause” or following a key person event. Removal for “cause” is also more likely to result in the general partner forfeiting all or a portion of its accrued but unpaid carried interest. If a removed general partner remains entitled to carry, its interest may be converted into a special limited partner interest for this purpose (in which case it will receive carry as investments are sold). Alternatively, the removed general partner may be entitled to receive the appraised value of its carried interest at the time of removal, either in cash or through a promissory note.

§ 2:16 Transferability of Interests

§ 2:16.1 General Restrictions on Transfers

Private equity funds are generally unregistered limited partnerships that must be held only by a limited number of sophisticated investors in order to comply with U.S. private placement rules and Investment Company Act restrictions.⁶² Additionally, a fund may need to limit liquidity to avoid being treated as a “publicly traded partnership” taxable as a corporation for U.S. federal tax purposes. For these reasons and also because investors have capital contribution obligations, voting rights and other powers that cause fund sponsors to care about the identity, solvency, and number of investors, private equity funds provide that investors are not permitted to sell, assign, pledge, or in any manner dispose of, or create, or suffer the creation of, a security interest in or any encumbrance on all or a portion of its interest in a private equity fund (collectively, a transfer) except in accordance with the terms and conditions set forth in the fund’s partnership agreement and, in certain cases, a side letter to which such investor is a party. Transfers or purported transfers of an interest in a fund not made in accordance with its limited partnership

62. See *infra* section 2:16.7.

agreement will be expressly considered null and void, and of no force or effect whatsoever.

§ 2:16.2 Typical Restrictions on Transferability

[A] General Partner Consent

A limited partner may not transfer all or any portion of its interest in a partnership under the fund's partnership agreement without the prior consent of the general partner. The partnership agreement may provide that such consent may be exercised in the general partner's sole discretion.

The general partner's consent is rarely granted other than in connection with the execution and delivery by the transferring partner and its transferee of an appropriate transfer agreement, under which the transferee agrees to (a) be bound by the terms imposed upon such transfer by the general partner and by the terms of the fund's partnership agreement, and (b) assume all obligations of the transferor under the partnership agreement relating to the interest in the fund that is the subject of such transfer. Also, the seller or the buyer will expressly agree to reimburse the fund for the costs incurred by the fund in permitting and effecting such a transfer. Notably, the transfer agreement to which the general partner gives its consent should specify that the transferee will be required to return to the partnership any distributions that are subject to recall in respect of the interest so transferred, including the distributions made prior to the transfer. The transfer agreement also contains representations to the general partner and the partnership as to the suitability of the transferee to own an interest in the fund for regulatory purposes.⁶³

[B] Transfers Between Unrelated Parties

If the transfer is between unrelated parties (as opposed to a transfer among affiliates, which may be handled more informally), then, in addition to the transfer agreement, a purchase agreement is typically delivered by the seller and buyer of a limited partnership interest. The purchase agreement specifies the purchase price to be paid by the buyer for its interest in the fund. It also contains representations, warranties, and indemnities provided by the seller and the buyer to one another. For instance, the seller may make representations about its unfunded capital commitment to a fund. If it turns out that the unfunded capital commitment is greater than so represented, the seller would be required to make the buyer whole for such understatement. The general partner would, in any event, look to the new

63. For an example of a transfer agreement, see Appendix K.

owner for the funding of all future capital contributions associated with the interest transferred. If there had been any default in the making of capital contributions or payment of other items required of the transferring partner under the partnership agreement, the general partner would also require the cure of such defaults as a condition to permitting the transfer. Similarly, the seller of an interest would make representations to the buyer as to the amount of distributions that could be required to be returned to the fund. If such representations prove inaccurate, the seller would once again be required to make the buyer whole. The general partner is indifferent to this arrangement. A significant investor requesting consent to transfer its interest in a fund may ask the general partner to release it under the fund's partnership agreement. These releases are rarely granted.

Other possible documents required for the grant by the general partner's consent to a transfer include an opinion of counsel covering the tax and regulatory subjects referred to below⁶⁴ and tax forms, such as Form W-9 and Form W-8 relating to withholding obligations with respect to investors. Legal opinions are usually waivable by the general partner, and are often waived.

[C] General Partner's Discretion

Investors are sometimes able to negotiate that the general partner must act "reasonably," as opposed to "in its sole discretion,"⁶⁵ in deciding whether to consent to a transfer (or perhaps to a subset of transfers, for example, those among affiliates). This change should enable investors to compel the general partner to articulate a reason why a particular transfer would be burdensome for the fund, rather than rejecting it out of hand. However, while the words "sole discretion" give the general partner greater discretion in withholding its consent to transfer, generally, the general partner is protected under the exculpation provisions of a fund's limited partnership agreement in refusing to grant a consent to transfer absent gross negligence, willful misconduct, or bad faith. Therefore, assuming the general partner acts in good faith, the general partner will not have liability exposure for rejecting a transfer, and it is unlikely that an investor will wish to pursue the factual question of reasonableness in court.

64. See *infra* section 2:16.7.

65. See *Paige Capital Mgmt., LLC v. Lerner Capital Fund, LLC*, C.A. No. 5502-CS 2011 WL 3505355 (Del. Ch. Aug. 8, 2011), (noting that, in the absence of contractual language indicating that "sole discretion" means that the general partner need not consider any other interests, including those of the limited partners, "sole discretion" means that the general partner has the singular authority to consider and decide a particular matter, and does not limit the general partner's fiduciary duties owed to the limited partners).

To address this problem, investors sometimes seek to provide that transfers may be achieved without general partner consent if articulated criteria are satisfied. However, general partners rarely concede this point because it is difficult to devise a complete list of the potential problems a particular transfer may cause, and it is undesirable to let the transferring investor be the arbiter of whether these have occurred. There are various legitimate business, legal, or tax reasons for withholding consent. Reasons to reject a transfer could include the lack of creditworthiness of the new owner of the limited partnership interest, or a dearth of publicly available information regarding prior misconduct or crimes committed by the transferee. More commonly, however, transfers are not permitted for legal or tax reasons.⁶⁶

Transfers of interests in funds may be viewed as independent commercial transactions between sellers and buyers of such interests. Nevertheless, a selective general partner often scrutinizes the identity of its investors, and even when legal and tax issues are not present, may prefer to allow one buyer into a fund over another. Also, the mere fact that interests are being transferred can sometimes create issues for funds. Because the funds whose interests are being transferred own for the most part illiquid securities, the price at which these transactions are effected may indirectly create unintended valuations of a private equity fund's assets. For instance, during the Internet "bubble" phase of venture capital funds, investors valuing a fund's assets at zero were often willing to sell their interests solely for the assumption by the buyer of the seller's unfunded capital commitment to such fund. In addition, the fact that a major investor has elected to dispose of its interest in a fund may be shared with others. This information could have an adverse impact on a fund insofar as the decision to divest may suggest that the perceived future prospects of such fund did not warrant continued participation by the investor.

§ 2:16.3 Permitted Transfers

Investors may seek certain consents to transfer their interests in a fund under specially negotiated side letters.⁶⁷ Frequently, the transfers permitted in side letters relate to transfers to affiliates of the investor. Other permitted transfers may be driven by regulatory requirements. In any event, permitted transfers of fund interests covered by side letters should not override the restrictions on transfer that cover legal and tax concerns triggered by such transfers (that is, a transfer, even if to an affiliate, cannot be permitted if such transfer would violate

66. *Id.*

67. *See infra* section 2:19.

securities laws or cause the fund to be a publicly traded partnership taxable as a corporation).

Through a side letter, an investor may also request that transfers of other investors' interests be presented to such investor before the general partner grants its consent to such other transfers. The acknowledgment of an investor's interest in learning of opportunities to purchase other interests in the fund would be an appropriate response to such a request. However, it would be ill-advised to agree to such a side letter provision obligating disclosure of the details of specific transfers, and this would be a disclosable item in the partnership's offering memorandum.⁶⁸

§ 2:16.4 Rights of First Refusal

In addition to needing the consent of the general partner for a transfer of interests in a private equity fund, a significant investor (or sometimes all investors) may negotiate for the inclusion of a right of first refusal regarding the proposed transfer by any other investor of the same fund to acquire such other investor's interest in the fund before a transfer can be made to a third party. These provisions are unusual and may create unnecessary burdens on fundraising, because they limit the liquidity of other investors. It is difficult enough to find a buyer willing to dedicate the time and effort needed to understand a secondary interest in a private equity fund. If the buyer can then be outbid by existing investors, then the universe of buyers will be reduced and price discounts will likely be deeper. Sometimes, the right of first refusal is instead given to the general partners (acting on behalf of the fund), and sometimes it is given to all partners, pro rata to their interests. Where the right is given to the fund of all partners rather than select partners, it may raise fewer investor objections. Practically, however, these provisions delay and complicate the transfer process, which can be an issue especially when the investor is seeking to transfer due to tax, regulatory, or cash flow reasons, and must dispose of its interest promptly. In any case, existing partners in a private equity fund are often the most logical buyers of secondary interests, because they are already familiar with the fund and its investments. Assuming they are prepared to offer a fair price, they will likely be approached about purchase opportunities even in the absence of a right of first refusal.

§ 2:16.5 Pledges of Interests

Investors who borrow funds in order to make capital calls to a private equity fund may be required to pledge their interest in the fund as collateral for the repayment of their loans. Such a pledge would be

68. See *infra* sections 2:16.4 and 2:19.2.

subject to the general partner's consent, even though this transaction does not constitute an actual transfer of the interest in the fund. In seeking such consent from the general partner, the investor and the lending party would present the general partner with an agreement specifying the rights of the lender regarding the interest in the fund while the pledge is in place, the rights of the borrower during such time, and the terms and conditions under which the lender may require the interest in the fund to be transferred. For example, a lender typically would require that any distributions to be made to the borrower instead be sent to a specific account to be applied against the loan, while the borrower would require the preservation of all voting rights (unless there were a default under the loan documents) regarding the interest. If a default were to occur under the loan documents, the lender would have the authority to require the transfer of the pledged limited partnership interest to it. Such a transfer would be approved in advance by the general partner, but like approved transfers to affiliates of an investor, no such consent may override the requirement that a transfer be made in compliance with securities laws and not trigger publicly traded partnership issues.

Lenders sometimes seek representations from the general partner regarding the fund and the good standing of the investor's interest. In practice, general partners have little incentive to make more representations, and the lender will likely have to rely on representations from the borrower instead.

§ 2:16.6 *Locating Buyers*

An investor wishing to transfer its interest in a fund may do so only in a privately negotiated transaction. Yet, there are certain informal methods of locating potential buyers of interests. The general partner can be instrumental in locating buyers. In the course of dealing with existing investors, the general partner routinely learns of potential buyers. Placement agents can be helpful too, but often only work on transactions involving many funds owned by a single investor. Since investors are bound by confidentiality provisions under which they are not allowed to share non-public information regarding a fund with prospective buyers without the general partner's consent, the general partner has a very early role in approving the owners of interests in its fund.

§ 2:16.7 *Legal and Tax Issues*

In addition to the commercial aspects involved in the transfer of a fund interest, such transfers raise significant legal and tax issues. These issues generally fall under the following categories:

1. Will the transfer cause the partnership to be treated as an association taxable as a corporation for U.S. federal tax purposes or cause the partnership to be treated as a publicly traded partnership (PTP) within the meaning of section 7704 of the Internal Revenue Code⁶⁹ (also resulting in the partnership being taxable as a corporation for U.S. federal income tax purposes)?
2. Will the transfer violate the registration requirements of the Securities Act⁷⁰ or any other applicable securities laws, rules, or regulations?
3. Will the transfer cause the partnership to be an investment company required to be registered under the Investment Company Act?⁷¹
4. Will the transfer cause the partnership's assets to be treated as "plan assets" under ERISA or the Internal Revenue Code?
5. Will the transfer cause the partnership to face additional tax burdens, for example, withholding or additional reporting obligations?

Under U.S. tax laws, if a partnership has more than 100 partners and does not meet certain income tests, certain transfers of its interests may result in the partnership being treated as a publicly traded partnership taxable as a corporation for U.S. federal tax purposes. For example, transfers in excess of 2% of the capital of a partnership during a calendar year that would not be deemed "disregarded transfers" may trigger the PTP problem. Notably, a single transfer in excess of 2% of the capital (as opposed to multiple unrelated transfers aggregating in excess of 2% of the fund's capital) would be such a "disregarded transfer."

Because the interests in the fund are issued in reliance on exemptions from the registration requirements of securities laws (such as the Securities Act or other local laws), they may not be transferred in a manner that would cause a deemed public offering of such securities. If the transfer would taint the private placement by the general partner of interests in the fund, such event might result in the fund losing its exemption from registering as an investment company as well. Therefore, the general partner will require transferees to be accredited investors. If the fund relies on section 3(c)(1) of the Investment

69. 26 U.S.C. § 7704.

70. Securities Act of 1933, Pub. L. No. 73-22 tit. 1, 48 Stat. 74 (May 27, 1933) (codified at 15 U.S.C. § 77a).

71. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (Aug. 22, 1940), codified at 15 U.S.C. § 80a-1-80a-64.

Company Act, the general partner must also confirm that the transfer will not result in the number of holders of voting equity securities of the fund to exceed 100. Alternatively, with certain permitted exceptions related to gifts, divorce, and death, the transferee must be a “qualified purchaser” if the fund relies on section 3(c)(7) of the Investment Company Act.

ERISA concerns arise when fund participation by benefit plan investors increases from less than 25% of a class of interests to 25% or more of a class of interests after a transfer.

§ 2:17 Valuation of Fund Assets

§ 2:17.1 In General

Unlike hedge funds, where the valuation of assets plays a critical role in the economic sharing arrangements among the hedge fund’s partners, the valuation of the assets of a private equity fund has much less significance in respect of such economic arrangements. For instance, the carried interest allocated to the general partner of a hedge fund is based on an increase in the value of assets under management, whether or not an investment is sold. Management fees paid by hedge funds are also paid as a percentage of the value of assets under management. Investors purchasing interests in hedge funds buy into (and redeem out of) the hedge fund based on the then-existing value of investments. By contrast, in private equity funds, carried interest distributions are made based on actual realizations, management fees are paid as a percentage of investors’ capital commitments to the private equity fund during the investment period of a private equity fund (or invested capital thereafter), and purchases of interests in a private equity fund are generally made at cost.

§ 2:17.2 Economic Features of Private Equity Funds Affected by Valuation of Assets

In operating a private equity fund, there are three principal areas in which the value of its assets can be relevant: (a) the calculation of distributions; (b) calculation of management fees after the investment period; and (c) distributions in-kind.

[A] Distribution Calculations

When a private equity fund distributes proceeds on a deal-by-deal basis (as opposed to a total return of capital waterfall), it is required to make up write-downs of investments before the general partner is entitled to participate in distributions of carried interest. The general

partner may be permitted to count write-ups of investments against write-downs for this calculation.⁷²

[B] Management Fee Calculations

After the investment period of a private equity fund, management fees are often calculated as a percentage of invested capital. The definition of invested capital is generally reduced by write-downs or write-offs of investments. The general partner may receive the benefit of write-ups against the reduction in value of investments.

[C] Distributions In-Kind

If assets are distributed in-kind by a fund, the value of such assets will be used to determine the general partner's share of such distribution as its carried interest. For example, if the fund owns eighty shares valued at \$800 and for which the fund paid \$300, the investors will receive shares worth \$700 (or seventy shares), and the general partner will receive as its carried interest shares worth \$100 (or ten shares).

§ 2:17.3 Determination of Values of Investments

In most cases, the general partner determines in the first instance the fair value of its partnership's assets. Such determination may be made based on a disclosed methodology or general rules in the partnership agreement. Notably, the value of publicly traded securities that are being distributed in-kind by private equity funds is often based on the pricing average over a five- to ten-day period before (or sometimes after) the date of distribution so that the general partner is not able to manipulate its share of the distribution based on a non-recurring spike in value. Other anticipated issues in valuation of investments are expected to arise from the implementation of the new ASC 820, formerly known as FAS 157, accounting rules,⁷³ under which valuation guidelines are expected to be more difficult to implement, possibly resulting in greater swings in values of investments carried by funds. General partners may consider following ASC 820 for financial statement purposes, and using other valuation methods for other fund purposes.

Valuation decisions are often presented to investor committees for approval and may be subject to other dispute resolutions, such as the use of a third-party appraiser or valuation agent. Real estate funds are more

72. See discussion *supra* section 2:8.1[G][5].

73. Fair-Value Measurement Standard (a relatively new accounting standard that went into effect on November 15, 2007), available at www.fasb.org/st/summary/stsum157.shtml.

likely to rely on third-party appraisers for approval of the general partner's valuation.

§ 2:17.4 *Marketing Based on Valuation*

In the new world of having registered investment advisers, private equity funds expect to face greater scrutiny from the SEC on the valuation of unrealized investments presented in marketing materials.

§ 2:18 *Duration*

§ 2:18.1 *Term of the Fund*

The term of a private equity fund is the period that begins on the date of the fund's formation (that is, the date of its filing of formation documents) and that ends on the date stated in the fund's partnership agreement. Notably, hedge funds do not generally have stated terms, resulting in the term of a hedge fund continuing until its general partner otherwise determines.

A standard private equity fund term ends on the tenth anniversary of the final closing of the sale of partnership interests by the fund. Thereafter, the general partner may have the right to extend the term of the partnership for a stated period, generally for up to two additional one-year periods. Such extension may be subject to approval by the investor committee or a limited partner vote.

Nevertheless, certain investment strategies to be pursued by a fund will dictate longer or shorter terms because certain investments are believed to be more easily disposed of than others. For instance, venture capital funds tend to have the longer terms, as investments in start-up businesses are expected to take the longest time to mature and to sell. On the other hand, credit opportunity funds or distressed funds have shorter terms, as investments of this type are considered more marketable and therefore more readily disposable. Similarly, real estate funds tend to have shorter terms than buyout funds because real estate is viewed as an asset for which a buyer can be more readily identified, although this rule will not hold true for funds engaged in property development. Funds of funds' terms will be dictated by the terms of the funds in which they invest, with a few extra years added on to reflect the fact that not all investments will be made at inception.

§ 2:18.2 *Early Dissolution*

[A] *Overview*

The occurrence of many events can lead to an early dissolution of a private equity fund prior to its stated termination. These events may include the following categories:

- (1) *Dissolution under applicable law.* Among other examples, limited partnership laws provide that a limited partnership will dissolve if its general partner dissolves, is removed, withdraws, or suffers a bankruptcy without being replaced.
- (2) *Dissolution for misconduct or for “cause.”* A standard dissolution provision in a partnership agreement provides investors with the right to dissolve the fund if the general partner or its principals engage in misconduct such as fraud, gross negligence or willful misconduct.
- (3) *Dissolution following key person events.* If a key person event (that is, the departure of named professionals) occurs, then investors may have the right to vote to dissolve the fund.⁷⁴
- (4) *Dissolution by reason of general partner determination.* The general partner may retain the right to dissolve a fund if it determines that changes in applicable law or regulation would have a material adverse effect on the continuation of the fund, or that such action is necessary or desirable in order for the fund to comply with certain laws.
- (5) *No fault dissolution.* Limited partners may be given the right to dissolve a fund without any reason. This “no fault” dissolution right generally requires a super majority vote from investors.

[B] “No Fault” Dissolutions

As discussed above, many existing partnerships have (or will have, due to pressures from investors) “no fault” clauses that allow limited partners to terminate the fund or its investment period without cause. If triggered, either of these events could substantially reduce the capital contributed by investors to the fund. In the experience of these authors, such clauses have rarely been invoked, and if invoked, typically have involved misconduct by fund sponsors that is not easily proven. In difficult times, however, these rights provide investors with leverage to obtain other concessions. A no-fault vote generally requires a super majority vote of investors, which takes coordination of investors normally managed by the general partner. Investors that are not accustomed to such voting procedures may encounter broader resistance from other investors, especially if those other investors believe that the continued purchase of new investments and management of existing investments is necessary to achieve diversification, and to permit the fund’s investment thesis to play out. Investors may

74. See *supra* section 2:15.2.

also be dissuaded from exercising these powers by a desire to remain in the manager's good graces (or the good graces of other managers who will likely learn which investors have sought to exercise extraordinary remedies or demand unusual concessions) when the market rebounds and funds are once again over-subscribed.

No-fault termination rights, as discussed above, offer investors the option to dissolve the fund. It is important to consider, from the investor's point of view, what the benefits are to such an act, other than a possible reduction in its capital contributions to the fund. Investors should evaluate the amount already invested in a fund and the financial condition of the portfolio, as well as the feasibility of accelerating asset dispositions, before they seek a dissolution.

Similarly, the general partner of a fund may determine that it wishes to terminate a private equity fund. If the general partner believes that the investments under management are irremediably under water (that is, likely to be sold at or near a complete loss), one might assume that the general partner's incentive to remain as the manager no longer exists. Management fees are also typically reduced after the investment period expires. A general partner does not typically have the unilateral flexibility to shut down a private equity fund prior to the scheduled expiration of its term or disposal of its investments without investor consent, and would not be advised to walk away to the prejudice of the limited partners. The trend toward increased capital commitments from general partners also helps ensure that they are aligned with limited partners in wanting to reduce losses in asset value even when carry is no longer possible.

If a fund is in dissolution, the general partner must seek an orderly liquidation of the fund's remaining assets or distribute those assets in kind. There may be little reason for investors or general partners to rush this process in weak markets. Selling assets at low prices helps no one, even if completion of the fund ends the general partner's management fee stream and accelerates the timing of a clawback payment. Investors generally do not wish to receive distributions in kind, and are less likely than the general partner to find buyers for these assets. Fund sponsors may also be less motivated to get rid of remaining assets when they do not have new capital to deploy; if so, maintaining the possibility of a better outcome through continued management of troubled assets can be the best agenda for sponsors and investors.

An interesting issue is the legal status of a fund that has passed its scheduled term. Unseasoned investors may think that they should receive all proceeds by the time dissolution is required to commence, but in actuality, since the fund is required to liquidate assets in an orderly fashion, the process can take a number of years.

Many general partners continue to earn management fees during this phase, depending on how the fund's documents have been drafted.

Clawbacks are often triggered only upon the completion of the dissolution and wind-up process. If so, delays in disposing of lingering assets can also delay the clawback payment obligation. Some investors prefer the general partner to have an interim clawback obligation so that they do not need to wait until dissolution of the fund (and may condition their agreement to extension of the fund term on payment of an accrued clawback). However, established managers are usually not willing to offer interim clawbacks if they can attract sufficient investors without them.

The interim clawback, which has gained in popularity over the past few years, is a point of negotiation, and may occur at any point from the end of the investment period or after a set period of years. Also, at the end of winding down, the general partner may be required to return offsets to the management fees and transaction fees, if such offsets have not been used or applied to management fees during the life of the fund. Tax-exempt and foreign investors may have the right to reject such payment due to tax considerations.

§ 2:18.3 *Liquidation and Winding Up of the Fund*

The completion of the partnership term (whether by reason of reaching the stated term or by early termination) denotes the partnership's date of dissolution. After the dissolution of a fund, the general partner, or, if the general partner has dissolved, a liquidating agent appointed by the investors, is empowered to wind up the affairs of the fund and to liquidate the fund's assets in an orderly manner. Such liquidation may occur over a reasonable period of time, and therefore a fund is not required to sell its assets in a "fire sale." As the affairs of the partnership are wound up and the assets of the fund are sold, the proceeds from such sales will be distributed as follows:

- (1) first, to pay the costs and expenses of the winding up, liquidation, and termination of the fund;
- (2) second, to creditors of the fund (including investors and the management company);
- (3) third, to establish reserves reasonably adequate to meet any and all contingent or unforeseen liabilities or obligations of the partnership; and
- (4) thereafter, in accordance with the distribution waterfall provisions.

As part of the completion of the liquidation of the partnership's properties, each of the partners will receive final financial statements and

tax reports of the fund. More importantly, the general partner's obligation to make any "clawback" payment typically arises in this phase of the fund.

Once the sale of assets has been completed and a final distribution has been made to the partners, the general partner will have a certificate of cancellation or similar filing made with the applicable offices in which the fund's certificate of limited partnership or other formation documents is filed. The fund will cease to have any legal existence after this filing.

§ 2:19 Side Letters

§ 2:19.1 In General

Although it is possible for the manager of a private equity fund to attempt to avoid issuing side letters to investors, this goal is difficult to achieve. Unless the fund has a highly retail investor base or a small number of investors, it is very likely that investors will seek individual protections that cannot be built into the governing documents of the funds. In some cases, these protections may relate to specific tax, regulatory, or policy considerations of an investor, and not be applicable to investors generally. In other cases, the preferential terms may be things that any investor would be glad to receive, but that the sponsor is willing to offer only to the largest or otherwise most valued of investors.

One of the most common protections sought by investors is a "most favored nation" clause pursuant to which the investor is assured that it will be able to benefit from side letter protections granted to other investors.⁷⁵ Because this request is so common, a sponsor considering whether to give a preferential term to a particular investor must consider the possibility that the same term will be demanded by other investors, or at least those of comparable or greater size. If it becomes apparent that all investors will require the same preferential term, the side letter provision may be eliminated and the partnership documents amended for the benefit of all investors.

Some managers take up the position at the outset that all terms negotiated by investors should be given on a level playing field to everyone and should appear in the partnership agreements. Those managers may include in a partnership agreement the promise that there will be no side letters, other than with respect to matters affecting the tax or regulatory considerations of individual investors, and may build the most favored nation protection into the partnership agreement itself.

75. See *infra* section 2:19.3[A].

It is important to note that side letters that grant strategic investors different fees or other material rights may require the creation of an additional class of shares in an offshore fund to reflect the different rights granted to strategic investors. This will generally require the amendment of the fund's offering documents. Additionally, to the extent that a fund is managing amounts invested by ERISA plans, the creation of an additional class of shares could, in some cases, inadvertently cause the fund to be considered "plan assets" that would make the fund subject to ERISA.

Additionally, granting side letters may make administration of the fund more difficult. For instance, to the extent that different investors are charged different fees, the fund sponsor may need to keep track of such arrangements whenever fees are charged. Sometimes, the fund administrator may be capable of keeping track of these arrangements, but in some circumstances, the fund sponsor may need to appoint its own personnel to keep track of such arrangements. This can become particularly difficult as the number of side letters granted increases, especially side letters with most favored nation provisions.

When entering into side letter arrangements, fund sponsors must ensure that the proper party is executing the side letter. For instance, for many offshore funds, only the fund's board of directors (as opposed to the investment manager) is authorized to enter into side letter agreements binding the fund.

§ 2:19.2 *Legal and Regulatory Concerns Raised by Side Letters*

Fund sponsors have common law and statutory fiduciary duties to their investors, including the duty of loyalty, duty of care, and the obligation to make full and fair disclosure to their investors.⁷⁶ Granting preferential terms to strategic investors in side letters brings into question whether fund sponsors that grant such rights are fulfilling their fiduciary duties to all investors. Some investors may not want to invest in funds that grant preferential terms to select investors, and yet, at the time of making such investments, they may not know that the fund sponsor has entered into or will enter into arrangements to grant side letters without appropriate disclosures.

As side letters have become more prevalent, and because regulators have increasingly focused their attention toward addressing conflicts of interest associated with investment activities, both the SEC and the regulatory authorities in the European Union (EU) have addressed the regulatory risks posed by granting preferential rights to select investors.

76. *See supra* section 2:10.

In the EU, the Alternative Investment Fund Managers Directive⁷⁷ (which came into force across the EU on July 22, 2013) requires that for (i) any funds established in the EU, (ii) any funds managed in the EU, or (iii) any non-EU funds that are marketed into the EU, must provide EU investors (and any applicable EU regulators) with a description of the terms of any scenarios when an investor obtains “preferential treatment” or the right to obtain “preferential treatment,” providing a description of the “preferential treatment,” the type of investors who obtain such “preferential treatment” and, where relevant, their legal or economic links with the fund or its manager. The “preferential treatment” encompassed by this requirement is much broader than was previously covered in the United Kingdom, for example, and covers more than just material terms; any preferential treatment must be described to EU investors.

The SEC has also expressed its own concerns over side letters. On May 16, 2006, Susan Wyderko, former Acting Director of the SEC’s Division of Investment Management, testified before the Senate Subcommittee on Securities and Investment regarding the SEC’s position on side letters by noting, among other things, the following:⁷⁸

- Some side letter arrangements pose greater concern than others, including those arrangements where certain investors are granted greater liquidity or information rights that may give such investors an advantage in determining when to withdraw their investment from a fund.
- The SEC will review side letter arrangements in their examinations of registered investment advisers focusing on both appropriate disclosure and monitoring of such arrangements.

While private equity funds do not present their investors with liquidity (and therefore raise fewer side letter issues than do hedge funds, for example), side letter arrangements can nonetheless present problems because of the conflicts of interest that they raise.

In addition to regulators’ heightened scrutiny of side letter arrangements, investors are also increasingly sensitive to such arrangements. Fund managers that grant preferential investor rights without appropriate consideration and disclosure of such arrangements

77. Directive 2011/61/EU, of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and Amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No. 1060/2009 and (EU) No. 1095/2010.

78. *Testimony Concerning Hedge Funds Before the Subcomm. on Sec. & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs, 109th Cong.* (May 16, 2006) (statement of Susan Ferris Wyderko, Dir., Office of Investor Educ. and Assistance, U.S. SEC).

may face investor lawsuits alleging fraud arising out of such arrangements, especially if the funds do not attain satisfactory performance results.

Fund managers should undertake several measures that will minimize the risks associated with granting side letters. For the most part, mitigating such risks involves full and fair disclosure of the existence and terms of such side letters. However, the fund sponsor may need to take other measures.

At the outset, prior to granting a side letter, a fund sponsor should review the offering documents of the fund in which the investor will invest to ensure that the offering documents notify investors that the fund sponsor has the authority to grant rights to certain investors that are more favorable than, or different from, the rights granted to other fund investors. To the extent that such offering documents do not authorize such actions, the fund sponsor should amend the offering documents prior to granting the side letter. Even if the fund sponsor discloses the existence or material terms of side letters, the fund sponsor should still monitor all side letter arrangements to manage any conflicts of interest.

§ 2:19.3 Common Types of Side Letter Provisions

Side letters can cover a vast range of topics, including fee terms, additional representations and covenants of the general partner and affiliates relating to conduct of the funds and other ventures, representations about the absence of litigation, receipt of necessary approvals and other corporate-style matters, promise of capacity in future funds, restrictions on the use of the investor's name in marketing, assurances that the fund's investment program will conform to investment policies of the investor, and clarification of terms in the fund's governing documents that the investor finds to be ambiguous but that the manager is unwilling to go through the formal process necessary to amend.⁷⁹ Some of the most common side letter provisions are discussed below.

[A] Most Favored Nation Provisions

Most favored nation provisions (MFNs) come in two basic varieties: (1) those that offer the investor the ability to benefit from side letter terms given to any investor subscribing before or after them, and (2) "schoolyard MFNs" that permit the investor to piggyback only on the side letter rights of investors of their own size or smaller. In either case, it is typical to carve out the following: (a) preferential rights given to the general partner, its affiliates, and employees; (b) advisory board

79. Sample provisions are available in Appendix J.

seats; (c) confidentiality arrangements; (d) confidentiality restrictions; and (e) co-investment rights. Additionally, if there is a seed investor, subsequent investors may not be able to access the seed investor's rights.

Sometimes, investors who are offered schoolyard MFNs seek to negotiate the upper end of their schoolyard above their actual investment amount. For example, an investor who is subscribing for \$50 million of interests may request the right to piggyback on rights offered to investors subscribing for \$100 million or less. These types of requests can themselves create MFN rights for other investors. For example, if the \$50 million investor is allowed to piggyback up to \$100 million, a \$75 million investor who did not previously request an uptick will similarly benefit from the \$100 million clause. These ripple effects can complicate the side letter negotiation process. Some sponsors tackle the issue up front by deciding on a few buckets. For example, unlimited MFN protections for investors subscribing for at least \$100 million, schoolyard for those subscribing at least \$20 million, and nothing for smaller investors. Other sponsors offer MFN protection to any investor who requests it without trying to draw distinctions by commitment amounts.

Other nuances of MFN clauses include the following:

- whether they will apply to all provisions investors negotiate or only to listed key items such as fee levels and liquidity;
- whether they will apply only to a particular fund or also to other parallel or similar funds and managed accounts;
- whether an investor may aggregate investment amounts it subscribes to other funds managed by the sponsor for purposes of determining the schoolyard level;
- whether an investor may aggregate amounts invested by its affiliates for this purpose;
- whether a gatekeeper may aggregate amounts invested by different investors referred by that gatekeeper;
- whether investors can cherry-pick isolated provisions from others' side letters without assuming the related obligations; and
- whether a manager may decline to offer provisions to investors that were given to a particular investor viewed by the sponsor as adding strategic value to the funds.

[B] Compensation Provisions

Sometimes, large investors or early seed investors may negotiate preferential compensation terms that are embodied in side letters.

These terms may include reductions of the carried interest or management fee, changes to the hurdle rates applicable to the investor, or modification of the fee split arrangements on transactional and other fees. Arguably, the reductions are a private matter between the general partner and the investor that do not affect other investors, and that therefore do not need to be disclosed in the offering memorandum or set forth in the partnership agreements of the fund. Better practice, however, is to disclose in both documents that the general partner reserves the right to reduce or waive fees selectively.

[C] Redemption Provisions

The offering of preferential redemption terms is an issue that has received significant SEC attention because granting preferential liquidity to some investors can adversely affect remaining investors in a fund. This issue is commonly faced by hedge funds, but is more rare in the case of private equity funds, which typically do not offer investors any ability to redeem. When this issue does come up in the private equity context, it is likely to revolve around particular tax or regulatory issues for an investor, such as bank holding company control or ERISA issues. Typically these matters are flushed out in the partnership agreement rather than by side letter, because if an investor is permitted to redeem, then the fund will need to find the necessary cash and other investors will be affected.

[D] Transfer Provisions

Although a typical private equity fund partnership agreement gives the general partner the sole discretion to decide whether to approve transfers, investors often seek less restrictive terms. Institutional investors may, for example, request that transfers to their affiliates either be unrestricted or be subject to the general partner's consent not to be unreasonably withheld. Funds of funds groups similarly may request more liberal transfer rights among their various constituent funds. Trusts may request clarification that a change of trustee will be permitted, and investors planning to use leverage may seek consent to the resulting pledge. Because these provisions depend so heavily on the specific factual circumstances surrounding each investor, they are often addressed by side letter rather than being handled exclusively in the fund's partnership agreements.

If transfer restrictions are liberalized, it is important to consult with tax counsel to ensure that the liberalization does not adversely affect the partnership's tax status. Overly liberal transfer provisions can result in a fund being potentially treated as a publicly traded partnership taxable as a corporation for federal tax purposes, with a material adverse effect on investors generally.

Also, the right to transfer should always be subject to satisfactory completion of the fund's subscription documents, including anti-money laundering provisions, and satisfaction of the fund's other investor suitability requirements. Additionally, the prior investor should not be released from its capital commitments unless the new investor is creditworthy.

[E] Information Rights

Some investors use side letters to increase the amount of information the fund must provide to them about its operations, portfolio, and other matters. In the hedge fund context, the SEC has focused on the adverse consequence to remaining investors of selective provision of information to other investors who may use that information to exercise redemption rights. In the private equity context, investors rarely have meaningful liquidity rights and, as a result, the adverse effects of an investor receiving additional information about the funds while others do not is less of a concern. Instead, managers typically address informational rights requests by considering whether it will be burdensome to gather the additional information requested, and whether that information may somehow be used against the funds.

Often, a distinction is drawn between "above the line" information that a sponsor is willing to provide to investors generally, and more sensitive information that will not be provided or that will be provided only to those investors that can assure that it will be treated confidentially. "Above the line" information typically includes the following:

- the fact that the investor is invested in the fund,
- the amount of that investment,
- the fund's general strategy,
- the names of service providers to the fund,
- the size of the funds, and
- the identity of the sponsor.

More sensitive information includes performance data and confidential information about specific portfolio investments.

Certain state pension plans and other governmental investors are subject to the Freedom of Information Act (FOIA).⁸⁰ As a result, they may be required to publicly disclose the information they receive from portfolio funds in response to inquiries. Side letters with this type of investor often include extensive discussion of the manager's ability to hold back information from the investor to avoid public disclosure and

80. Freedom of Information Act, 5 U.S.C. § 552.

the investor's rights to receive this information if it can provide reasonable assurance of confidentiality.

On the flip side, side letters may address particular investors' desire for confidentiality as to their identities and the terms of their investments. When negotiating these provisions, it is important to consider whether the level of confidentiality being requested is consistent with the fund's need to disclose investor names to regulatory agencies and counterparties, and the MFN rights of other investors.

[F] Investment Guidelines

Some governmental and private investors have investment guidelines and, through side letters, seek to ensure that managers will adhere to them. For example, an investor with a "socially responsible" investment mandate may prohibit investments in weapons, pornography, or selected troubled international regions. A state pension plan may require that the manager consider the positive or adverse effects on public employees in that state of particular investment opportunities. A sovereign wealth entity may seek to restrict dealings with the enemy nations.

When analyzing whether to grant these types of provisions, general partners should consider whether the restrictions being sought will materially affect their investment mandates. For example, a fund formed to invest in U.S. real estate will have little difficulty agreeing not to invest in Northern Ireland, but a fund focused on European distressed investing may find this restriction intolerable. Similarly, provisions requiring that a fund not intentionally harm employees in a particular state may be acceptable, while a provision requiring that investments affirmatively be sought only if they foster the objectives of these employees would be unacceptable. The good news is that the types of investors who seek these protections are typically large institutions or governmental entities who have been through this process many times before, and who, if prodded, can live with variations on their proposed investment restrictions that are not problematic for funds. In order to get these modifications, however, the fund sponsor must know to ask.

Fund documents typically provide investors with the right to ask to be excused from particular investments that cause tax or regulatory difficulties. Sometimes side letters are used to clarify that specific types of investments will be assumed to create these issues.⁸¹ For example, a tax-exempt U.S. investor may seek assurance that it can be excused from investments that create UBTI, and

81. See *supra* section 2:14.2.

a non-U.S. investor may seek assurance that it can be excused from investments that generate effectively connected income (ECI) and result in taxes under the Foreign Investment in Real Property Tax Act (FIRPTA).⁸² When considering these provisions, it is important to ensure that the sponsor does not expect too material a portion of the fund's portfolio to be comprised of investments of the type from which the investor will be excused. Otherwise, it will be difficult to deploy the investor's capital, and remaining investors will have to take a larger piece of the number of investments, which distorts the fund's desired portfolio mix.

Another troublesome issue is requests by investors to be allowed to be excused retroactively from investments that have already been made if, for example, their investment policies or applicable laws change. These provisions should be treated with caution, because they may require the fund (and thus indirectly the remaining investors) to buy back the problematic investment from the investor being retroactively excused. If at all possible, it is preferable to address these issues by granting the affected investor the right to transfer its interest instead.

[G] Requirement That Other Investors Sign Substantially Similar Subscription Documents

In addition to MFN protection, investors may seek to require that all other investors sign subscription agreements in substantially the same form as their own. This requirement can prevent other investors from giving more limited indemnities or powers of attorney, or from adding conditions to their commitments. If this term is granted, it is advisable to carve out differences necessitated by regulatory requirements of other investors (for example, limits on their ability to provide indemnities or to submit to jurisdiction). Also, even if no investor explicitly negotiates this provision, sponsors should recognize that MFN protections typically do not depend on whether special rights are granted in a document labeled "side letter," versus appearing in other documents, including subscription agreements. As a result, if an investor makes material modifications to its subscription agreements, those changes should be analyzed to ensure that no MFN is triggered.

[H] Sovereign Immunity

Government investors, such as state pension plans and sovereign wealth plans, often seek to include side letter provisions acknowledging their sovereign immunity. These provisions may state that

82. Foreign Investment in Real Property Tax Act of 1980 (codified at 26 U.S.C. §§ 897, 1445, 6039C).

the investor is statutorily prohibited from providing indemnities. Fund sponsors should modify this language to provide that it does not limit the ability of the fund to indemnify the sponsors, nor limit the obligation of the investor to fund capital calls to meet that obligation.

[I] Capacity Rights

Fund managers may grant a strategic investor the right to increase its investment in the manager's fund products, even if the fund is closed to new investors or to additional investments by other existing investors. Fund managers should consider whether granting capacity rights will allow the fund sponsor to fulfill its fiduciary duties, especially if the added capacity permits the strategic investor to invest amounts over and above what the fund sponsor is able to effectively manage. Capacity rights in private equity funds should apply only during their normal offering periods. Another issue that arises is the terms of the additional investment. The fund sponsor will often provide that the new investment will be on the same terms offered to investors generally. Sometimes an MFN will be given, but it is important not to draft capacity rights that promise to offer the same fund terms as are given in the initial fund even if subsequent funds have different structures and strategies.

[J] Co-Investment Rights

Investors may seek to obtain a right to consider co-investment opportunities generated by the fund sponsor. If some investors will receive a right to be offered co-investments in priority to others, this fact should be disclosed in the fund's offering materials. The fees payable with respect to co-investments may also be addressed.

§ 2:20 Amendments

The general principle of amendment provisions is to divide amendments into four categories:

- (1) innocuous amendments that can be adopted by the general partner acting alone (such as correction of typographical errors and similar obvious errors, and effectuating the admission of new partners pursuant to the terms of the governing documents);
- (2) amendments that require the consent of a majority (or super majority) of investors;
- (3) amendments so fundamental that they require consent of all affected investors (including matters such as changes to fee

levels or percentage interests that require unanimous consent of all involved); and

- (4) amendments that require the consent of an affected group of investors such as to ERISA, tax, or exempt investors.

Amendment provisions vary substantially. Manager-favorable versions permit the general partner to make most changes unilaterally, provided there is no material adverse effect on investors as a whole. Investor-negotiated versions likely remove “material” from that construct, and specifically identify a variety of provisions that are subject to more extensive consent.

Fund documents generally require affirmative, written consent to amendments, but some funds provide for negative consent—that is, investor consent is presumed unless the investor submits a timely objection in writing. Sometimes negative consent is confined to investor-initiated changes made during the fund’s offering period. Additionally, some funds empower the advisory committee to consent to certain types of amendments, such as waivers of position limits or leverage restrictions. However, in the 2009 case of *In re Nextmedia Investors LLC*,⁸³ certain members of an LLC argued that the extension of the dissolution date of the fund without the unanimous consent of the members of its board of managers contravened the amendment provision in the LLC agreement of the fund. Nextmedia argued that the consent to amendments provision is only applicable in instances where a proposed amendment is intended to adversely affect certain or all of the members. The Delaware Chancery Court rejected this argument and held that the purpose of such provisions was to assure members that certain rights they possessed could not be changed without their approval, regardless of good faith. The court further held that the question of whether an amendment triggers consent focuses “not on an empirical factual assessment of whether a member is correct about the effect of a change in the contract, but on whether the proposed contractual amendment would alter an economically meaningful term” and a change to the lifespan of a fund was clearly such an amendment.

If an investor is particularly concerned that a specified fund provision is preserved, and if the fund documents do not provide for unanimous consent as a condition to changing the item, then the investor may seek to protect itself by including the same term in a side letter. This technique may also be used if the investor is joining in a subsequent closing and the general partner is unwilling to seek investor consent to amend the governing documents’ provisions

83. *In re Nextmedia Investors LLC*, C.A. No. 4067-VCS, 2009 WL 1228665 (Del. Ch. May 6, 2009).

regarding amendments (which often itself requires unanimous consent).

One recurring issue is whether particular side letters themselves constitute amendments to the fund's governing documents and, if so, whether the general partner has the power to unilaterally adopt them. This issue should be examined whenever the side letter is inconsistent with the express terms of the governing documents, or limits the partnership's powers. For example, a provision entitling a particular investor to withdraw from the fund, or to prevent the fund from making particular types of investments, may constitute an amendment.

Fund documents often expressly contemplate that side letters will be entered into and may permit amendment of fund documents to be achieved in this manner. Waivers or reductions of management fees and incentive compensation are also often specifically permitted.

No matter how carefully fund documents are drafted, it is likely that, at some point during the life of the fund, amendments will be needed to clarify a provision in fund documents. To limit the need for amendment, some funds provide for an alternative mechanism to resolve these interpretive questions. That mechanism might consist of reliance on the general partner's good faith judgment, on advisory committee concurrence, or on the concurrence of outside counsel.

In some cases, the gray area may involve the level of consent required for a particular amendment. For example, it is not always obvious whether a particular amendment will have an "adverse" or "materially adverse" effect. This issue can become further complicated if the amendment is beneficial to some investors and adverse to others.

Seed or lead investors may be given broader consent rights regarding amendments than are given to investors as a whole. Additionally, if these investors own slices of the general partner, they may, at the general partner level, have consent rights to fund-related matters.⁸⁴

§ 2:21 Certificates

General partners of private equity funds may be required to provide a variety of certificates in connection with the fund's offering. Among other things, these may include backup support to external counsel as to matters covered in legal opinions (for example, that private placement rules were obeyed, that launch of the fund does not contravene other documents entered into by the sponsors, and that there is no relevant litigation). Certificates may be required by placement agents representing that the fund's offering documents are accurate and that distribution of these documents has been controlled. Certificates also

84. For a sample private equity fund amendment provision, see Appendix M.

may be required by investors, for example, to confirm compliance with ERISA.

Sometimes, in-house counsel provides the relevant certifications, either as certificates or as legal opinions. Consents of upstream entities at the sponsor institution are often handled in this manner, as are issues such as representations regarding existing contractual obligations of the sponsor group, or the status of litigation that are not cost-effective for outside counsel to evaluate. In other cases, certificates may come from the sponsoring institution as an entity.

§ 2:22 Closing Process

Private equity funds generally do not have the physical, in-person closing process common in corporate transactions—accordion files full of executed documents, counterparties circling the table, and a closing checklist in hand. Instead, closings are handled by the sponsor and its counsel, who circulate revised and, eventually, final fund documents, collect subscription documents, distribute side letters, and, once all comments have been addressed and subscriptions have been received, declare the closing to be complete.

Some investors insist on seeing fully executed documentation, including side letters, subscription agreements, and opinions, before they will release their own subscription and agree that they have invested in the fund. Most investors, however, are comfortable signing off based on “final” versions of the relevant papers, with execution copies to follow weeks later. (Those weeks can stretch out once the urgency of the closing has passed; to address this, some investors include closing document delivery deadlines in their side letters, although it is unclear what the penalty would be to a sponsor who violates this promise.)

If closing documents are not delivered at closing, the fund sponsor will typically instead advise investors that the closing has occurred through a “welcome” letter (which may be combined with the first capital call letter to investors). The letter often includes an indication of the size of the investor’s commitment that has been accepted. In an oversubscribed fund, the accepted amount may be less than the investor’s subscription document offered to acquire.

Initial closings of private equity funds are often “dry” (that is, no immediate funding is required at closing). If the fund has warehoused investments, contributions sometimes may be drawn at closing, and in any case an initial capital contribution may be called shortly after the “dry” closing to fund organizational expenses and management fees. In the case of subsequent closings, contributions are in theory due

immediately to reimburse existing investors for their excess contributions and to pay retroactive management fees. In practice, however, these contributions are also made after the fact, in part because it is impossible to accurately determine the amount to be contributed while the amount of incoming capital remains in flux.

Capital calls typically require a specified number of days of advance written notice. If a fund sponsor expects to need capital immediately, then the fund documents may waive this notice requirement in connection with capital called at the initial closing.

§ 2:23 Warehousing of Deals

Sometimes, fund sponsors have investments before they have investors. This can occur for a variety of reasons, including:

1. Fund sponsors (often institutions) who hold assets for their own account and are spinning them out in connection with the fund launch.
2. Fund sponsors who believe there is a window of opportunity in their target sector and seek to exploit it.
3. Fund sponsors who believe it will be helpful marketing to present a defined portfolio rather than a pure blind pool.

Obviously, it is not possible to buy investments without capital, so pre-closing investments is only an option for sponsors willing and able to use their own capital to buy assets if the fund fails to launch (or to launch on time). Other managers can seek to build a pipeline of investments but cannot commit to them, which is a source of growing frustration if the marketing process drags on.

If investments are to be warehoused, the sponsor must choose whether to hold them inside or outside the fund. There are offsetting considerations to each approach. Holding investments in the fund requires forming the relevant entities before it is clear that third-party investors will invest, and perhaps before it is clear that the vehicles are formed with the optimal structure for the types of investors who eventually appear. Warehousing in the fund also means that if the fund fails to close, the sponsor will hold its investments through the fund vehicles, which may be inefficient. If the fund is too small, or if parallel investment vehicles are necessary, the warehoused investments may have to be transferred.

Holding warehoused investments outside the fund increases the burden on the manager to prove that, when it later transfers these assets to the fund, there is no adverse cherry-picking in deciding which assets to sell. Also, the transfer from the sponsor to the fund may be taxable or administratively burdensome.

Whichever approach is adopted, warehousing can raise issues if assets materially increase or decrease in value. If there are losses, it can be difficult to convince new investors to buy into the portfolio at cost. If there are gains, the sponsor may be reluctant to sell at cost, and it is quite possible that different assets will move in different directions. As a result, warehousing may be limited as to the amount and timing of deals completed before the fund closes.

From an investor's perspective, the existence of a material-identified portfolio is both a benefit and a burden. On the plus side, the investor can evaluate investments rather than guessing at what the manager will do in the future, and does not have to wonder whether committed capital will remain undeployed. On the negative side, the investor may not have the skills or desire to analyze particular portfolio assets, or to determine whether they have been fairly valued; by offering an identified warehouse, the sponsor may force investors to review these issues rather than doing the more limited diligence that can be achieved with a blind pool.

§ 2:24 Powers of Attorney

Typically, the subscription documents of private equity funds give the general partner the ability to sign the partnership agreement on behalf of investors, avoiding the need to collect individual signature pages. The subscription agreement contains a notarization to ensure that the power of attorney is effective; whether this is necessary depends on the jurisdiction in which the investor signs the agreement, but the easiest course is to require notarization from everyone.⁸⁵

The limited partnership agreement also typically contains a power of attorney authorizing the general partner to sign amendments to the partnership agreement, and to sign and file various certificates, as agent of each investor. To some extent this latter concept is antiquated, as there are few, if any, filings that cannot be accomplished by the

85. Often prepared in connection with financial and estate planning, generally, a power of attorney is a formal document that establishes an agency relationship. Many states have enacted statutes that establish formal execution procedures that must be followed for a power of attorney to be valid (*e.g.*, notarization requirements). Certain states, such as New York, apply such formalities to powers of attorney created for financial or estate planning purposes but specifically exclude powers of attorney created for business purposes from the execution formalities. However, most state statutes do not clearly indicate whether execution formalities apply to all or certain types of powers of attorney. Note also that fund subscription documents should be notarized as a matter of best practice under anti-money laundering procedures. Accordingly, it is best practice for an investor to have its signature notarized when executing fund subscription documents.

signature of the general partner alone. Nonetheless, the language remains and is sometimes of use when the fund does business in non-U.S. jurisdictions.

The language used in the power of attorney varies in scope, and investors sometimes seek to negotiate it. Typical requests are that nothing be signed that would increase the liability of the investors, and that amendments be limited to those otherwise permitted under the partnership agreement. These changes should not be controversial.

Certain investors, such as state pension plans, have regulatory limits on their ability to grant powers of attorney. Additionally, when funds are created for a single investor, that investor may refuse to provide a power of attorney on the theory that all actions should require its consent.

§ 2:25 Governing Law

Delaware is the most popular jurisdiction for formation of U.S.-domiciled private equity funds sponsored by U.S. general partners. Reasons for Delaware's popularity include:

- the Delaware legislature's success in creating and continually updating flexible, manager-friendly statutes;
- the ability of sponsors to contractually reduce fiduciary duties; clarity as to the limited liability of investors notwithstanding their participation on advisory committees, receipt of consent rights and similar roles; the availability of Delaware's Chancery Court, which focuses exclusively on business disputes, as a forum for litigation; and
- the cache of experienced service providers, including local counsel and service agents.

Some sponsors prefer to use the laws of the state in which they otherwise operate. In many cases, this causes no material issues because the laws of other states are generally modeled closely on the same Revised Uniform Limited Partnership Act⁸⁶ and Revised Uniform Limited Liability Company Act⁸⁷ that formed the basis of Delaware law. However, there can be some significant differences that should be considered—for example, fiduciary duties and the actions that may submit a limited partner to unlimited liability to creditors. Also, investors will be less accustomed to dealing with other jurisdictions, which may complicate their review.

86. REVISED UNIF. LTD. P'SHIP ACT, 6A U.L.A. 59 (1995).

87. REVISED UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 408 (2006).

Common formational jurisdictions for funds formed outside the United States include, among others, the Cayman Islands, Bermuda, the British Virgin Islands, the U.S. Virgin Islands, the Bahamas, Jersey, Guernsey, Ireland, and Luxembourg. The best choice for a non-U.S.-domiciled fund will depend on tax and regulatory considerations beyond the scope of this book, as well as on the location (and time zone) of the fund's sponsors and its investors. Often, the same sponsor will choose to operate a fund strategy using parallel vehicles formed in different jurisdictions (for example, a Delaware limited partnership and a parallel Cayman vehicle) to address the needs of different types of investors. The sponsor will typically seek to cause the documentation for these multiple funds to be as similar as possible; however, due to differences in local law, achievement of identical fund terms may not be possible.

§ 2:26 Submission to Jurisdiction

For reasons of convenience, U.S. private equity fund sponsors often seek to require disputes to be resolved in either the federal or state courts of their home jurisdiction or, because of its perceived sophistication, in Delaware Chancery Court. These provisions are typically accepted by investors. However, certain types of investors (for example, certain state pension plans) may be statutorily prohibited from submitting to the jurisdiction of another state. Also, large seed investors sometimes seek to impose a forum more convenient to them. Often, this issue is resolved by side letter, with the sponsor agreeing to pursue disputes with specified investors in alternate jurisdictions while retaining the ability to litigate with other investors in the originally specified forum. Funds with non-U.S. sponsors may choose non-U.S. forums for dispute resolution. In some cases, such disputes may be referred to international tribunals instead.

§ 2:27 Arbitration/Mediation

To address disputes among the principals, arbitration is a dispute resolution method that is often used in the governing documents of general partners and management companies due to its speed and confidentiality. However, it is far less common in fund documents governing the relationship between sponsors and investors. Similarly, mediation is sometimes specified in sponsor-level documents, but is very rare in the documents governing funds.

