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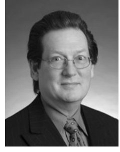
Private Equity Fund Formation



By Stan Johnson, *Loeb & Loeb LLP*

While it is not possible to discuss all aspects of fund formation in an article of this length, the following is an attempt to provide the reader with a general overview and a flavor of some of the issues that arise during the formative stages of a private equity fund.

The Fund

Private equity sponsor group funds and mezzanine funds can take on various legal forms but the most common form by far are limited partnerships, most often formed in Delaware. Limited partnerships remain the preferred form for at least two reasons. First, everyone in the private equity world is familiar with them. Second, by law it is clear that limited partners do not participate in management, whereas in a LLC, for example, it is not immediately apparent to third parties that investors who are members of the LLC do not have at least some management authority. For example, with respect to those investors who are concerned about FCC attribution rules, being a limited partner provides a good measure of insulation from those attribution rules because, by law, limited partners do not participate in management of the fund.

The General Partner

It is most common these days for a general partner to be a LLC, with the sponsor group's managers, the principals and others as members. However, some general partners are structured as limited partnerships, S-corporations and in some rare instances as C-corporations. The arrangements vary but typically founding principals are vested fully in the "carried interest" in the fund and other, more junior, members are subject to vesting schedules over a three- to five-year period. Some such vesting schedules start on the date of employment, vesting across the board with respect to all portfolio investments. Other vesting schedules start anew with each of the fund's portfolio investments.

The General Partner Commitment

In most funds, investors require the general partner to commit to invest 1% of all capital committed by the limited partners. Historically, the 1% threshold was driven by federal tax considerations, but that concern is now dated. There is no longer a tax motivation, just a market expectation on the part of the investors who want to see that the general partner has some "skin in the game." Generally, as sponsors who have grown rich on previous funds organize new ones, investors can be expected to insist that the general partner commit a larger percentage, on the theory that a greater commitment is required to keep the general partner motivated to generate the carried interest.

The Carried Interest

Almost all equity sponsor funds and mezzanine funds are structured such that the limited partners invest 99% of the capital and the general partner, 1% (the general partner often invests as a limited partner, just to confuse matters a bit). The limited partners receive 99% of the distributions until all their capital has been returned, as well as a preferred return (typically 8% compounded), which is sometimes called "payback." Thereafter, distributions generally go 80% to the limited partners and 20% to the general partner, meaning, of course, that 20% of the gain goes to the general partner. This 20% interest is referred to as the "carried interest" or sometimes as the "promote." The carried interest is taxable at capital gains rates.

Typically, there is a "clawback" provision in the partnership agreement that serves as a true-up mechanism in case the distribution of gains to the general partner exceeds 20%. The typical term of a private equity fund partnership is 10 years; a five-year commitment period during which investments are made and a five-year run off, with two one-year extensions available. The general partner's obligation to give back (clawback) money to the limited partners in excess of 20% of the gain can come at the end of the term, at various intervals during the term, or upon the realization of each portfolio investment.

Structure

The following chart may be helpful in understanding a typical organizational structure.

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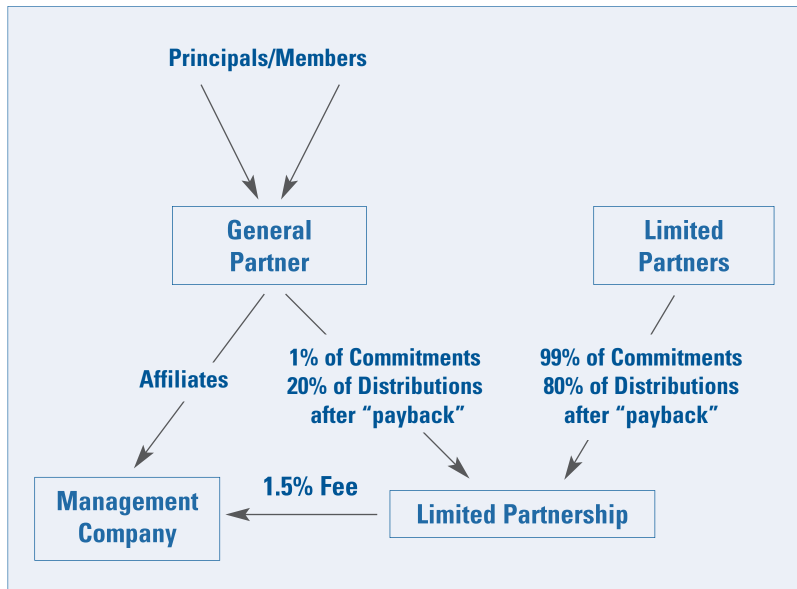

Issues Affecting The Structure

The above is a general snapshot of a typical fund structure. Variations can include the establishment of an offshore parallel fund for non-U.S. investors, structured for U.S. tax planning purposes to avoid non-U.S. limited partners being deemed to have received U.S. effectively connected income, or ECI. Other variations can be dictated by unrelated business taxable income, or UBTI, issues for U.S. tax-exempt investors such as public pension funds. The UBTI problem typically occurs when the fund itself is permitted to borrow (e.g., a subscription line of indebtedness for such uses as to fund organization costs, bridge financings and the initial payment of management fees). UBTI and ECI issues also result from the fund's investment in LLCs and other pass through entities. U.S. tax-exempt investors and all non-U.S. investors are often grouped together to invest through an offshore "blocker" corporation to structure around the ECI and UBTI issues. In addition, the structure may include domestic or offshore "feeder" funds, for example, where investors who are not able individually to meet the general partner's minimum investment criteria pool their investments to form one limited partner.

The Management Company And Management Fees

Most sponsor funds have a management company affiliated with the general partner that manages the fund's investments and receives a management fee from the partnership. In these arrangements, the general partner manages the partnership, makes capital calls, provides records and tax information, distributes cash to the partners and the like. The management company monitors the portfolio investments and receives the management fee.

The management fee is typically 1.5% of committed capital in funds with, say, less than $5 billion in committed capital. In funds with over $5 billion or so in committed capital, investors can be expected to insist that the percentage decrease on any additional capital raised beyond $5 billion. Management fees are typically payable semi-annually in advance, but other arrangements can easily be made. It is common at the initial closing of the fund for the management fee for that fee period to be paid on a pro rata basis and the fee for the next period to be paid as well.

Please note that the above discussion of fees assumes that the principals are only sponsoring one fund at a time. Scale-up and scale-down issues arise if they are managing more than one fund at a time.

Credits against the management fee are generally given to the limited partners for consulting fees, transaction fees, breakup fees, monitoring fees and the like received by the management company from portfolio companies. The amount of the credit is generally 50% of such fees, but in larger funds that percentage can increase. On a recent $10 billion plus fund, the credit was 65%.

Organizational Costs And Placement Fees

Organizational costs for funds marketed exclusively or almost exclusively in the U.S. are typically capped at $500,000 at present, meaning that the partnership will pay up to $500,000 of these costs, with the general partner paying the excess. This cap increases substantially as offshore parallel funds, subscription or other lines of indebtedness, blocker corporations, feeder funds and other features are added.

Fees to placement agents are almost universally paid by the general partner, not the partnership. Most placement agents charge a fee of between 2% and 2.5% on commitments made by investors other than the general partner, its affiliates and perhaps investors brought to the table by the general partner. Most placement agents will stagger the payment of the fee over the first two years of the fund's first closing at prime or prime plus

100 to 200 basis points, especially for first-time funds. The sponsors would be well advised to time the payment of placement fees to the management company's receipt of management fees. For example, half of the semi-annual management fee could be made payable to the placement agent within five days of the management company's receipt of management fees over the first two years, until the placement fee is paid in full.

Striking The Deal With The Limited Partners

In terms of working out the details in a negotiation with limited partners, it is typical for certain major investors and their counsel to take the lead in hammering out the specific terms of a partnership agreement, with other investors tracking the changes as drafts of the partnership agreement and other documents are circulated. ERISA-governed investors will be keen to make sure that their investments and related escrow provisions are ERISA compliant. Media-sensitive investors will want assurances that they are insulated from FCC attribution rules. Almost all investors will want "most favored nation" provisions. However, it is common to grant the "big" investors some rights that the "little guys" do not get. For example, major investors are more likely to have a right to be on the advisory committee, to have co-investment rights and, in the case of very large investors in smaller funds, the right to suspend the commitment period under certain circumstances. Though common, side letters are problematic if the rights granted to any one investor conflict with the best interests of the other investors. Some sponsors simply won't agree to them, while others accept them, but, correctly, disclose them to the other investors and offer the same terms to other similarly situated investors.

Compliance With Laws

It goes without saying that U.S. and other jurisdictions' securities laws must be complied with, as must anti-money laundering statutes. In the U.S., these securities laws include the Securities Act, the Investment Company Act, the Investment Advisers Act and state Blue Sky laws. The principal anti-money laundering act in the U.S. is the USA PATRIOT Act.

Some Specific Issues

While it is not possible to cover all the issues that arise in the context of a fund formation within the confines of this article, the following issues are noted.

Reinvestment of fund capital. Will the fund be able to reinvest capital from a deal sold within, say, the first 18 to 24 months of the fund's initial close or its initial investment? Will it be permitted to reinvest capital and gain? While reinvestment of capital is becoming more common, reinvestment of gain remains as of this writing relatively rare.

Bridge financing. Will the general partner be allowed to bridge a partnership investment from a debt line which is recourse to the partnership? Indebtedness at the partnership level, as opposed to debt at the portfolio company level, presents UBTI issues for U.S. tax-exempt investors. Many larger funds allow bridge financings, while smaller funds typically do not.

Divorce and key person provisions. Sponsors and limited partners will typically come to an agreement as to who the key principals are and what happens if one or more of them are no longer primarily engaged in the operation of the partnership. In addition to these key-person terms, the parties will also need to address for-cause divorces in the event of irregularities on the part of the sponsors, no-fault divorces where there is no impropriety but the fund is simply not performing well, no-fault suspensions of the commitment period and other similar provisions, in the event, for example, of the death or disability of one or more of the principals.

Disclosure by investors of fund performance and portfolio company performance. Public pension funds and other similar investors in California, Texas and some other states are now required to disclose IRR and other performance data with respect to the funds they have invested in. At present, this public disclosure is limited to performance at the fund level. There is increasing demand for such investors to disclose information at the portfolio company level. Thus, if the California Public Employees' Retirement System, for example, were to receive portfolio company-level information from a fund in which it has invested, can it be compelled under FOIA and other laws to disclose that information to the public? If so, this presents several problems. Does it include due diligence files regarding the portfolio company? Does it include personnel files of the management of the portfolio company? Will such information be exploited by the portfolio company's competitors? The reaction from sponsors has ranged from simply not letting such public investors invest in

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the fund (a painful result as it entails turning away an otherwise qualified investor) to not giving them the portfolio-company-specific information that other limited partners receive over the life of a fund.

A General Note

There are many issues that arise during the course of the formation and administration of a private equity fund. The above are only a few but are hopefully of help to you in raising your fund. Good luck!

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