MASTERING PRIVATE EQUITY

Transformation via Venture Capital, Minority Investments & Buyouts

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WILEY

This edition first published 2017

Registered office
John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

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A catalogue record for this book is available from the Library of Congress

A catalogue record for this book is available from the British Library.

ISBN 978-1-119-32797-4 (hardback) ISBN 978-1-119-32794-3 (ebk)
ISBN 978-1-119-32798-1 (ebk)

10 9 8 7 6 5 4 3 2 1

Set in is 10/12pt Helvetica LT Std by Aptara, New Delhi, India
Printed in Great Britain by Bell & Bain Ltd, Glasgow

SECTION IV
Fund Management and the GP–LP Relationship

We have so far focused on the investment side of private equity (PE): how to identify, execute, manage and exit a single investment. We now turn to a central relationship in PE: that between and general partners (GPs) and limited partners (LPs), the PE firms that raise and manage funds and the investors that back them. The GP–LP model allows for specialized roles, separating the investment function from the capital allocation role and thereby limiting the liability of LPs. With this blueprint the industry was able to scale and grow significantly over the past four decades.

Yet the separation of roles adds substantial legal and fundraising cost to the PE model. To reduce the legal complexity, standards for documents and processes have evolved, most notably the limited partnership agreement.

The separation of activities can also lead to resource and information asymmetries between a fund's GP and its LPs. From the LP's perspective selecting a manager and managing a portfolio of PE funds are the main tasks requiring significant (and not always available) resources.

One feature embedded into the model to minimize the principal/agent conflict is the finite lifetime of funds. This instills discipline in the GP, focuses their attention on exits to return proceeds to investors and gives LPs the ability to reconsider the relationship at regular intervals.

Section Overview

The chapters in this section cover the main elements of the institutional GP–LP fund model, from raising to winding down a fund (for GPs) to allocation decisions when developing a PE program (for LPs).

Chapter 16: Fund Formation: The PE fund model determines the rules of engagement for GPs and LPs over the life of a PE fund. We touch on the structural and contractual foundations of a PE limited partnership, examine key considerations for GPs and LPs and discuss the limited partnership agreement.

Chapter 17: Fundraising: Fundraising is the first step in a PE fund's lifecycle. The capital raised from investors will not only be used to invest in portfolio companies but will also finance the fund manager's business as a going concern. We describe the standard steps, key considerations and documents involved in this process.

Chapter 18: LP Portfolio Management: An LP's allocation to PE must be considered within the context of its broad investment mandate and its overall portfolio construction. Key elements discussed in this chapter include the benefits and challenges presented by the PE asset class, defining parameters of a PE program, fund manager selection and managing an existing portfolio of PE funds.

Chapter 19: Performance Reporting: The challenge of evaluating PE performance comes from its very nature as an illiquid asset class with long investment horizons. This chapter explains the steps taken to derive a fund's gross and net performance and highlights potential issues to be considered in the process. We conclude with a closer look at methods to compare PE performance to public equity performance.

Chapter 20: Winding Down a Fund: This chapter closes the loop by discussing how to wind down a PE fund and bring the parties' legal obligations to an end. We describe the standard process of dissolving, liquidating and terminating a fund and investigate specific end-of-fund-life solutions in the case of unrealized assets at the end of the regular—and irregular (zombie)—fund life.

FUND FORMATION 16

Private equity (PE) funds today—be they venture capital, growth equity or buyout funds—operate in a global market and invite investors with distinct mandates to deploy their assets via a single fund vehicle. As the PE industry has grown over the past 30 years, investors have increasingly demanded more transparency and flexibility to accommodate their specific needs. With greater visibility of and interest in the PE asset class than ever, the demands on fund formation have expanded.

The fund formation process determines the rules of engagement for general partners (GPs) and limited partners (LPs) over the life of a PE fund. While many of the provisions found in fund formation documentation are standardized or revolve closely around a market standard, an effective and expertly executed fund formation process can optimize a fund's structure and its key terms for LPs and GPs alike. Due to a fund's longevity—often 10 years or more—setting clear and transparent rules is essential for the GP's ability to attract investors, mitigate potential future risks and navigate a complex and changing regulatory, tax and investment landscape in the process.

In this chapter, we touch on the structural and contractual foundations of a PE fund—the PE limited partnership—elaborating on the broad terms laid out in Chapter 1. We begin by examining the key considerations for GPs and LPs during the fund formation process; we then present the various vehicles typically employed to channel capital to a fund and its investments. We conclude with a discussion of the key legal document in the fund formation process: the limited partnership agreement (LPA). Please note that this chapter is highly technical, making it more of a source of reference for the general reader.

SETTING UP A PE FUND

The primary goal in fund formation is simple: structure a collection of vehicles that allows for an optimal flow of capital from LPs to the fund—and ultimately to its portfolio companies and back to the LPs upon exit—preferably with minimal tax impact at the fund level.[1] The most common and effective structures allow for the flexible management of the fund's capital throughout the PE investment cycle (i.e., investment phase/divestment phase) and avoid double taxation on distributions of income and capital for LPs in the fund.

PE funds are usually set up as limited partnership closed-end funds; we will focus the discussion in this chapter on this legal structure. Less commonly employed fund

1. A note on taxation: Limited partnerships have in general no entity-level tax. Each GP, manager and LP will respectively manage its own tax situation. Nevertheless, much attention is paid to withholding taxes for proceeds coming to the fund upon exit of deals. Also, the much-discussed topic of tax treatment for carry—should it be treated as capital gain or general income—is no longer a US issue only, but incurs greater scrutiny in many jurisdictions.

structures include search funds, deal-by-deal structures, opt-in/opt-out funds and open-ended (evergreen) vehicles.[2]

Frequently employed onshore limited partnership structures include the Delaware Limited Partnerships for funds primarily investing in the United States, English Limited Partnerships for funds primarily investing in the United Kingdom and various limited partnership structures employed in European and Asian jurisdictions. PE funds may also employ offshore limited partnership structures—including Cayman Islands, Jersey and Guernsey Limited Partnerships—to optimize a fund offering. When offshore vehicles are employed, tax treaties and other bilateral/multilateral agreements can help mitigate unfavorable tax treatment of the offshore fund.

On the one hand, PE firms aim to establish a simple funding structure with entities in as few jurisdictions as possible to minimize cost and the complexity of fund operation, administration, reporting and regulatory compliance; on the other hand, demands from LPs and the desire to operate in multiple countries may make this a futile effort. From the GP's perspective, PE funds are ideally structured as onshore vehicles within the jurisdiction and location of its target portfolio companies. This eliminates any red tape or restrictions imposed on foreign investment vehicles and can cast a favorable light on the fund's activity in the public eye. However, more often than not, circumstances may lead the fund to a more flexible offshore vehicle—for instance, in the Cayman Islands, Luxembourg or Jersey. In such cases, a primary fund is established offshore, with capital invested through wholly owned subfunds or acquisition vehicles domiciled in the onshore jurisdiction.

LPs look for a familiar structure in a recognized onshore or offshore jurisdiction when considering capital allocations to a PE fund. Investors will ensure that the structure limits their own liability to the capital committed to the fund and that the laws supporting their limited liability are familiar and robust. For US domiciled LPs, a fund structure that optimizes outcomes under the US tax and regulatory system (for example, UBTI, ERISA, CFC, PFIC) is a paramount requirement.

FUND VEHICLES

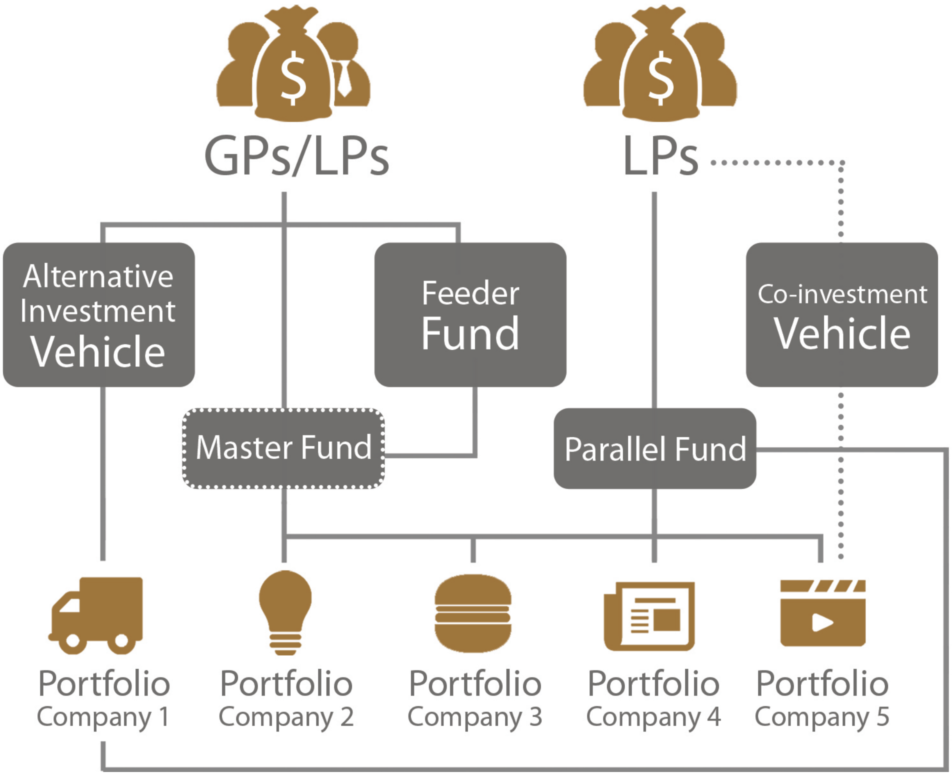
GPs have a variety of fund structures and supporting vehicles to choose from when establishing a closed-end PE fund. To optimize specific tax, regulatory and other structuring needs of one or more LPs, multiple fund vehicles are often established to channel investments alongside a single primary fund. These include parallel funds, feeder funds, and co-investment vehicles. Exhibit 16.1 provides an example of a fund structure with a variety of supporting vehicles; their primary functions are described in the section that follows.

PRIMARY FUND

The primary fund is the main vehicle to which the GP and the majority of LPs commit. The provisions of a fund's LPA govern substantially all investment, divestment, and fund management activities made through any vehicle associated with it.

2. Please refer to our Glossary for a brief definition of those vehicles.

Exhibit 16.1 PE Primary Fund and Complementary Vehicles



PARALLEL FUND

Parallel funds are usually set up to accommodate the special legal, tax, regulatory, accounting or other needs of an individual LP or group of LPs participating in a fund offering. These vehicles invest and divest side by side with the primary fund in fixed proportions typically based on each vehicle's capital commitments; both funds will usually maintain the same percentage of invested-to-committed capital over the life of the fund. LPs in the parallel fund share in all expenses related to managing the funds and fund investments on a pro rata basis. The terms of the parallel fund are substantially the same as the primary fund, except as is reasonably necessary to address the needs of LPs in the parallel fund. Parallel funds are often established to accommodate, for example, foreign investors subject to taxes from an onshore vehicle, the need for opt-out from LPs (for example, Sharia compliance), or when the terms of a single investor are difficult to disclose in full to other fund investors.

FEEDER FUND

Feeder funds aggregate commitments from one or more investors and invest directly into the primary fund as an LP. Feeder funds are primarily formed for tax purposes; as such, they may, for instance, file and pay taxes in a specific jurisdiction (rather than each investor paying individual taxes) or may have special tax attributes. A feeder may allow foreign investors to avoid onshore taxes. Feeder funds may also be established by banks and other institutions that pool capital from multiple clients to meet minimum check size required for investment in a PE fund; in this case, they are at times referred to as "platforms." Investors in a feeder fund are responsible for meeting capital calls and paying expenses and fees on the same terms as LPs in the primary fund.

ALTERNATIVE INVESTMENT VEHICLE

Alternative investment vehicles (AIVs) are structured to accommodate one or more special investments made outside of the primary fund (and/or a parallel fund). These vehicles are employed when the main fund is not the optimal vehicle for a particular investment, whether for tax, regulatory or other legal reasons. GPs have broad discretion to establish an AIV but they are typically deal specific or established for a group of related deals. AIVs may invest in parallel to or in lieu of a primary fund and have full rights to draw on LP capital commitments on substantially the same terms as the primary fund.

CO-INVESTMENT FUND

These vehicles are set up by the GP to invest alongside the master and parallel funds in a portion of a single investment. The co-investment is typically provided by one or more of a fund's LPs at lower (or no) fee and carried interest terms than the primary fund; at times capital may be drawn from an external party. Co-investors may be granted more flexibility than fund LPs around exit timing allowing them to stay on post-exit of the primary fund. LP co-investment rights are subject to negotiation and may provide preferential access to co-investment opportunities for a cornerstone LP or may be granted on a case-by-case basis at the full discretion of the GP. The primary fund typically needs to receive its full allocation of an investment opportunity before co-investment can be sought, with the co-investment amount typically being smaller than the investment from the primary fund.

LIMITED PARTNERSHIP AGREEMENT

A fund's LPA sets out the general terms and conditions applicable to all participants in a PE fund. This document establishes the rights and responsibilities of a fund's general partner and limited partners related to fundraising, capital calls and distributions, expenses and profit sharing, fund governance and reporting, and fund termination. The section that follows outlines the key provisions found in an LPA.

ORGANIZATION

This section of the LPA sets out basic information on the fund, including but not limited to:

- The laws and regulations governing formation of the partnership
- The name, place of business and registered agent of the partnership
- The purpose of the partnership and the types of investment it will make
- The term of the partnership, typically 10 years with two, one-year extensions

- The investment period and the minimum capital a fund must deploy before its GP can raise a follow-on fund
- The additional fund vehicles associated with the fund

PARTNERS AND CAPITAL

In this section of the LPA, key stakeholders and the ways in which they contribute capital to the fund are defined. An entity affiliated with the sponsoring PE firm will serve as a fund's GP and will typically commit from 1 to 5% of a fund's capital, with the GP commitment rarely exceeding 10% of a fund's total capital. A GP admits an initial group of LPs to the fund and the GP then commences investing.

CAPITAL CALLS: As soon as a fund has had its first close, the GP may issue capital calls to LPs to make investments and cover deal expenses, pay fund fees and expenses related to establishing the fund up to a cap, and settle the general obligations and liabilities of the partnership. The capital called by a fund is referred to as contributed capital. LPs must meet capital calls within a limited period (e.g., 10–20 days) of receipt; an LP that fails to meet capital calls suffers severe penalties such as the loss of the right to make future capital contributions, the loss or reduction of its stake in existing investments, or the forced sale of its stake in the fund. An LP may be excused from meeting a capital call for investment if its participation would result in violation of a law or regulation. The GP may request that the other LPs meet the shortfall from an excused or defaulting LP.

SUBSEQUENT CLOSINGS: GPs may at their discretion admit additional LPs into the fund via subsequent closings within a specific time period—typically nine to 18 months—following the initial closing. LPs that are admitted post-first closing will typically participate in fund investments made prior to their admittance and are required to pay all fund fees and expenses as if they had committed on the initial closing date. At the time of their subscription, these LPs must contribute capital to the fund equal to their proportionate share of total contributed capital plus interest. This contribution is distributed to a fund's existing LPs to align the ratio of capital called to capital committed for all LPs while the interest payment compensates existing LPs for effectively "covering" a new LP's capital commitments.

LP LIMITED LIABILITY: LPs' liability in a fund is limited to their capital commitment; an LP is under no obligation to commit any additional capital to the fund beyond its unused capital commitments at any point during the fund's term. GPs may be permitted to recycle committed capital during the investment period, if an investment is exited within a certain period, often one to two years (so-called "quick-flips"), or to the extent distributions represent a return of capital drawn for fees or expenses. An LP may also be required to return distributed capital to a fund to meet indemnity or partnership obligations.

DISTRIBUTIONS POST-EXIT AND CARRIED INTEREST

Distributions to LPs and GPs from a limited partnership consist of current income generated by fund investments and proceeds realized from the sale of fund investments, net of outstanding and reserved partnership expenses and obligations. Distributions may be made in the form of cash or marketable securities; marketable securities typically represent "in-kind" distributions of listed equity resulting from an initial or secondary public offering. LPAs set out the period within which current income and sale proceeds must be distributed to fund investors, for instance 60 days following the close of the fiscal quarter for current income and 45 days after proceeds are received from a sale of fund assets. In addition, distributions may be made to cover the proportionate tax expense incurred by fund investors for investments held in the portfolio.

DISTRIBUTION WATERFALL: The order of priority and timing of distributions made to a fund's LPs and its GP are set out in an LPA. Priority is typically defined by a waterfall consisting of four steps: the first two steps allocate distributions to fund LPs, the third allocates proceeds to the GP, and the fourth allocates distributions to both fund LPs and the GP. Proceeds shared with the GP in the third and fourth step are referred to as a GP's carried interest (or profit share)—the key incentive for PE professionals—and is most frequently set at a 20% share of fund net profits. An example of the generic language defining the steps in a distribution waterfall is set out in Exhibit 16.2.[3] It should be noted that venture funds typically do not have a hurdle rate.

CARRIED INTEREST: PE funds employ two common methodologies that determine when a GP is entitled to carried interest: all capital first carry and deal-by-deal carry with loss carry-forward. When an all capital first carry (also known as a European-style waterfall) is employed, a GP is entitled to carried interest only after all LP capital contributions made to the fund have been returned and a hurdle rate on all contributed capital has been achieved.

In the case of deal-by-deal carry with loss carry-forward (also known as an American-style waterfall), a GP is entitled to carried interest following the sale of each investment in a fund, after LPs' capital contributions and the hurdle rate for that investment and all previously exited investments have been returned. See Box 16.1 for worked examples of both carried interest methodologies.

CLAWBACK: If, at the end of a fund's term, a GP has received carried interest in excess of the agreed share of fund-level profits (usually 20% of net profits) or has received carry without the LPs realizing their hurdle rate, a clawback provision is triggered that allows LPs to reclaim any overdistribution and align the share of fund profits with the terms set

Exhibit 16.2 Distribution Waterfall and Carried Interest

STEP 1: Return of LP Contributed Capital

Distribution of capital until each LP has received 100% of its aggregate contributed capital for investment, fees and fund expenses.

STEP 2: Hurdle Rate

Distribution of capital to each LP until a hurdle rate – a preferred return typically in the range of 8% to 10% per annum – on contributed capital has been achieved.

STEP 3: GP Catch-up

20%

Distribution of capital until the GP has received carried interest equal to 20% of the distributions made to fund LPs in Step 2 and to the GP in Step 3.

STEP 4: 80/20 Split

80% 20%

Distribution of remaining capital in the ratio of 80% to fund LPs and 20% to the GP.

3. In recent years, some of the most sought-after funds started to lower or even omit the hurdle rate (traditionally 8%).

out in the LPA.[4] Clawback provisions are most commonly activated in an American-style waterfall, and rarely in the context of a European-style waterfall. The clawback covers the whole life of the fund and essentially looks at the economic position once all the dust settles (and all investments have been made, exited and proceeds distributed). At times, LPAs may define an interim clawback. If in place, return distributions will be measured half-way through the fund and (if necessary) overdistributions may be "clawed back" or future distributions diverted to the LPs until alignment has been restored. The obligation to meet clawback payments sits with a PE firm's senior partners and a portion of the GP's carried interest may be held in an escrow account (especially if there is no guarantee in place).[5] Nevertheless, it should be added that experienced PE partners will avoid a clawback situation and forego carry if and when the risk of overdistribution arises.

Box 16.1

CARRIED INTEREST IN PRACTICE

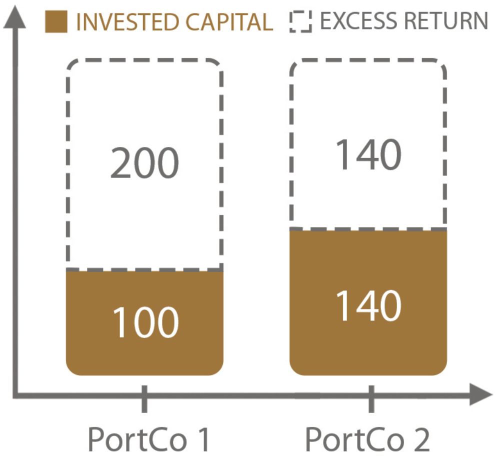
All Capital First vs. Deal-by-deal

The example below shows the impact of the two carried interest models on the timing of cash flows to both GP and LPs as the proceeds from exits are distributed.

Our sample fund makes only two investments—$100 million in PortCo 1 in year one and $140 million in PortCo 2 in year two—and exits each after five years. PortCo 1 is sold for $300 million, generating an excess return of $200 million (MoM of 3×), and PortCo 2 is sold for $280 million, generating an excess return of $140 million (MoM of 2×); see Exhibit 16.3. We further assume for simplicity a hurdle rate of 8% per annum, carried interest of 20% and no management or portfolio fees.

Exhibits 16.4 and 16.5 show how each carried interest model allocates distributions to the fund's GP and LPs.

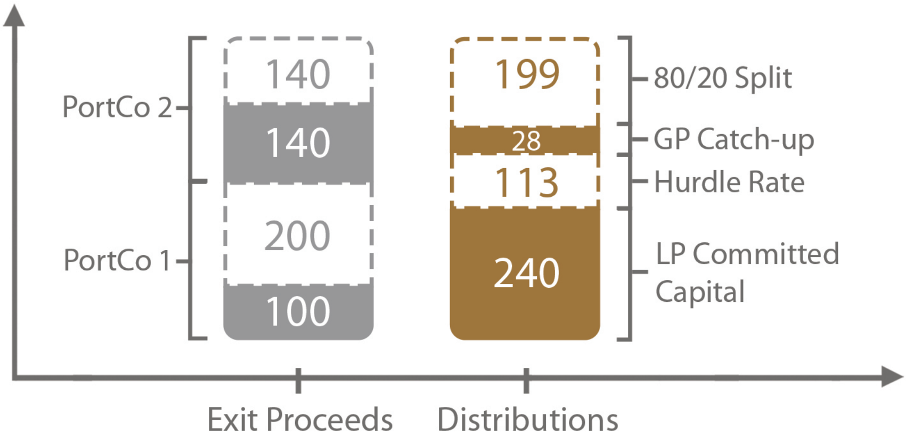
Exhibit 16.3 Fund Investments



4. GPs typically provide clawback payments that are "net of taxes."

5. Where the GP is a special purpose vehicle, the "owners" of the GP often guarantee the GP's clawback obligation. In some cases, the sponsor itself may guarantee the clawback, or much less frequently the "key" principals may jointly guarantee the clawback obligations of all carry recipients.

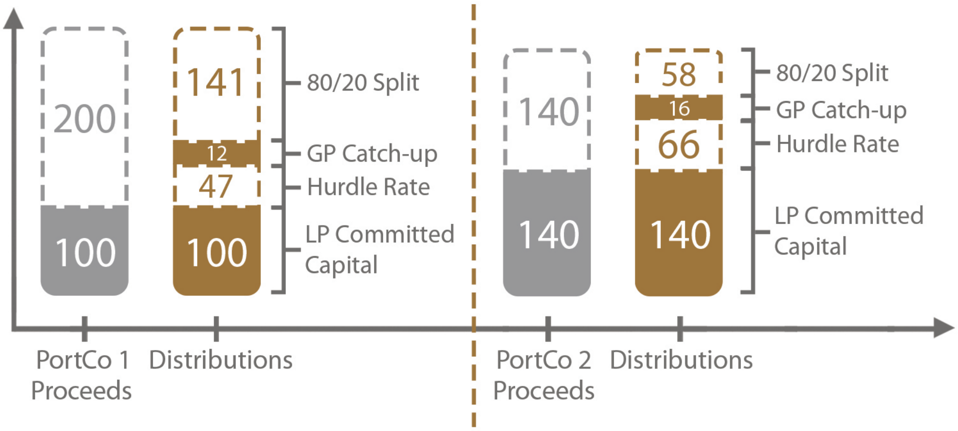
Exhibit 16.4 All Capital First Waterfall



Carry Distribution—All Capital First:

- **Exit PortCo 1:** ($300 million) → funds are used to:
  - Step 1: return all of the LP capital drawn by the fund ($240 million).
  - Step 2: part one of the $113 million[6] hurdle rate paid to LPs ($60 million).
  - No carry for the GP—all proceeds from the exit have been distributed.
- **Exit PortCo 2:** ($280 million) → funds are used to:
  - Complete step 2: part two of the $113 million hurdle rate paid to LPs ($53 million).
  - Step 3: GP entitled to carried interest ("catch-up" $28 million).
  - Step 4: remaining proceeds from exit are divided between LPs and the GP on an 80/20 basis (total: $199 million; LPs: $159 million; GP: $40 million).

Exhibit 16.5 Deal-by-deal Waterfall



6. The hurdle rate calculation = ($240 million * 1.08^5) – $240 million.

Carry Distribution—Deal-by-deal:

- **Exit PortCo 1** ($300 million) → funds are used to:
  - Step 1: return all of the LPs' capital invested in PortCo 1 ($100 million).
  - Step 2: hurdle rate for PortCo 1 is paid to LPs ($47 million[7]).
  - Step 3: GP entitled to carried interest ("catch-up" $12 million).
  - Step 4: remaining proceeds from exit are divided between LPs and the GP on an 80/20 basis (total: $141 million; LPs: $113 million; GP: $28 million).
- **Exit PortCo 2** ($280 million) → funds are used to:
  - Step 1: return all of the LPs' capital invested in PortCo 2 ($140 million).
  - Step 2: hurdle rate for PortCo 2 is paid to LPs ($66 million[8]).
  - Step 3: GP entitled to carried interest ("catch-up" $16 million).
  - Step 4: remaining proceeds from the exit are divided between LPs and the GP on an 80/20 basis (total: $58 million; LPs: $46 million; GP: $12 million).

Within the setting of our straightforward example, the fund GP receives the same amount of carried interest, independent of the model applied; yet, the timing under the deal-by-deal waterfall is more favorable to the GP (carry is received earlier).

RIGHTS AND DUTIES OF THE GP

A PE fund's GP is solely responsible for operating, managing, administering and controlling the affairs of a PE limited partnership, notably including all decision-making related to investing and divesting the fund's capital. GPs are required to maintain a fund's status with properly authorized regulatory authorities so that it may carry out its duties within the jurisdictions in which it operates, or appoint an authorized investment manager to carry out those functions on its behalf. While fund LPs have no input on investment decision-making, the LPA sets out certain limits and obligations that govern GP investment and portfolio management activity to protect LP interests and align with the fund strategy presented during fundraising. These may include but are not limited to:

- Limits on the amount of capital the GP may invest in a single investment, in a single year or before certain fund milestones
- Limits on the sectors, geographies, strategies and type of instruments within which the fund can invest
- An obligation to value fund portfolio companies and report those values to fund LPs on a regular basis
- An obligation for the GP to prepare and pay taxes on behalf of the partnership, and use certain efforts to secure relevant tax exemptions or refunds on behalf of fund LPs
- The right to offer co-investment rights to certain LPs in case the fund does not take up the entire investment amount
- Rights to secure fund-level debt, incur expense, and hedge portfolio exposure on behalf of the fund
- The right to hire consultants and advisors to execute investment and portfolio management activity

7. The hurdle rate calculation = ($100 million * 1.08^5) – $100 million.
8. The hurdle rate calculation = ($140 million * 1.08^5) – $140 million.

KEY PERSON CLAUSE: The LPA will clearly define the key personnel or "key persons"—typically senior partners—responsible for the fund's activities. In general, key persons are required to devote substantially all of their time to managing the fund. In the case of one (rarely) or several key persons leaving, the following remedies may apply: termination of the investment period (most commonly), removal of the GP or dissolution of the fund.

AFFILIATED FUNDS: LPAs will clearly lay out any restrictions of investment activities for the fund's GP and its affiliates. Provisions typically limit the GP or its affiliates to raising a follow-on fund during the fund's investment period or until a certain portion of fund commitments have been invested. Specifically, the provisions will detail the "devotion of time" of the key persons in the fund and the "allocation of deal flow" in the case of a family of funds. Any violation of these provisions/duties can lead to the suspension of a fund's investment period. Investment activity of the GP and its affiliates outside of the fund is typically limited to investments previously earmarked from an existing fund, follow-on investment in portfolio companies of existing funds, investments that fall outside of the fund's mandate and an affiliate's co-investment in the fund's investment. GPs may also be required to disclose any opportunity that falls within the fund's mandate but is pursued by an affiliated fund to the fund's LP Advisory Committee (LPAC), which may need to provide consent before the investment is executed by the affiliate.

MANAGEMENT, PORTFOLIO AND OTHER FEES: A fund's LPA typically includes a provision that requires the fund to enter into an investment advisory agreement with a third-party investment advisor, typically an affiliate of the GP. The investment advisor manages the day-to-day activity of the PE fund—including but not limited to evaluating investment opportunities, providing advisory services to portfolio companies, and managing the fund audit and reporting function—in exchange for a management fee. The management fee usually ranges between 1.3% and 2.5% during the investment period and often steps down to a lower percentage and/or a lower capital base—for instance, invested capital rather than committed capital—at the expiration of the investment period. The investment advisor, the GP and its affiliates often generate fee income—including but not limited to transaction fees, monitoring fees, break-up fees, directors' fees and acquisition and disposal fees—for services rendered to the fund or its portfolio companies. A large proportion of this additional fee income—historically between 50% and 100%, now trending towards 100%—is shared with a fund's LPs via a management fee offset.

FUND-LEVEL FEES: A fund's GP and investment advisor incur significant expenses in the set-up and throughout the term of a PE fund. LPAs set out a mechanism for a GP to recoup the organizational expenses incurred in establishing a fund from its LPs through an initial capital call immediately following an LP's subscription to the fund. Additional expenses incurred in the management of a PE fund include broken-deal expenses, taxes imposed on the partnership, the cost of fund-level borrowing, and fees and expenses for attorneys, accountants, advisors and consultants. To the extent that fund-level expenses incurred are not reimbursed by a prospective or actual portfolio company, the fund will pay directly or reimburse the GP or the investment advisor for the payment of these expenses.

INDEMNIFICATION: This clause protects or limits the liability of individuals involved in the fund. LPAs include clauses that remove the liability for a fund's GP and its investment advisor—as well as their directors, officers, partners, members, employees, agents and other affiliates—for any action or inaction made in good faith that results in a liability, claim, cost or expense against the fund. The indemnification typically does not extend to liabilities resulting from fraud, willful misconduct, violation of a law or breach of contract. These clauses typically include give-back provisions that allow the GP to claw back a portion of distributions made to fund LPs to satisfy indemnification obligations.

OTHER PROVISIONS

LP ADVISORY COMMITTEE: An LPAC is formed to advise the GP on select issues over the course of a PE fund's term. LPAC members are nominated by the GP and consist primarily of the largest LPs in the fund. A fund's LPAC generally does not owe a fiduciary duty to the fund or its LPs, and the activities of an LPAC should be limited strictly to review of fund matters—as opposed to active management—to preserve the limited liability of the LP with which an LPAC member is associated. Key functions of the LPAC include:

- Reviewing valuation methodologies, portfolio company valuations and proposed write-ups/write-downs of fund assets
- Reviewing and providing or withholding consent for any potential conflict of interest in any potential transaction, particularly those concerning related party transactions
- Reviewing and providing or withholding consent for issues related to changes in the fund's governing documents, including but not restricted to extension of the investment period, removal of investment restrictions and approval of changes to key personnel within a fund

TRANSFERABILITY OF FUND INTERESTS: The LPA sets out specific guidelines and circumstances under which a GP's or LP's interests in a fund may be transferred to a different party.

- *GP interests:* The voluntary withdrawal or forced removal of a GP from a fund is typically subject to a supermajority of votes from fund LPs. In the event of a transfer, the outgoing GP remains responsible for all activity related to managing the fund until its departure, and maintains all indemnities granted by the fund. The treatment of economics in the context of a transfer of GP interest is subject to negotiation; for example, the outgoing GP may retain its rights to carried interest on a portion of the portfolio. In addition to a for-cause termination right, many LPAs provide LPs with the right to remove and replace the GP on a no-fault basis. The "cause" triggers for GP removal and the voting thresholds required to remove a GP are often heavily negotiated.
- *LP interests:* LPs are typically not permitted to transfer their interest in a fund without the express consent of its GP. Other LPs in a fund may have a right-of-first-offer, which requires the LP transferring the interest to first field offers from existing LPs before seeking an external buyer with a superior offer.

DISSOLUTION, LIQUIDATION AND TERMINATION OF THE FUND: LPAs typically lay out a specific process for winding down a fund. An LPA will typically define specific events that will cause a PE fund to dissolve, including, for example, the sale of all fund investments, a supermajority vote by fund LPs, or the bankruptcy of the GP. Following the dissolution of the fund, remaining fund investments will be liquidated in a prudent manner over a stated time period. If a fund's GP or its assigned liquidating trustee determines that the sale of investments within that time period would result in undue losses to the fund, liquidation for such investments may be delayed. Termination results in the partnership coming to an end.[9]

REPORTING: LPAs typically set out specific guidelines under which a GP must report a fund's activity to each of its LPs. GPs issue formal reports on a quarterly basis—consisting of an annual report and interim quarterly reports—that include a fund's net asset value (NAV), descriptions of new investments and follow-on investments, the sale of fund assets, cash or in-kind distributions, and the amount of management fees due. Key among the information reported is the NAV, which is prepared on a quarterly basis and represents the sum of each portfolio company's fair market value.[10] Fund NAVs are a particular focus as they determine the number of shares for distributions-in-kind or set the headline price in the context of a sale of an LP's interest in the fund.

SIDE LETTERS

Side letters are contractual agreements that alter the terms of individual investors' participation in a PE fund without impacting the LPA and other governing documents. These agreements are widely used during the fundraising process to provide preferential rights for large or cornerstone investors in a fund or to cater to the specific needs of an LP without renegotiating a fund's LPA. Typical provisions addressed in a side letter include:

- Preferential fees (management fees or terms on management fee offsets)
- Preferential information or disclosure rights
- Co-investment rights
- Provisions related to the tax, legal or regulatory status of an investor
- "Most favored nation" (MFN) provisions

Not on the Side

By Andrew M. Ostrognai, Partner, Debevoise & Plimpton LLP

One of the biggest trends in the negotiation of private equity funds has a name that ironically suggests it is a small detail to be wrapped up right before closing: *the side letter*. The side letter is simply a side agreement between an investor and a fund's general partner or manager, and the right of the general partner or manager to enter into side letters is well-accepted in the market and is typically spelled out in the fund's limited partnership agreement (LPA) and private placement memorandum. But this simple explanation belies the growing role and importance of the side letter.

The practice of entering into side letters has grown over the last decade or so from something rather small and truly on the side—confirmation of a bespoke tax issue, or granting an investor the right to see draft financial accounts earlier—to

9. Please refer to Chapter 20 Winding Down a Fund for a full discussion of this topic.
10. Please refer to Chapter 19 Performance Reporting for an overview on valuation methodology.

lengthy and complex agreements central to many fundraisings. They can and do cover every topic imaginable, from favorable economics, to reporting, to compliance with laws (even those which the general partner would not otherwise need to comply with), to opt-outs and the list goes on.

For the most sophisticated investors in the largest funds, side letters are far from being on the side of anything; they may well be the main attraction, and the subject of the most negotiation during a fundraise. Indeed, for a well-established fund that has been through multiple fundraises, the LPA or other constitutive document may change little, but the side letters may vary greatly from fund to fund in terms of number and nature of issues they address.

Sophisticated sponsors will spend considerable time thinking about the interplay of the LPA and side letters. For example, if a sponsor moves terms from side letters to the LPA, it may obviate the need for some negotiation, but the sponsor may also lose the ability to generate some goodwill in negotiations by giving investors some of the terms they have sought. At the same time, if a sponsor saves everything for the side letter—even terms it is otherwise quite willing to give to all investors—the grinding process of negotiating scores of provisions with dozens of investors may finally outweigh any joy investors would otherwise have received in getting the terms they seek.

On top of that, a sponsor may at times wish to stash a particular provision in a side letter—for privacy's sake, or because they don't want to clutter the negotiating history of the LPA—but find the provision simply won't work unless it is in the LPA. Such provisions include those that put burdens or obligations on the other investors if they are exercised, such as withdrawal rights.

As if all of this was not already complex enough, these side letter negotiations are conducted against a backdrop of most favored nations (MFN) provisions. MFN provisions at their most basic simply mean the sponsor needs to treat investors equally in what it gives them in side letters. But the process is never that simple.

It is common in the market today to group investors by the amount committed, a practice often referred to as *economic tiering*. In this way, investors get the benefit only of provisions given to investors committing the same amount or less to a fund. The benefit of MFN to an investor may be further limited by carving certain rights found in side letters from the MFN provisions, such as rights to seats on the fund's advisory committee. Additionally, it is not uncommon for MFN for a particular investor to apply only to those rights of benefit to that investor; for example, a non-US taxpayer would not be offered a special right that benefits only US tax exempt investors.

These are only the most common modifications and adjustments to the MFN concept, but there are many others. So MFN is equality of a sort, but heavily caveated and footnoted.

The rise of the side letter should not be surprising. This business is, after all, called *private* equity. With a name like that, it should be expected that, for the most sophisticated investors and funds, private side deals have become business as usual.

CLOSING

Getting the legal structure and rules of engagement right while ensuring that all parties involved understand their rights and responsibilities is key in fund formation; after all, PE funds face many obligations, chief among them fiduciary duty towards their investors. Given the long duration of the typical closed-end PE fund, any structure must be sufficiently robust to ensure investor's rights yet flexible enough to adapt to changing circumstances.

KEY LEARNING POINTS

- **PE funds are usually set up as closed-end limited partnerships to facilitate the investment and divestment of capital in the fund's mandated jurisdiction.**
- **When setting up the legal foundations of a PE fund, GPs will carefully consider the requirements of their LPs with regards to tax issues; various fund structures from feeder funds, parallel, and co-investment vehicles may be set up to accommodate different classes of investors.**
- **The LPA sets out the terms and conditions applicable to all parties involved and defines their rights and responsibilities.**
- **In particular, the LPA clearly defines the rules related to distributions, carried interest, fee structure, the rights and duties of the GP and the process to terminate and dissolve the fund.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from the World of Venture, Growth and Buyouts*

Case #1: Beroni Group: Managing GP–LP Relationships

Case #6: Adara Venture Partners: Building a Venture Capital Firm

Case #18: Private Equity in Frontier Markets: Creating a Fund in Georgia

REFERENCES AND ADDITIONAL READING

Debevoise & Plimpton (2015) Private Equity Funds: Key Business, Legal and Tax Issues, Debevoise & Plimpton LLP.

Naidech, S. (2011) Private Equity Fund Formation. Chadbourne & Parke LLP, with Practical Law Corporate & Securities.