LEGAL STRUCTURE AND FORMATION OF PRIVATE EQUITY FUNDS

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Alignment of Interest Association – *The "Silo" Treatment Problem*, April 2015
Alignment of Interest Association – *Hedge Fund Investing Principles*, December 2014
Journal of Corporate Accounting and Finance, *Purchase Agreements: How One Common Flaw Can Cost You Big Money!*, January/February 2007

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LEGAL STRUCTURE AND FORMATION OF PRIVATE EQUITY FUNDS

I. INTRODUCTION

Before getting into the nuts and bolts of private equity fund formation, first it is necessary to clarify what this article is not. This article is not intended to be an all-encompassing treatise on every facet of the legal needs of a private equity fund sponsor, nor is it a complete guide to how to draft and negotiate every term in private equity fund formation documents. There are several excellent (and voluminous) treatises that provide a more comprehensive guide to private equity fund formation.[1] Instead, this article is intended to be a high-level, beginner's guide on the core terms of a private equity fund that also addresses some important considerations that are easy to overlook.

II. WHY PRIVATE EQUITY FUND FORMATION

A private equity fund formation practice is considered by many to be the ultimate practice for a corporate lawyer. If one can master the skills needed to be a successful private equity fund formation lawyer and be fortunate enough to win a private equity sponsor or two as clients, one can look forward to a highly lucrative annuity of high paying legal work. This work starts with the formation of the fund itself. More lucrative is the underlying mergers and acquisitions work (and the occasional initial public offering). A typical private equity fund will buy about 10 companies, which means some law firms will have about 20 mergers and acquisition transactions (first the buy-side and then the sell-side), and perhaps an initial public offering or two. Of course there is regulatory work, tax work, often finance work, possible litigation, and other ancillary work needed by a private equity fund / fund sponsor client. One private equity fund client could result in millions in legal fees per year on a recurring basis.

III. KNOW YOUR AUDIENCE

An often overlooked but imperative piece of the private equity fund puzzle is to understand who are the target investors. Are the target investors friends and family, wealthy individuals, money managers that specialize in seeding private equity sponsors/funds, private equity funds of funds, tax-exempt investors like foundations and university endowments, private pensions, public pensions, or foreign investors? The answer to this question (which likely would include more than one category of the above) has very important implications, ranging from the budget for the work (the identity of the investors could change the number of digits in the estimate), the amount of time it will likely take to close and likely the number of closings, what legal specialists will be needed, and in many cases, the types of terms that one can expect investors to press on in negotiations.

For example, a "friends and family" only fund will in almost all cases result in the lowest legal fees, the shortest time to close, the fewest legal specialists needed, minimal reporting requirements, and the most general partner-friendly terms that one can obtain. On the other end of the spectrum, if public pension plans and foreign sovereign wealth funds are target investors, then one should expect negotiations to be long and hard fought, legal bills to be much higher, extensive bespoke reporting and disclosure obligations, with the landing point on the terms of the fund to be considerably more skewed in favor of the limited partners than otherwise would be the case. Public pensions and sovereign wealth funds make very large commitments, often have legal and/or special tax considerations that must be met, and expect/demand much more in return for their patronage.

[1] See Private Equity Funds *Formation and Operation* by Stephanie Breslow and Phyllis Schwartz of Schulte, Roth & Zabel LLC, Practicing Law Institute.

If tax-exempt investors (other than public pension plans) or foreign investors are among the target investors, then there is a reasonable chance that at least two funds (the main fund and a parallel "blocker" fund, which is an entity treated as a corporation for U.S. tax purposes) may be needed. Knowing the types of investors that the fund sponsor is targeting will help level-set expectations for both the formation lawyer and the client.

IV. ASSEMBLING THE TEAM

The barriers to entry to private equity fund formation work are high. There is a reason that a relatively few number of law firms control most of the private equity fund formation work. Private equity fund formation requires not only a corporate and securities lawyer skilled in offering exemptions under the Securities Act (the offering of fund interests is a securities offering) and the Investment Company Act of 1940 (in order to qualify from an exemption thereunder), but also requires the enlistment of several legal specialists, including experts in: tax (partnership tax, corporate tax, the Foreign Account Tax Compliance Act ("FATCA"), and similar foreign tax sharing regimes if applicable, the new partnership audit rules under the Bipartisan Budget Act of 2015, and the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), the Investment Advisers Act of 1940 (today almost all private equity sponsors now have to be registered investment advisers) and related regulatory compliance, and anti-money laundering, and potentially European and other foreign securities and investment management laws depending on the target client base. If private pensions are target investors, one must add to the list an Employees Retirement Income Security Act of 1974 ("ERISA") specialist (that is familiar with the plan assets rules, not all ERISA lawyer are).

V. THE DOCUMENTS

A. Partnership Agreement

The partnership agreement (or less common the limited liability company agreement) is the core document that sets out the terms of the fund. Most private equity funds are formed as limited partnerships (typically in Delaware for U.S. managers); however, there is no legal reason why a limited liability company cannot be used, and a small minority of fund sponsors have migrated to using limited liability companies. Experienced investors are more accustomed to seeing private equity funds formed as limited partnerships, and that is the likely reason that the usage of limited partnerships remains as the clearly dominant entity of choice.[2]

B. Private Placement Memorandum

One may be tempted to forgo a private placement memorandum. Take caution if doing so. The private placement memorandum is first and foremost a disclosure document designed to protect the fund sponsor from securities fraud claims. If drafted well, it also presents the core terms of the fund in plain English, and as such, the private placement memorandum helps avoid any misunderstanding as to what the terms of the deal are between the fund sponsor and the investors. Last, the private placement memorandum is a marketing document in which the sponsor can explain its niche or strategy and investment track record (if applicable). Note, one must be very careful when including track record information as there are very stringent requirements as to when track record can be used, and this is an area where Investment Advisers Act counsel will be very helpful.

C. Subscription Agreement and Investor Questionnaire

The subscription agreement and investor questionnaire are typically two distinct sections of one document. The subscription agreement is designed to protect the general partner and the fund and typically

[2] Of the hundreds of private equity funds our firm reviews each year on behalf of investors, only a very small minority each year are formed as limited liability companies.

contains a number of representations, warranties, covenants and indemnities from the subscriber. The investor questionnaire contains a series of questions designed to confirm that the investor meets the minimum qualifications necessary for the various securities laws, Investment Company Act, ERISA, anti-money laundering, and related legal requirements that the investor and fund must meet in order to operate as intended. The forms of subscription documents are often updated to deal with new regulatory/statutory changes.

D. Investment Management Agreement

Not all private equity funds require an investment management agreement. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required most private equity fund managers to register as investment advisers under the Investment Advisers Act, and as a result most private equity fund sponsors have elected to create a single entity that serves as the investment manager and registered investment adviser to all of such fund sponsor's private equity funds. This saves on the costs and burden on filing registration applications, Form ADVs and Form PFs. As such, most private equity funds will have a separate investment management agreement between the fund and the fund sponsor's registered investment adviser entity. These agreements are typically quite short, containing a description of the management services, the management fee, scope of liability, and not much more.

E. Clawback Guaranty

Virtually all private equity funds have some form of general partner clawback (as will be described in more detail below). As security for the general partner's obligations under the clawback provisions, most private equity funds have some form of guaranty (typically several but not joint) as to which the ultimate recipients of the carried interest guaranty their share of the general partner's clawback obligations. In some funds, the obligation is built into the governing document of the general partner (in which case there would be no separate guaranty), but most funds use a separate clawback guaranty. The clawback guaranty is a fairly standard guaranty of performance, not collection, but areas that are often negotiated center around whether the entire clawback obligation is fully covered, whether certain guarantors might take on more than their share of the liability, who pays for collection costs, and who can enforce the guaranty (e.g., all limited partners, a subset of limited partners, an appointed representative on behalf of all limited partners, or solely the general partner).

F. Side Letters

Depending on the investor base, side letters may be required. The larger, more "institutional" the investor base, the more likely side letters will be. Side letters are basically side agreements designed to deal with things like bespoke fee reductions, custom reporting requirements, and special provisions to deal with subjects such as open records laws and sovereign immunity. The side letter negotiation and drafting component of a fund can be a very sizeable part of the representation, so determining the targeted types of investors is critical when budgeting for side letter work.

G. Other Documents

In addition to the partnership (or limited liability company) agreement, the private placement memorandum, the subscription agreement and investor questionnaire, and where applicable the investment management agreement and/or clawback guaranty, depending on the nature of the limited partner investors, there may also be a separate governing document for one or more "parallel funds" (funds that invest pro rata with the main private equity fund but are formed as a separate entity, typically for unique tax or other regulatory purposes). There are also the upstream governing documents of the general partner (or in some cases the "special limited partner" (a partner formed by the sponsor solely to act as a conduit for carried interest distributions in lieu of the general partner)), which, among other basic terms, govern the split of the carried interest among the fund sponsor parties. Finally, there may be other marketing materials (e.g. "flip decks"), due diligence questionnaires, sample financial reports and various other diligence documents that fund sponsors may require their counsel to draft.

VI. THE CORE TERMS

A. Stages of Life – Term, Investment Period and Harvest Period

Private equity funds are limited life funds, often referred to as "closed-end" funds. They typically have set terms of around 10 years with the possibility of term extensions, usually in one-year increments, and rarely are more than two extensions permitted without an amendment. Who has the authority to extend the term is fund specific and often the subject of negotiation between the limited partners and the general partner. Note, at the end of the term lies liquidation, which itself can take several years. Private equity funds that remain in liquidation for several years are often referred to as "zombie" funds, a term that neither sounds, nor is it intended to be, flattering.

If one omits any marketing and capital raising time before a private equity fund goes live, the term of a private equity fund can be divided into three distinct periods, beginning with the commitment period (also known as the investment period), followed by the harvest period (also known as the post-commitment or post-investment period), and finished with the liquidation period.

Subject to a few exceptions that will be discussed below, only during the commitment period may new investments in privately held companies (or public companies with the goal of taking them private) be made. The commitment period typically lasts four to six years, although certain strategies such as credit tend to have commitment periods around two to three years. It is during the commitment period that the fund sponsor is sourcing, diligencing and closing investments.

Following the commitment period is the harvest period, which lasts from the end of the commitment period until the fund dissolves and moves into liquidation. The primary purpose of the harvest period is to sell (or make a public offering) of the fund's investments and "harvest" the fruits of the fund's labor. However, two types of investments may typically be made during the commitment period.

First, "follow-on" investments may be made after the expiration of the commitment period. Follow-on investments are additional investments in existing portfolio companies held by the fund. Often, a partnership agreement will have caps on the amount of and timing of follow-on investments. For example, a fund may be limited to invest no more than 20% of aggregate capital commitments in follow-on investments and/or follow-on investments may be permitted for only one or two years after the end of the commitment period. What, if any, limits there are on follow-on investments is highly strategy specific. Certain strategies expect to make multiple rounds of investment in a portfolio company over a longer period of time whereas others expect a single, large investment funded all at one time.

Second, new investments (sometimes referred to as "follow-up" investments) may be made at the beginning of the harvest period with respect to purchase transactions that were in process as of the end of the commitment period. How far along such proposed transactions were as of the end of the commitment period is often determinative of whether they are permitted to be consummated after the commitment period, and the specifics of such rules are often the subject of negotiation. For example, some funds may require a binding letter of intent or agreement, while others may simply require disclosure of all deals "in process" to the limited partners or the fund's advisory committee (discussed below) contemporaneously with the end of the commitment period, and other funds may not have any rules other than that any new investments that were in process during the commitment period must be closed within a certain period of time after the end of the commitment period.

B. Capital Commitment; Capital Contributions; Credit Facilities

Unlike many other types of investments where 100% of an investor's subscription is due at the outset (e.g., hedge funds), private equity funds are structured with capital commitments that are called or drawn over time as funds are needed for investments, expenses, and management fees. Capital contributions are typically due around 10 days after the capital call notice date, although in certain circumstances (e.g., the initial closing, if other partners default, or other exigent circumstances), the timing may be shorter.

A concept that has been around for some time but was not that widely used until recently is the credit facility (also known as a subscription line (of credit)). With the cost of borrowing being so low, many funds are now building in the ability to set-up credit facilities with third-party lenders. The lenders of these credit facilities take the capital commitments of the partners (and often the other assets of the fund) as security, with the power to call capital, direct where capital contributions are paid, etc. The original purpose of such credit facilities was to bridge capital calls where funds were needed faster than the fund could expect to receive all of the capital contributions from investors and, to a lesser extent, to smooth out capital calls for funds that expected to need frequent capital inflows in smaller amounts. However, with the costs of borrowing so low under current market conditions, many funds have started using credit facilities as semi-permanent financing of the fund's investments, and in certain credit strategies, as a pure rate arbitrage. Using a credit facility does not typically cause the preferred return (explained below) to begin to accrue, so the general partner may have a financial incentive to choose third-party borrowing over calling capital. Use of the credit facility also tends to improve a fund's internal rate of return, but at the expense of cash on cash investment multiple. Use of a credit facility may also raise significant negative tax consequences for tax-exempt investors in the fund that are sensitive to "unrelated business taxable income". For example, many tax advisors would advise against the fund having any particular loan outstanding for more than one year lest it trigger unrelated business income tax. This is another area where one's specialists (in this case tax) are invaluable. Limits on credit facility usage are presently a subject of considerable negotiation between the general partner and the limited partners, but unlike most areas of negotiation, not all limited partners have the same view. Some prefer heavy usage of a credit facility to improve internal rates of return, while others strenuously object to using a credit facility for anything other than short-term bridging of capital calls, making this topic particularly prickly.

C. Fund Size

Most investors will require that a private equity fund will cap the amount of subscriptions it may accept. Investors assume that the sponsors have an expertise in investments within certain capitalization ranges. In addition, there are only so many deals that a private equity sponsor can diligence and handle within a certain period of time and do so effectively. As such, investors typically expect a hard cap on the total commitments the fund can accept. For example, if a successful first fund has total commitments of $300,000,000 and invested in about 10 "small cap" deals, if the sponsor's next fund tried to accept total commitments of $2 billion, the capital raise would likely be met with significant resistance from potential investors. Some increase fund to fund is expected, but trying to increase the size of the next fund by too much can result in a failed capital raise.

D. Fees and Carried Interest

1. The Management Fee

Private equity fund sponsors are expected to work for their fund on a full-time basis. As such, most fund sponsors are not in the financial position to not get paid or reimbursed for expenses during the period preceding the recognition of profits. Fund sponsors have employees and operating expenses to pay. Covering such expenses is the purpose of the management fee, although management fees have become a profit center for some fund sponsors. The management fee in private equity typically ranges from 1.5% to 2.0%, but can be higher (especially for very small funds).

The management fee base (the number to which the aforementioned percentage is applied) is typically broken out into two periods: the commitment period and the harvest period. During the commitment period (the period up until the fund stops making new investments, typically 4-6 years), the management fee base is typically the sum of the limited partners' capital commitments to the fund. During the harvest period, the management fee base typically (although not always) changes to "invested capital", which is the amount of capital contributions from the limited partners used to make investments (as opposed to pay management fees or expenses) that have not been returned (and in some cases that have not been written down or off). The management fee rate may also be reduced (or go through a series of reductions) during the harvest period. There is no one-size fits all structure for the management fee, but the description above represents the structure used in the majority of buy-out private equity funds (as opposed to venture capital or credit funds).

2. Carried Interest Waterfall

There may be no more important provision in the partnership agreement than the carried interest waterfall.3 The carried interest waterfall is the means by which the fund sponsor is paid a portion of the profits of the fund in exchange for the sponsor's investment acumen.

The carried interest waterfall generally has four basic stages: first is return of capital, second is preferred return, third is general partner catch-up, and last is profit split. Return of capital means simply the terms of returning limited partners' capital contributions (i.e., cost) before dividing up profits. The preferred return is a temporary means by which limited partners are paid the first X% of profits (typically 8%) before any profits are paid to the general partner. A preferred return is not to be confused with a "hurdle". Hurdles are more often associated with hedge funds and real estate funds and have no general partner catch-up stage. The general partner catch-up is necessitated by the presence of a preferred return and is simply a means by which the general partner is paid more than its share of profits until the profit split to date matches the final intended profit split. For example, while the limited partners may be entitled to the first 8% of profits from an investment, the general partner may then be entitled to receive 100% of the next distributions until the general partner has received 20% of the total profits to date. Note, the general partner catch-up could be a "split catch-up" (e.g., 80% to the general partner and 20% to the limited partners), which effectively means that the fund's total return needs to be higher in order for the general partner to achieve its full carried interest percentage of the profits. Finally, the carried interest split is simply the ultimate profit split between the limited partners and the general partner (most commonly 80% to the limited partners and 20% to the general partner).[4]

There are many permutations of the carried interest waterfall, but there are two dominant structures in the market today, the "European" waterfall and the "American" waterfall. Not surprisingly, European fund sponsors tend to use the European waterfall and American fund sponsors tend to us the American waterfall, but there are many examples to the contrary in both cases.

a) The European Waterfall

The European waterfall is the more limited partner-friendly of the two waterfalls. The European waterfall will require the return of all of the limited partners' capital contributions before any profit is split between the limited partners and the general partner. A typical European waterfall could read as follows:

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[3] A "waterfall" is simply an order of payments/distributions.

[4] A minority of funds may have a premium carried interest rate if overall returns exceed a certain percentage. In such cases, the waterfall will have two additional stages, a catch-up to premium carry and then the ultimate premium carry split.

(a) *Return of Capital*: first, 100% to the Limited Partner (pro rata to its Capital Commitments) until its aggregate Capital Contributions made as of such date have been repaid;

(b) *Preferred Return*: second, 100% to the Limited Partner (pro rata to its Capital Commitment) in payment of an amount equal to a return of 8% per annum, compounded annually, on the amount set forth in clause (a) above, calculated as to each Capital Contribution from the later of (i) the date the relevant Capital Contribution was due and (ii) the date on which it was paid to the date on which the relevant distribution was made or deemed to have been made by the Partnership to the Limited Partner;

(c) *GP Catch-Up*: third, 100% to the General Partner until the General Partner has received 20% of (i) the aggregate amount distributed to the Limited Partner under clause (b) above plus (ii) the amount distributed to the General Partner under this clause (c); and

(d) *80/20 Carry Split*: fourth: 80% to the Limited Partner (pro rata to its Capital Commitments); and 20% to the General Partner.

b) The American Waterfall

The American waterfall is the more general partner-friendly of the two waterfalls. The American waterfall requires only the return of limited partner capital on all realized investments to date (along with some portion of management fees and expenses). Therefore, if a fund had made ten investments, upon the sale of the first investment, the general partner stands a strong chance of receiving carried interest (this would be very unlikely in a European waterfall). Note, because the American waterfall requires the return of capital on all realized investments, if the first investment were sold at a loss, that loss would need to be covered by later realized investments in order for the general partner to receive carried interest. This is to be contrasted with the “pure deal-by-deal” waterfall that is all but extinct (except in very special circumstances) that views every investment in isolation with no need to recover losses from other investments to earn carry on an investment. A typical American waterfall could read as follows:

(a) Return of Capital: To the Limited Partner,

(I) first, up to an amount equal to the excess of (x) the Capital Contributions made by such Limited Partner with respect to such Portfolio Investment (or portion thereof), including Capital Contributions made to fund such Limited Partner’s share of Partnership Expenses, over (y) the amounts previously distributed to such Limited Partner pursuant to this clause (I) or clause (II) below with respect to such Portfolio Investment (or portion thereof) referred to in clause (x) above;

(II) next, up to an amount equal to the excess of (x) the Capital Contributions made by such Limited Partner with respect to each Portfolio Investment (or portion thereof) as to which a Disposition has occurred other than the Portfolio Investment (or portion thereof) giving rise to the current distribution pursuant to clause (I) above, including Capital Contributions made to fund such Limited Partner’s share of Partnership Expenses, over (y) the amounts previously distributed to such Limited Partner pursuant to clause (I) above or this clause (II) with respect to the Portfolio Investments (or portions thereof) referred to in clause (x) above; and

(III) next, up to an amount equal to the excess of (x) such Limited Partner’s Allocable Fees and Expenses allocated to such Portfolio Investment (or portion thereof) and each other Portfolio Investment (or portion thereof) as to which a Disposition has occurred, in each case, as of the date of such distribution, over (y) the amounts previously distributed to such Limited Partner pursuant to this clause (III).

(b) Preferred Return: Second, to the Limited Partner until the Limited Partner has received cumulative distributions pursuant to this clause (b) equal to the amounts described in subclauses (x) of clauses (a) (I), (II) and (III) above with an internal rate of return thereon of 8% per annum, compounded annually, determined by taking into account (i) in the case of amounts described in subclauses (x) of clauses (a)(I) and (II), the scheduled Funding Date of the related Investment, (ii) in the case of amounts described in sub-clause (x) of clause (a)(III), the scheduled Funding Date related to such contributions and (iii) the times at which distributions by the Partnership were made.

(c) GP Catch-Up: Third, 100% to the General Partner, until the General Partner has received an amount equal to the sum of distributed cumulative distributions pursuant to this clause (c) equal to 20% of the sum of (i) the cumulative amounts distributed pursuant to clause (b) to such Limited Partner and (ii) cumulative amounts distributed to the General Partner in respect of such Limited Partner pursuant to this clause (c); and

(d) 80/20 Split: Thereafter, 80% to the Limited Partner and 20% to the General Partner.

Note, American waterfalls tend to have more ancillary issues than European waterfalls. For example, whether or not write-downs or write-offs are considered realization events is very important for an American waterfall but irrelevant for a European waterfall. Similarly, whether a dividend-recapitalization transaction should be considered a realization event is relevant only in an American waterfall. Further, clawback terms and clawback security take on heightened importance with an American Waterfall.

E. General Partner Clawback

The general partner clawback is the mechanism by which the economic arrangement regarding the split of profits between the general partner and the limited partners is trued-up at the end of the life of a private equity fund (and in some cases, on several interim dates along the way). Such a mechanism is necessary because the profits (and losses) on each private equity fund investment will not be the same, and it is possible for the general partner to receive aggregate carried interest distributions in excess of what it is ultimately entitled to receive. For example, if earlier realized deals are realized at significant profits but later realized deals are realized at losses, in an American waterfall, the general partner will have received carried interest distributions in excess of the carried interest percentage of profits. This can happen in a European waterfall as well, although it is much less likely, if the fund realizes significantly profits before all capital is called. Similarly, due to the lumpiness of realizations and the possibility of higher profit transactions being realized before lower profit transactions or loss transactions it is possible for the general partner to have received carried interest distributions early during the harvest period or later stages of the commitment period, but due to later capital calls, the limited partners might not have received their full preferred return (the general partner should not receive any carried interest profits if the limited partners have not received their full preferred return). As such, a clawback provision will typically true-up both the possible over-payment of carried interest to the general partner and the underpayment of preferred return to the limited partners.

Note, there is one additional economic part of the carried interest waterfall that may need to be trued up. If a carried interest waterfall has a shared general partner catch-up (i.e., the general partner catch-up stage of the waterfall pays some percentage to the limited partners (e.g., 75% to the general partner and 25% to the limited partners)), then there are certain return scenarios where the preferred return can be met, but the general partner is entitled to receive a percentage of the profits less than the full the carried interest percentage. Many clawback provisions miss truing-up for this important economic term of the waterfall.

Because the clawback may occur several years after the general partner has paid taxes on its carried interest, the maximum aggregate general partner clawback obligation is generally capped at the general partner’s carried interest received less the general partner’s tax obligations with respect to that carried interest. The tax obligations are often based on an assumed tax rate for ease of calculation (e.g., the maximum combined federal, state and city taxes for a resident of New York City, NY, taking into account the character of the relevant income). Character of income is important, as in many cases under current law, carried interest is taxed at the lower long-term capital gains rate, not the ordinary income rate.

F. Partner Giveback

Not to be confused with the general partner clawback, the partner giveback provides the fund a means of recalling distributions in order to fund certain fund liabilities (e.g., an indemnification event). A private equity fund could have liabilities from many sources, but the largest area of exposure relates to the underlying indemnity obligations the fund has to purchasers of portfolio companies. In lieu of the fund holding large reserves until such indemnity terms expire, which was a common early practice, the giveback was developed as a means to permit the fund to make distributions shortly after transactions are realized. Having the security of a giveback provision permits the fund to make distributions significantly faster, increase the fund's internal rate of return, and decrease the amount of preferred interest accrual.

The giveback obligation needs to include both the limited partners and the general partner and cover both the general partner's capital and carried interest (although some funds do not include the general partner's carried interest and instead rely on the general partner clawback provision to true up the carry economics). Generally, the giveback is structured as a return of distributions in reverse order of the waterfall (i.e., the parties' return of distribution obligations start in the last stage of the waterfall and work backwards, so distributions are returned first from profits and only then, if need be, from contributed capital). Note, if the general partner clawback is used as the true-up instead of the general partner's carried interest participating in the giveback obligation, the economic outcome can be different, because the general partner clawback is capped at the general partner's after-tax carried interest, whereas the giveback provision typically does not have an after-tax cap.

The limited partners' obligations under the partner giveback provision are typically limited in both time and amount. For example, a limited partner may be obligated to return distributions for only 2 or 3 years after the date of distribution (or 2 to 3 years after final liquidation) and the maximum amount of total giveback obligation may be limited to some percentage of either total distributions, a percentage of the limited partner's capital commitment, or the lesser of both. The time and amount limits on the partner giveback are often a subject of considerable negotiation.

G. Investment Restrictions

Private equity funds typically start with the general authorization to invest in just about anything and then scale those powers back in the investment restrictions provisions. Typical investment restrictions include such items as: concentration limits on investments in single issuers (15% - 20% are common), restrictions on the amount of fund-level debt that may be outstanding, geographic restrictions on where the fund can invest (or how much may be invested outside of a designated geography), restrictions on investments in oil and gas or other mineral right investments, restrictions on investing in real estate, restrictions or limits on the amount of publicly traded securities that may be held (often with carve-outs for take-private strategies), prohibitions on engaging in hostile takeovers, and restrictions on investments in speculative derivatives.

H. Reinvestment

Reinvestment (also known as "recycling") is the ability of a fund to reinvest proceeds received from realized investments into other new or follow-on investments. Reinvestment terms are highly bespoke to individual strategies and managers. For example, credit-oriented funds tend to turn their investments faster, and reinvestment is typically a key feature of these funds. On the contrary, pure buy-out funds often hold investments for a longer-period of time, in which case, reinvestment is often not practically possible because by the time proceeds are realized, the commitment period will have expired.

There are two types of reinvestment. The first type is simply reinvesting investment proceeds without having distributed the proceeds to the Partners. With this first type of reinvestment, typically the proceeds that are to be reinvested will be deemed to have been distributed to the Partners and immediately recontributed to the fund, thereby allowing the general partner to receive carried interest distributions on the profits realized from the original transaction.

The second type of reinvestment is where proceeds are actually distributed to the Partners and then are subject to recall and reinvestment (sometimes taking the form of an add-back to the partners' unfunded capital commitment balance). Some funds may have no recycling, or only one form of the above, whereas others may have both.

Where reinvestment is permitted, there are typically some limits. Common limits include: limiting reinvestment to the amount of distributions equal to the amount of funds used to pay management fees and expenses, limiting reinvestment to the amount of capital (not profits) returned with respect to investments that are realized within a relatively short period of time (e.g., within eighteen months of making the investment), and limiting total investments to some percentage of aggregate capital commitments (e.g., no more than 110% of aggregate commitments may be invested in portfolio companies).

I. Defaults

Because a private equity fund is a capital call model (i.e., the partners do not fund a private equity fund in full at the time of subscription but rather over time in varying installments as capital is needed), there is a significant risk of one or more partners not making a required contribution payment. If this happens, it can negatively impact all of the other partners as it could cause the fund to breach its obligations in a portfolio company transaction, unless the other partners fill the shortfall. As such, the default provisions contain draconian remedies by design with the purpose being to convince any partner that is in sufficient financial trouble to not pay all of its debts, to make its capital contributions to the fund whenever possible and default on other unrelated obligations. Typical remedies include forfeiture of some or all of the defaulting partner's capital account, the forced sale of the defaulting partner's interest, liquidated damages, specific performance, and many others.

J. Standard of Care – Exculpation and Indemnification

Without specific provisions on exculpation and indemnification, a fund sponsor will be liable in accordance with the default laws of the jurisdiction in which the fund is organized for the type of entity of the fund. For example, without express provisions on point, for a Delaware limited partnership, the general partner generally will be liable for breaches of fiduciary duty as defined under Delaware law as well as for breaches of the express terms of the partnership agreement. However, Delaware, and most other jurisdictions, allow modification of the default rules if expressly provided for in the governing documents. As such, it is not uncommon for a general partner (and its employees, affiliates, agents, etc.) to be exculpated and indemnified by the fund with respect to their acts and omissions relating to the fund except in the case of a specific list of carve-outs. The most common carve-outs are bad faith, fraud, willful misconduct and gross negligence. However, since 2008, several other carve-outs have become commonplace, including breach or material breach of the partnership agreement, breach of applicable fiduciary duties as otherwise expressly modified by the partnership agreement (e.g., for modifications to the duty of loyalty with respect to the allocation of investment opportunities among the sponsor's clients), violations of all (or sometimes solely securities) laws and disputes among sponsor parties (e.g., internal compensation disputes).

Typically, partnership agreements include a provision that requires the fund to advance indemnity expenses to the list of indemnified parties, so long as such indemnified party enters into an undertaking to pay the fund back if the indemnified party is ultimately held to have not met the standards of indemnification. However, more recently, investors have been requiring an additional carve-out for claims brought against an indemnified party be a certain percentage in interest of the investors (most often a majority in interest).

K. No Fault and for Cause Rights

Not to be confused with sponsor liability and the exculpation and indemnification provisions, many private equity funds provide the investors with certain "no fault" rights and most funds provide the investors with certain "for cause" rights vis-à-vis the general partner. Regarding "no fault" rights, many private equity funds may afford a certain percentage in interest of the limited partners (typically at least two-thirds in interest, and often three-quarters or higher) the right to do one or more of the following: terminate the fund's investment period, cause the fund to move into liquidation or remove the general partner as general partner of the fund. Similarly, most funds contain at least some "for cause" rights for the investors to terminate the fund's term and move into liquidation or remove the general partner. There are typically negative economic consequences to the general partner in the case of "for cause" removal and sometimes also in "for cause" early termination of the fund, including what is referred to as a "carry haircut", which is a reduction in the carried interest rate that the general partner receives, which can on the extreme end be a 100% reduction. Due to the significant negative economic consequences to the general partner of a "for cause" termination or removal right, the definition of "cause" is a highly negotiated point, and often demarks conduct that is of a more culpable character than what is provided for under the exculpation clause. In addition, the general partner typically has some ability to cure a "cause" event prior to the termination or removal right becoming available to the investors.

L. Key Person Event

A private equity fund's performance is typically highly dependent on one or a small set of individuals. The individuals are often referred to as "key persons." If something were to happen to one or more (the exact number and combination is often very bespoke and heavily negotiated) of the key persons (e.g., death, permanent mental incapacity, termination of employment, etc.), the fund's performance and future could be put in jeopardy. As such, upon a key person event, most funds will suspend the investment period for a set period of time (e.g., 180 days), thereby ending the ability of the fund to make new investments (that were not already in process), unless and until a replacement key person is identified and approved (by either some percentage of the investors or by the advisory committee (discussed below)). If a suitable replacement is not found within the requisite time period, the investment period will typically automatically terminate unless some percentage of the investors vote to reinstate the investment period without such a replacement individual. Some funds flip the provision to require an affirmative vote of the investors to suspend and/or terminate the investment period and at least one major private equity sponsor uses an individualized approach after a key person event giving each investor the option to cancel its participation in new investments solely for itself. The key person clause is typically highly negotiated because it is a term with respect to which the investor's business team is particularly concerned.

M. Capital Account and Tax Allocations and Other Tax Provisions

Every partnership agreement (that is treated as a partnership for U.S. tax purposes) will need to have capital account allocation provisions and tax provisions. Generally, these provisions mirror or are intended to mirror the economic provisions (e.g., the carried interest waterfall), although certain funds have tax allocation provisions that do not exactly mirror the economic distribution provisions.

Federal, state, and where applicable, foreign withholding issues need to be dealt with in the partnership agreement. Typically, withholding taxes are paid by the fund and treated as a deemed distribution (passing through the carried interest waterfall) as if the funds had been distributed to the limited partners and the limited partners had paid the taxes. Partnership agreements typically have an indemnity from each investor regarding payment of withholding taxes, as well as in nearly all regards in favor of the party acting as the "tax matters partner" or beginning on January 1, 2018 the "partnership representative" (typically the general partner) for tax purposes. A relatively new section of partnership agreements has been introduced to deal with the new partnership audit rules under the Bipartisan Budget Act (cite), which go into effect for tax years beginning in 2018.

Most partnership agreements will provide the general partner, and in fewer cases all partners, with the ability to withdraw from its capital account tax advances to pay the taxes on the realized profits. There are many reasons why tax advances may be needed. For example, even though a fund may have a European distribution waterfall, the general partner will be allocated profits for tax purposes as if the waterfall were American. Also, a fund may have a reinvestment provision, so a distribution might not otherwise be made. As income taxes are based on realized gains and losses, not distributions, the general partner typically wants the option to withdraw proceeds from its capital account (ahead of when the distribution waterfall would otherwise allow) to the extent of the general partner's income tax burden.

For all of the above reasons and more, a tax specialist is critical in fund formation work.

N. Reports and Confidentiality

All private equity funds will insist on at least some level of reporting from the general partner, with the minimum typically being a quarterly balance sheet and capital account statement and a set of annual, audited financial statements. However, the more sophisticated the investor base, the more reporting that will be demanded. For example, it is not uncommon for investors to demand annual or even quarterly updates on the investments in the portfolio (on an investment by investment basis). Some investors may also require detailed reporting on any litigation, regulatory proceedings and investigations, deficiency letters or indemnification claims as well as on expenses and ancillary fees that the sponsor or its affiliates may be earning. On the far end of the disclosure spectrum, investors may demand that the Institutional Limited Partners Association's Fee and Expense Template be provided, which is a very robust spreadsheet providing quite a bit of detail and requiring a fair amount of time and effort. One-off or bespoke reporting requirements are often addressed in side letters rather than in the partnership agreement itself, but, unless specifically carved-out of the most favored nations clause (discussed immediately below), such reporting obligations can spread via most favored nations elections to other investors.

As the information disclosure requirements increase, the need to protect such information from being disclosed to the public at large (or competitors) increases. All private equity funds should have confidentially provisions coupled with typical carve-outs for disclosures that are required by law or legal process, information that was garnered from an independent source, etc.

However, like several of the other provisions, whether a short one paragraph confidentiality provision will suffice depends on the types of investors in the fund. Will any of the investors be funds of funds? If so, funds of funds investors have made their own reporting promises to their investors. It is common to have a special set of confidentiality carve-outs for funds of funds to address this issue. Similarly, will public pensions or public university endowments be investing? If so, these investors may be subject to open records and open meetings laws that greatly increase the chance of information being required to be disclosed under the standard carve-outs. Private equity funds that expect to have such investors typically have robust provisions dealing with the inevitable public disclosure requests that will come, such as requiring such investors to notify the general partner with sufficient time prior to disclosing the information in order for the general partner to seek a protective order, or even requiring the public investor to cooperate in seeking that protective order or to actively oppose the disclosure request. That said, many public investors are bound by statutory processes from which they cannot deviate, so significant side letter negotiations on this topic are common.

O. Advisory Committee

Today, virtually all private equity funds have an advisory committee (although it can go by other names) made up of representatives of a subset of the investors (not affiliated with the fund sponsor) who are selected by the fund sponsor. More often than not, the investors with the largest commitments receive the advisory committee seats, but not always.

The advisory committee is primarily a governance check on the otherwise nearly unlimited powers of the general partner. However, the breadth of powers of an advisory committee, and whether the committee is really "advisory-only" or has certain actual powers depends in part on the jurisdiction of the fund (many offshore funds do not afford advisory committees any actual decision-making authority) and in part on the negotiating leverage of the sponsor versus the investors. Advisory committee powers can include such items as: waiving investment restrictions, approving valuations of investments, and deciding on whether to approve or deny transactions that present a conflict of interest to the fund sponsor. Some funds have separate, detailed charters about the scope and workings of the advisory committee.

Advisory committees typically have their travel expenses paid for by the fund (to the extent of actual meetings, which are not a given in every fund). Advisory committee members are not intended to be fiduciaries to the investors, and this is best stated in the governing document. Further, advisory committee members are typically exculpated and indemnified by the fund for their actions absent bad faith. Whether or not such advisory committee members are third party beneficiaries of the indemnification rights can be dependent on the jurisdiction. For example, until recent changes in Cayman Islands laws, advisory committee members needed a separate agreement with the fund (referred to as a "deed poll") in order to be able to enforce their indemnity rights against the fund (as opposed to relying on their appointing limited partner to do so). However, the trend in offshore funds is to move toward Delaware law on this point, which is to say not to require a separate deed poll.

P. Most Favored Nation

The term "most favored nation" comes from international trade treaties regarding tariffs. A country that was afforded "most favored nation" status would receive the lowest tariff on its imported goods as offered to any other country. The "most favored nation" clause in a private equity fund works much the same way, although it can go far beyond economic terms. A broad most favored nation clause could cover virtually every right granted to other investors (typically by side letter). Most funds, however, carve-out certain types of rights (e.g., rights to an advisory committee seat, rights granted to a regulated partner that are necessary for such regulated partner to invest, etc.). Many, but not all, funds also will offer an investor only the rights given to other investors with the same or smaller commitment to the fund. Some funds will establish a certain commitment threshold that, once exceeded, opens up all most favored nations rights to create a more binary clause (i.e., one either has most favored nation rights or one does not). A newer concept that is presently gaining favor is to bifurcate the most favored nation clause such that economic rights are offered based on relative commitments to the fund but non-economic rights are offered to all regardless of commitment size.

Whether the most favored nation clause appears in the partnership agreement or side letters is a matter of sponsor choice, but more often than not, the clause appears in side letters. Doing so gives the sponsor more flexibility in making bespoke changes to the most favored nation clause itself (although those changes can potentially spread through the most favored nations process). Placing the clause in the side letter may also make it easier for the sponsor to change the most favored nation clause more easily in future funds. This is because investors in one fund that seek to invest in the sponsor's next fund will typically request a redline comparison of the new fund partnership agreement versus that of the prior fund, and any changes to the most favored nations clause will be readily apparent to all investors.

VII. MISCELLANEOUS

Finally, the partnership agreement should contain a robust miscellaneous section, including such terms as the express authorization of side letters (if not expressly authorized, in some jurisdictions the side letter may not be enforceable), notices, governing law, jurisdiction and venue for disputes (including mandatory, binding arbitration if desired), jury trial waiver, counterparts, severability, definitions, and interpretative provisions. While the above may be considered "boilerplate," it would be wise not to overlook the importance of these provisions.

VIII. FINAL THOUGHTS

The information above only scratches the surface. Ultimately, virtually every term described above has additional levels of nuance and certainly many variations as there is no one-size fits all solution to any of the above-described provisions. Further, there are additional terms not discussed above that may be needed depending on the type of fund, the strategy and other bespoke consideration. In the end, while the barriers of entry may be high, private equity fund formation work can be not only lucrative, but also highly rewarding as it is ever-changing with each deal being unique.