

Top 10 Issues to Consider in Creating a Private Equity Fund

For tax reasons, funds established in Canada are typically set up as partnerships, which provide for flow-through treatment for fund gains and losses. Following is a list of some of the issues that require consideration in establishing a private equity fund. The list is far from exhaustive, but will give you a flavour of the types of issues that require consideration, and which may result in some negotiation with anchor limited partners.

When a fund goes to market for the first time, the General Partner typically prepares a term sheet summarizing the structure of the fund. This term sheet is typically reviewed by one or two potential anchor Limited Partners. Once the terms have been negotiated to their satisfaction, an offering memorandum incorporating those terms is generally prepared and a more detailed marketing process is undertaken for investment by other potential Limited Partners.

1. General Partner Contribution

Limited Partners like to see a meaningful contribution from the General Partner group in order to seek to ensure an alignment of interest between the Limited Partners and the General Partner. Typically, this is in the range of 1% to 5%, and may depend, in part, upon the financial circumstances of the General Partner group. Also, Limited Partners typically fund organizational expenses to a cap, with any amounts expended above that cap being the responsibility of the General Partner.

2. Carried Interest

The General Partner is typically entitled to a certain interest in the returns made by the fund. Compensation by way of a "carried interest" in the returns made by the fund is seen to help ensure that the General Partner's motives are aligned with those of the Limited Partners – to

maximize the return on the investment in the fund. The carried interest is calculated on the fund's returns and the General Partner will likely be required to have returned all of the capital contributed by the Limited Partners (taking into account write-downs on unrealized investments) plus an agreed priority return (often between 6% and 10% per annum) prior to being entitled to its "carry". Carry is traditionally 20%, though some highly successful subsequent funds may have higher carry rates.

3. Management Fees

Typically, management fees are up to 2% of committed capital of the fund, reducing to 2% of funded commitments once the commitment period (usually 5 to 6 years) has closed. These fees are generally perceived to be for the purpose of covering expenses of the General Partner (including the basic costs of running and administering the fund – salaries, office expenses, investment development, travel and entertainment) and are therefore not meant to provide material upside compensation. For very large funds, there is often pressure to reduce the fees to help align the General Partner's interests with the Limited Partners' goal of return on investment. Fees received by the General Partner or related persons (such as break-up fees, monitoring fees, consulting fees, directory fees and other similar fees) are often deducted in whole or in part from the management fee. Creative ideas with respect to management fees

include: exchanging lower management fees for a greater carried interest percentage; scaling down management fees as the fund's investment period runs; and offering lower management fees to anchor Limited Partners. First time funds may even see requests for management fees which are based on a budget of expected expenses.

4. Clawback

Since distributions are made on the basis of sales of investments (most private equity investments, even those in public companies, have liquidity constraints), most partnership agreements provide for some kind of clawback or escrow provision to seek to ensure that the General Partner is not overpaid with respect to its entitlement to carried interest. The clawback or escrow requires that the General Partner holds back a certain portion of its carry to guard against the risk of overpayment if subsequent investments do not turn out well. Waiting until the dissolution of the fund, which is often 10 years from the first closing, is obviously not desirable for the General Partner and, as a result, there is often an annual true-up or a deal-by-deal true-up.

5. Size of the Fund

While most General Partners might think it best to raise as much money as possible, it is important to consider how much money can be reasonably invested in the permitted investment period of the fund. Since fund performance will make or break the General Partner's success and ability to raise future funds, it is important not to be under pressure to invest too fast or in deals larger than those with which the General Partner is comfortable. Consider using minimum and maximum overall fund size in fund documents to enable more flexibility in the fundraising process. Also remember that, because of the need to keep aside money for follow-on investments in existing portfolio companies, among other reasons, it is unlikely that a fund will draw down 100% of its committed capital. There is typically a minimum Limited Partner investment required to participate in the fund. General Partners may wish to have the ability to bring in "special investors" at lower than such minimum investment amounts for strategic or other reasons.

6. Co-Investment Opportunities

Limited Partners will often ask for the ability to co-invest in the event the deal size would enable additional investment beyond the investment by the fund. General Partners generally commit on either a "hard" or "soft" basis to offer co-investment to some or all of the Limited Partners. Where General Partners or their personnel also have co-investment rights, there is often pressure to co-invest in all deals to prevent "cherry-picking" of the best investments for co-investment purposes. Often, there is no carry or management fee paid by co-investors on co-investments, but this is not always true, and transaction fees may also apply.

7. Limited Partner Involvement

In order for Limited Partners to maintain their limited liability status in Ontario, they are generally not permitted to be involved in the business of the partnership. While certain other jurisdictions in Canada, such as Manitoba, provide other means to limit liability while still enabling Limited Partners to be involved in the business, Limited Partners are understandably cautious to risk their limited liability status. As a result, most Limited Partners have very limited involvement in the business of the fund. Funds often have advisory committees consisting of Limited Partner representatives whose role is to give input on (and in some cases consent to) such things as mark-ups and mark-downs of investments, valuations, conflict of interest issues and default remedies, without being involved in such things as investment and disposition decisions.

8. Investment Restrictions

Some funds choose to focus on certain industries or markets. Often, investment restrictions are permissive rather than obligatory to prevent the need for the cumbersome process of seeking Limited Partner consent if what is perceived as a great deal arises outside of the expected investment parameters. Investment restrictions may also provide that the advisory committee may consent to waive such restrictions in appropriate circumstances. Investment restrictions may include: limits on investments in public companies (as fees are often

higher with private equity funds than public money managers); majority ownership requirements (since minority investments often lack necessary control); limits on the amount of the fund to be invested in any one portfolio company; geographical limitations (to ensure diversification); tax-related and/or ERISA limits; investments in existing investments of a prior fund or investments made by a subsequent fund which may require advisory committee approval; and borrowing/guarantee limits.

9. Defaulting Limited Partners

Given that most funds have capital call provisions for contributions and require only a small percentage of committed capital, if any, to be provided to the fund up front at closing, there is often concern about Limited Partners committing to invest but not following through when the capital call is made. This concern is sometimes addressed by requiring the escrow of capital contributions, particularly for Limited Partners committing smaller amounts. Guarantees or other credit support may be required in certain cases. There are also typically somewhat harsh provisions for Limited Partners who defaulted, including forfeiture of some or all of their interest in the fund, forcing them to transfer their interest at a discount to other Limited Partners (who fund their default); and/or forfeiture of some or all of partnership profits, among others.

10. Key-Person Provisions and Succession Issues

The skill and experience of the General Partner is typically critically important to a Limited Partner's decision to invest in a fund. As a result, Limited Partners often request termination provisions tied to management changes or key-person departures. These range from prohibiting further capital calls until new management acceptable to a majority or super-majority of Limited Partners is in place, to terminating the fund at the request of a majority or super-majority of Limited Partners. Key-person termination provisions are often dependent upon what other termination provision, if any, have been negotiated. The timing for raising a subsequent fund is also often an

issue subject to much negotiation, as the General Partner wants to be able to raise another fund soon after the bulk of the current fund has been invested, while Limited Partners want to ensure that sufficient time and attention of the General Partner continues to be spent on the current fund. Typically, a certain percentage (75% or more) of the fund's committed capital must be invested prior to raising a subsequent fund, and agreements may specify certain standards regarding time to be spent on the current fund once such subsequent fund is up and running. There are also conflicts issues regarding investing by both funds in the same companies and sectors, and allocation of opportunities issues, which may require approval by the advisory committee(s). ■

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