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# PRIVATE EQUITY FUNDS

## What are the different types of private equity funds?

There are different ways of categorizing private equity funds. Some of the principle representative types include the following:

A. Venture Capital Funds provide capital to businesses in the early stages of development of new products or services. The term “early-stage” venture capital is often used to refer to financing provided at the earliest stage of a company’s life. The term “later-stage” venture capital refers to providing financing later in a company’s life when its products or services are ready for or already in the market, but additional capital is needed for expanded production or marketing or until sales can grow enough to sustain routine needs for working capital and to allow the company to qualify for conventional bank or other debt financing. Investments in Venture Capital Funds often take the form of convertible preferred stock which provides down side protection in the form of preferences over the common stock relating to dividends and liquidation, as well as upside potential through the ability to convert the preferred stock into common stock. The exit strategy for Venture Capital Funds can involve anything from a sale of common stock following an initial public offering of the portfolio company or in connection with an acquisition of the portfolio company by a strategic buyer or another fund.

B. Leveraged Buyout and Merchant Banking Funds commonly structure their investments as a purchase of equity securities in a newly-formed corporation that acquires the stock or assets of the target company. The newly-formed corporation typically uses a significant amount of borrowed money to fund the purchase price. The use of cash flow from the target company to service and repay the acquisition indebtedness is the hallmark of a leveraged buyout.

C. Hedge Funds traditionally invest in currencies and financial assets such as interests in securitization vehicles, government and private bonds, and publicly-traded stock and derivative securities. More recently, Hedge Funds have become participants in acquiring significant stakes or even control of business enterprises. Investors in Hedge Funds are generally prohibited from transferring their interests in the fund without the consent of the general partner. However, a contractual right

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to redeem based on net asset value is typically provided after an initial lock-up period. In a traditional Hedge Fund, redemption was practical because the assets of the Hedge Fund were largely marketable securities that could be readily sold to fund redemptions. However, some Hedge Funds have “side pocket” arrangements allowing the Hedge Fund to invest a specified portion of its assets in non-marketable investments with more limited redemption rights.

D. A Fund of Funds is simply a private equity fund which invests exclusively or primarily in other private equity funds.

E. A Real Estate Fund provides investors with the ability to achieve greater liquidity and portfolio diversification in large, generally illiquid, real estate assets. Real Estate Funds are generally structured with a specific investment focus, which may include the direct acquisition of real estate, the acquisition of majority or minority equity interest in properties on a joint venture basis, the investment in public or private real estate operating companies, the origination of real estate loans or the acquisition of existing real estate debt instruments. Real Estate Funds may also be structured with an investment strategy that focuses on specific real estate asset types such as commercial office buildings, retail or shopping mall facilities, multi-family properties or hotels. They are also sometimes structured with an investment strategy that focuses on specific geographic regions.

F. A Captive Fund or Semi-Captive Fund does not denote a particular investment strategy. Rather, the terms refer to a private equity fund structure characterized by a high degree of involvement and control by a lead or sole investor or institutional sponsor. For example, Captive Funds are often sponsored by financial institutions that are already active participants in the capital markets because of the size of their investment portfolio (e.g., a pension plan or charitable foundation) or because of its core business lines (e.g., banks, insurance companies and investment banking firms) or both.

G. The term “Hybrid Fund” refers to a private equity fund that combines the attributes of a Venture Capital Fund or Leveraged Buyout Fund, on the one hand, and the model of a Hedge Fund on the other.

H. The term “Pledge Fund” is a misnomer in the sense that there is no fund in the conventional sense. The term refers to an arrangement, usually embodied in a contract, under which one party undertakes to identify and/or manage investment opportunities on behalf of one or more other parties. Typically, the other parties

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retain complete investment discretion and they agree to participate or not in particular opportunities. However, there is no pooled investment vehicle organized to make multiple investments on behalf of the same investors.

I. A Mezzanine Fund typically shares many of the characteristics of a Leveraged Buyout Fund. In the capital markets, mezzanine investments occupy a midway point between common equity and senior debt. Mezzanine investments may be subordinated debt or preferred equity, but they usually come with a right to participate in future common equity appreciation, whether through a conversion feature or through issuance of an investment unit with warrants, options or low-cost common stock.

### **What are the economic expectations of the parties?**

Investors in private equity funds hope for higher investment returns, coupled with somewhat higher risk, relative to direct investments in freely tradable public market investments. They also have expectations of diversification, although not necessarily within the private equity fund itself as between investments in the private equity fund category and other general categories of financial assets. In the case of institutional investors, investments in private equity funds are often considered to be part of an alternative asset class that may include investments in unregistered debt and equity securities, real estate, commodities, currencies, derivatives and other unconventional investments. For institutional investors, the portfolio allocation model is vital because it provides the foundation for investment managers within those financial institutions to satisfy their fiduciary responsibilities by assessing risk on a portfolio-wide basis allowing them to balance the potentially higher risk and higher returns of private equity with the relative security afforded by other portions of the portfolio, such as those comprised of investment grade debt. Private equity funds also represent a high risk and potentially higher return endeavor from the point of view of the sponsors and the principals. Many sponsors and principals initiate private equity funds at least in part because of the wealth generating potential of the carried interest.

### **What is the life cycle of a typical private equity fund?**

Initially, the sponsors of a private equity fund must decide what terms to offer prospective investors. These initial determinations are often made in conjunction with legal counsel, accountants, business advisors and prospective placement agents. In some cases, sponsors will “test the market” by circulating, often in draft

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form, to a limited number of potential investors a comparatively brief investment proposal. Whether or not any initial test marketing is performed, at some point the sponsors must prepare and circulate their offering materials to potential investors. It is at this stage that a decision is often made whether to attain a placement agent to assist in the fund raising process. In order to obtain binding commitments from investors, it is necessary to prepare the legal documentation for the proposed private equity fund. At a minimum, this documentation ordinarily includes a partnership agreement, a subscription agreement, and documents relating to the establishment of an entity to serve as the general partner. Assuming the successful establishment of the private equity fund, the sponsors and principals must then face the reoccurring expenses associated with running the fund. This includes the travel and other out-of-pocket expenses associated with identifying and evaluating potential investments, as well as related third-party costs such as the fees of lawyers, accountants and other professional advisers. Income to cover some or all of these items is available in the form of management fees and a contractual provision is found in most private equity fund arrangements allowing the sponsor to treat various costs associated with the investment program as partnership expenses which can be paid from capital contributions. Finally, as investments mature and begin to be sold, the private equity fund will realize the disposition proceeds.

### **What is carried interest?**

Private equity revolves around the recruitment and retention of talent primarily by providing incentive compensation. The most important element of incentive compensation takes the form of a profits interest that is significantly greater than the sponsor's capital interest. This profits interest is commonly referred to as "carried interest." Carried interest is typically structured for tax purposes as an allocation of a portion of the partnership's profits. Absent this feature, the fund could be hard pressed to achieve after-tax returns for their principals competitive with the principals' other investments. For private equity funds with investment strategies where a significant portion of its income is in the form of capital gains, preserving the capital gains character of the incentive compensation in the hands of the individual principals is also a critical structuring feature.

### **How much is the carried interest?**

The amount of the carried interest can vary depending on the nature of the fund. For example, it is often less in a Fund of Funds than, for example, a Venture

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Capital Fund. Carried interest of 20% is perhaps the most common. For example, profits generated by a fund might be divided according to a formula which provides the general partner with carried interest in the amount of 20% of the profits attributable to the investors' capital contributions. In such a case, the limited partners might be entitled first to a return all capital contributed by them, and then a previously agreed-upon rate of return (the "hurdle rate" or "preferred return"). Afterward, the general partner may be entitled to receive a share of incremental profits which sometimes will actually exceed the carried interest percentage until, on a cumulative basis, the general partner has received the agreed carried interest percentage of total profits. This is sometimes referred to as a "general partner make-up." In cases where early sales of portfolio investments generate profits and later sales do not, it is possible for the general partner to receive carried interest distributions which exceed those that would be payable when the profit-sharing formula is applied on a cumulative basis to the gains and losses realized during the entire life of the fund. This possibility is sometimes addressed by imposing upon the general partner an obligation (the "clawback") to restore to the fund or a portion of the carried interest distributions previously received so that cumulative distributions are consistent with the profit sharing formula.

### **What other issues are involved with the determination of the carried interest?**

In the case of Venture Capital Funds and Leveraged Buyout Funds, the income base to which the carried interest percentage will be applied almost invariably includes capital gains. Other types of income sometimes present more difficult questions. For example, a Venture Capital Fund or Leveraged Buyout Fund may invest the proceeds of capital contributions on a short term basis pending consummation of the purchase of a portfolio investment. In addition, some private equity funds are able to earn commitment fees or break-up fees in circumstances where a commitment to make a portfolio investment is made, but the actual investment is never consummated. Some investors take the position that income of this kind should be excluded for purposes of calculating the carried interest. Similar questions can arise on the expense side. For example, in the case of Venture Capital Funds and Leveraged Buyout Funds, the question of whether management fees are included as an expense for purposes of calculating the profits subject to the carried interest remains somewhat controversial.

### **How much are management fees?**

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Almost all private equity funds charge an annual management fee formulated as a percentage of some amount reflecting the size of the fund. In most private equity funds the annual percentage will be between 1% and 2.5%. Smaller private equity funds will often set the annual percentage at the higher end of the range, reflecting the lower absolute amount of fee income. Venture Capital Funds and funds characterized by emerging market investment strategies are also more likely to set the annual percentage at the higher end of the typical range reflecting a higher level of expenses compared to Leveraged Buyout Funds or Hedge Funds.

### **How are private equity funds structured?**

The majority of domestic private equity funds use the limited partnership form of organization for the fund. In the past, an important consideration concerned the organization of the general partner due to the broad scope of personal liability associated with serving as the general partner of a limited partnership. These considerations have for the most part been alleviated with the wide-spread adoption of state statutes authorizing the limited liability company form of organization in which neither the owners (called “members”) nor the managers have personal liability for the debts and obligations of the limited liability company.

### **What does it mean to establish a “series” within a limited partnership?**

An option sometimes used with Delaware limited partnerships is to take advantage of Section 218 of Delaware’s Limited Partnership Act to create a “series” of separate entities within the limited partnership. The general idea is to have the functional equivalent of a division in a conventional legal entity that would nonetheless be treated as a separate legal entity from a creditor rights point of view. Thus, the assets of one “series” would not be subject to the claims of creditors of a different series within the same limited partnership. In the case of a private equity fund availing itself of the series structure, capital commitments may need to be apportioned among the different series. Capital contributions, capital accounts, allocations and distributions may similarly need to reflect the series structure.

### **What is the typical investment made by the general partner in the fund?**

Traditionally, private equity funds had a capital structure in which the general

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partner agreed to provide 1% of the total capital contributions and the limited partners agreed to provide the remaining 99% of the total capital contributions. This structure was based on prior law under which a 1% or greater interest of the general partner in total capital contributions was generally an important factor in ensuring that the fund would be classified as a partnership for Federal income tax purposes. The 1% standard for the general partner's share of total capital contributions is no longer necessary for the fund to be classified as a partnership for tax purposes which has led to a greater degree of variation in the general partner's share of total capital contributions. Nonetheless, investors often view larger capital contributions on the part of the general partner as an important element in an effective alignment of interest between the general and limited partners.

### **What is a hub and spoke structure?“**

Hub and spoke” structures generally only address tax and regulatory matters. A typical “hub and spoke” structure may involve the establishment of a limited partnership to serve as the “hub” entity sometimes in a low tax jurisdiction such as Bermuda, the British Virgin Islands or the Cayman Islands. The “hub” entity serves as the vehicle that actually acquires portfolio investments. However, third-party investors do not ordinarily become limited partners of the “hub” limited partnership. Instead, they acquire equity interest in the various “spoke” or “feeder” vehicles.

### **How is carried interest shared among principals?**

Private equity firms vary greatly in terms of how the carried interest is shared among the principals, other employees of the general partner or the manager and, in some cases, third parties. In the simplest case, one or more individuals receive a fixed percentage share of the carried interest throughout the life of the underlying fund. In more complicated situations, the sponsor or the senior principal may desire to retain the ability to establish different sharing ratios for the carried interest each time the underlying fund makes a portfolio investment.

### **Are there estate planning considerations involved with the structure of private equity funds?**

Principals will often want to use the flexibility afforded by the limited liability company form of organization as part of their tax or estate planning. Although

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readily accomplished from a legal point of view, achieving optimal flexibility from a tax and estate planning perspective requires a more detailed approach to the contractual provisions of the limited liability company agreement. A variety of legal and contractual issues need to be considered when principals are granted the flexibility to make transfers for tax and estate planning purposes. For example, the implications of the transfers need to be considered under the Securities Act and the Investment Company Act. The limited liability company agreement also needs to reflect how any vesting, removal or similar provisions will operate in view of those transfers.

### **Does the Tax Cuts and Jobs Act impact private equity structuring?**

Lower corporate tax rates and the qualified business income deduction will make it harder to analyze alternative structures for private equity portfolio companies and may result in more C corporations. On the one hand, the Tax Cuts and Jobs Act favors C corporations by reducing the corporate tax rate from 35% to 21%. On the other hand, it favors pass-through entities by allowing a new deduction for qualified pass-through income. The deduction is 20% of qualified business income determined at the partner level, subject to a cap that is based either on wages paid or on wages paid plus a capital element. The cap equals the greater of 50% of the W-2 wages paid or the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. The cap phases in for joint return filers with taxable income between \$315,000 and \$415,000, and for other filers earning between \$157,500 and \$207,500.

### **How are private equity funds regulated?**

The Securities Act is the principal regime for regulating the offering of securities, including interests and shares offered by private equity funds. Private equity funds typically rely on several exemptions from the Securities Act's registration requirement. Most private equity funds rely on a safe harbor provided by Regulation D, which encompasses Rules 501-508 of the Securities Act. The most common exception used is in Rule 506, because it does not cap the dollar amount of a private offering and generally permits an issuer to offer and sell its securities to an unlimited number of "accredited investors" and up to 35 non-accredited investors.

Federal regulations govern not only any securities offered by private equity funds, but also the operations of the fund itself. The Investment Company Act requires



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“any issuer of securities that is or holds itself out as being engaged primarily or proposes to engage primarily in the business of investing, reinvesting or trading in securities” to register with the SEC. To avoid the onerous regulatory requirements imposed by the Investment Company Act, most private equity fund sponsors structure their funds to fall outside the Investment Company Act’s definition of an “investment company.” For example, a private equity fund is excluded from the definition of an “investment company” if it does not make or propose to make a public offering of its securities and it either limits the number of beneficial owners of the outstanding securities to 100 investors or all of the owners of the outstanding securities are qualified purchasers as defined under the Act.

Federal securities laws also govern investment advisers involved with private equity funds. For example, the Investment Advisers Act governs the activities of “investment advisers,” which generally means any natural person or entity that “for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regulated business, issues or promulgates analyses or reports concerning securities.” Generally, both the investment manager and the general partner of a private equity fund are considered to be investment advisers.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was enacted. Among other things, it eliminated the private fund adviser exemption from registration that had permitted investment advisers to avoid registration with the SEC if they did not hold themselves out as investment advisers and advised fewer than 15 clients in any rolling 12 month period. Prior to the Dodd-Frank Act, most managers of private equity funds relied on the private fund advisory exemption. Although the Dodd-Frank Act eliminated this exemption, it did create three new exemptions from registration that may be available if the applicable requirements can be met. For example, one rule exempts an investment adviser with its principal office and place of business in the United States if it acts solely as an investment adviser to one or more qualifying private funds and manages private fund assets of less than \$150 million. Another exempts from registration investment advisers that act solely as an adviser to Venture Capital Funds meeting certain criteria.

Persons or entities that are involved in the marketing or sale of private equity fund interests must also determine whether they are acting as “brokers” or “dealers”

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and whether they are subject to regulation under the Securities Exchange Act of 1934. Sponsors of private equity funds that self-issue (rather than hiring third party placement agents) generally do not register as broker-dealers if they meet the requirements of the exemption set forth in Rule 3a4-1.

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