Schulte Roth&Zabel

Investment Management Hot Topics

Evolving Terms of Private Equity Funds

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Investment Management Hot Topics

1. About the Speakers

Schulte Roth&Zabel

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Stephanie R. Breslow is a partner in the New York office of Schulte Roth & Zabel, co-head of the Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of liquid-securities funds (including hedge funds and hybrid funds), private equity funds (including LBO, mezzanine, distressed, real estate and venture) and providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment-management businesses, and represents funds of funds and other institutional investors in connection with their investment activities.

Recently named Secretary of the Investment Funds Committee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a former member of the Steering Committee of the Wall Street Fund Forum, and a member of the Board of Directors of 100 Women in Hedge Funds. She is listed in *Chambers USA, Chambers Global: The World's Leading Lawyers, The Legal 500 United States, Best Lawyers in America, America's Leading Lawyers, Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *IFLR Best of the Best USA* (Investment Funds), *IFLR Guide to the World's Leading Investment Funds Lawyers, IFLR Guide to the World's Leading Women in Business Law* (Investment Funds), *IFLR Guide to the World's Leading Private Equity Lawyers*, and the *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was also named one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds.

Stephanie is a much sought-after speaker on fund formation and operation and compliance issues, and publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute, 2009), contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2005–2006* (PLC Cross-border Handbooks), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West). Stephanie received her B.A., *cum laude*, from Harvard University, and her J.D. from Columbia Law School where she was a Harlan Fiske Stone Scholar.

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Omoz Osayimwese is a partner in the New York office of Schulte Roth & Zabel, where he focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. Omoz has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed capital transactions, and advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz speaks regularly to investment managers about current developments relating to private investment funds. His speaking engagements have included “Investing in Financial Institutions” at SRZ’s 20th Annual Private Investment Funds Seminar, “Private Equity Funds: New Investor Demands” at SRZ’s Investment Management Hot Topics seminar, a roundtable discussion at the AIFEA meeting regarding investment adviser registration for private equity firm and the Hedgeworld Webinar “Emerging Managers: Raising a Hedge Fund in a Bear Market.” Omoz received his B.A., with highest honors, from Michigan State University and his J.D. from University of Michigan Law School.

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Phyllis A. Schwartz is a partner in the New York office of Schulte Roth & Zabel, where she focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, real estate funds and small business investment companies. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements and the creation of internal investment vehicles, she has extensive experience with institutional investors and regularly advises on the acquisition and disposition of partnership interests and market terms of investment funds. Phyllis also represents private equity funds in connection with their investments in, and disposition of, portfolio companies.

A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She discussed the "State of the Industry" at FRA's Private Equity C-Level Summit, and presented "Fund Formation: Considerations for Effective Tax and Operational Standards" at FRA's 2nd Annual Private Investment Funds Tax Master Class. She is co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute, 2009), which is considered the leading treatise on the subject, and she recently co-authored the PLC Practice Note "Structuring Waterfall Provisions," which appeared in *Practical Law The Journal*. Phyllis received her A.B. from Smith College and her J.D. from Columbia Law School.

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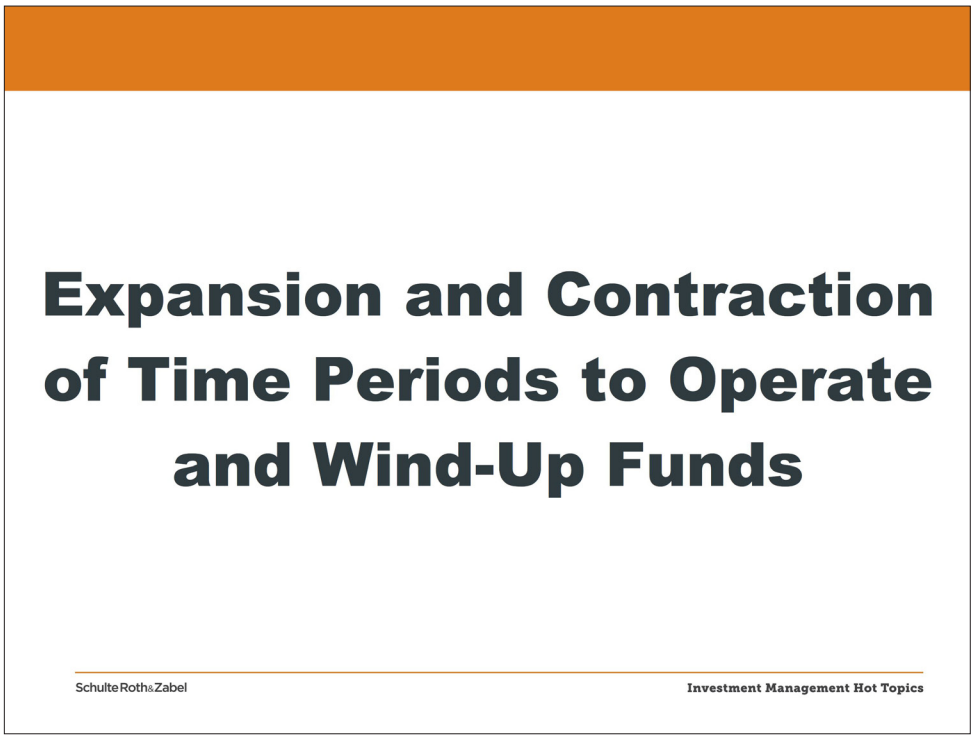
2. PowerPoint Presentation



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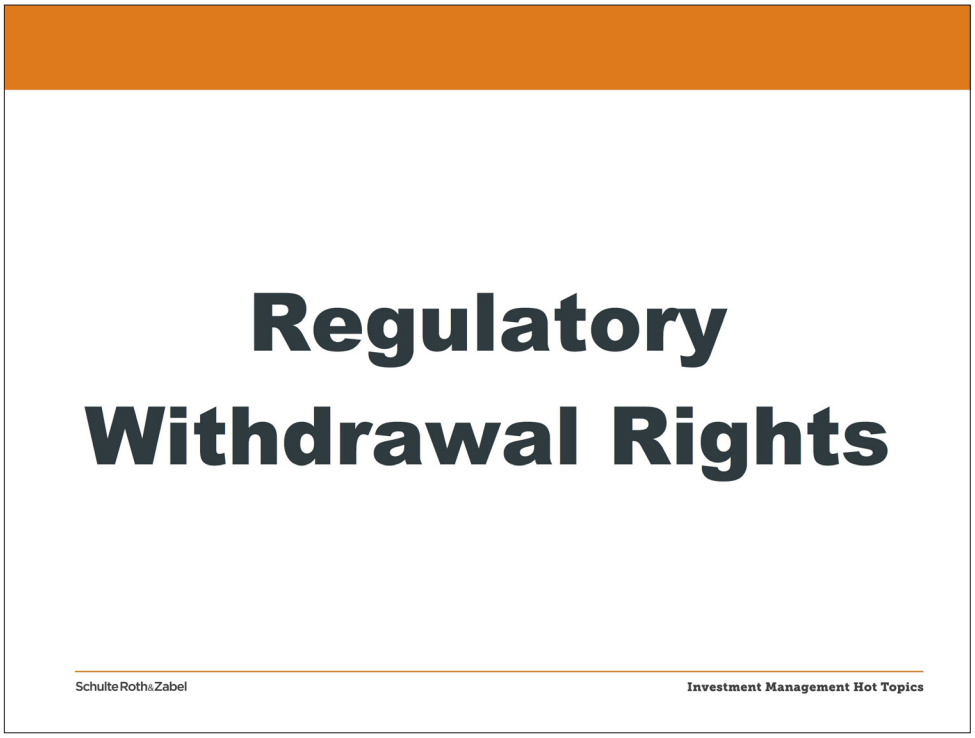

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3. Outline

Evolving Terms of Private Equity Funds

I. Introduction

A. A weak economic climate and investor concerns about the operational controls and conflicts of general partners are at the core of today's evolving terms of private equity funds

B. Poorer returns and a relatively weak fundraising climate have resulted in heightened demands for economic alignment between limited partners and general partners

1. Limited partners have been the drivers of the terms of private equity funds for several years, unless, in very rare instances, the fund is oversubscribed

2. Unlike prior cycles, managers forming successor funds are still subject to new, more investor-favorable terms

3. The terms of future funds are likely to contain some of the new investor-favorable terms now being included in partnership documents, regardless whether the economy improves

C. A few prominent scandals, combined with a more general awareness of the importance of strong operational controls and a culture of compliance, have resulted in more scrutiny of managers

1. Investors are performing extensive due diligence on managers before commitments are made, which can take many months to complete

2. Investors are requiring extensive reporting during the life of a fund, including reports on conflicts issues

3. Investors are requiring "no-fault divorce" rights, more user-friendly for-cause removal provisions and enhanced ability to control general partners

4. As a result of the trend toward more extensive diligence and focus on operational stability and controls, larger fund firms have a growing advantage over smaller private equity firms

5. Large institutional investors prefer to make a smaller number of larger commitments to funds and typically do not want to own more than 10 percent or 20 percent of a given fund

D. SEC registration could alleviate some aspects of investor concerns, but the formation of private equity funds involves extensive investor negotiations, and it is unlikely that investors will defer their attention to the SEC's oversight

E. On the bright side for managers, current economic uncertainty has caused many investors to rely more heavily on alternative investments, including private equity

II. Expansion and Contraction of Time Periods to Operate and Wind-Up Funds

A. Managers must plan for three main time periods in order to operate private equity funds:

1. Marketing period

2. Investment period

3. Harvesting period

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B. Generally, marketing periods have become longer

1. Managers negotiate the terms of their funds well in advance of the first closing

2. The contractual marketing period between the actual first closing and final closing under a fund's limited partnership agreement may now allow for closings 18 months after the first closing, even though, historically, it has been routine to amend partnership agreements for closings after the 12th month

3. Longer marketing periods may result in more valuation issues and the price at which investors buy into a private equity fund, similar to NAV issuances by hedge funds

4. Investors have requested that later investors be excluded from investments completed before later closings

C. Investment and harvest periods are usually tailored to the fund's strategy

1. Credit funds generally have shorter investment and harvest periods

2. Real estate funds historically had shorter periods, but may now have longer investment and harvest periods to reflect the more difficult environment in which real estate deals are negotiated and financed

3. Buyout, mezzanine and venture funds still have the longest investment and harvest periods

4. Fund terms often include limits on the amount of follow-on investments that can be made after the investment periods, at least with newly-called capital. This can present an issue if assets are held longer than anticipated due to poor market conditions

5. Typically, any permitted reinvestment activity of investment proceeds ceases after the investment period

6. Managers seeking investor approval to extend the investment period of their funds may find that those amendments require 100 percent approval — drafting is important here

D. Liquidation of the portfolio has become the most challenging

1. Once the fund reaches its date of dissolution (whether at the end of the term or earlier based on an investor vote to dissolve a fund for "cause" or under a "no-fault divorce"), the fund must engage in orderly liquidation or "winding-up" of its assets

2. The time period for winding-up is generally left to the reasonable discretion of the general partner, but older funds may have deadlines for completing the liquidation, and may not provide for continued fees after the deadline has passed

3. While the interests of investors and managers are aligned in benefiting from distributions, neither group wants a "fire sale" of assets; therefore, the date of dissolution of a fund has become less relevant, as there is no certainty as to when assets can be sold at their perceived best value

4. In addition to a lack of certainty on the timing of sale transactions of assets, buyers of assets are implementing extended escrow and earn-out provisions in their acquisition documentation; these tails to acquisition transactions are presenting significant challenges to complete the winding-up of a fund even when all assets have been effectively disposed of

5. Liquidating trusts and other liquidators don't solve for these challenges

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6. Just as the carried interest will be payable as the fund winds down, management fees should also continue to be paid through the winding-up of the fund; drafting is very important here, as investors will have great leverage on compensation of managers if the limited partnership agreement does not provide for payment of management fees after the dissolution date of a fund

7. Funds must also reserve for ongoing operating costs of funds through winding-up, such as audit fees and tax reports

E. No-fault termination rights are creating uncertainty in managing funds

1. Investors are negotiating for the right to terminate the investment period and to dissolve the fund (meaning a trigger of the wind-down period) without cause may also have no-fault general partner removal

2. Their right generally requires a super-majority vote, which is generally a 70 percent or 75 percent vote

3. The general partner's continuing right to receive carry following removal is an issue

a) Will the general partner take a haircut on its future compensation?

b) At what value will the general partner receive its carry?

III. Alignment of Economic Interests

A. Poor returns have resulted in greater investor demands for an alignment of their economic interests with managers'

B. Timing of payment of the carried interest to the general partner may be a potential misalignment

1. Investors often request the "European" or "back-ended" distribution waterfall to ensure that they receive a return of their capital before the carry is paid to the general partner

a) Total return waterfalls have been required of some managers even if they are forming successor funds to prior funds that had deal-by-deal carry

2. In lieu of a pure total return waterfall, investors are also negotiating for hybrid waterfalls

a) This commonly results in the cost of deals sold plus all fund expenses, including management fees, to be returned to investors before the carried interest is paid

3. Interim clawbacks are now sometimes required well before the fund approaches its winding-up period

a) Investors have learned that a fund's life can extend well beyond 10 years and no longer want to wait for a true-up of distributions

b) Interim clawbacks may occur as early as the end of the investment period

4. Tax distributions may be included in the clawback payments

5. Escrows are not gone either; but, in that case, it may be better to use a back-ended waterfall than to have cash sitting in accounts earning little returns

6. Personal guarantees of clawbacks are common

a) Some investors are requesting joint and several liability

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C. Management fees

1. Investors continue to seek lower management fees to avoid management fees servicing as a profit center

   a) Smaller funds have less certainty in their ability to raise a successor fund plus have increased compliance costs, which all raise the level of management fees needed to run the business

2. Management fee offsets for transaction and monitoring fees are seen as the largest non-alignment issue

   a) 50 percent offsets have been replaced by 80 percent offsets

   b) Many investors are now demanding 100 percent offsets

   c) Service fees may still fall outside offsets if they are earned for a business purpose unrelated to management of a fund (e.g., loan servicing)

   d) Limited partnership agreements should be carefully drafted to allocate fees offsets only among partners who are charged fees

3. Step-downs of management fees are now often triggered upon the earlier of the end of the investment period and the formation of successor funds

D. General fund expenses are scrutinized more carefully by investors

1. Travel expenses should be covered by the fund for investments and divestments; however, monitoring costs are generally covered by the management company

2. Internal costs (e.g., accounting services) are unlikely to be borne by the fund

IV. Restrictions on Fund Investments

A. Investors restrict fund investment activities to reduce risk and to satisfy their own investment restrictions

B. Concentration caps

1. As more funds are sourcing deals of a size that exceeds their concentration caps, general partners must arrange for co-investment capital

2. Investors often want co-investment rights and receive side letter rights on the topic

   a) The level of fees paid for co-investments varies (and may be zero)

3. General partners are likely to seek co-investments from other institutional funds or co-investors, but might also want to co-invest themselves

   a) The partnership agreement will likely require limited partner committee approval for general partners to co-invest

   b) Some partnership agreements do allow general partner co-investments if the fund reaches its concentration cap

C. Socially responsible covenants

1. Investors generally address their socially responsible investment duties, and impose such duties on the general partner, in side letters when first investing in a fund

2. Occasionally, investors request restrictions mid-way through the fund's life (e.g., Illinois restrictions on Sudan investments)

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3. Socially responsible covenants have given rise to additional investor opt-out rights in side letters

4. The general partner should consider whether socially restrictive investment covenants should be included in side letters or the fund's partnership agreement or offering memorandum

    a) The SEC may consider restrictions on investments contained in side letters insufficient disclosure to other investors

    b) It is important for the general partner to evaluate whether the fund would have made the restricted investments as part of the fund's investment regular activity

V. Liability Standards: Indemnification

A. Investors are increasingly seeking to broaden the general partner's standard of liability beyond gross negligence, willful misconduct, fraud and bad faith

1. Delaware law allows fiduciary duties to be modified or replaced pursuant to the fund's limited partnership agreement, but does not allow bad faith to be waived

2. Certain institutional investors are now requiring the general partner to acknowledge that it owes a fiduciary duty to investors

    a) This could result in the general partner having liability at a level closer to simple negligence

    b) The general partner should be protected from claims for breach of fiduciary duties if it obtains limited partner committee approval for a transaction

3. It is standard for a material breach of the fund's partnership agreement to give rise to a claim by investors

    a) The issue is whether such a breach must be willful

    b) Investors do permit cure rights, including the removal of the employee who engaged in the misconduct

    c) Some institutional investors will only respect removal of the employee if the economic loss suffered by the fund is also restored

4. A material breach of laws is now standard as a measure of the general partner's liability

    a) Again, the issue is whether such breach must be willful

    b) A breach of law may allow for-cause removal; should be the conviction of a felony or other laws related to securities businesses

5. Investors resist requirement of non-appealable judgments before misconduct is deemed to have occurred

    a) A lower court decision is often sufficient for liability

    b) Sometimes the investment period freezes during any period of litigation over whether misconduct has occurred

B. Advisory committee members and limited partners focus on limiting their liability

1. Advisory committee members often seek a simple good faith liability standard, although frequently, a fund agreement will also include fraud as a standard

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2. Advisory committee members often ask that the limited partnership agreement provide that advisory committee members do not owe any duties (including fiduciary duties) to other partners, as there is not clear legal guidance on this standard

    a) Consistent with not owing duties to other partners, an advisory committee member may be allowed to take into consideration the individual interest of the limited partner such member represents

3. Investors have requested that the fund cover legal costs of the advisory committee in connection with fund disputes, although it is fairly unusual for this cost to be borne by the fund

4. Government plan investors seek caps on liability

    a) The most typical cap on a limited partner's liability is under its subscription agreement, which is limited to the total committed capital of the limited partner

    b) Government plans also expressly carve out the duty to make indemnification payments

C. Indemnification payments

1. Indemnification payments can be obtained from three principal sources — the fund, insurance companies and portfolio companies

    a) The fund satisfies its obligation to make indemnification payments out of:

        i. Uncalled capital commitments;

        ii. Proceeds from investments; and

        iii. Clawbacks of distributions from partners

2. Investors now often require the indemnified party to seek coverage from portfolio companies and insurance before the fund makes payment

    a) Obtaining coverage from insurance companies and portfolio companies may take extended time; therefore, the fund is likely to make indemnification payments

    b) If coverage is ultimately received from a portfolio company or under insurance, the fund would have a duty to restore fund assets previously used to make the indemnity payment

3. Clawbacks of distributions have become more restricted as to timing (e.g., a clawback of a distribution cannot be made later than the third anniversary of the date on which the distribution was made) and as to amount (e.g., no greater than the lesser of 50 percent of distributions and 30 percent of commitments)

    a) Clawbacks of distributions are made in a manner that reverses out the most recent distributions

    b) Therefore, the first dollars to be returned are likely to include any carried interest that has already been distributed

    c) Reserves from investment proceeds for indemnity payments are likely to be established in lieu of utilizing clawback, as a result of which the completion of a fund's winding-up may be delayed until it is determined if the indemnity obligation is owing

4. Indemnification obligations are being curtailed by investors in several instances

    a) When a significant amount of investors (typically 40–50 percent in interest of the limited partners) bring a claim against the general partner or its related parties, the fund will not be permitted to advance the costs of defense

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b) The fund will not be permitted to indemnify one general-partner-indemnified party with respect to a dispute with another general-partner-indemnified party

VI. Conflicts of Interest

A. The advisory committee is helpful for both the general partner, to protect against possible claims for self-dealing, and for investors, to protect against unauthorized interested party transactions

1. The general partner will generally be required to bring conflict-of-interest transactions to the attention of the advisory committee for approval

a) Certain transactions may be carved out, such as authority for the fund to retain an affiliate to provide services for the portfolio

b) Investors are now requesting copies of materials sent to the advisory committee and notice of actions taken by the advisory committee

2. The advisory committee members may not be willing to act if the transaction is of sufficient controversy or if they have their own conflict

B. Funds are subject to more disclosure than ever to allow investors to determine compliance with the partnership documents

1. Regular reports include summaries of material events, payments of management fee payments (including offsets for transaction fees), calculation of carried interest distributions and certification of compliance with the partnership agreement

2. Special reports including notice of general partner defaults, claims for indemnification and other litigation

a) Limited partners now want to exercise default remedies if the general partner is the defaulting partner

C. Larger investors are requiring preferential treatment

1. These arrangements may be established in separate vehicles, but will generally be disclosed or at least referenced in offering materials and under "most favored nation" side letters

VII. Regulatory Withdrawal Rights

A. Government plans now require additional withdrawal rights

1. Pay-to-play rules have been drivers of these rights

2. Government plans' side letters contain extensive representations regarding payments to placement agents and other parties with respect to the investment decision of the investor

B. Banks

1. Under the Volcker Rule, the withdrawal of banks from private equity funds is expected

2. Many general partners are waiting to see if divestiture can be avoided

C. Side letters are commonly used to cover withdrawal rights, but the SEC may require the disclosure of all side letter provisions to investors

D. It is helpful to broaden partnership agreement withdrawal rights to allow for side letter withdrawal provisions

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