Developments in Private Equity Funds

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Stephanie R. Breslow

Stephanie R. Breslow is co-head of the Investment Management Group and a member of the firm's Executive Committee. She maintains a diverse practice that includes liquid funds, private equity funds and the structuring of investment management businesses. She focuses her practice on the formation of private equity funds (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds, hybrid funds, credit funds and activist funds) as well as providing regulatory advice to investment managers. 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 funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

Recently serving as chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a former member of the Advisory Board of Third Way's Capital Markets Initiative, a former member of the Board of Directors and a member of 100 Women in Finance, a member of the Board of Visitors of Columbia Law School and a member of the Board of Directors of the Girl Scouts of Greater New York. Stephanie has received the highest industry honors. She was named to the inaugural *Legal 500 US* Hall of Fame in the category of "Investment Fund Formation and Management: Alternative/Hedge Funds." Stephanie is also listed in *Chambers USA: America's Leading Lawyers, Chambers Global: The World's Leading Lawyers, Crain's Notable Women in Law, IFLR1000, Best Lawyers in America, Who's Who Legal: The International Who's Who of Business Lawyers*), *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Who's Who Legal: Thought Leaders: Global Elite, Who's Who Legal: Thought Leaders: Private Funds, Expert Guide to the Best of the Best USA, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers, Expert Guide to the World's Leading Women in Business Law and PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the *Who's Who Legal Awards* and the *Euromoney Legal Media Group*'s "Best in Investment Funds" and "Outstanding Practitioner," both at the Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s "50 Leading Women in Hedge Funds." Stephanie's representation of leading private investment funds has won numerous awards, including, most recently, *Law360*'s Asset Management Practice Group of the Year. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* and *Hedge Funds: Formation, Operation and Regulation*. Stephanie received her J.D. from Columbia Law School and her B.A., c*um laude*, from Harvard University.

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Peter G. Naismith focuses his practice on advising hedge funds, private equity funds, hybrid funds and investment advisers in connection with their structuring, formation and ongoing operational needs, as well as on certain regulatory and compliance matters. He represents a wide variety of institutional and entrepreneurial fund sponsors and asset managers. Peter also has extensive experience advising on mergers and acquisitions, including a range of complex, high-value public and private transactions across a number of industry sectors.

Prior to joining Schulte, Peter served as in-house counsel at a privately held investment firm, where he focused on fund formation, hedge fund and private equity fund seeding and family office matters. His broad expertise includes roles with firms based in New York, London and Adelaide, Australia. Peter received his LL.M., *magna cum laude*, from Duke University School of Law, his LL.M. (commercial), with honors, from The University of Melbourne, his Graduate Certificate in Legal Practice from The University of South Australia and his LL.B., with first class honors, from The Flinders University of South Australia.

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Phyllis A. Schwartz focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, litigation financing funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning, capital call borrowing facilities and formation of co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their capital call credit lines and investments in, and dispositions of, portfolio companies.

Phyllis is listed in *The Legal 500 US*, *The Best Lawyers in America*, *New York Super Lawyers*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and the *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). 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 recently discussed compliance concerns for co-investments and issues related to fund restructuring and secondary transactions. Interviewed by *Private Funds Management* in the article "Ringing the Changes," Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject. In addition, she contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ), as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" in *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute). Phyllis received her J.D. from Columbia Law School and her A.B. from Smith College.

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Joseph A. Smith represents private equity fund sponsors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive regulatory expertise, and wide-ranging experience with all alternative asset classes, including LBO funds, venture capital and later-stage growth equity funds, energy and infrastructure funds, credit funds, real estate funds and joint ventures, fund restructurings and other complex secondary transactions, and funds of funds. Joe has also represented many fund managers in connection with spinoffs and consolidations.

In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. Joe's clients include Arel Capital, Coller Capital, DRA Advisors, DuPont Capital Management, Fort Washington Investment Advisors, GE Asset Management (now State Street Global Advisors), Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Investors Diversified Realty, Kotak Mahindra Group, LCN Capital Partners, Mauá Capital, Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, Value4Capital, VCFA Group, Vortus Investments and Westport Capital Partners. Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 US* and *New York Super Lawyers*. Most recently, Joe was quoted by *Private Equity International* in the article "LPAs: Finding the Right Balance" and by *Private Funds Management* in the article "Ringing the Changes." Joe co-authored the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research Ltd.) and he contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ). He received his J.D. from NYU School of Law and his A.B. from Columbia University.

Developments in Private Equity Funds

I. Introduction

A. With their proven ability to outperform the public markets in recent periods, private equity funds continue to attract new capital.[1] Although robust asset prices are making it more difficult to deploy that capital at comfortable valuations,[2] and despite a general concern about potential market downturns, the private equity industry remains a very attractive choice for fund sponsors and investors.

B. That said, particularly for new or smaller sponsors, or sponsors that have had poor returns, there is still significant pressure to delineate a clear strategy, provide terms that are compelling, and otherwise cater to investors that, generally, are more likely to favor the larger, more-established sponsors.[3]

II. Formation

A. Investment Programs

1. Obviously, conventional private equity strategies (e.g., leveraged buyout and real estate strategies) have continued to do well in 2019. We also continue to see sponsors doing well by positioning themselves in niche areas: healthcare, litigation finance, specialty finance and other fixed income alternatives, fintech and other technology strategies, emerging markets, distressed investing and impact investing (i.e., ESG, environmental and employment-focused investing), among others.

2. This trend toward niche strategies is the result of several factors. Investors may have a particular mandate, or may view a sponsor as more skilled in certain areas than others. In some cases, the personal goals of investment professionals, and talent retention issues, may be important drivers.

3. The proliferation of different investment strategies under a single parent company creates challenges, such as structuring compensation arrangements for investment professionals.

4. In addition, this trend requires PPMs, pitch books and other marketing documents that utilize hypothetical performance figures (by extracting the data linked to a single investment strategy from data covering multiple investment strategies) to be prepared with detailed legal disclosure.

B. Side Letter Requests

1. Side letter requests (including the most favored nations, or "MFN," election process) continue to play an important role in the fund formation process. Institutional investors continue to deliver extensive requests, among which are ESG topics, extensive notice requests and sponsor representations.

2. Considerable discipline remains a necessity if sponsors wish to avoid an explosion of differing side letter provisions.

3. Managers attempt to lessen side letter burdens by integrating overlapping side letter requests into their fund agreements. This approach does succeed in stemming the flow of requests in some cases. The downside of this approach, however, is that it will tend to lock these provisions into your documents for perpetuity, and may not prevent more granular or form-over-substance requests. Some sponsors include the MFN provision in their LPAs.

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[1] Surveys published separately in 2019 by Ernst & Young (2019 Global Private Equity Survey) and *Preqin* (2019 Global Private Equity and Venture Capital Report) indicated that around two-fifths of respondents planned to increase their exposure to private equity in 2019.

[2] Witness the record levels of dry powder currently sitting on the sidelines. *Preqin* estimates $1.7 trillion across the private equity fund space, up from $1.5 trillion in 2018. Bain & Company (Global Private Equity Report 2019) pegs the figure even higher, calculating that this dry powder increased by almost two-thirds in the five years through year-end 2018. About half of the dry powder cited by Bain is attributed to the 2017 and 2018 vintage years.

[3] *Preqin* found that 24% of total capital raised by the industry in 2018 was secured by the 10 largest funds closed.

4. In our view, the approach of integrating side letter requests into fund documents makes the most sense in those cases where the failure to afford the same treatment to all investors would create selective disclosure or other basic fairness issues (e.g., a provision requiring notice of a material event).

5. The erosion of MFN rights has continued. Most investors now accept that MFN rights are available on the relative size of investors' commitments. However, we see investors focusing intently on how one will measure size (e.g., do you look across the sponsor's suite of products, do you credit investors with the investments made by other clients of the same gatekeeper, if so, does the credit extend to all clients of that gatekeeper or only clients for whom the gatekeeper exercising investment discretion, etc.) We also now see a broader list of topics excluded from MFN rights, regardless of the size of an investor's commitment to a fund. These excluded rights often cover rights to serve on investor committees, co-investment rights, agreements regarding the investor's right to receive or the obligation to provide information, transfer rights and modifications to investor representations.

C. Compensation for Investment Professionals

1. Clients are best served by focusing on their general partner and management company documents as early as possible, including the governing agreements of the entities themselves and any grant-related agreements for individual team members, to ensure that such documents are finalized in advance of significant economics accruing to top tier entities from the underlying funds.

2. The many reasons for prioritizing these documents include:

   (a) These documents provide the framework for managing the multiple cash flow streams that may result from sponsoring multiple products under the same firm (the proliferation of products referenced earlier).

   (b) As a talent retention matter, these documents are key to ensuring that the best performers are directly incentivized, while also ensuring that the firm can effectively restrain leavers from competing and protect its intellectual property.

   (c) From a risk management perspective, particularly for founders, these documents can be critical in times of stress. For example, in a clawback scenario, having had the forethought to establish holdbacks at the level of your general partner or carry vehicle may mean that a sponsor does not have to chase its people to return distributions received in earlier years.

   (d) There are a host of tax-related considerations raised by granting equity or phantom equity interests to team members.

III. Economics

A. Management Fees

1. Generally, the traditional model, including a management fee based on commitments during the investment period and a management fee based on invested capital thereafter, remains the most common approach.

2. Likewise, headline management fee rates remain stable, with most funds still charging fees in the 1.75%-2% range. Smaller funds need to earn enough fee revenue to build teams and achieve their potential — investors generally understand that. For the larger and more-established sponsors, however, it is harder to establish that a full 2% rate is appropriate.

3. Of course, only a portion of investors actually pay the highest management fee rate. Many sponsors have adopted a tiered approach, with larger investors receiving some fee break. "Early bird discounts" also remain a relatively common means of encouraging investors to commit at an early stage in the fundraising process.

4. Less commonly (albeit logically, given that many investors are repeat customers), investors have started to request credit for their aggregate capital invested across a sponsor's affiliated funds, rather than the amount invested in the particular fund at hand.

5. Access to co-investment opportunities remains a means for investors to achieve a lower blended management fee rate and therefore, has been a topic for negotiation in fund raising.

B. Carried Interest

1. We continue to see "American" or "deal-by-deal" waterfalls less frequently than the "European" or "whole fund" model, especially for funds launched by newer or smaller sponsors. While there is some innovation to be found on the carried interest structures, as a general matter, investors seem to remain comfortable with the 20% carry over a 8% preferred return hurdle with a full catch up.[4]

2. While the basic model is stable, more and more sponsors are questioning the sense of retaining a preferred return hurdle in the 8% range. Long seen as a proxy for a risk-free rate and therefore a reasonable means of incentivizing a sponsor to put capital to work quickly (particularly if the sponsor told investors it had a robust pipeline and was targeting mid-teens returns or higher), an 8% hurdle is viewed as harder to justify when real interest rates have remained so low for several years, and presents particular challenges in more niche areas (e.g., for funds pursuing fixed income-related strategies, which have been popular in the prevailing low-interest rate environment). Some degradation of the 8% standard is therefore becoming evident.

C. Recycling

1. Provisions permitting reinvestment or "recycling" of investment proceeds (and distributions followed by recalls of permitted reinvestment amounts) remain standard features of private equity funds. However, we continue to see broader reinvestment rights, such as the right to recycle investment proceeds after the investment period, the right to recycle all deal proceeds (as opposed to only the cost of an investment), subject to an overall investment limit of 120% of commitments, and the right to recycle investment proceeds in an amount equal to capital contributions utilized for fund expenses.

IV. Operations

A. Expenses

1. The SEC has been focused on expense allocations for several years now, and as a result the industry has collectively moved toward more extensive permitted expense litanies and expense allocation requirements within fund documents, including significantly more detailed expense allocation policies and procedures.

2. Developments of note in this area have included:

   (a) *Broken-Deal Expenses*. In recent years, sponsors have been warning investors in their main funds that prospective co-investors may not agree to bear their share of broken-deal expenses as a condition to participating in a co-investment. In response to such disclosures, we are starting to see investors seeking to negotiate caps on broken-deal expenses, raising the prospect that some portion of such expenses will need to be borne by the sponsor.

   (b) *Organizational Expenses*. "Org caps" continue to increase, particularly for funds with complex structures, and newer funds, where significant expenses can be incurred in structuring and building documents and negotiating with investors over what might be an extensive marketing period.[5]

      (i) Whether expenses incurred in handling an MFN process are organizational expenses (i.e., counting toward any cap) or operating expenses (i.e., an uncapped, permitted expense) is becoming an important consideration.

      (ii) In addition, parallel funds established for particular investors or groups of investors may add significant organizational expenses and the approach to treating those organizational expenses as

[4] One 2019 survey (MJ Hudson's Private Equity Fund Terms Research) found that, of funds surveyed, over four-fifths included a 20% carried interest, over two-thirds included an 8% preferred return hurdle, and over three-quarters included a full catchup.

[5] *Preqin* (cited above) found that the average launch timeline for a private equity fund in 2019 was around 15 months to final close, slightly down from 16 months in 2018.

shared expenses across the complex or expenses allocable only to those investors requires consideration.

(c) *Affiliated Service Providers*. For the more-established sponsors that have affiliates that service portfolio companies, extensive disclosures are becoming a common feature. Investors are very focused on the use of affiliated servicers by sponsors and will demand comfort that any related charges are at rates that match or better market rates; but in our experience, investors are generally willing to permit the use of affiliated servicers if it is evident that the services cannot be readily sourced at a lower cost. For sponsors that maintain internal legal and other professional staff, it is possible to treat a portion of the related expenses as permitted fund expenses, but again, investors pay close attention to this issue and clear disclosure must be made.

(d) *Regulatory Compliance.* The expense of regulatory compliance is another area where granularity in fund documents continues to expand. To ensure no disconnect with investors, sponsors must think about where their offering and investing activity will occur and which regimes will apply. Documents should clearly record the types of expense that will be borne by investors and provide the basis for that allocation.

B. Advisory Boards

1. Nearly all private equity funds have a committee of investor representatives ("LPAC" or "advisory board").

2. Advisory board provisions in fund documents are, however, another area where the level of detail has expanded in fund documents. For example, we have seen broader provisions describing the scope of the advisory board's role and specific functions, including provisions that specifically exclude certain transactions from requiring advisory board-level reporting or voting.

3. Provisions spelling out how to deal with conflicts that arise for individual advisory board members are receiving greater attention (e.g., the scenario — becoming more common — where an advisory board member sits on several advisory boards and the relevant funds hold investments at different levels of the same issuer's structure; whether members can or must abstain from voting; how the quorum and voting majority is determined in such a case; and whether the advisory board has a right to seek advice from legal counsel at expense of the fund, among others).

4. Investors are, in some cases, seeking observer rights instead of voting membership on an advisory board. This status provides investors with access to materials provided to, and minutes of, advisory board meetings.

5. There has been an increasing level of concern on the part of investors as to their potential exposures as advisory board members. Such concerns appear widespread notwithstanding that regulators and courts appears to be generally respectful of provisions purporting to relieve advisory board members of responsibility for other investors. Consequently, investors regularly negotiate for the right to obtain separate counsel for advisory boards at the expense of the fund.

C. Subscription Facilities

1. Managers have been generally able to persuade investors that subscription facilities are a good means of bridging calls and ensuring no loss of access to opportunities. The period for repayment of a facility is growing longer — frequently up to one year. The effects of a facility on IRR need to be considered and should be addressed in marketing materials, risk factors and fund reporting.

2. In the case of longer-term subscription facilities, UBTI can be another issue that your tax lawyers and accountants will want to focus on.

3. The overall limit on borrowings under such facilities remains in the vicinity of 20-25% of committed capital (aligned with the maximum amount that a fund can invest in a single company).

4. In side letters, expect to see investors wanting to limit their obligation to deliver commitment letters or financial information to lenders; the best practice here is to determine at an early stage what the lenders will

want to see in the fund documents, and make sure that lenders are reviewing any relevant side letter provisions before they are finalized.

D. Co-Investments

1. As referenced earlier, co-investments remain a draw by sponsors for raising funds and are important for funds to pursue investments that are larger than permitted under fund documents. However, perhaps somewhat surprisingly, investors have become more tolerant of co-investments where co-investors buy and sell at different times and on different terms than the fund.

2. Fees and carry charged to co-investors are not uniform, but they are expected to be lower than fund rates.

V. End-of-Life

A. Clawbacks

1. There remains little chance of avoiding the inclusion of a general partner giveback or "clawback" provision,[6] albeit that sponsors sometimes try, usually by pointing to the "European" waterfall in their fund documents and the likely pace of calls and distributions.

2. Variations in this area arise more often in respect of when the sponsor will be calculating any clawback obligation. Notwithstanding efforts by ILPA to encourage the use of interim clawbacks, they are still far from universal (albeit somewhat more prevalent in buyout funds).

3. Carried interest escrow provisions are rare, with clawback guarantees from founders or entities with significant assets generally regarded as acceptable alternatives (particular for funds with "European" waterfalls).

B. Term Extensions

1. In seeking consent to an extension to a fund's term, it can be tempting to offer a reduced management fee to investors as an inducement, but sponsors should beware of doing this without carefully running the models — it can be expensive to operate a fund that has only a small number of remaining investments.

2. In addition, a sponsor's willingness to agree to reduce fees in return for an extension can set a precedent that is difficult to depart from.

C. Secondary Transactions

1. GP-Led Transactions

(a) As the industry matures, it is still frequently the case that funds reach the end of their term with assets that they have been unable to sell. Generally, we see sponsors having some difficulty persuading investors in successor funds of the merits of acquiring such assets, due to the perception that such assets must be impaired.

(b) Sponsor-led secondary transactions can provide an effective solution, but usually a relatively expensive one, and some of that expense typically lands on the sponsor. For example, the sponsor may find itself building and populating a data room for bidders, which can be a time-consuming and expensive exercise.

(c) Sponsor-led secondary transactions also give rise to a host of tax, ERISA and securities law issues which need to be appropriately managed.

2. *Investor-Led Transactions*. Investors have sought to exit positions across multiple funds to meet their own liquidity needs. These transactions can be extremely burdensome for the parties, including sponsors, but they have also become important transactions in which sponsors can build investor relationships.

[6] The MJ Hudson study (cited above) found that 97% of the surveyed funds had a carried interest clawback mechanism.

VI. ILPA

A. The Institutional Limited Partners Association ("ILPA") had a very busy 2019, delivering on a number of initiatives.

B. *Sponsor-Led Secondary Fund Restructurings*. In April, ILPA released its report on sponsor–led secondary fund restructurings,[7] which we believe provides a framework and guidance that sponsors and investors alike will find useful.

C. *ESG*. In June, ILPA published the latest edition of its ESG principles, which we also generally view as a useful tool for the industry.[8]

D. *Model LPA*. In October, ILPA released a form of model LPA with a stated aim of strengthening investor-sponsor alignment in the private equity industry. The industry is still digesting this document at the time of writing. On initial review, we are concerned that it is off-market in a number of respects.[9] However, like the 2009 ILPA private equity principles and other ILPA initiatives, it will almost certainly inform the comments that sponsors receive from investors.

VII. Conclusion

A. Private equity has had another banner year, and should 2020 see any economic downturn, the industry seems well positioned to negotiate it successfully.

B. However, staying abreast of developments in private equity fund terms can prove the difference for sponsors seeking to raise capital in a more challenging environment.

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[7] ILPA, "GP-led Secondary Fund Restructurings — Considerations for Limited and General Partners," April 2019 (publicly available at www.ilpa.org).

[8] ILPA, "ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners," (publicly available at www.ilpa.org).

[9] Among the recommendations reflected in the model LPA that we consider off-market are its adoption of ERISA-like prudent person standards in describing general partner duties; certain burdensome provisions regarding the approval of conflicts, which are in certain respects at odds with the prevailing SEC guidance; the grant of significant decision making authority to the advisory board; departure from a full general partner catchup within the carry waterfall; carried interest escrows and interim clawbacks; certain provisions relating to management fees, when they start and when they step down; provisions whereby the preferred return starts to accrue immediately on a drawing under a subline; a 100% haircut on removal of the general partner for cause; and a haircut even if the general partner is removed without cause.

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