Farris

Barristers • Solicitors

Vancouver - Victoria - Kelowna

Farris is the top ranked corporate, transactional, and commercial litigation firm in British Columbia

- Lexpert 2008

Vancouver
2500 - 700 W Georgia St
Vancouver, BC
Canada V7Y 1B3

Tel 604 684 9151
Fax 604 661 9349

Kelowna
800 - 1708 Dolphin Ave
Kelowna, BC
Canada V1Y 9S4

Tel 250 861 5332
Fax 250 861 8772

Victoria
208 - 852 Fort Street
Victoria, BC
Canada V8W 1H8

Tel 250 405 1980
Fax 250 405 1984

www.farris.com

Private Equity Fund Formation

2009 'at market' deal terms

Al Hudec, CFA

This client alert discusses current 'at market' deal terms for 2009 vintage private equity funds. In today's difficult economy, pension funds and fund managers are focusing on different issues than in past years. We expect an evolution in key limited partnership deal terms in response to current market conditions.

Introduction

In the current economic environment the business issues which arise in the course of negotiating the documentation governing new Funds, as well amending existing Fund terms, will be different than in the era of easy and cheap credit which fueled the leveraged buyout boom of 2002-2007.

There are currently 1600 private equity Funds in the market looking for $900 billion of new funding (Preqin statistics). At the same time, successful fundraising is down dramatically, falling over 75% in the last quarter of 2008 relative to the same period in 2007. In 2009 expect tough bargaining between sponsors and investors over the terms of new investments and amendments to existing Fund terms.

Incentives and Alignment of Interests

The key to establishing a successful private equity Fund is strict adherence to the private equity business model. Properly crafted, a good private equity deal is structured to ensure that a single-minded alignment of interests flows through the entire structure, from limited partner to general partner to portfolio company management and employees. This alignment of interests does not happen by accident; it is the result of team work between the portfolio managers working within the major pension plans and their lawyers to ensure that the incentives and controls built into deal documentation operate effectively to align and incentivize all parties to the common objective of efficiently growing the business.

"In 2009 expect continued downward pressure on management fees and tough bargaining on transaction fee offsets"

Management Fees

One of the big issues in 2009, as in recent years, is the negative impact of excessive management fees in distorting proper incentives and alignment of interests. Management fees have fallen as a percentage of 'assets under management' as Funds have become exponentially larger, and are now in the 1.5-2.5% range, stepping down to around 1.0% at the end of the investment period or upon the establishment of a successor Fund. This year look for investors to bargain hard to bring fees closer in line with the budgeted expenses of the sponsor's management company.

Most private equity investors believe that these fees are still too high given the significant economies of scale in operating a larger Fund. As they see it, management fees are intended to cover salaries, rent and operating expenses, and not to provide material upside compensation to managers. Sophisticated investors recognize that depending on the rate of investment a 2% management fee levied on committed capital can equate to an effective 4-5% fee on capital actually invested. This can constitute a serious drag on internal rate of return performance.

Transaction Fee Offsets

In recent years investors have made significant progress in indirectly reducing management fees by requiring managers to turn over to the Fund most of the extra directors, advisory and transaction fees that they earn from investee companies. There has been a clear shift in the market away from 50-50 sharing of transactions fees. Expect continued hard bargaining on this point in 2009, with 100% of directors' fees and 80% or more of other transaction and advisory fees being credited against management fees otherwise payable.

Typically, transactions fees payable to the Fund are offset against management's fees rather than being allocated directly to investors, many of whom are tax-exempt or foreign investors for whom fee income has negative tax consequences. Placement fees, which would otherwise have to be amortized by the manager for tax purposes, are typically initially paid by the Fund but credited against management fees.

Management Capital Commitments

Look also for investors to exert continued pressure on sponsors to recycle their management fees into further capital commitments in their Funds. Typically, the expectation is that the sponsor's management group will take a significant 2.5-3.5% interest in the Fund as a way of further aligning sponsor and investor interests. Initially this 'management

The Farris private equity group has expertise in

- *Fund formation*
- *Private equity M&A*
- *Leveraged buyouts*
- *Distressed M&A*
- *Infrastructure investing*
- *Public private partnerships*
- *REITs*
- *Income funds*
- *Private timberlands*
- *Canadian and cross boarder tax issues*
- *Independent representation of nominee directors*
- *D&O insurance and indemnification*

profits' interest will be paid for by way of a promissory note which is retired by set-off against management fees otherwise payable.

Capital Call Defaults

"Expect creative solutions to capital call defaults in 2009"

In today's tough economy, Funds are experiencing frequent capital call defaults. Investors are asking managers to defer capital calls to help with their cash flow issues or to reduce the size of their total commitments. Funds are finding out that they may not have as much committed capital as they believed.

Capital call default remedies are another standard deal term that will receive close attention in 2009. Private equity money is patient money; that is one of its strengths. In a typical private equity Fund the manager has 4-6 years to invest committed capital. 'Re-up' provisions allow the re-investment of capital returned within the first 14-18 months of the commencement of the Fund.

Investors advance this capital on a 'just in time' basis when called upon by the general partner. These advances are funded, in part, from distributions paid to investors in earlier vintage Funds. In the current environment, however, these distributions have all but dried up. Also, many investors are required under their investment mandates to rebalance their portfolios and to redirect investment funds to their traded equity portfolios which have suffered significant losses due to the recent collapse of stock market prices.

Fund documentation typically gives the sponsor several draconian tools to deal with defaulting limited partners. Remedies include penalty rates of interest, forfeiture of the limited partners' interest in the Fund, cessation of future distributions or the commencement of a legal action to pursue a full range of possible legal remedies. Before invoking these remedies the cautious manager will discuss the situation with the advisory committee and, in many cases, may chose to implement alternative solutions to the problem.

In 2009, expect managers to be creative in designing solutions to help investors deal with liquidity and funding problems. Two of the world's biggest Funds have already come up with innovative solutions. Texas Pacific Corporation, a leading private equity sponsor with over US$50 billion under management, has committed not to draw down more than 30% of their investors total commitment in 2009 without advisory committee approval. It has also offered to release its limited partners from up to 10% of their capital commitments and to reduce its management fee by 10%. Permira, an innovative European private equity Fund, has also taken a fresh approach by offering its limited partners a pre-packaged default option. Investors who agree to give up 25% of the upside on their current funded capital and pay full management fees on their original commitment are relieved from 40% of their commitments.

Capital Call Lines of Credit

"Capital call lines of credit have become more common"

Capital call lines of credit have become very common. They are usually set up as revolving secured credit facilities that can be used repeatedly over time, with a cap on borrowing set at some percentage of unfunded commitments to the Fund. That cap varies, but 50% would be typical. The security is usually an assignment to the lender of the general partner's right to make capital calls from the limited partners, together with a security interest on the proceeds from such capital calls. Generally, security is not granted on existing portfolio assets, as typically the lender regards itself as ill-suited to manage or dispose of these illiquid investments. In some cases, lenders will require the limited partners to acknowledge the assignment of the capital call right. Care must be taken not to cause UBTI problems.

Secondary Sales

Historically, successful Funds have achieved investor liquidity during their term through periodic distributions funded by the sale or initial public offering of portfolio companies. In the current economy such exit opportunities have all but disappeared and distributions have been reduced dramatically (78% between the third quarter of 2007 and the last quarter of 2008).

In the absence of distributions, sponsors are showing an increasing willingness to accommodate the portfolio rebalancing and liquidity concerns of their investors by facilitating the secondary sale of Fund interests. Pricing in the secondary market, however, reflects uncertainty over investment valuations as well as a significant supply-demand imbalance between sellers and buyers. Advisory firm Cogent Partners recently reported that pricing for limited partnership interests in the secondary market declined to an average of 61% of NAV in the second half of 2008 compared to 85% in the first half of that year.

Carried Interest Claw-backs

Claw-backs of the general partner's carried interest are another big issue in 2009. In a private equity deal the carried interest is the principal tool used to align interests and drive incentives. Under the typical distribution 'waterfall', the general partner does not receive payout of its 20% carried interest until investors have received a full return of their invested capital and the Fund has achieved a hurdle rate of return, typically 8%, after the recovery of management fees and other expenses. Unless they become permanent financing 'bridge loans' are typically excluded from the waterfall.

"Expect more GP carried interest claw-backs and a further shift back to aggregate waterfall provisions"

In many North American buyout Funds the waterfall provisions provide that the general partner's carried interest is paid out periodically on a deal by deal basis. Claw-back mechanisms are put in place requiring the general partner to pay back profit distributions already received if subsequent losses arise from the sale of portfolio companies at a loss or from the write down of investment assets. Today, in a market environment where most investment assets have fallen significantly in value, it is inevitable that some general partners will be subject to claw-back. In many cases where the carry has already been distributed through to the Fund's management team, the principals of the Fund and their family trusts will be jointly and severally liable with the general partner for the claw-back repayment obligation.

As claw-back becomes a reality in 2009 watch for an acceleration in the trend way from deal by deal distribution formulas back to aggregate waterfall provisions where the general partner's profit interest is paid at the end of term rather than intermittently. In cases where the waterfall remains on a deal to deal basis, watch for investors to build in a cushion prohibiting the distribution of carried interest until the net realizable value of the Fund's assets is at least 120% of unreturned capital and expenses yet to be reimbursed.

In extreme cases, recent events may have resulted in losses so large that they have permanently distorted the usual management incentives in some funds – creating an environment in which management will either be driven to take extreme risks in order to recoup early losses or to give up entirely because their carried interest is so deeply under water as to make the situation hopeless. This is a problem that requires creative solutions.

Claw-backs from Limited Partners

"Expect more LP give backs in 2009 to honour indemnification obligations"

Fund agreements often contain claw-back obligations applying to limited partners as well, and these are also likely to be triggered more frequently in 2009. In today's 'buyer friendly' deal environment, buyers of assets from private equity Funds are negotiating more exhaustive indemnities for breaches of representations and warranties. Over the past few years it has become more common to include 'give back' obligations in private equity documentation, requiring limited partners to return prior distributions where such a buyer invokes these indemnification rights.

As limited partner claw-back becomes a more significant issue watch for investors to bargain hard to cap both the amount (typically 10-30% of commitments) and the duration (typically 2-3 years) of their claw-back obligations. In Europe, investors protect themselves against claw-back by advancing capital to the fund as debt rather than as equity. In a limited partnership, limited partners remain liable for the amount of their committed capital even if it is returned to them, but if capital is advanced by way of loan there is no lingering liability once the loan is repaid.

Taxation of Carried Interest

"Will Obama fully tax carried interests in 2011?"

President Obama's fiscal year 2010 budget proposal, which was submitted to Congress on February 26, 2009, calls for legislation to tax carried interest as ordinary income (maximum 35% federal rate) rather than as long term capital gains (maximum 15% federal rate) beginning in 2011. If enacted, this proposal could significantly impact deal structures.

Currently, the proposal is a one line budget item with no details, so the scope of the proposal is unclear. Resulting legislation could tax the grant of a carried interest, treat allocations in respect of a carried interest as ordinary income rather than long-term capital gains or take some other form. Given the absence of specifics, and the fact that prior similar proposals have not been enacted into law, it is probably premature to seek alternative structures that can be adopted on a pre-emptive basis. Nevertheless, sponsors entering into new fund agreements this year should at least consider the possibility that those agreements may need to be revised when and if definitive details emerge.

Winding-up of Maturing Funds

"The wind-up of 1998-2001 vintage funds is a growing industry issue"

The problem of maturing funds is becoming a significant industry problem. The large number of venture funds established in the years leading up to the technology industry melt down of 2001 are starting to reach the end of their ten year terms. Their portfolios often include a significant residual collection of investee companies that have not performed well and which have not generated exit opportunities. Generally, limited partnership agreements provide for the winding up of a Fund at the end of its term and one or more annual extensions, with a liquidating distribution in cash or in kind of residual assets.

In practice these residual assets are illiquid securities of private companies. Receiving an in-kind distribution of assets for which there is no market is not an attractive proposition for pension fund managers who have a fiduciary duty to actively manage their portfolios. Yet it is expensive in terms of auditing and monitoring costs to extend the life of these expiring funds solely to continue to hold these low prospect residual investments. This is an industry problem that calls for an industry solution.

Changes of Control

"Expect a changing of guard and industry consolidation in 2009"

Expect significant industry consolidation this year. The successful Fund sponsors are growth oriented; but many are unable to grow in the current environment. Sponsors with existing Funds are prohibited from starting new Funds until their existing Funds are at least 75% invested. In addition, many Funds are pre-occupied with salvaging troubled portfolio companies rather than making new investments or raising additional capital. Managers are focused on keeping distressed portfolio companies alive through downsizing initiatives, debt restructurings and extremely dilutive equity injections.

A survey completed last month by Private Equity News in connection with the industry's Super Return Conference in Berlin reveals that almost 80% of managers expect significant sponsor merger activity in 2009. Such transactions can trigger the change of control provisions in Fund documentation permitting investors to terminate the Fund or its investment period. Expect, however, that investors will generally accommodate industry consolidation as they focus their investment activity on 'branded' sponsors with the longest track record of success or specialized expertise in attractive market niches.

'Key-Person' Clauses

2009 is likely to see both a significant changing of the guard in private equity firms in addition to the significant consolidation in the industry. Many Funds are under cost pressures and are scaling back their management teams to achieve operational efficiencies. Also, many members of the 'boomer' generation of managers may decide to take an early retirement as industry prospects deteriorate rather than re-tool for the new world order of distressed and turnaround transactions.

Smart managers will take care to ensure that their investors are informed and on side with their succession plans; and that the 'key person' provisions of Fund documentation are sufficiently flexible to accommodate the anticipated management changes. A number of variants of 'key person' provisions are common in the market. The result of triggering a 'key person' provision can be the automatic termination of the commitment period (unless the limited partners vote otherwise) or a reduction in the general partner's carried interest on subsequent investments.

In some cases, if investors are unhappy with management changes they may choose to terminate the partnership by super-majority vote under the 'no fault divorce' provisions of the limited partnership agreement.

Investment Mandates

"The focus this year is on distressed funds and infrastructure funds"

The Funds that raise money successfully in 2009 will be focused on distressed or infrastructure investing. Distressed Funds will target the indirect acquisition or control of troubled companies through the acquisition of 'fulcrum' debt – the class of securities most likely to be converted to a controlling equity position in a restructuring. Infrastructure Funds will position themselves to take advantage of strong deal flow as governments worldwide support infrastructure projects in an effort to restart their economies.

With the debt markets remaining largely closed buyout Funds will focus on transactions that require little or no incremental leverage. In 2009, expect a shift to transactions such as private investments in public equity (PIPEs), portfolio company add-on acquisitions that can be funded with existing credit facilities or additional equity and acquisitions that are structured to preserve existing leverage by avoiding the change of control provisions in existing loan agreements. Watch also for partnering deals between private equity and strategic buyers and for the reorganization of portfolio companies into partnerships or other flow-through entities where borrowing constraints limit the ability of the portfolio entity to borrow to shelter income with interest expense.

Responsible Investing

"There is an ongoing emphasis on principles of responsible investing"

Notwithstanding the economic downturn, responsible investors will insist that the Funds in which they invest adhere to principles of ethical investing with a focus on environmental, social and good governance principles. Just last month, the Private Equity Counsel and its membership adopted a comprehensive set of responsible investing principles in consultation with the world's major institutional investors.

Maximization of long term return on investment is not inconsistent with acting as a 'good corporate citizen'. The Supreme Court of Canada has recently made clear in the seminal BCE decision that in satisfying their fiduciary duties to act in the best interests of the corporation, directors exercising their business judgment may consider the interests of all of the corporation's stakeholders, including employees, the environment and the community in which the company does business.

"Are LLCs a preferred entity structure?"

Fund Entity

Most private equity is structured as Delaware limited partnerships, both as a means of attaining pass-through status for tax purposes, and as a means of preserving limited liability status for limited partners. Specialized parallel or feeder entities are used to accommodate special categories of investors such as US non-taxable and foreign investors.

Although there are advantages to the use of Delaware limited liability corporations there is still a lack of experience with the governance structure of LLCs and a lack of familiarity and comfort with limited liability company statutes which, to date, have received little judicial interpretation. Watch for an increased focus on the benefits of the LLC structure in 2009.

Advisory Committees

This year expect continued reliance on advisory committees, made up of representatives of the largest investors in a fund, to oversee potential conflicts of interest and the valuation of investments. Other duties of the advisory committee may include waiving certain investment restrictions, substituting investment team members, terminating the investment period early and settling indemnity claims.

The role of an advisory committee is intended to remain strictly advisory so that its members do not endanger the limited liability status of the member investors. The advisory committee members generally have no fiduciary duties to the Fund and expect to have no liability for serving the committee.

Tax Provisions

"Hard times breed buying opportunities. 2009 vintage funds will be high performers."

Most Funds are organized as Delaware limited partnerships which, under the 'check the box' provisions of US tax law, elect to be taxed as partnerships. If the Fund contains Canadian pension funds or other non-taxable entities the limited partnership agreement will contain specific provisions requiring the general partner to use reasonable efforts to minimize the earning of any 'unrelated business taxable income' ("UBTI"), which is essentially active business income, or any 'effectively connected income' ("ECI") by the non-taxable entities.

Information Rights

It is now routine to exclude investors subject to the Freedom of Information Act (U.S.) from the receipt of sensitive information so as to preserve confidentiality.

Side Letters

Side letters continue to proliferate. In these letters investors negotiate special terms (e.g. reduced managed fees) reflecting their greater bargaining power or contract for special terms reflecting their particular circumstances e.g. particular rights to facilitate their compliance with special legal or reporting requirements.

Investors should negotiate the right to receive prompt notice of all side letters issued by the Fund or Parallel Funds, the right to review a compendium of such side letters and a most favoured nations clause entitling investors to the extension to it of the benefits negotiated by other investors, subject only to limited carveouts that pertain solely to the particular circumstances of particular investors.

Conclusion

I remain bullish about the private equity business model in 2009. A major study on the management and performance of private equity owned businesses presented at the World Economic Forum late last year concluded that firms owned by private equity are better managed and experience greater productivity growth than other businesses. Private equity management is particularly adept at achieving cost efficiencies, restructuring businesses and divesting their non-core assets. These are exactly the skills needed during the current downturn.

Sophisticated institutional investors are keenly aware that hard times breed extraordinary buying opportunities. They appreciate the fact that the Funds that have had their investment periods during the worst market downturns are, over time, among the best-performing vintages. My bet is that when the performance of the private equity and infrastructure Funds formed in this year is assessed a decade from now, 2009 will rate as a vintage year.

Al Hudec is a senior partner in Farris' Vancouver office.
He can be contacted at 604.661.9356 (office), 604-802.6463 (cell) or e-mail: ahudec@farris.com

Private Equity at Farris

Al Hudec
(604) 802-6463
ahudec@farris.com

Mitch Gropper, Q.C.
(604) 661-9322
mgropper@farris.com

Brian Canfield
(604) 661-9362
bcanfield@farris.com

Brad Newby
(604) 661-9308
bnewby@farris.com

Trevor Scott
(604) 661-1732
tscott@farris.com

Joseph Yang
(604) 661-9378
jyang@farris.com

Denise Nawata
(604) 661-1746
dnawata@farris.com

Perminder Tung
(604) 661-9328
ptung@farris.com

Tax at Farris

Sandy Sheinin
(604) 661-1709
ssheini@farris.com

Brian Lougheed
(604) 661-1738
blougheed@farris.com

Ron Dueck
(604) 661-9395
rdueck@farris.com