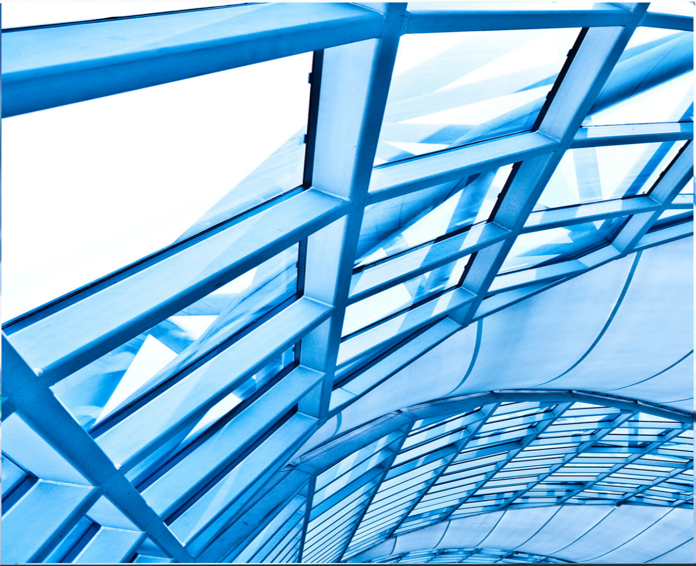
STARTING A PRIVATE EQUITY FUND

Structure and Investment Terms

By John S. Lore, Esq.



CAPITAL FUND LAW GROUP

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A private equity fund is a pooled investment vehicle created for investments in equity securities and real estate. This white paper discusses some of the key structural considerations and investment terms involved in starting a private equity fund. The term "private equity fund" covers a broad spectrum of closed-end investment strategies, including early stage funds (venture capital), growth equity funds, leveraged buyout funds, and real estate funds. For specific information on structuring a real estate fund, see our white paper entitled: *Forming a Real Estate Fund--Strategy, Structure and Investment Terms.*

The structure of a private equity fund is dependent on a number of tax, regulatory, and financial considerations. Fund structure is driven in large part by the tax needs of the investors.

STRUCTURE

Closed-End Structure

Private equity funds are almost always closed-end funds. A closed-end fund is an investment fund intended to last for a fixed term. A private equity fund's term is usually between five to ten years. Investors in a closed-end fund are generally not permitted to make withdrawals or additional capital contributions during the life of the fund. Once funded, an investor's capital will be returned only upon the sale or refinancing of a fund asset, or upon positive cash flow from rents and other operations. Most private equity funds, real estate funds, venture capital funds, and other funds investing in illiquid assets are structured as closed-end funds.

Successive Funds

With closed-end funds, once an investment is sold, it generally cannot be reinvested in the fund. Rather, the fund sponsor would create a subsequent fund to allow investors to reinvest. Successful private equity fund sponsors usually develop a portfolio of different funds to facilitate reinvestment into new projects. Fund sponsors can form subsequent, analogous private equity funds at substantial cost savings to the initial funds, because significantly less legal structuring is required.

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Domestic Fund Structure

A domestic-only investment fund structure is typically comprised of the following entities:

- A limited partnership, generally formed in Delaware, to act as the fund entity (although LLCs are becoming increasingly popular).
- An LLC to act as the investment manager of the fund, formed in the jurisdiction of the sponsor.
- A general partner of the fund (managing member in the case of an LLC), also formed in the jurisdiction of the sponsor.

For private equity funds, the general partner and the investment manager are formed as two distinct entities to allow subsequent funds to maintain separate general partners for liability purposes. Management fees are paid to the investment manager, while carried interest is allocated to the general partner.

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US Tax-Exempt Investors—UBTI Issues

Tax-exempt entities, including IRAs, 401Ks, pensions, charities, etc., are subject to the unrelated taxable income (or "UBTI"), a tax on certain business income that is imposed notwithstanding the organization or exempt status.

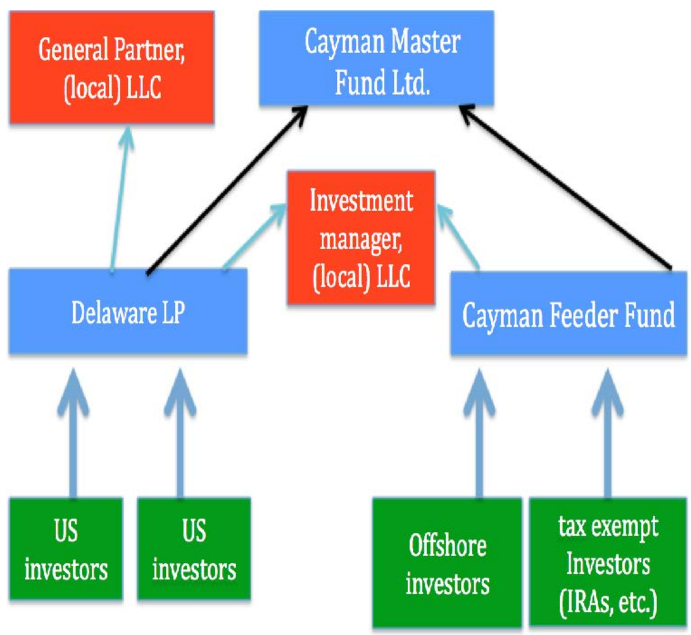
Under Sect. 512(b) of the Internal Revenue Code, investment income, including income from stocks, bonds and real estate, is subject to UBTI if derived from leverage (technically defined as acquisition indebtedness). Such distribution may subject the fund to UBTI. while others expect only concessions on fees. Fund sponsors should work closely with experienced legal counsel when negotiating seed funding arrangements.

Offshore Fund Structures

When properly structured, an offshore fund structure blocks offshore and tax-exempt US investors from direct US tax liability. The most common offshore fund structures are the master- feeder structure and the side-by- side structure.

Master-Feeder Fund

A master feeder structure consists of a domestic feeder fund and an offshore feeder fund (in a tax-free jurisdiction) that feed into a single offshore master fund, where all the trading activity of the fund takes place.



Parallel Fund Structure

A side-by-side structure has a US fund and offshore fund that parallel each other in trading and have the same investment manager, but maintain separate investment portfolios.

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Cayman Islands

The Cayman Islands has historically been the top choice for offshore funds because of its business friendly structure, stable government and well-developed investment laws. The Cayman Islands is the world leader as a jurisdiction for investment fund domicile.

British Virgin Islands (BVI)

BVI is a popular jurisdiction for offshore funds. BVI has recently gained the reputation for being a cost-effective and convenient jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI's regulatory filing fees are considerably lower than those of the Cayman Islands.

OFFSHORE INVESTORS AND REAL ESTATE RELATED INVESTMENTS

If the private equity fund expects offshore investors and intends to invest, directly or indirectly in real estate, the fund should consider potential tax and regulatory issues faced by its offshore investors.

FIRPTA Considerations

The primary concern for offshore investors in US private equity funds is the US Foreign Investment in Real Property Tax Act of 1980 (known as FIRPTA). Under FIRPTA, non-US investors are taxed on income from US real property investments at extremely high effective rates. Additionally, FIRPTA requires that offshore investors file US tax returns and become subject to the IRS's investigatory and subpoena powers. For more detail regarding tax structuring for a real estate offering, see our white paper: *Forming a Real Estate Fund--Strategy, Structure and Investment Terms.*

Investment Terms

One of the most important aspects of forming a private equity fund is to set the terms of the investment. When properly structured, private equity fund offering documents contain terms that adequately protect the fund sponsor and are attractive to investors. Private equity fund terms are driven by the fund's strategy, the market trends within the fund's specific asset class and the particular needs and objectives of the fund. It is crucial that the investment fund legal counsel have an in-depth understanding of current investment market trends and how those trends affect the strategy the fund will employ.

Fund Expenses

During the formation process the fund sponsor designates which of the expenses of the fund will be borne by the manager and which will be borne by the fund. Typically, the fund bears expenses directly related to forming and operating the fund, including:
formation costs, accounting and legal services, regulatory brokerage costs, clearing costs, administrative filings, etc.

> "The shorter the track record of the sponsor, the more streamlined the fee structure should be."

Sponsor Fees

A private equity fund sponsor's compensation includes the carried interest (generally approximately 20% of the fund's net capital appreciation) and fees. There are a number of fees that private equity fund sponsors can charge, depending on the fund's negotiating position with investors. We recommend that the shorter the track record of the sponsors the more streamlined the fee structure should be. The most basic fee is an investment management fee. The investment management fee is assessed annually, typically ranging from 0.5% to 2%, (based on committed capital during the commitment period and based on capital contributions thereafter). Other potential fees include property management fees, leasing fees, financing fees and other administrative fees.

Capital Commitments

When private equity fund investors subscribe to an investment in the fund, they usually do so by entering into an agreement committing to invest a certain sum (a capital commitment) when called for by the fund sponsor (a capital call). Upon the capital call by the sponsor for a specific percentage of the investor's capital commitment, the investor has a fixed period of time in which to satisfy the capital call. Once contributed, an investor's capital will be returned only upon the occurrence of a capital event, such as a sale or refinancing of all or a portion of the fund's assets, recognizing income, or other events resulting in positive cash flow from operations.

Distribution Waterfall

The distribution provisions control the priority of distributions from capital events. The priority of distributions between limited partners and the general partner is referred to as the "distribution waterfall." The distribution waterfall can be pictured as a set of allocation pools. When a higher priority allocation pool is filled, the capital flows into the next pool. Distribution waterfalls vary significantly from fund to fund, depending on a number of factors, but generally follow the following conceptual framework.

Distribution waterfalls generally follow the following three phases:

(ii) preferred return and recovery phase;

(iii) catch-up phase; and

(iv) carried interest phase.

Preferred Return/Recovery Phase

The first phase in the distribution waterfall is the preferred return and recovery phase. Generally, investors receive distribution first, until their preferred return and capital contributions have been paid in full.

Preferred Return

Many private equity funds include a preferred return. Preferred returns can range from 6% to 12% of the initial capital contribution. The preferred returns are accrued and compounded annually. The preferred return is distributed in accordance with the distribution provisions upon capital events.

Catch-up Phase

After the preferred return and capital contributions are recovered by investors, the remaining funds are split between the investors (typically 80%) and the sponsor, in the form of carried interest (typically 20%). However, since the limited partners have already received substantial distributions, the distribution waterfall now accelerates allocations to the general partner according to the catch-up rate (often 50-60%). In the catch-up phase, the general partner receives allocations at the catch-up rate until the carried interest allocations are caught up.

Carried Interest Phase

Following the catch-up phase, capital allocations will be distributed based on the carried interest (typically 20%). The general partner will then receive 20% of the distributed amount, while the limited partners will receive 80%.

General Partner Clawback

Upon liquidation of the fund, limited partners are sometimes distributed less than the agreed-upon allocation (due to early positive performance and lagging performance toward the end of the fund). When this occurs, the limited partners "claw back" the unpaid amount from the carried interest distributed to the general partner. Since the clawback provision is only activated at end of the fund, fund sponsors must be cautious to maintain reserves to satisfy any such contingencies.

Side Letters

Most offering documents allow the management team to negotiate special terms (known as side letters) that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management fees. Care must be taken, however, not to allow side letters to prejudice other investors. For example, side letters that provide additional information rights or preferential allocation should be avoided.

John S. Lore, Esq. is the managing partner of Capital Fund Law Group, a boutique law firm providing expertise focused on the alternative investment industry. Call 212.203.4300 or email us to schedule a consultation to discuss your fund.