LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
TUESDAY, AUGUST 29, 2017

PERSPECTIVE

Fund fundamentals

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If you are contemplating starting your own fund, the key documentation necessary to begin fundraising is a private placement memorandum (or PPM), a subscription agreement and a limited partnership agreement (or LPA). You may also want to consider preemptively preparing a diligence package to give you a head start on investor requests. The PPM serves as your primary offering document. It will typically cover: investment strategy and market opportunity, track record (when available and able to be shared), management team, operations and investment process, principal terms and legal and tax disclosures (including legends, risk factors and conflicts of interest).

The subscription agreement is the questionnaire that interested investors complete to determine their suitability for investing from a financial and regulatory perspective. The LPA is the operating agreement reflecting the final terms between the general partner and limited partners.

A large amount of time will be spent drafting the business sections of the PPM and considering the fund structure and outlining the principal terms. Depending on your investment and overall strategy, as well as size, it is also critical to consider tax and regulatory implications that would be relevant. The below outline of common principal terms provides a place to start on your path to forming your own fund.

Structure

Fund. The fund entity is often structured as a Delaware limited partnership. This is the entity into which your potential investors will be admitted as limited partners once it is determined they meet the suitability requirements.

General Partner and Management Company. It is typical for carried interest earned by the fund's investments to be directed to the general partner and the management fee to be paid to the management company. In some funds, these two entities are combined as one. Both are most often structured as Delaware limited liability companies. In addition, while not covered herein, it is important to consider the terms amongst the members of the general partner. Some of the key decisions include ownership, vesting, capital contribution, governance, fee sharing percentage upon termination, transfers and covenants applicable upon termination.

Economics

Waterfall. The waterfall is one of the key economic provisions and outlines the order in which distributions are made upon realization of an investment or dissolution. There are typically four tiers considered:

• Return of Capital: Can be applied at an aggregate fund level (often called European style where capital called for all deals to date is returned) or on a deal-by-deal basis (often called American style where only capital called in connection with the deal being realized is returned).

• Preferred Return or Hurdle Rate (if applicable): Minimum return (typically 7 to 9 percent) paid to limited partners before any carried interest is allocated to the general partner.

• Catch-Up: Allows the general partner to collect profits until they catch up to their carried interest allocation (typically 20 percent).

• Carried Interest: This level splits remaining profits (common that 80 percent goes to the limited partners and 20 percent goes to the general partner).

Management Fee and Offset. The management company is usually paid a management fee (typically 1 to 2 percent) for services and investment advice it provides to the fund. Such rates often step down at the end of the investment period. In many cases, the general partner and/or management company may receive monitoring, transaction, director or other fees in connection with portfolio investments and it is typical to offset such fees earned against the management fee. The offset can range from 50 to 100 percent and investors will often negotiate for maximum offset.

Expenses. Expenses can be considered in two buckets, organizational and operational. For purposes of the term sheet, it is important to be clear about what expenses will be allocated to the fund and what expenses will be covered by the general partner and/or the management company. Organizational expenses are also often subject to a cap and investors will negotiate to lower it.

Investments

Term and Investment Period. The fundraising process typically lasts 12 to 18 months. Once closing occurs, the investment period begins. The investment (or commitment) period typically lasts three to five years. The overall term includes the investment period and the time period following the investment period (typically five to seven years but can often be extended depending on fund mechanics) where the general partner is managing the portfolio investments made during the investment period and seeking opportunities to realize and distribute profits back to investors. It is important to consider what length of term and investment period are appropriate for your strategy.

Investment Restrictions. In crafting your investment strategy, consider what investment restrictions would be relevant. Investment restrictions often include a cap on what percentage of the fund can be invested in one company. Other restrictions can include geographic, industry, hedging, leverage, investments in public securities, investments in disfavored industries (alcohol, tobacco, firearms), real estate and hostile takeovers. It is typical that investment restrictions can be waived with the consent of the limited partner advisory committee.

Co-Investments. Increasingly, limited partners are demanding co-investment rights. Negotiations focus on a number of factors such as who gets access to such opportunities, how long co-investors have to diligence an opportunity, level of commitment and fee and carry. In most cases, general partners do not charge fees or carry to limited partners who co-invest alongside them but this can vary depending on sponsor and investment strategy.

Governance

Investor Protections. There are several provisions that offer investors some form of walk-away protection. These provisions include key person, no-fault dissolution, no-fault removal of the general partner and removal for cause. If limited partners do not like the direction or are unhappy with the overall management of the fund and its investments, then limited partners may have some recourse to remove the general partner or vote to dissolve the fund depending on the chosen set of mechanics.

Limited Partner Advisory Committee. Sponsors will often form a limited partner advisory committee typically consisting of three to eight members. Investors will often negotiate to have a seat while others may request an observer role. The primary purpose is to review and approve potential conflicts of interest but can also function as an approval body for other fund-related matters, such as waivers of investment restrictions, general partner valuations, transfers, fund covenants and providing general advice to the general partner upon request.

Conclusion

While there is a great amount of preparation and work that goes into raising a fund, these principals terms provide a foundation to start fleshing out your PPM term sheet and begin to make important decisions around the structure, economics, investment strategy and governance of your new fund.

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