Pepper Hamilton LLP
Attorneys at Law

Gotchas and What You Can Do About Them in PE Investing

July 18, 2019

Julia D. Corelli | corellij@pepperlaw.com
Irwin Latner | latneri@pepperlaw.com

Investors in private equity funds need to come in with their eyes open, with consideration given to where and what the pitfalls are, as well as what opportunities exist for avoiding them and perhaps improving the terms of the investment opportunity. Any private equity investor should, of course, thoroughly review the fund documents before investing to ensure that they reflect market standards, appropriately align investor and manager interests, and adequately address the anticipated potential events that could have a negative impact on the investor during the fund's lifetime.

The chart below highlights some of the less talked about issues and considerations, provides some guidance, and should spark new thoughts on how an investor should approach investing in private equity-type funds. Note, we refer to private equity "type" funds. The same considerations will often be applicable to more than just private equity strategies. The issues addressed in the chart below are also relevant to funds that have a private credit, venture, real estate or growth equity strategy. Many of these issues also apply to the types of evergreen and permanent capital structures that are growing in prevalence.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Current investing landscape	Understanding the big picture is essential to successful private equity investing. PE fund terms and conditions have a market standard, and managers fear that anything off of that standard will drive away investor interest. New terms may be introduced, and may make sense, but do not gain traction because they are not the market standard. There is typically a lag between when a new term hits the market and when it is accepted enough by the world that it shows up in most fund documents. Then there is the macro land-scape. What position does the fund hold in the competitive landscape? There's a lot of dry powder out there…	Associate with strong advisors who can give you an assessment of: • recent changes in the legal landscape • economic outlook during the term of the fund in the fund's sector • the general market for fund terms and conditions as well as what may be the trending changes in, or additions to, those terms and conditions. Familiarize yourself with the ILPA 3.0 PE investment standards, available at https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf. Above all, maintain a com-mon-sense, realistic perspective on what fund managers can do, should do and should not do.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
What kind of investing structure is best?	There is a range of types of investing partnerships – to name a few: • investment clubs • independent sponsors • pledge funds • permanent capital vehicles (PCVs), also known as evergreen funds (not to be confused with hedge funds – which are evergreen but do not have PE investing economics) • long-term PE model funds • PE model funds.	Investors need to understand the landscape of possibilities: • for a family office, a PE model fund that is investing in cash-flowing businesses may not be right. The PE model requires that the investment be sold at some point in the 10-12 year life of the fund, for example. • for first-time/unproven managers, noncommitted capital structures may be more appropriate (*e.g.*, independent sponsor, pledge fund, investment club). • foreign and tax-exempt investors may require enhanced structures, *e.g.*, with entities that block UBTI or ECI.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
How to conduct due diligence on managers?	Data rooms and due diligence questionnaires (DDQs) come in all types and sizes. What to expect from them is often a mystery as there is no industry standard.	Data rooms for diligence will vary based on the investing history of the management team. Ask yourself, does it cover everything that a deal professional would expect to see in the data room? Are there any inconsistencies or holes in the data room disclosures themselves or between the private placement memorandum (PPM) and the data room disclosures. Look for a DDQ that does not just regurgitate what is in the PPM. It should demonstrate the manager's integrity and transparency. It should anticipate the questions an investor would want to have answered, not just be an aggregation of questions actually asked. Updates to data rooms and DDQs should be for new developments. Data rooms DDQs that constantly are updated other than for temporally new developments are red flags. To be most efficient, an in-person meeting is appropriate after a DDQ and data room are available. If the manager is SEC-registered, the investor should also review the manager's Form ADV.

<table>
<tr><th>TOPIC</th><th>PROBLEM</th><th>SOLUTION?
Or at least what are the right questions to ask?</th></tr>
<tr><td>Conflicts of interest</td><td>Managers deal with conflicts in a whole spectrum of ways:

• disclosures in PPM

• ADV brochures

• ad hoc disclosures during the life of the fund.

Some obvious places where conflicts inherently exist:

• allocation issues vis-à-vis other clients

• time devoted to other clients or outside businesses

• affiliate relationships

• prioritization of LPs over other LPs with respect to certain rights (purchase of default interests)

• Successor fund co-investments

• principal co-investments

• investing multiple funds in the capital stack (debt and equity strategies, for example)

• secondary transactions where LPs exist, new money comes in, and the GP continues.</td><td>There should be precise policies and procedures around managing conflicts that a manager can show to an investor. Then, the manager needs to be held accountable to following those policies and procedures (consider making aberrations from conflict procedures a “cause for removal,” for example)

A properly structured limited partner advisory committee (LPAC) can be a helpful backstop to facilitate LP oversight and approval of manager conflicts.</td></tr>
</table>

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Use of leverage	Leverage comes in all shapes and sizes and is often a substitute for active cash management on the part of the manager (a laudable protection), but it is also used to provide more AUM or a better internal rate of return (IRR) for the manager (which could be a questionable and risky goal for investors): • subscription facilities to bridge to investments • manager/GP loans to cover operating deficits • permanent borrowings to fund investments. You need to understand the distinction between leverage at the fund level and leverage at the portfolio company/asset level.	Investors need to look closely at the terms describing authorization to undertake leverage and ask a number of questions: • Do/should LPs have the right to make the loans? • What interest rate applies (especially relevant for management/GP loans to cover operating deficits)? • What is the security package? • What costs could an LP incur to satisfy lender requirements (*e.g.*, legal opinions, ongoing certifications)? • What is the projected impact on the expected IRR (*e.g.*, longer duration loans that defer deployment of LP capital and commencement of preferred return)? • How has leverage been used by the manager in the past? Did net and gross track record disclosures account for the difference between the leverage used then and the leverage proposed for the current fund? (They need to.) Investor caveat: There is not usually a counsel looking at the credit facility and its security package on behalf of investors.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Co-investment opportunities	How co-investment opportunities are addressed varies considerably between managers — from very loose to very precise. They can be a mechanism for greater industry/strategy exposure and profits, but co-investments require more active LP participation and decision-making.	Investors should ensure there are fulsome policies and procedures around dealing with co-investment opportunities that address: • allocation • disclosure of preferences given to particular LPs • expense sharing (including broken deal expenses) • due diligence information to be made available • timeframes and procedures expected for reviewing documents • manager economics in co-investment vehicles (these are typically lower than fund-level fees) • conflicts management (*e.g.*, enter and exit on same terms/time).

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Management fee deduction	Under the Tax Cuts and Jobs Act, passed in 2017, management fees charged by a PE manager to a PE fund it manages are nondeductible investment management expenses. Before that, for individual taxpayer investors, they were subject to limitations based on adjusted gross income, but at least 20 percent of management fees were always deductible.	There are several ways to address this: (a) Manager turns the fee into a profits interest in the fund: • This works best in credit funds and direct investment (single asset) investment partnerships. • The profits interest must be structured so the manager has true entrepreneurial risk. • Investors need to ask whether they can be effective in reducing profits taxed to the investor, and how and when it might influence management team behaviors if the fund does well or when it does not do well. (b) A family office may choose to structure around the problem, using the above in combination with a C corp structure — *i.e.*, set up its management entity as a C corp and convert the fee to a profits interest in an amount that is offset by anticipated management company salaries and expenses (which should be deductible compensation expenses). (c) Pay the management fee outside the fund, *i.e.*, directly from the family office to the manager (*Lenders Bagels*): • This works only in certain family offices that can meet the criteria for being in the business of managing investments.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
		(d) Manager charges consulting/ monitoring fees to portfolio companies: • This moves the deduction to the portfolio company so you have to consider the value of the deduction given other factors, including the percentage owned by the fund and flow-through or blocked status of the portfolio company.
Management fee credits to GP capital contributions	Larger managers waive the right to receive management fees and instead treat the dollars not paid as management fees as their capital contribution. The IRS's view of these management fee waivers is the subject of proposed regulations that would impose substantial restrictions on the ability to use them.	If structured correctly, management fee waivers can reduce the amount of profits taxed to an investor in the PE fund. When they are used in lieu of capital contributions, it is often an attempt to convert ordinary income (management fee) into capital gain (distribute share of capital gains earned by the partnership). The IRS's proposed regulations are designed to prevent this shift. Questions that arise from these structures that investors should ask: • How and when might it influence management team behaviors if the fund does well or does not do well? • What is the real skin in the game that the managers have? • What are the incremental (often hidden) administrative costs to the fund (*e.g.*, more complex waterfall structures and tax/legal monitoring costs)? • Whose capital contribution is really being funded this way (*i.e.*, who gets the reward)?

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
LPAC constituents	LPACs are there to resolve conflicts and keep an eye on the management team. There are always questions about how the committee is appointed, who is on it, what it handles, whether it is influenced by a GP presence/ participant, etc.	Familiarize yourself with the ILPA 3.0 guidelines on LPACs. Due diligence is needed on who is on the LPAC, what their relationship is with the GP outside of the fund (investor in prior funds, for example, service on other LPACs with this GP), the governance principles under which the LPAC operates, and what decisions go to the LPAC vs. left to a vote of the partners.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Investment period	Many managers design an investment period based on how fast they can deploy your money responsibly. Then something happens (*e.g.*, the 2008 financial crisis), and there is a hiatus in activity and LPs start to feel the management fee is unfair. Other managers delay the start of the management fee until the first investment (seems fair) and then tie the investment period to the period after the first investment (seems fair), and the result is a longer time period for collecting fees in a prior fund that is fully invested but has not yet hit the anniversary to close its investment period (seems not so good).	Investors should look at the prior fund's documents to understand the motivation behind any delay in management fees. They should also understand the impact of the fee provisions on the ramp-up period while the new fund is fundraising. There are lots of different takes on the "solution" to the problem of a true hiatus in activity — all of which probably depend on the reason for the hiatus: • mandatory suspension of the management fee if the LPAC or enough LPs require it • mandatory meetings with the LPs to discuss the situation (do not wait for the annual meeting) — this is covered if the LPs (or some low percentage of them) have the ability to call a meeting • have the LPs able to amend the LPA without the GP's consent (as opposed to full-fledged no-fault termination) • switch to a management fee based on contributed or invested capital (the incentive to deploy even faster has to be tempered/balanced with the carry incentive). This may also reduce a manager's incentive to defer capital calls in favor of a subscription facility.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Term of the fund	The term of the fund will determine when and how the end of the fund's life may occur. Many funds permit the term to be extended by the GP for an additional one or two years, with further extensions permitted with LPAC or LP consent. PE fund terms should be driven by the nature of the underlying assets (*e.g.*, holding period for real estate assets, loan duration for private credit, longer hold periods may be applicable for earlier stage, portfolio companies, or yield oriented assets, etc.). Many funds end up holding assets at the end of their term that are not able to be sold or cannot be sold at fair value. Is an investor able to handle distributions of non-marketable securities?	First, ask the question of whether the fund's strategy is in sync with the term. An LP's ability to transfer its interest in a desire for liquidity should not be able to be blocked entirely by the requirement that GP consent is needed for the transfer. Holding an interest through an SPV may give you more flexibility when it comes to obtaining liquidity through a secondary transaction because the SPV interests usually can be transferred so long as the SPV manager remains the same. Determine the scope of extensions permitted in the GP's discretion without LP input and whether the fund is obligated to pay full management fees during each extension period. Review fund liquidation provisions and the GP's ability to make mandatory in-kind distributions and related valuation mechanics. Preordain the mechanics for liquidation of non-marketable securities if the LP is not able to receive and deal with those.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Succession planning within the management team	Too many teams have senior members with no transition plan to ensure that the next set of leaders is ready should something happen to them over the life of the fund.	Do a test run on each senior management member, and ask what happens to your investment if that person "gets hit by a bus." Does the management team have a real disaster recovery plan? Identify the key persons, *i.e.*, those with unique skill sets necessary to the success of the strategy. Examine whether the fund has key person provisions that reflect the same level of importance of the senior portfolio managers as the investor identified.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Fee and expense allocations	This topic has received a lot of attention in the past few years, and transparency is the name of the game. But there is still a lot of discussion needed, especially around the use of catchall provisions and the ability to monitor the manager's compliance with the LPA (it should not all be left to "the audit will catch any noncompliance").	Clear and detailed fee and expense provisions in the LPA go a long way to solving this problem. But there are always things not addressed that come up over the 10-15 years after a fund is formed: • consider requesting a CFO certification of compliance with the expense allocation provisions or LPAC review of all expense allocations • consider how the fund addresses certain "grey" area expense allocations that may provide only marginal benefits to LPs (*e.g.*, GP regulatory compliance costs, liability insurance premiums, marketing costs, placement agent fees, co-investment expenses) • identify the potential for the manager to augment its revenues with other fee income (*e.g.*, director fees, BD-type compensation or other ancillary transaction or advisory fees received by the GP or affiliates from portfolio companies or assets). Does the fund have a management fee offset for that income (customary is 100 percent, but there can be reasons for less)?

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Valuation policies/portfolio transparency	Valuation guidelines are often so high-level as to not be helpful.	Due diligence on a manager should reveal to the investor how securities will be valued. You should not only review valuation guidelines, but also undertake due diligence on prior investments to assess compliance with the guidelines. Consider having the LPAC be required to stress-test adherence to the valuation guidelines. Consider if assets or strategy warrants independent third-party verification (*e.g.*, appraisals of real estate portfolio).
Opportunities for liquidity	Secondary transactions are fairly prevalent in the market, and the interest in them is growing. They come up in: • default provisions • transfer provisions • liquidity features in PCVs. How do investors make sure they are not left behind when others are selling?	LPA provisions can include a fair amount of detail about secondary opportunities (and not only after an LP defaults). Or, a side letter can provide that, if another LP indicates it wants to sell, then you are notified and will be introduced to the potential seller. Default provisions often afford an opportunity to pick up another investor's interest at a discount (must cure the default as well).

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Environmental, social and governance (ESG) transparency	The importance of ESG provisions varies between investors.	Investors who are not as concerned with mandatory or recommended ESG modifications should be asking how much management time is absorbed by ESG considerations, how are deal terms skewed by them, and how much are portfolio company operations altered to incorporate ESG as compared with the portfolio company's historical operations. For investors who are ESG proponents, how and when there will there be verification of compliance with ESG guidelines, as well as what the monitoring metrics will be, are the key questions. Be mindful of manager assertions of ESG benefits without specific ESG investment criteria and measurement methodology.

TOPIC	PROBLEM	SOLUTION? Or at least what are the right questions to ask?
Side letters	Side letters often contain most favored nations (MFN) clauses and special reporting requirements, ensuring that the investor has access to information, tax provisions, representations and notice provisions.	Whether you have the opportunity to negotiate a side letter is a function of a few things: • size of the investment • need for side letter provisions based on legal, tax or regulatory attributes of the investor (and limitation of the provisions to those needed) • potential for a long-term investment relationship with the manager. An MFN may be a rational exemption to the “need to have” requirement because there is an element of fairness to it. Consider requesting that the MFN be moved into the fund document itself. Side letters are often a useful tool to obtain clarifications from the GP as to the fund’s strategy or any LPA terms that are ambiguous (*e.g.*, co-investment policy).

Investing in any kind of fund is complex and not for the uninitiated without proper guidance. Marrying investor goals and expectations to the fund's strategy and terms is fundamental to every step along the way. From start to finish, the investor due diligence process may take weeks or even months to complete. As this is an interactive, back-and-forth process, investor interaction with managers needs to be coordinated with the manager's schedule of development and rollout of the fund. Joining early in a fundraise and before the fund's initial closing may give the investor first-mover advantage and allow the investor to influence the development of the terms, but may come with greater risk and probably requires a relatively large check. For these early investors, any subsequent changes to fund terms after their subscription either will be favorable to the investor or will require the consent of the early subscribers already in when the change is made.

A different strategy may be to subscribe later in the fundraising process (*e.g.*, after the fund's initial closing and perhaps even after initial investments are made), and let other investors shape the terms. This has its obvious pros and cons and generally results in any special terms for the investor being only those that are the traditional fodder of side letters. Certain investors take a different tack altogether and partner with a manager team to create a bespoke customized investment vehicle that is just what the investor wants, and then the manager brings in other investors to join it. While more costly to set up, many family office investors look at this as the holy grail.