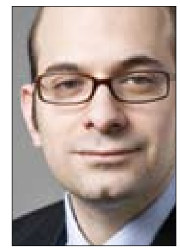
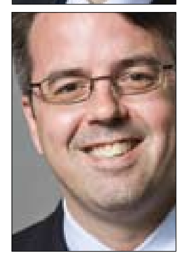
FUND EC

Nine Issues to Look Out for in Closed-End

FUND PERFORMANCE IN 2008–2009 was mostly a product of luck—and for many readers, most of that luck was bad. Many topics discussed in this article—waterfalls, fees, clawbacks, leaky pools, and leaky buckets—didn't signify in the investment results over the past 18 months. But that doesn't mean they don't matter. Things will right themselves. When they do, good drafting of fund documents and a solid understanding of how a fund's economic terms work will separate some of the winners from some of the losers. This article discusses nine important economic concepts all fund investors and fund sponsors should keep in mind when approaching their next closed-end private equity real estate fund.





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1. The ILPA's Private Equity Principles

In September 2009, the Institutional Limited Partners Association (ILPA) issued the position paper Private Equity Principles, outlining its view on a wide range of fund business terms. The ILPA is an organization of more than 200 institutional investor members from multiple countries. Members represent assets in the trillions of dollars. Leading members include the California Public Employees' Retirement System and the Ontario Municipal Employees' Retirement System. While some general partners have grumbled that the

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Private Equity Real Estate Fund Documents

Private Equity Principles document is one-sided, that doesn't detract from the fact that everyone should know what is in it, even if deciding not to follow it.

2. Deal-by-Deal Versus Back-End Waterfalls

The distribution scheme in private equity is called the waterfall. A waterfall distribution structure controls who in the fund will receive distributable funds and may be on either a deal-by-deal or a back-end basis. The waterfall typically governs all distributions in private equity except distributions upon dissolution of the fund.

Only distributable funds are run through the waterfall. In general, net operating proceeds and net disposition proceeds from investments will be considered distributable funds. Net operating proceeds typically is all operating income of the fund less allocated expenses, obligations, and reserves, other than with respect to dispositions. Net disposition proceeds typically is all disposition proceeds less allocated expenses, obligations, and reserves.

Sometimes fund sponsors provide that reinvested proceeds will be withheld from distributable funds. The general partner may nonetheless want to receive carried interest on such amounts. Reinvested amounts may be deemed distributed and recalled per the reinvestment provision and can be deemed run through the waterfall. As a result, the profit portions that do not constitute a return of capital or preferred return may be distributed in part as carried interest, which would result in the GP receiving profits on a previously disposed asset even though the investors did not actually receive their return of capital plus preferred return. This could result in a leaky bucket.

In a deal-by-deal waterfall, all distributable funds that are generated by a particular investment are allocated to that investment and are then distributed to the investors. The GP earns a carried interest as soon as there has been a complete return of capital and preferred return[1] on the particular investment. Thus, suppose that the return of capital and preferred return with respect to an investment was $20. If the distributable cash for the investment was $50, the GP would take carried interest on $30, even if subsequent investments resulted in a loss.

In a back-end waterfall, distributable funds are run through the waterfall on a cumulative basis—all the investors' capital and preferred return must be returned before the GP is paid its carried interest. In a back-end waterfall, the GP does not earn its carried interest until there has been a complete return of capital and preferred return with respect to all fund investments. Thus, suppose the return of capital and preferred return of all fund investments was $80. If there are two dispositions where the distributable cash is $50 each, the GP would not take carried interest on the first disposition and would take carried interest on only $20 of the second disposition.

A back-end waterfall is more favorable for the investors, as it gets more cash to them more quickly. There is also less risk of loss from later investments that underperform. Even if GP clawback mechanisms are used in the deal-by deal waterfall, those mechanisms can have shortcomings, including credit risk, tax drag (most clawbacks have been historically on an after-tax basis, although that may be beginning to change), and disputes over calculations. In today's market, investors more frequently can expect to find back-end waterfalls, and the ILPA has been arguing for back-end waterfalls or, at a minimum, enhanced deal-by-deal waterfalls that are not subject to leaky pools and leaky buckets.

3. Leaky Pools

A leaky pool is a situation in which investors may not receive a full return of capital plus their preferred return, even though the fund generated enough cash to repay these amounts. This usually occurs in one of four ways: (1) a contribution component is missing from the capital being repaid under the waterfall (for example, expenses or direct payments are not returned), (2) a capital component is missing from the calculation of the preferred return, (3) in deal-by-deal funds, prior losses or write-downs are not recaptured, and (4) in deal-by-deal funds, prior liquidated investments that were not previously distributed are not ultimately distributed.

Needless to say, investors should make sure that all capital paid in is returned plus preferred return, regardless of whether capital paid in is called a "capital contribution" under the fund documents. In a deal-by-deal fund, investors should verify that all general fund expenses and investment-specific expenses to date are returned as capital upon a disposition, although the GP may want to return only a pro rata portion of such expenses for the exited deal. Investors should confirm that general fund expenses are allocated to investments on an objective basis, such as based on investment percentages in a particular investment. Sometimes the waterfall returns capital allocated to only a particular investment, which could result in capital not allocated to a particular investment not being returned.

1. The typical preferred return today is 9% to 10%, compounded annually, but can typically range from 8% to 12%, compounded annually.

If a preferred return is calculated based on simple rather than compound interest and the return of capital is run through the waterfall after the preferred return, a leaky pool may occur. This is because paying down the preferred return first in this situation will stop the preferred return from continuing to accrue to the extent that the preferred return is paid down. Most waterfall distributions use compounded interest, but it is something to look for.

4. Leaky Buckets

A leaky bucket occurs when the GP can be paid its carried interest (or other disproportionate payment) before the investor receives a full return of capital plus the preferred return. As a result, leaky buckets can be caused by leaky pools, but they are not leaky pools themselves.

Leaky buckets may or may not be intentional. The most common leaky bucket is completely intentional: the deal-by-deal waterfall. Split waterfalls are another example of an intentional leaky bucket. The enhanced sort of deal-by-deal waterfall advocated by the ILPA is less likely to have leaky buckets in it. Deal-by-deal waterfalls will not ultimately result in a leaky bucket if the GP clawback works correctly and is properly guaranteed.

Except in a case in a which leaky pool is present, an unintentional leaky bucket typically shows up only in a deal-by-deal fund because, by definition, it is an early payment of carried interest to the GP. If a back-end waterfall is put together correctly, a leaky bucket shouldn't happen, outside of certain reinvestment or LP-giveback scenarios.

Leaky buckets are most common when there are unrecouped losses from prior dispositions (including partial dispositions) or write-downs. Such unrecouped losses and write-downs should be offset against future net proceeds that are run through the waterfall. Some GPs may argue that such unrecouped losses and write-downs should also be prorated among investments, but this is less persuasive.

The ILPA argues that all general fund expenses and investment-specific expenses to date should be returned before the GP receives its carried interest on an investment. However, the GP may want to return only a pro rata portion of such expenses for the exited deal. If a pro rata approach is taken, investors should confirm that general fund expenses are allocated to investments on an objective basis and not simply at the GP's discretion. Whether all or a pro rata portion of such expenses must be returned is a business point.

5. Taxes Paid or Withheld As Deemed Distribution

Certain funds characterize taxes paid or withheld as deemed distributions to investors. This most frequently occurs with respect to non-U.S. holdings. For example, suppose that the amount of a tax paid by the fund in respect of fund investors in a particular jurisdiction was 1%, that the amount of the contributions by investors was $90 million, that the preferred return was 10%, that the carried interest was 20%, and that the amount of the disposition after one year was $100 million. In the event taxes were not deemed distributed, $99 million would be run through the waterfall, and the investors would receive $99 million ($90 million plus a 10% preferred return), while the GP would not receive any carried interest. In the event such taxes were deemed distributed, the GP would receive $200,000 (20% of $1 million).

Deeming taxes paid or withheld as distributed therefore accelerates when the GP will reach the carried interest layer of the waterfall and results in a higher carried interest for the GP. GPs argue that they have the right to deem such taxes paid or withheld as distributions since such taxes are not fund-level expenses that reduce carried interest, but rather expenses relating to an individual investor. Investors, however, may take the view that such taxes paid or withheld are fund-level expenses, which reduce distributions and reduce the GP's carried interest. One compromise is that taxes may not be deemed distributed unless they relate specifically to the LPs as opposed to the fund itself.

This is a business point, and resolution may center on the type of taxes paid. One solution may be to limit it to taxes for which tax credits are available. Investors will want the GP to use reasonable efforts to reduce or eliminate foreign taxes, while the GP will want investors to cooperate in connection with the foregoing.

6. Management Fees

The biggest issue with respect to a management fee, of course, is how much it is; the market seems to be holding steady at between 1% and 2%, with larger investors generally paying lower management fees. The management fee, unlike the carried interest (and perhaps the GP clawback in certain circumstances), is an economic term that does not provide for much alignment of interests between investors and fund sponsors. The ILPA recommends that the management fee should be based on the

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reasonable operating expenses and salaries of the fund sponsor. Larger managers with scalable strategies may need smaller fees. The Townsend Group recommends that investors understand manager operations in greater detail and that fund sponsors provide such details when the management fee is negotiated.

Most frequently, the management fee is calculated on committed capital during the investment period and then invested capital (or a similar defined term) after the investment period. Calculating management fees based on invested capital after the investment period steps down management fees following the end of the investment period. The ILPA recommends calculating management fees based on invested capital after the investment period.

While the way in which a fund's documents define and calculate management fees can lead to all kinds of issues, we focus on these four, three of which occur when the management fee is based on contributions after the investment period:

- **Use of Invested Capital as the Base During the Investment Period:** A big issue investors push for is basing management fees on invested capital during the commitment period. Doing so prevents fund sponsors from earning management fees in a dry market when they are unable to make fund investments. However, it can also incentivize fund sponsors to acquire fund assets that are suboptimal in order to earn management fees. The fund sponsor may be left without any cash at the beginning of the fund. GPs still have overhead, so some allowance should be made to provide operating cash without giving them an incentive to invest in subpar assets. Two potential solutions are either to front-load the fee by combining a management fee based on invested capital with an acquisition fee (in the neighborhood of 1%) or to provide a floor (usually around 50 basis points of commitments) or, increasingly, a fixed dollar amount. The floor is a better solution, since it avoids incentivizing fund sponsors to undertake weak investments.
- **Fees on Fees:** If management fees are based on contributions after the investment period, investors should be careful because, in many funds, contributions can be called to pay management fees, which could produce fees on fees. This is because a fee would be paid on the capital called to pay the management fee. Some fund sponsors have stood by this, arguing that if a fee based on total commitments during the investment period is acceptable, then a fee based on total contributions should also be OK, especially if it's earning a preferred return and it will be first returned to investors as contributions in the waterfall. Whichever side you come out on, read the defined terms carefully and understand the base from which the fee is calculated.
- **The Base of Capital After the Investment Period:** When calculating the management fee base, investors need to determine whether there is a high-water mark of contributions (that never goes down), whether there is an invested capital concept that reduces over time as assets are disposed of, or whether contributions are reduced by distributions (including tax distributions). The ILPA prefers either of the latter two situations, since they reduce the management fee after the investment period. Many investors further argue that it is not appropriate to charge a management fee on dispositions that are no longer actively managed. Again, focus on the defined terms.
- **Issues Involving Refinancings:** Refinancings may present a difficult issue with respect to management fee calculations. Investors and the GP should assess whether "dispositions" or "liquidated investments" as defined in a fund's partnership agreement include refinancings. More than a few fund lawyers have been fired on either side for including refinancings as a "disposition" because it was beneficial in one context but overlooked that it was not beneficial in another. Both sides should consider the degree to which treating refinancings as dispositions may reduce management fees, brings a halt to the preferred return clock with respect to such refinanced investments, and triggers carried interest for the GP with respect to such refinanced investments. Depending on how the waterfall operates, investors may argue that it is no longer appropriate for investors to pay management fees on refinancings that have been treated as "dispositions," permitting payment of the GP's carried interest under the waterfall. In the event refinancings reduce the management fee, the GP, as a compromise, may want to obtain a reduced management fee with respect to those refinanced assets, particularly if the GP has to actively manage the asset. As with management fees in general, larger investors can probably negotiate better management fees following refinancings.

7. Acquisition Fees

Acquisition fees are one-time fees charged upon the acquisition of an asset for the fund. Investors should ensure that the definition of "assets" subject to the acquisition fee does not include temporary investments such as cash and cash equivalent–type investments.

Many investors say acquisition fees are not appropriate, believing that the GP should receive its day-to-day compensation solely from the management fee, with the rest of the GP's compensation being incentive-based. There are exceptions, of course. One is when the management fees are based on invested capital[2] instead of on commitments during the investment period (or when the management fees are based on operating income of the assets). In such cases, an acquisition fee of 1% of the purchase price may be appropriate to help even out the back-loaded nature of the management fee during the initial ramp-up phase of the fund. However, this solution may over-incentivize the GP to purchase investments. Acquisition fees are also found in funds that are sponsored by vertically integrated fund sponsors, where the fund sponsor employs broker personnel and the acquisition fee is a proxy for the broker's fee that would otherwise be charged.

Related-party transactions can also present an acquisition fee issue for investors and fund sponsors if acquisition fees are charged on warehoused assets (assets already held by the fund sponsor) or assets that are acquired in anticipation of establishing a fund. Generally, investors do not want to pay acquisition fees on assets transferred by the fund sponsor (and its affiliates and related persons) to the fund. The GP may feel differently. The solution is a business point. A compromise can be that such fees will be charged on only the warehoused assets (the assets purchased with the intention of transferring to the fund) but not other preexisting assets.

The important thing is that each side understands acquisition fees on such assets and that each side agrees on how they will be treated. Fund sponsors should keep in mind that such transactions may be subject to a conflict of interest under Section 206 of the Advisers Act, if the Advisers Act applies, and will need to consider how to disclose and potentially receive investor (or advisory board) approval with respect to such transactions. If securities were the subject of such related-party transactions, such transactions would be considered principal transactions under Section 206(3) of the Advisers Act and would require disclosure and investor approval.

8. Unfunded Commitments

An investor's unfunded commitment is usually defined as the investor's capital commitments *minus* its capital contributions *plus* distributions made to it. Distributions typically only increase unfunded commitments if there is a reinvestment obligation or a provision that recycles proceeds of investments that are disposed of in a short period of time (such as six months). As a result, unfunded commitments often is a floating number that goes up and down as capital is called and returned.

Investors generally never want capital calls to be made in excess of the sum of unfunded commitments and unfunded reserve because when investors commit capital, they don't want to be liable for more capital than they've agreed to commit. Some investors may pay attention to only the unfunded commitments and ignore the unfunded reserves provisions. Investors need to carefully evaluate the definition of unfunded commitments and unfunded reserves. In some funds, investors can be liable for more capital than they've committed, if there are carve-outs to amounts that typically reduce unfunded commitments.

Not surprisingly, many investors focus on the items that reduce the unfunded commitment figure. They may request that all called capital should reduce unfunded capital commitments, including, without limitation, direct payments (including management fees and placement fees); payments for credit facility obligations (including capital called directly by lenders); organizational expenses; reinvestments; amounts that the GP intends to call, particularly in regard to fund liabilities and obligations (without the possibility that unfunded commitments would be further reduced); and LP givebacks. They may even request that certain amounts that are not called from investors still reduce unfunded commitments, such as bridge financing secured by capital commitments beyond a certain time period (generally six to twelve months), which would be deemed contributions. The GP may, of course, have a different view.

Also affected by this negotiation is what constitutes a "capital contribution" for purposes of maintaining capital accounts and returns of capital under the distribution waterfall. For instance, real estate funds that have scaled fees (different rates for different-sized investors), and maintain fractions rule compliance for UBTI purposes, will usually implement a direct payment mechanic to pay those fees. If so, those fees usually do not get picked up as "capital contributions" and therefore need to be rebuilt into the unfunded commitment reduction.

Whether reinvestments should increase unfunded commitments presents a difficult issue. One possibility is for reinvestment proceeds to be treated as a distribution and a recall, which does not increase unfunded commitments. This allows the GP to take a carried interest. Another possibility is to treat the reinvestment as an additional capital call, without an offsetting distribution, particularly if the reinvestment occurs a short period of time after the initial investment (such as less than six months). In such event,

2. Many of the management fee issues relating to invested capital also apply to acquisition fees tied to invested capital.

the GP is often able to take carried interest by deeming the reinvested amount distributed. This saves the GP from having to distribute and recall reinvestment proceeds.

The GP will want all distributions to investors to increase unfunded commitments. LPs may resist, but the GP may want at least distributions relating to investments that have been disposed of in the short term, such as within six to twelve months after acquisition (or sometimes the initial closing), to increase unfunded commitments, provided that such dispositions have not been reinvested. LPs may want such distributions to increase only unfunded commitments in the event they receive a complete return of their capital contributions relating to the investment and any other unrecouped direct payments and fees paid by the LPs. LPs may want the return of capital for such purposes to include amounts from prior dispositions that were not previously returned. True-up distributions relating to subsequent closings of other investors should not increase unfunded commitments to the extent interest is distributed, but to the extent capital is returned, it is appropriate to increase unfunded commitments.

As noted, the GP may be able to negotiate a reserve, which investors may be obligated for on top of unfunded commitments. The reserve amount may be as high as 10% of a partner's aggregate capital contributions, which investors will not want to be obligated for until their unfunded commitments equal zero or are otherwise canceled. Investors will want reserves to be for limited purposes and not too broad or for infinite duration. Typically, investors will want reserves only for the purposes of preserving or enhancing the value of existing investments (which can include related, strategic acquisitions). Fund sponsors sometimes ask for reserves to pay or establish reasonable reserves in respect of management fees and partnership expenses, repay any fund indebtedness, or satisfy guarantees or other obligations of the fund outstanding on the date of the termination of the investment period (or any refinancing or renewal thereof).

If investors are obligated for reserves prior to the time when their unfunded commitments equal zero or are otherwise canceled, they will want reserve amounts to reduce unfunded commitments and will not want to be obligated for reserves during the investment period.

9. LP Givebacks

Some funds have LP giveback provisions that require partners to return capital following distributions. Investors may want to ensure that the purposes of the LP giveback are not too broad. Some limits on LP givebacks that investors often ask for include (1) terminating the LP giveback two to three years following a distribution or upon termination of the fund (but the GP may want pending claims and liabilities on such dates to be subject to the LP giveback) and (2) capping the LP giveback.[3]

If an LP giveback is adopted, investors should determine whether all partners (not just LPs) should be obligated under the LP giveback. Presumably, all partners that receive distributions should be obligated to fund the LP clawback. Further, investors and GPs should consider whether the giveback should be paid in reverse waterfall order, since paying the giveback on a proportionate basis could result in the GP funding a lower percentage (at least until the profits are exhausted) than its carried interest, which is typically 20%.

Generally, any amounts returned under a LP giveback should be treated as a contribution of capital that decreases unfunded commitments and accrues preferred return.

Conclusion

Needless to say, there are many more economic, governance, and reporting terms other than the economic issues discussed in this article. We think the business terms discussed here are some of the most important economic ones. Fund sponsors and investors should keep in mind the economic points addressed in this article when negotiating fund documents.

Most important, investors may want to negotiate back-end waterfalls, or if back-end waterfalls are not possible, enhanced deal-by-deal waterfalls that do not present possibilities for leaky pools or leaky buckets. Investors and fund sponsors should agree on management fees and the base from which management fees will be calculated, taking into consideration the economics of such fees. Open discussion and a clear understanding of a fund's terms and economics beforehand will go a long way toward preserving a solid relationship between GPs and their clients. ■

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3. The LP giveback could be capped at, for example, (1) a specified percentage (such as 25%) of capital contributions, including, without limitation, expense capital and direct payments (if any); (2) a specified percentage (such as 25%) of capital commitments; or (3) the lesser of (A) 25% of an investor's capital commitments or (B) a pro rata share of 10% of the aggregate capital commitments of the fund.