Cassels

Key Considerations in Forming a Private Equity Fund

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With the continuing rise in popularity of alternative investment strategies, many professional managers are focusing on creating private equity funds through which pools of capital can be invested.

Before forming a fund, here’s a look at the top five things we think managers should consider:

1. What Structure to Use

While most funds typically end up in a closed-end limited partner/general partner (LP/GP) structure, it is important for managers establishing funds to look at the following factors at the outset to help guide their ultimate decision:

- tax considerations, both for the limited partners of the fund and of the fund itself;
- jurisdiction and type of assets/businesses to be acquired;
- jurisdiction of expected investors in the fund and limited liability considerations of those investors;
- ability to comply with regulatory requirements;
- privacy considerations for investors in the fund; and
- flexibility.

These factors, and others, should be explored by fund managers and may lead to considerations of other structures such as the use of an LLC or corporate model (rather than an LP/GP structure), particularly when establishing an initial fund.

2. What Jurisdiction to Form the Fund Under

Closely related to the question of what structure to use is what jurisdiction to form the fund under. Along with the considerations noted above (particularly tax), managers often look to provide fund investors with the greatest comfort they can regarding “limited liability.” To that end, multiple Canadian provincial jurisdictions have been used when forming funds using the typical LP/GP structure. Many funds, including large international funds, find the legislative structure and flexibility of several Canadian provincial jurisdictions to be helpful in this regard.

3. Fund Economics

The economic structure of a fund is perhaps the most widely debated and negotiated aspect of forming a new fund. The economic provisions of a fund set out, among other things, how the fund manager is paid and how profits are allocated and distributed between the parties to the fund. Important factors to consider when negotiating fund economics include:

- whether to use a “committed capital” fund structure or a “fully funded” fund structure;
- management fees;
- how to allocate profits and in what priority to make distributions (i.e., what is the “preferred return” and the “carried interest” amount);
- the inclusion of a “clawback” provision (i.e., protecting against overpayment of carried interest to the fund manager); and
- allocation of expenses.

Fund economics play an important role in attracting investors to funds, so fund managers should carefully consider these factors, and others, when establishing a fund.

4. Fund Governance

The manager is generally responsible for managing the business of the fund. However, provisions may be included in a fund’s constating documents which impose restrictions on the decision-making powers of the manager. For example, while investors are typically required to remain passive and not take part in management decisions, funds often have an advisory committee made up of qualifying investors who vote on various decisions affecting the fund. The following list provides examples of situations where a manager may need to seek approval from the advisory committee before proceeding:

- participating in related party transactions and other transactions that might give rise to an actual or apparent conflict of interest;
- making restricted investments (restrictions may range from industry type, company size, diversification requirements, and the location of potential acquisition targets); and
- choosing a valuation method for private equity investments.

The advisory committee is usually composed of nominees from select investors in a fund. Investors are more likely to have a representative on the advisory committee if they make a larger capital commitment to a fund, or particularly relevant expertise. There is no requirement that every investor in a fund have a representative on the advisory committee. However, there are situations where a fund will require approval from all (or a very high threshold of) investors in a fund. This is usually required when amendments are made to certain provisions in a fund's constating documents, such as investment restrictions and capital contributions.

5. Establishing Well Defined Triggering Events

Unlike other investment opportunities, investments in private equity can be highly illiquid. This is because closed-end funds generally have a lifespan of around 7 to 15 years, with the average lifespan of around 13 years. There are very limited circumstances in which an investor may withdraw or transfer their interest in a fund during that time. However, in certain circumstances, investors can benefit from liquidity provisions in a fund's constating documents. These provisions protect investors should certain triggering events take place during the lifetime of a fund by calling for remedies such as suspension of investments, and the early termination of the fund. Triggering events may range from the departure of a key investment professional who is responsible for managing the fund to underperformance of the fund and should be carefully considered at the outset to avoid issues later. Having well defined triggering events that are established at the outset of a fund can provide investors with a higher degree of protection and security for their investment.
