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Private Equity Fund Formation: Overview

Resource type: **Practice Note: Overview** Status: **Published on 22-Dec-2016** Jurisdiction: **Canada**

This Practice Note provides an overview of private equity (PE) funds formed in Canada, discussing the key considerations involved in forming a private equity fund. It covers the general structure and key entities involved in the fund, fund economics (including fund fees and expenses), fundraising and closings, fund term, fund investment and divestment periods and certain regulatory matters affecting fund formation. This Note also describes the principal legal documents involved including the fund limited partnership agreement, management agreement, subscription agreement and side letters.

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Contents

General Description of Private Equity Funds

Structure

- Limited Partnership
- General Partner
- Manager
- Limited Partners
- Parallel Funds and Feeder Vehicles

Fund Economics

- Capital Commitments
- Fees
- Allocations and Distributions
- Clawback
- Expenses

Fundraising and Fund Closings

- Marketing
- Fund Closings

Fund Term: Investment and Divestment Periods

- Fund Term
- Investment Period
- Divestment Period
- Termination

Managing Conflicts

- Successor Funds
- Investment Allocation
- Related Party Transactions
- Limited Partner Advisory Committee

Certain Regulatory Matters

- National Instrument 31-103
- Inapplicability of Mutual Fund Regulation
- Private Placement Regulation
- US Laws

Principal Legal Documents

- Private Placement Memorandum
- Limited Partnership Agreement
- Subscription Agreement
- Side Letters
- Management Agreement

General Description of Private Equity Funds

A private equity fund is a form of pooled investment vehicle used by managers and passive investors to make investments in private (that is, non-public) businesses. Private equity funds are distinguished from hedge funds and mutual funds by:

- The type of investments which they make (typically medium to long term investments in which the private equity fund will take a direct management role).
- Some of the terms by which investors will take part in the fund (typically "closed ended", providing limited or no ability for an investor to withdraw its investment on demand).

Private equity funds typically seek to achieve medium to long term capital gains by investing in, and taking an active role in the management of, a number of private investments. Investment objectives vary depending on the class of fund:

- Growth funds typically have the widest mandate and focus on non-control equity investments but may also participate in buyout or mezzanine transactions.
- Buyout funds invest for control of the entity, often with participation of management of the entity, and subsequent sale.
- Distressed funds are a subset of buyout funds, using debt instruments or other mechanisms to acquire control of distressed businesses.

- Mezzanine funds invest in debt instruments which typically pay a high rate of return and may include an equity participation.
- Venture capital funds typically make non-control investments in early stage (pre-initial public offering) technology companies with preferential participation rights.
- Funds of funds invest substantially all of their capital in other private equity funds.

This Practice Note does not include a substantive discussion of applicable income tax considerations.

Structure

Limited Partnership

The structure used almost exclusively in Canada as a vehicle for private equity funds is the limited partnership. Limited partnerships are governed by provincial law and may be formed under the laws of each province and territory in Canada by executing a limited partnership agreement and filing a form of certificate or declaration with the appropriate governing body in the province or territory in which the limited partnership is formed. The form of certificate or declaration and the information required to be included varies from province to province (see, for example, Form 3, Declaration under the *Limited Partnerships Act*, R.S.O. 1990, c. L.16 (Ontario LPA) and section 51 of the *Partnership Act,* R.S.B.C. 1996, c. 348 (BC PA)).

A limited partnership has two types of partners: limited partners and general partners. For more on the structure of limited partnerships, see *Practice Note, Limited Partnerships: Overview*.

Investors in a limited partnership participate as “limited partners” who are essentially passive investors that do not take part in the management of the partnership. Limited partners have limited liability for the liabilities of the limited partnership to third parties, subject to certain narrow exceptions. The management of the limited partnership is the responsibility of the general partner (usually a company or another limited partnership), who is subject to unlimited liability for the limited partnership’s liabilities to third parties. The general partner may delegate management of the private equity fund to a separate manager.

The term of a private equity fund is usually 10 years, often with a right granted to the general partner or manager to extend for one or more one-year periods with, or sometimes without, investor consent. Capital is drawn down from investors during an initial investment period or commitment period, which is generally five years from the initial closing of commitments to the fund but often may be extended with investor or advisory committee approval (see *Fund Term: Investment and Divestment Periods*). Distributions of profits are typically made to investors following disposition of an investment by the fund.

General Partner

The general partner is responsible for the management of the limited partnership and has unlimited liability for the liabilities of the limited partnership to third parties. For this reason, the general partner will usually be a special purpose vehicle formed solely for the specific fund and will itself be a limited liability vehicle of some sort. Most commonly the general partner will be a company, but it is possible for the general partner to also be a limited partnership (with its own limited liability general partner) or even a limited liability company. The exact form of vehicle chosen to act as the general partner will usually be determined by tax considerations and whether:

- There is a manager of the fund.
- Payments of carried interest flow through the general partner or the manager.

The general partner is not typically permitted to withdraw from its position as general partner or to transfer its general partner interest to an unaffiliated third party. The limited partnership agreement may also contain restrictions on a change of control of the general partner.

Manager

Private equity funds are usually promoted and managed by a small group of individuals. It is common for these management groups to manage multiple funds, usually with a new fund being created at the time of completion of the investment period for the previous fund (see *Investment Period*). Because the general partner for each fund is subject to unlimited liability for the obligations of a fund, it is typical for the general partner to be a special purpose vehicle to be used only with respect to a particular fund. To manage and structure their business across multiple funds, it is therefore common for management groups to form a separate entity which will act as manager for each of the funds managed by that group.

In funds using a manager structure, the general partner will delegate to the manager the power to manage the business of the fund under a separate management agreement. The management agreement will generally pass through the powers and obligations of the general partner under the limited partnership agreement to the manager who will then also be entitled to receive the management fee and carried interest payments under the limited partnership agreement (see *Fund Economics*). One important exception to this is that the general partner will usually retain the sole right to make investments on behalf of the fund, because granting this power to the manager may result in the manager being required to register as an "adviser" under ***applicable securities laws*** (see *National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations*) (NI 31-103). Notwithstanding any delegation of power to the manager, the general partner will retain ultimate liability for the obligations of the limited partnership and will continue to have a fiduciary duty to the limited partners.

This Practice Note generally assumes that the fund will use a manager structure as that is most common. References to the manager in this Note should generally be read to also mean the general partner in a fund which does not have a manager.

Limited Partners

Limited partners are passive investors and do not take part in the management of the limited partnership (although the general partner may also participate in a limited partnership as a limited partner). Subject to any provision to the contrary in the limited partnership agreement, the limited partners are entitled to a pro-rata interest in the assets of the limited partnership.

The interests of limited partners in private equity funds may be represented by a number of limited partner "units" or simply as limited partner "interests" represented by a dollar amount of commitments and a capital account. There is no material difference in practice between the two, and they represent only drafting conventions.

Under the applicable statute, the liability of a limited partner for the obligations of the limited partnership to third parties is limited to the amount of property which the limited partner agrees to contribute to the capital of the limited partnership which, in the case of a private equity fund, will be the amount of the investor's capital commitment (see *Capital Commitments*).

However, a limited partner who actively engages in the conduct of the business of the limited partnership may lose this limited liability protection and be treated as a general partner (the exact circumstances will vary depending on the governing statute). For example, section 13(1) of the Ontario LPA refers to a limited partner that "takes part in the control of the business", while section 64 of the BC PA states a limited partner will lose limited liability protection if it "takes part in the management of the business".

There are other instances where a limited partner may lose the protection of limited liability depending upon the governing statute. For example, under section 6(2) of the Ontario LPA and section 53(4) of the BC PA, a limited partner whose surname or corporate name appears in the name of the limited partnership may be treated as a general partner.

Limited partners may also be required to repay distributions to the general partner or the fund in certain circumstances (see *Investor Giveback*).

For more on the limited partner liability shield and its exceptions, see *Practice Note, Limited Partnerships: Overview: Management: Limited Partners*.

Limited partners are typically not permitted to withdraw from a private equity fund. They are also usually unable to transfer their interests in the limited partnership without approval of the general partner (although institutional investors will commonly obtain side letter rights allowing for transfers to their affiliates). See *Side Letters*. Limited partners may, however, lose their interest in the partnership as a result of a default (see *Default Provisions*).

Parallel Funds and Feeder Vehicles

A "parallel fund" is an entity formed to accommodate investors with specific tax or other characteristics which would make it disadvantageous for them to invest in the main private equity fund. For example, parallel vehicles are often created for non-Canadian investors. The general partner may have the power to move investors from the main fund into a parallel fund structure if necessary.

The parallel fund will usually be a limited partnership, which may be formed under the laws of another jurisdiction (typically Delaware for parallel funds formed for US investors).

The terms of the parallel fund will be substantively the same as the terms of the main fund with necessary changes to account for the different tax or other characteristics of the investors participating in this type of vehicle and any other differences that may be applicable under the laws of the governing jurisdiction. The intent is that the two entities will be treated, as much as possible, as if they were a single entity. As a result, most limited partner voting will be conducted on an aggregated basis, the investment periods and fund terms will be identical and the funds will share a limited partner advisory committee. The funds will typically enter into an agreement, variously called a "co-investment agreement" or a "parallel fund agreement" under which the funds will also agree to:

- Share costs.
- Invest on a pro-rata basis in the same portfolio investments and on the same terms.
- Dispose of such investments at the same time and on the same terms.

Private equity funds may also establish “feeder vehicles” for certain types of investors, depending on their specific tax characteristics. A “feeder vehicle” is a separate entity (which may be a company or a limited partnership) in which a number of investors with similar characteristics will invest which will participate as a limited partner in the fund. The feeder vehicle is typically managed by management of the fund (which is sometimes referred to as the “master fund”). However, the governing documents of the feeder vehicle will typically restrict the feeder’s business to only investing in the master fund and will require that capital calls, distributions and voting rights will effectively be flowed through to the investors in the feeder vehicle to put them in effectively the same position, as much as possible, as they would be in if they had invested directly in the master fund.

Fund Economics

Capital Commitments

Investors in private equity funds do not generally pay the full amount of their investment to the fund at the time of their subscription. Rather, investors will make a commitment (usually referred to as a “capital commitment”) to the fund to advance up to the full amount of their subscription in instalments when called by the manager from time to time. The limited partnership agreement will specify a maximum amount of capital commitments that the fund may raise and may specify a maximum amount that can be drawn down in a particular year. The limited partnership agreement typically requires that members of the management group make capital commitments to the fund in order to align their interests with those of the other investors.

To draw down capital from the fund’s investors, the manager will send a capital call notice to the investors specifying the amount to be drawn down. All drawdowns must be made pro rata from the investors in accordance with their capital commitments to the fund. The limited partnership agreement may specify certain information that is required to be included in the capital call notice (for example, the purpose of the drawdown). Limited partners will then be required to advance the required sum within the time period specified by the limited partnership agreement (typically five to 10 business days). The limited partnership agreement may include a “force majeure” or “disaster” provision extending the due date for a capital call in certain extenuating circumstances, but this is not common.

Excused and Excluded Partners

Investors may have a host of different tax characteristics and certain institutional investors may have other constraints with respect to the investments which they can participate in.

Therefore, it is common for a limited partnership agreement to include provisions allowing an investor to be excused from a capital call with respect to a portfolio investment where participation by the investor in the portfolio investment would result in a breach of law. Conversely, the manager may also have the right to exclude an investor from participation in a portfolio investment where participation by that investor would result in an adverse impact on the fund itself or on other investors.

In both cases, the capital commitment of the affected investor will usually be unaffected and the investor will continue to be liable to advance the full amount of its capital commitment in response to future capital calls. The investor will not, however, be entitled to any of the gains from the portfolio investment in question. Some limited partnership agreements provide that excused or excluded investors will be moved to a parallel fund that will be formed and that, through the parallel fund, they will participate in all portfolio investments (except those that have been the subject of an excuse or exclusion provision).

Capital Recycling

Private equity funds incur expenses, including fees payable to the manager or general partner, in the course of their business. These expenses are paid out of drawdowns on the capital committed to the fund by its investors. As a result, the full amount of the capital commitments will not be invested in portfolio investments, creating a drag on returns.

To account for this drag (or simply to increase the total capital available for investment), it is common for a fund's limited partnership agreement to include a provision for "capital recycling".

A fund will typically make distributions of capital to its investors following the disposition of each of its portfolio investments (see *Allocations and Distributions*). A capital recycling clause provides that, subject to certain limitations, the manager may cause the fund to retain a portion of the distribution proceeds and re-invest the proceeds in new portfolio investments.

Common restrictions on capital recycling clauses include:

- A cap on the total amount that may be re-invested (sometimes, this may be limited to the amount of expenses and management fees incurred by the fund, or it could be expressed as a percentage of the total capital commitments of the fund).
- A time limit on when capital may be recycled (typically, capital recycling may only take place early on in the life of the fund and rarely may it take place after the completion of the investment period).
- A requirement that only the initial capital paid in to the fund by the investors can be recycled, with any profits on that amount being paid to the investors.
- Restriction of capital recycling to capital returned from short term or "bridge" investments.

Default Provisions

An investor who does not advance to the fund the appropriate amount in response to a capital call will generally be deemed to be in default under the limited partnership agreement. Some limited partnership agreements provide that this investor will automatically be in default, while other agreements will provide the manager with discretion as to whether or not to designate the investor as being in default.

The impact of a default on the fund in general can be quite serious. For example, the fund may be unable to complete a portfolio investment if it does not receive capital when called from its investors. Even if the fund is able to complete the investment, it may be delayed as a result of needing to borrow funds under a bridge loan or sending out a new capital call to non-defaulting partners to fund the shortfall in capital. As a result, the penalties applicable to defaulting investors are quite severe. These penalties may include some or all of the following:

- Sale of the defaulting investor's interest to other investors, often with consideration deferred and usually at some form of discount.
- Forfeiture of the entirety of the defaulting investor's interest in the fund, either with or without compensation.
- Payment of interest on amounts in default until the defaulting amount has been paid by the defaulting partner.
- Set off of future distributions against amounts in default.
- Loss of voting rights and side letter rights.

Fees

Management Fees and Priority Distribution

The private equity fund will typically pay a management fee to the general partner or manager to cover its expenses for managing the fund. Management fees are typically paid in advance on a quarterly basis. During the investment period, the quantum of the management fee is typically in the range of 1.5% to 2.0% of the total capital commitments to the fund depending on the type of fund and the total amount of commitments it has received (fee rates tend to be lower for larger funds).

After the conclusion of the investment period, there is typically a "step down" in the amount of the management fee with the fee calculated instead on the basis of net invested capital of the fund (that is, fees are only paid on capital which is currently deployed). The management fee may also be reduced further during any extension of the initial term of the fund (see *Fund Term*).

Funds may sometimes offer fee discounts to early investors or to investors committing greater amounts of capital. Managers have also begun looking at more tax efficient alternatives for payment of management fees, and it is now relatively common for management fees to be structured as a priority payment through the distribution "waterfall" (see *Allocations and Distributions*).

Portfolio Company Fees and Management Offset

Managers often have the opportunity to earn additional fees from portfolio companies (for example, directors' fees, transaction fees and break fees).

It is common for limited partnership agreements to provide that all such fees earned by the manager or its related parties will be offset by a corresponding reduction in the management fee. If all such fees have not been offset by reductions in the management fee then the manager is usually required to repay the excess to the limited partners on liquidation of the fund.

Allocations and Distributions

Waterfall

Typically private equity funds have two sources of income:

- Most importantly, income from the sale or other disposition of its portfolio investments (so-called “exits”).
- Current income received periodically on the basis of its portfolio investments or on the basis of short term investments of available cash which has been drawn down from limited partners but not yet deployed.

The amount of current income will vary widely depending on the investment class of the fund. A buyout fund will often receive dividends and other distributions of income from portfolio investments that generate strong business income. In contrast, the businesses in which a venture capital fund will tend to invest are not usually at a stage where they generate profits and, therefore, distributions of current income for such funds are uncommon.

Distributions are generally made net of fund expenses and liabilities.

The limited partnership agreement may establish deadlines for when a private equity fund must distribute its income. Typically, this will be a set number of days following the date on which the fund receives proceeds from an exit transaction.

Current income is normally distributed on a quarterly basis. The manager may also be required to give advance notice of a distribution and provide certain information to the investors in connection with the distribution (for example, the source of the distribution and whether the distribution is on account of current income or as a result of a disposition).

Different classes of partners in the limited partnership will have different entitlements with respect to distributions. These entitlements are referred to as the “waterfall”. Each time that the fund makes a distribution, the funds available for distribution will be divided in accordance with the waterfall formula, commencing with *First Step: Return of Capital*.

First Step: Return of Capital

The first step in the waterfall will generally be to return to the investors a certain amount of the capital which they have contributed to the fund. However, a fund that uses a general partner priority distribution in lieu of a management fee will instead have the priority distribution as the first step.

The return of capital clause typically comes in one of two types:

- **American model**: where the investors will receive in this step an amount equal to the capital contributions they have made with respect to the particular investment from which the proceeds to be distributed have been derived, sometimes with an adjustment for realized losses and write-offs of other investments.
- **European model**: where the investors are entitled to receive an amount equal to all capital contributions which they have made to the fund before the next step in the waterfall.

Most Canadian funds follow the European model, which is generally viewed as being more favourable to the investors.

Second Step: Preferred Return

The next step in the waterfall is referred to as the “preferred return” or “hurdle”. Under this step, the investors will, if there is sufficient capital available to the fund, receive an annual return on amounts which they have contributed to the fund from the date of contribution until the date on which such amounts have been returned under the previous step. Typically, the rate of return will be in the 7% to 8% range and usually compounded annually.

The preferred return is not a guarantee of any particular returns. The preferred return represents only a priority in payment before the management group receives its “catch-up” under the next step in the waterfall. The preferred return ensures only that the investors will receive a minimum return on their invested capital before the management group participates in profits of the fund.

Third and Fourth Steps: Carried Interest and Catch-Up before Distributing Remainder

The management group receives the bulk of its revenue from what is typically referred to as its “carried interest”. The carried interest is a performance payment calculated as a percentage of distributions by the fund after the investors have received the return of their capital.

The amount of the carried interest can vary, but it is usually in the 20% range. The carried interest is typically paid to the general partner or the manager; however, the carried interest may instead be paid to a separate class of limited partners (referred to variously as “carried interest partners”, “performance partners” or as a designated class of limited partner interests such as “Class B limited partner interests”), who will be either the principals behind the fund or some form of aggregating vehicle created for the purpose.

The carried interest is payable in two sequential steps:

- Once the investors have received their return of capital and preferred return, the carried interest recipient receives a “catch-up” payment (note that in some limited partnership agreements there may also be a concurrent payment to the investors, but generally this payment is made 100% to the carried interest recipient). The catch-up payment is calculated such that, upon completion of the catch-up, the carried interest recipient will have received an amount equal to the carried interest percentage on all payments after the return of capital to the limited partners under the waterfall, including the preferred return and the catch-up.
- After the carried interest recipient has received its full catch-up, the waterfall provides for a simple split of all further distributions by the private equity fund with the carried interest recipient receiving its carried interest on such income and the remainder being paid out to the investors.

(For sample carried interest and waterfall provisions, see *Standard Clause, Limited Partnership Agreement: Investor Units and Carried Interests*.)

Clawback

A private equity fund may make distributions before it has drawn down all of its capital commitments, and there is no guarantee that future exits will be profitable for the fund. Therefore, it is possible that carried interest payments will have been made early on under the waterfall that, if recalculated at a later date, may have been in excess of the carried interest entitlement.

This is most likely to happen where the fund has a highly successful early exit and then suffers from a number of later write-offs. It is also more likely to occur in funds using an “American waterfall”, due to the structure of the distributions in these funds.

To guard against this eventuality, the limited partnership agreement will typically include a provision which requires that the fund recalculate the waterfall on a whole fund basis at a later date and that any excess carried interest payments be paid out to the investors. This is referred to as a “clawback” provision.

Clawback provisions vary widely in terms of how often the recalculation is required to be made. The simplest approach is for the recalculation to be made only at the end of the fund’s term. However, this may result in the carried interest recipient having the benefit of an overpayment for many years. Therefore, it has become common for there to be one or more “interim” calculations of the clawback (sometimes as often as on an annual basis after completion of the investment period or following each distribution by the fund).

Two general methods have been developed to ensure that the carried interest recipient has sufficient funds to enable it to pay the clawback when and if required:

- The carried interest recipient may be required to pay a portion of each distribution of carried interest into an escrow account with various rules as to how much needs to be paid into the escrow and how long the funds need to remain in escrow.
- The principals who are the ultimate recipients of the carried interest provide their personal guarantees of payment.

Funds may use either or both methods.

Investor Giveback

There are also circumstances in which the investors may be required to repay distributions to the fund. Most provincial statutes provide that, where a limited partnership has made distributions to its limited partners, the limited partners are liable to return to the partnership that part of the distribution which represented capital contributed by the limited partner to settle any claims against the limited partnership by third parties if the partnership does not have sufficient assets to fund pay such liabilities.

It is also common for the limited partnership agreement to:

- Provide that the investors are required to return distributions (in this case not limited to the amount of their capital contribution) to fund any indemnity payments which the fund is required to make to the manager or other indemnified parties (this is often referred to as the limited partners’ “giveback” obligation).
- Impose limits on the ability of the manager to recall amounts distributed to investors under the giveback obligation in terms of both:
  - the length of time from the date of the applicable distributions; and
  - an aggregate maximum amount that can be recalled.

Tax Distributions

Because a limited partnership is a flow-through entity for income tax purposes, any income earned by the partnership is attributed directly to its partners. It is possible (and even likely, especially early in the fund's lifespan) for partners to be attributed income for tax purposes without having received a corresponding distribution from the partnership.

To protect against this possibility, the limited partnership agreement may provide for a "tax distribution" to be payable at the discretion of the manager. This distribution is typically payable only to the general partner, manager or other carried interest recipient as that person may have no other source of income with which to pay its tax liability. Any tax distribution is usually considered to be an advance against future payments of carried interest and will also be included in the calculation of clawback.

Expenses

Organizational Expenses

The organizational expenses of the private equity fund and the manager are borne by the fund as a whole. It is typical for the limited partnership agreement to establish a cap for organizational expenses, with any organizational expenses in excess of the cap borne by the manager. The limited partnership agreement may provide for the manager to offset its liability for this excess against future distributions payable by the fund to the manager.

It is common for Canadian funds to reimburse institutional investors for their expenses in connection with investing in the fund.

Operating Expenses

Generally, the operating expenses related to the operations of the private equity fund will be borne by the fund itself. These expenses include:

- Organizational expenses of the fund and the manager (subject to the cap referred to under *Organizational Expenses*).
- Expenses related to identifying and completing portfolio investments.
- Expenses of professional advisors to the fund.
- Borrowing costs.
- Insurance premiums.
- Costs of investor or advisory committee meetings.
- Litigation costs.
- Registration and filing fees related to the fund and general partner.
- Valuation fees.

Manager Expenses

The day-to-day costs and expenses for the general partner or manager to conduct its business are typically for the account of the manager and are not directly borne by the fund or the investors. These expenses include:

- Rent.
- Salaries.
- Utilities.
- Supplies.
- General overhead.

Although the manager may delegate some of its responsibilities to service providers, the expenses of these service providers will typically be the responsibility of the manager.

Fundraising and Fund Closings

Marketing

Fundraising by private equity funds is typically conducted on a private placement (that is, prospectus exempt) basis. Investors in private equity funds typically fit within the following general categories and most private equity funds will be marketed accordingly:

- Institutional investors (such as pension funds).
- So called “fund-of-funds” (private equity funds which invest in a portfolio of other private equity funds such as funds formed under the federal government’s Venture Capital Action Plan).
- High net worth individuals.
- Strategic investors (particularly in industry specific funds).

Investors in the fund will be required to be qualified under an applicable exemption from the prospectus requirements of applicable securities laws (see *Private Placement Regulation* and *Practice Note, Private Placement Offerings in Canada: Overview*).

Marketing activities will generally be restricted to one-on-one presentations.

Fund Closings

Private equity funds will typically seek to raise commitments over a limited time after the beginning of the fund’s investment period. This will generally result in the fund admitting investors as limited partners at multiple closings. The limited partnership agreement will set out a deadline for the final closing date, which is typically 12 to 18 months after the date on which the fund initially admits limited partners. The limited partnership agreement may also include a provision for the extension of this date, usually with investor approval.

Investors who participate in a closing subsequent to the fund’s initial closing will be required to contribute to the fund their proportionate share of all prior capital advances net of distributions. This ensures that:

- All investors are in the same position economically with respect to the fund, regardless of the date of their commitment.

- Investors are encouraged to commit to the private equity fund early.

To compensate those investors for the additional risk they take in committing to the fund early, investors who participate in a closing subsequent to the fund's initial closing are typically required to pay interest on such amount calculated from the date of the fund's initial closing date to the closing date in question. The amounts so contributed, except for amounts in respect of capital calls to pay management fees, will usually be required to be distributed to those investors who participated in prior closings. Any amount distributed to an investor (to the extent that it represents a recovery of contributed capital) will then be subject to recall by the fund.

Each investor that participates in a subsequent closing must:

- Contribute its proportionate share of the cumulative amount of the management fee that would have been paid if it had been an investor on the date of the initial closing (or an investor with the increased capital commitments, in the case of an investor increasing its previous capital commitment).
- Pay interest thereon, calculated from the initial closing date, and any other management fee payment dates, to the closing date in question.

Amounts contributed in respect of the management fee (and any related amount equivalent to interest) are paid to the manager. All other amounts contributed become fund property and may be returned to the limited partners as a whole. Any amounts returned to the limited partners will increase the undrawn capital commitments of the limited partners and would be available for recall by the manager.

Fund Term: Investment and Divestment Periods

Fund Term

Private equity funds are typically "closed ended" funds which have a defined lifespan. The limited partnership agreement will provide that the fund will terminate and the manager will commence liquidation of the fund on a particular date (most commonly 10 years following the initial closing of commitments to the fund). The term may be longer depending on the investment focus of the fund (for example, infrastructure funds tend to have a longer term).

It is common for limited partnership agreements to also allow for extensions of this period, usually by one or two one-year periods, either with or without investor or advisory committee approval. The term of a fund may also expire earlier in certain circumstances as described under *Termination*.

Investment Period

The limited partnership agreement will typically provide for an "investment period" or "commitment period" during which the manager seeks to identify investment opportunities and to consummate portfolio investments. The investment period commences on the date of the initial closing of commitments to the fund and typically ends five years later. The investment period and may end earlier in certain circumstances, including:

- Investment of a specified proportion of the total capital commitments to the fund (typically in the range of 80% to 90% and often including in the calculation amounts committed to an investment or reserved for future expenses and "follow-on" investments).

- Termination due to a key person default (see *Key Person Events*).
- Termination by investor resolution (see *Termination*).
- Formation by the manager, general partner or principals, directly or indirectly, of a private equity fund with primary investment objectives substantially similar to the investment criteria of the fund (commonly referred to as a “successor fund”).

Divestment Period

After conclusion of the investment period, the fund will typically enter into a period where it monitors its investments and seeks opportunities to dispose of them. After the end of the investment period, the investors will not be required to make any further capital advances to the fund except to:

- Pay partnership expenses and the management fee.
- Make investments in respect of which the general partner has previously granted approval and for which the fund entered into a binding written commitment before the completion of the investment period.
- Make follow-on investments in existing portfolio companies (often limited to the first year or two after the investment period has concluded).
- Satisfy indemnity obligations of the fund.

The limited partnership agreement may require the manager to disclose to the investors all investments in process as of the end of the investment period and to disclose any amounts reserved for follow-on investments.

Termination

It is common for limited partnership agreements to include several other investor protection rights including provisions allowing for:

- Early termination of the investment period or partnership term (both with cause and without cause).
- Removal of the general partner or manager (both with cause and without cause).

Removal for Cause

The limited partnership agreement will typically allow investors to terminate the manager or the fund itself upon the occurrence of a cause event. Typically “cause” will include:

- Fraud.
- Wilful and material breach of the limited partnership agreement.
- Breach of fiduciary duty.
- Negligence (sometimes, but not always, limited to gross negligence).
- Material breach of law.

Depending on the circumstances, the manager may have a “cure” right, allowing it to remedy a cause event. Usually on a cause event, the threshold for limited partner approval is a simple majority, although sometimes the threshold is higher. Less commonly, the limited partnership agreement may permit the investors to pass a resolution terminating the investment period, in which case the manager would remain in place but its ability to make further investments is restricted.

No Cause Removal

It can often be very difficult and time-consuming to prove “cause” and investors may wish to remove a manager or terminate the investment period in circumstances where there has not been cause (for example, where the fund has not adequately deployed capital or the fund’s investments are under-performing). As a result, it is common for limited partnership agreements to also provide that the investors may terminate the fund without need to prove cause.

Typically, a resolution terminating the fund or manager without cause requires a higher threshold than a resolution to terminate the fund or manager where there is cause. Generally such resolutions require “special” or “extraordinary” resolutions of the investors, with approval thresholds of two-thirds or higher.

Buy-Out of the Manager

Where the limited partnership agreement permits removal of the manager without termination of the fund as a whole, the manager will be entitled to some form of compensation. Typically, the outgoing manager will remain entitled to receive its carried interest on portfolio investments that were entered into by the fund before removal of the manager. In other cases, the manager may receive a priority payment determined on the basis of the fair market value of the fund’s portfolio as of the date of removal. There will frequently be some form of discount where the manager has been removed for cause.

An outgoing manager will usually not receive any form of compensation in connection with distributions relating to investments made by the fund after the manager has been removed.

Key Person Events

The success or failure of a private equity fund largely depends on the management team in control of the fund. Investors in the fund have a strong interest in ensuring that the management team remains with the fund through its life cycle and particularly during the investment period when the fund will make the bulk of its investment decisions.

To provide assurance to investors, it is common for the limited partnership agreement to contain a “key person” clause intended to ensure that the fund maintains an appropriate level of staffing by key investment professionals. The exact number of key persons and their identity will differ from fund to fund and is often the subject of negotiation with leading investors. Typically, this type of clause will provide that investors’ obligations to fund new investments will automatically be suspended if the specified number of key persons do not meet a specified time commitment (which can be as general as requiring them to be actively involved in the business of the fund).

Investors usually continue to be required to fund expenses of the fund and to meet capital calls to complete investments in process and follow-on investments in existing portfolio companies during the suspension period.

The suspension will last until the key person default has been remedied, which generally requires that replacement key persons will have been approved by the investors or the advisory committee. If the key person default has not been remedied within a set period (usually six to 12 months), it is common for the fund's investment period to then terminate.

Managing Conflicts

Successor Funds

It is important to the investors in a private equity fund that the management team stay focused on the business of the fund, especially during the initial investment period when the team is expected to be sourcing and completing portfolio investments. Therefore, it is common for the limited partnership agreement to include restrictions on the manager and its affiliates from forming a new private equity fund (often referred to as a "successor fund") during the investment period. This also has the effect of reducing the potential for conflict in the allocation of investment opportunities between separate funds managed by the same management group. Successor fund provisions typically refer only to funds with a similar mandate and industry focus but sometimes may be broader.

Provisions in limited partnership agreements on successor funds may vary as to the extent of the restrictions. For example, an agreement may prevent:

- Marketing a successor fund before its formation
- Forming a successor fund.
- Closing on capital commitments to a successor fund.

Investment Allocation

As the management group will often be acting on behalf of more than one private equity fund at a time (typically, a manager might be managing one fund in its investment period and one or more that have completed their investment periods), the allocation of investment opportunities between funds can be of great importance.

It is common for the limited partnership agreement to specify that, during the investment period of the fund, the management group must present to the fund all investment opportunities that fit the fund's investment criteria.

Related Party Transactions

It is typical for the limited partnership agreement to contain restrictions on related party transactions including restrictions on:

- The fund buying or selling an interest in a portfolio company from the management group, an investor or from another fund managed by the same group.
- The fund investing in any entity in which the management group, an investor or another fund managed by the same group has an existing interest.

- Members of the management group investing in an entity in which the fund has invested (although co-investments made at the same time and on the same terms as the fund's investment are often permitted).
- Transactions between the management group and the fund (for example, advisory services).

Any such transaction will generally only be permitted with the approval of the investors or the fund's limited partner advisory committee.

Limited Partner Advisory Committee

Limited partnership agreements typically provide for an advisory committee to oversee conflicts of interest, review valuations and provide approval of other matters specified in the limited partnership agreement.

The advisory committee is generally made up of nominees appointed by certain investors and are not elected by the investors as a group. The limited partnership agreement may specify that investors with a capital commitment in excess of a certain threshold are entitled to a seat on the advisory committee; however, more often, entitlement to appoint a nominee is at the discretion of the manager. The manager will typically provide nomination rights to institutional investors with significant commitments to the fund. Institutional investors without a nominee may ask for observer status.

Advisory committees are structured so that participation by nominees of an investor does not constitute "taking part in the management" of the fund and therefore does not result in loss of the limited liability of the investor under applicable law (see *Limited Partnership*). Advisory committee members do not owe a fiduciary duty to the fund or the other limited partners; however, it is common for board members to have protection under the limitation of liability and indemnity provisions of the limited partnership agreement, and advisory committee members are frequently covered by the fund's directors' and officers' liability insurance.

Certain Regulatory Matters

National Instrument 31-103

National Instrument 31-103 – Registration Requirements, Exemptions and Ongoing Registrant Obligations) (NI 31-103) provides for the registration of persons in connection with trading or advising in securities, investment fund management and other related matters. Determination as to whether or not a person is required to be registered under one or more of these categories is substantially dependent on the specific factual circumstances.

A detailed analysis of these requirements is therefore outside the scope of this Practice Note (for more information on who must be registered under NI 31-103, see *Practice Note, Registration Requirements: Overview*). However, the following sets out some general guidance regarding certain matters in the context of a private equity fund.

Any person who acts as a manager of an "investment fund" is required to be registered as an investment fund manager. An investment fund is defined as a mutual fund, or a fund whose primary purpose is to invest money, but that is not formed for the purposes of exercising control over or managing an issuer. A private equity fund does not typically fall within the definition of "mutual fund" (see *Inapplicability of Mutual Fund Regulation*). *Companion Policy 31-103CP – Registration Requirements, Exemptions and Ongoing Obligations* (CP 31-103)

provides some guidance as to whether a fund will be considered to have been formed for the purposes of exercising control or management over an issuer. CP 31-103 provides that a fund actively involved in management of its portfolio investments will not generally be considered to be an "investment fund". Examples of active management include:

- Representation on the board of directors of portfolio companies.
- Direct involvement in the appointment of managers of portfolio companies.
- A say in material management decisions of portfolio companies.

These factors do not need to apply to all investments by the fund. Although a determination will be fact specific, most private equity funds seek to exert some degree of control or management over their portfolio companies and therefore are not considered to be "investment funds". Accordingly, most private equity managers will not be required to be registered as investment fund managers.

Hedge fund managers, and in some circumstances mezzanine funds, may be required to register as investment fund managers if they are not actively involved in management of portfolio companies.

Any person who is in the business of advising another about the sale or purchase of securities must be registered as an adviser. A partner, director or officer of an adviser who advises on securities must also be personally registered as an adviser. The general partner of a private equity fund that is actively involved in managing its portfolio investments need not normally be registered so long as it only selects investments for the fund, as it is not providing investment advice to a third party.

The manager will not generally be required to be registered as an advisor so long as the power to select portfolio investments is reserved to the general partner (as is typically the case) (see *Management Agreement*) although, again, a final determination is fact specific and may be dependent on additional factors.

Inapplicability of Mutual Fund Regulation

Mutual funds in Canada are subject to a host of regulations under applicable securities laws including ***National Instrument 81-102 - Investment Funds*** (NI 81-102). The term "mutual fund" is defined under provincial securities laws as "an issuer of a security that entitles the holder to receive on demand … an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets". Essentially this refers to a class of vehicles which are known as "open-ended funds".

An investor in a private equity fund (which is a "closed ended fund") does not have a right at any time to redeem its interest or withdraw from the private equity fund in exchange for a portion of the net assets of the fund. Therefore, private equity funds are not subject to regulation as "mutual funds".

Private Placement Regulation

Interests in private equity funds are generally distributed on a "private placement" basis under exemptions from the prospectus requirements of applicable provincial securities laws. As private equity funds typically aim at sophisticated investors, the most commonly used exemption is the "accredited investor" exemption in Section 2.3 of ***National Instrument 45-106 - Prospectus Exemptions*** (NI 45-106) and, in Ontario, section 73.3 of the *Securities Act*, R.S.O. 1990, c. S.5, which applies to:

- High income or high net worth individuals.
- Registrants, governments and other sophisticated investors.

For more information on prospectus exemptions, see *Practice Note, Private Placement Offerings in Canada: Overview*.

It is uncommon for private equity funds to distribute interests under the “offering memorandum” exemption in Section 2.9 of NI 45-106, even where a private placement memorandum is being distributed (see *Private Placement Memorandum*). The “minimum amount” exemption in section 2.10 of NI 45-106 is also not commonly used as it is dependent on the consideration being received at the time of the investment. For private equity funds, the purchase price is typically paid over time as capital calls are made.

US Laws

Private equity funds which aim to have US based investors will need to take into account various US laws including:

- Securities laws related to the sale and marketing of limited partnership interests.
- Investment company legislation that also limits the sale and marketing of limited partner interests.
- Investment advisor legislation.
- Pension legislation including the *Employee Retirement Income Security Act of 1974*, *Pub. L. 93-406, 88 Stat. 829.*
- Tax legislation relating to distributions and withholdings.

Principal Legal Documents

Private Placement Memorandum

It is common for private equity fund managers to prepare a confidential disclosure document which is commonly referred to as a “private placement memorandum” for distribution to prospective investors. The private placement memorandum will typically describe the proposed investment strategy of the fund, discuss the history of the management group and include a description of the terms of the limited partnership agreement.

There is no requirement under Canadian securities laws to provide a private placement memorandum to potential investors as, in general, private equity funds seek to raise funds only from sophisticated (accredited) investors. The private placement memorandum is also not typically prepared to comply with the form requirements of a prospectus or an “offering memorandum” as defined in NI 45-106.

The private placement memorandum is, however, usually considered to be an “offering memorandum” for purposes of certain other securities laws in some provinces and therefore gives rise to statutory liability for misrepresentations and an obligation to file the private placement memorandum with the applicable securities commissions.

Limited Partnership Agreement

The relationship between the investors and the private equity fund is primarily governed by the fund's limited partnership agreement. Where the fund is raising commitments from institutional investors, the limited partnership agreement will typically be the subject of negotiation between those investors and the management group.

In addition to the matters referred to elsewhere in this Practice Note, the limited partnership agreement may contain some or all of the following provisions:

- Requirements for a minimum investment by the key persons or management group.
- Reporting requirements, which usually require the fund to provide annual (audited) and quarterly (unaudited) financial statements to the investors.
- Confidentiality provisions.
- Indemnity and limitation of liability clauses protecting the general partner, the manager, their affiliated parties and members of the fund's limited partnership advisory committee against any liability as a result of acting in their respective capacities on behalf of the fund (subject to "carve-outs" for matters such as fraud, negligence or breach of fiduciary duty).
- Limits on borrowing and guarantees.
- Investment restrictions on use of capital, including:
  - limits on the amount that can be invested in any one portfolio company (typically 10% to 20% of total capital commitments to the fund);
  - geographic requirements;
  - diversification of industries (or restrictions preventing investment in certain industries);
  - restrictions on public company investments and hostile take-over bids;
  - limits on hedging transactions;
  - restrictions on investing in other funds; and
  - ethical investment restrictions (such as a prohibition against investments in firearms or tobacco companies).

Because a private equity fund may need to enter into agreements before admitting investors as limited partners, it is common for funds to be formed in advance of closing on capital commitments.

Since a limited partnership can only be formed if there is at least one limited partner, an affiliate of the management group will sign the limited partnership agreement as the initial limited partner. Typically, this limited partnership agreement would be a simplified document including the minimum information necessary to form a limited partnership under applicable law. When the fund admits investors as limited partners, the simplified agreement is replaced with a final form of limited partnership agreement and the initial limited partner's interest is redeemed for nominal consideration.

Subscription Agreement

Investors in a private equity fund will generally be asked to execute a subscription agreement which will typically include representations designed to give the general partner or manager comfort that the investor is qualified as an "accredited investor" for purposes of NI 45-106. Investors will also be asked to provide representations relating to money laundering and will typically also be required to grant a limited power of attorney in connection with the execution of the limited partnership agreement and other related matters.

The subscription agreement will also contain an indemnity provision for any breach of the representations by the investor.

Side Letters

It is common for private equity funds to have enter into "side letters" with important investors. The "side letter" is a separate letter agreement between the fund and a particular investor that fills in some of the gaps in the limited partnership agreement or provides investor-specific protections. Common side letter provisions include the following:

- Notice rights for certain events.
- Additional excuse or exclusion rights.
- Disclosure rights.
- Acknowledgement by the manager of specific laws applicable to the limited partner (such as freedom of information legislation).
- Restriction on distributions in kind.
- Preferences on "co-investment" opportunities (investments in a portfolio company made by the investor outside of the fund that are made at the same time as the fund's investment and that are managed by the general partner or manager).
- The right to nominate a member of the fund's limited partner advisory committee.
- The right to transfer interests in the fund to an affiliate of the original limited partner.

Because of this phenomenon of side letters with investors coupled with multiple closings, it is also common for the side letters (or the limited partnership agreement itself) to include a so-called "most-favoured nations" (MFN) clause. This clause provides that if the fund enters into another side letter with another investor, it will provide the original investor with information regarding the additional side letter. This information can vary from the fund providing a list of all of the clauses which it has granted to additional investors to simply providing copies of the letters themselves (which may be redacted to remove names or other identifying information).

The original investor will then have the opportunity to take the benefit of any of the clauses granted to other investors. It is also common for:

- The MFN right to be limited so that the investor may not take the benefit of clauses granted to investors who have made greater capital commitments to the fund.
- Certain types of clauses to be exempt from the MFN right (such as rights that are particular to the tax or legal status of the investor).

Management Agreement

If the fund utilizes a separate manager, that manager will enter into a management agreement with the general partner under which the general partner delegates some or all of its authority to the manager. Unless the manager is already registered as an advisor under applicable securities law, the management agreement will generally reserve final authority for making investment decisions to the general partner.

The management agreement typically provides:

- That the manager is entitled to receive all of the management fees and payments of carried interest that would be due under the limited partnership agreement to the general partner.
- Indemnities and limitation of liabilities, protecting the manager on substantially the same terms as the clauses for the benefit of the general partner in the limited partnership agreement.

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