Special Article

PRIVATE EQUITY FUND STRUCTURING

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The private equity industry has experienced a boom both in the international and domestic markets in recent years. This special article examines the structure of a typical private equity fund, pointing out the various legal issues and commercial considerations arising during fund formation in the United Kingdom and in India.

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I. Introduction

In 2006, the value of investments into the Indian private equity market tripled to $7.5 billion as global private equity players increasingly focused their attention on the opportunities offered by India's growing economy. International private equity funds in India today, as with Europe and the United States, are driving large value M&A transactions as well as providing growth capital in sectors ranging from technology and telecommunications to real estate and infrastructure. This article explains the way in which international private equity funds are usually structured and why those structures are usually chosen.

II. What is Private Equity?

Any analysis of the structure of private equity funds has to begin with an understanding of what private equity is, and what it is seeking to achieve.

"Private equity" is sometimes used generically to cover both buyouts, when a fund buys an established business (often having teamed up with existing management, or with a new management team), and venture or growth/ development capital, when they invest relatively small sums into new or early stage businesses. There are some private equity funds who invest in early stage businesses, growth capital and buyout situations, but most now focus on one or the other.

Private equity funds have been very successful at raising money in the past few years across Europe, Asia and the United States. Their funds come from a range of investors, who are usually sophisticated, and most are institutional (rather than retail). For example, of the funds raised in Europe in 2005, 30% came from banks, 26% came from pension funds, and 13% from insurance companies. Only 5% came from private individuals.

III. Terms and Objectives of a Private Equity Fund

The actual structure of a private equity fund clearly has to be consistent with the terms and investment objectives of the fund itself. It is therefore important to establish those early in the process, and to identify any particular areas in which the fund does not conform to a typical private equity model.

A. Lifespan of the Fund

Private equity funds are usually "self-liquidating", which means that they make a single set of investments and (with only limited exceptions) when an investment is sold the proceeds are returned immediately to investors and are not available for re-investment. That means that any given fund will have a limited life, and once the fund has been fully invested and all investments sold the fund will be wound up.

There are some funds that are not self-liquidating (so called "evergreen" funds), where the proceeds are not returned to investors but re-invested in further transactions. Investors in those funds need some way ultimately to realise their investment, which is why many evergreen funds are quoted on a stock market, allowing realisation through sales of shares in the fund on a public market.

In general, a private equity fund will have "commitments" from investors that can be invested at any time during the first five years of the fund (although the precise "investment period" will vary from fund to fund). After that time, the fund continues to hold and to realise its investments and will generally be wound up ten years or so after it was established.

B. Fees and Incentives

Most funds charge management fees of between 1.5% and 2.5% on the amount committed to the fund, usually reducing to a percentage of the amount actually invested by the fund from the end of the "investment period". Fund managers also receive a "carried interest", which is a share of investment profits made by the fund. That usually amounts to 20% of profits, payable only once an initial "hurdle rate" of return has returned to investors. These terms give funds an incentive to realise investments, and to make capital profits from them, rather than to hold them for long periods.

C. Drawdown of Funds

In most funds (other than those that are widely marketed to individual and retail investors) the actual commitments are not "drawn down" from investors until an investment has been identified and is about to be made. That avoids funds having to hold cash for long periods of time, and helps to ensure that investment returns are not depressed by uninvested cash.

D. Style of Investment

Typically, private equity funds are "active" investors. Before the deal is done, the private equity house will have been involved in establishing a business plan for the company. Then, in the period immediately following the acquisition or investment (often referred to as the "first 100 days"), they will usually be heavily involved in its execution. They will assist in strategic planning, and – through their sectoral and financial expertise, and their extensive networks – will help with implementation.

Usually, the investor(s) will appoint one or more people to sit on the board of directors of the portfolio company to help set the strategic direction for the company and to take part in important decisions. On an ongoing basis the investor will expect to be kept informed of the progress of the business, through the provision of management accounts and other information, and will have a right to be consulted on (and usually a right to veto) strategic decisions.

E. Holding Periods

Private equity houses usually seek to hold an investment for between three to seven years before "exiting". Holding periods do vary – occasionally, the exit can be within a year or less of acquisition, and other investments can remain in the portfolio for much longer, but it will be important to the investor that it has considered its exit strategy even before it has invested.

IV. Basic Fund Structure

When structuring a private equity fund, the main objectives are:

A. Limited Liability

Investors into a private equity fund are passive, and will not accept any liability beyond the amount that they are committing to the fund by way of an investment. Therefore, it is essential that the chosen structure delivers limited liability for investors. A general partnership, for example, in which all partners are jointly and severally liable for the debts and obligations of the partnership, would be unacceptable.

B. Ease of Administration

One consideration when structuring a fund will be to ensure that its operation is not unduly complicated. Although clearly not the only factor, a structure which is not unduly burdensome and costly to administer will be preferred over one that is. As the private equity industry has matured, it has become easier to structure funds that are offshore or which require certain procedures to be followed, because advisers and other service providers have become increasingly available and sophisticated.

C. No Double Tax

The fund must be exempt or transparent for tax purposes both as regards capital gains and (usually less importantly) as regards dividends and interest. That is to ensure that the investors are in a similar position to the one they would be in if they had invested in the underlying portfolio company directly. They do not want to suffer tax at the fund level, and then again when they receive proceeds from the fund.

For self liquidating funds, the fund can be tax transparent because the investors will not mind paying tax on the realisation of an investment because that is when they will receive the corresponding cash. However, it will usually be important that an evergreen fund is tax exempt, because the investors will not receive cash when investments are realised and so will not want to be taxed on a tax transparent basis.

D. Tax Efficient Management Fees and Carried Interest

Any "carried interest" structure incorporated within the fund in favour of its management should not be taxable as income, but rather should preserve its character as capital gain.

Investors should not be charged to tax on income and capital gains arising within the fund to the extent that they are used for the payment of management charges.

The management charge structure should be efficient from a Value Added Tax (VAT) point of view given the fact that either the fund or the fund manager or both may be unable to recover VAT.

E. Marketing

The structure should be capable, from a regulatory standpoint, of being marketed to all relevant investors.

V. LIMITED PARTNERSHIPS

The most common international fund structure vehicle is the limited partnership. A number of jurisdictions, including the United States and many in Europe, have a limited partnership structure available, and these tend to share a number of features in common. Within Europe, the English limited partnership is the most commonly used. In the United States, the Delaware limited partnership is the most common.

Usually the limited partnership structure will be capable of achieving all of the above objectives, and typically has the following features:-

- It is an internationally recognised structure suitable for many types of investor (although in some cases the structure may need to be adapted to meet the needs of investors resident in certain jurisdictions).

- In many countries the limited partnership is treated as being tax transparent, which means that there is no double charge to tax. No charge to taxation should arise on the fund itself, as income and capital gains are treated as arising directly to investors: in particular, exempt investors would not therefore be liable to any tax at all directly or indirectly.

- Management charges should be charged, so far as possible, against the income arising from the fund so that investors will not be liable to tax on income without being able to obtain a corresponding deduction against management expenses.

- No VAT should be payable on management charges.

The main limitations of a limited partnership are:

- Because of its transparency, participants are liable to tax on chargeable gains as investments are disposed of by the fund: it is therefore likely that investors would wish the fund to return to them the proceeds of sale of investments (or at least sufficient to satisfy any taxation liability) rather than reinvesting on their behalf. That makes it difficult to use for evergreen or retail funds, for which a tax exempt corporate structure is usually more suitable.

- Because it is, in UK regulatory terms, a "collective investment scheme", the fund manager must be authorised by the UK Financial Services

Authority. That means that the manager will be regulated in the UK, and will have to submit to the authority of the UK regulator.

- As an unregulated collective investment scheme, an English limited partnership is also (like many other structures) subject to marketing restrictions. However, because the target investors tend to be institutions and "qualified" investors, these restrictions are not generally a problem in practice.

- Some limited partnerships are "legal entities" and some are not. In some cases, for example in Guernsey, an LP can elect either to have legal personality or not. There are sometimes advantages in not having legal personality - in particular, it might help some tax authorities to conclude that the partnership should be regarded as tax transparent - but it can also lead to some administrative and legal complexities. For example, it raises the question of whether a "new" partnership is created every time a new partner is admitted, or one leaves. That, in turn, can lead to the question of whether there has been a "transfer" of assets between the individual partners, which might have undesirable legal and tax consequences.

VI. Structuring the Fund

Basic Structure

In most countries, the basic law of limited partnerships is similar. Usually a ited partnership (LP) will have to have at least one "general partner", which unlimited liability for the debts and obligations of the partnership, and at st one "limited partner", which - provided that it does not take part in the nagement of the partnership - will have limited liability. When an LP is used a d vehicle, the fund manager or an associated company will become the general tner of the partnership, and investors will become limited partners.

Contributions by investors to a limited partnership could be by way of ital contributions to the partnership, or as loans to it. In some countries, uding in the UK, participations tend to comprise of, say, £999,990 of loan for ry £10 of partnership capital. The reason for the dominance of loan is that a ited partner's liability for the obligations of the partnership is linked to the ount of its capital contribution (and so the lower this is, the less liability the estors have), and also because it is hard to repay capital from the partnership il the end of its life.

The general partner may, but is not required to, contribute either partnership capital or loan capital.

A carried interest is incorporated by permitting management (or persons nominated by them) to become limited partners in the fund, usually indirectly through a separate carried interest vehicle, which is itself often another limited partnership. The carried interest vehicle contributes, say, 20% of the total partnership capital but does not advance any loan. As fund profits are shared by reference to partnership capital, the carried interest holders therefore receive 20% of the profits of the partnership (assuming that the fund repays capital and achieves a "preferred return", if any - and then makes profits).

The partnership agreement provides for investors' loans to be repaid before any distributions by reference to partnership capital are made. Usually, investors also receive a preferred return equivalent to an interest rate on the outstanding loan before the carried interest holders are entitled to share in profits. Once the preferred return has been paid, there is often a catch up so that the carried interest holders receive all or a large proportion of subsequent profits until an overall profit sharing ratio of 80:20 has been achieved. Thereafter distributions are shared in proportion to partnership capital, i.e. 80:20.

B. Tax Issues

(i) Permanent Establishment

Many countries charge non-residents to tax if they operate through a "permanent establishment" in the local jurisdiction. In a private equity fund, there will often be a large number of investors who are not resident in the country where the fund is based and/or where investments are being made, and (as investors) they do not therefore want to pay tax in that country. For that reason, it is often important to avoid creating a permanent establishment which can restrict the amount of activity that can take place in any one country. For example, it might be important to have advisers rather than managers in some countries, and to ensure that actual investment management decisions are taken elsewhere.

The presence of a limited partnership in the UK does not, of itself, create a permanent establishment in the UK for investors, which is one reason that the UK is an attractive location for European private equity funds.

(ii) Local tax on Capital Profits

A number of countries charge non-residents to tax on capital profits, and this is clearly something that investors will want to avoid wherever possible. This can give rise to a need for additional complexity in the structuring, perhaps by using local structures through which to invest.

(iii) Withholding Taxes on Interest and Dividends

Some countries charge withholding taxes on dividends and/or interest when a domestic person is paying a foreign recipient. That can be a real cost to the investors, who may therefore only receive the net amount and who may not be able to reclaim the tax. For this reason, it is often preferable for the fund to invest through an intermediate holding company based in a location like Mauritius, Cyprus, Luxembourg or Sweden, which has a tax treaty with the target jurisdiction which allows dividends and interest to be paid gross to the intermediate company. That company can then repatriate the proceeds to the partnership and, in turn, the ultimate investors.

(iv) Transparency of Partnerships Recognised

Not every country recognises limited partnerships as tax transparent entities. This can be an issue, and can sometimes mean that it is useful to use a local structure which is recognised as transparent for investors from that jurisdiction. A good example of that is France, which does not recognise the transparency of English limited partnerships. It is therefore often the case that French investors will prefer to use an FCPR, which is a French structure that is treated as tax transparent in France.

VII. Management Structure

The fund manager's group may wish to be involved in the partnership in up to four distinct capacities:

- As general partner (with responsibility for operating the fund)
- As manager (to act instead of the general partner)
- As a founder partner participating in the carried interest
- As an investor

These functions can all be carried out by a single general partner entity. However, it is frequently desirable for these roles (particularly those of the general partner and the manager) to be carried out by separate entities because of taxation, regulatory or organisational requirements and in order to ring-fence potential liabilities.

In the UK, the general partner or, more commonly, the manager will need to be an authorised person under the UK Financial Services and Markets Act 2000 ("FSMA"), and its scope of permission must cover all regulated activities to be carried on in relation to the partnership. These activities will generally include establishing, operating and winding up the partnership, managing the partnership's investments and acting as, or appointing, the custodian of the partnership's assets.

In a fairly typical (basic) structure for a European private equity fund, the main fund vehicle can be established as an English limited partnership. That partnership might be resident in England, or it might be "migrated" to another jurisdiction such as Jersey or Guernsey (mainly for tax reasons) so that it is not resident in England despite being an English LP. The fund management group participate through a separate partnership (often a Scottish partnership, because that is a legal entity (unlike an English LP) and it is not possible to have one non-legal entity as a member of another - they would just become one). It is through this partnership that they will extract their carried interest and sometimes that partnership will also act as the general partner. In any event, the general partner will often appoint a separate manager to operate the fund.

A. Management Charge

Pursuant to the partnership agreement, the general partner will (if authorised under FSMA) be responsible for the management of the partnership or (if not authorised) procuring its management by the manager. The general partner will receive a partnership share (being a first charge on the income and gains of the partnership) equal to, say, 2.5% of the value of the partnership in any year. As this "charge" will be a partnership share, no VAT should be payable on it. Assuming there is a separate manager, the general partner will agree to pay the manager a fee for its management services. The general partner and the manager will be registered as members of a VAT group, so that no VAT is payable on this management fee.

VIII. Indian Structural Issues

A significant proportion of the foreign private equity investment in India is routed through Mauritius. There is no tax levied on capital gains made by an investment company located in Mauritius and other countries such as Cyprus and Singapore with similar double tax avoidance agreements with India. Mauritius remains the preferred route for investments owing to the fact that it has over time become a well established route and has been tested by the Indian tax authorities although there have been indications recently that the Indo-Mauritius tax treaty may be renegotiated to restrict the usage of shell/conduit companies for claiming treaty benefits.

Another jurisdiction that has gained prominence in recent years as an alternative to Mauritius is Cyprus. One reason for this is the fact that the treaty with Cyprus offers lower withholding tax on interest payments.

In a typical overseas fund arrangement, there is an offshore fund manager that manages the assets of the fund and an investment advisor in India that identifies investment opportunities. The offshore manager would typically register as a Foreign Institutional Investor (FII) with the Securities Exchange Board of India (SEBI) and the fund vehicle, for example the Mauritius company, would be registered as a sub-account of the FII.

A foreign private equity firm can also choose to register with SEBI as a Foreign Venture Capital Investor (FVCI). An FVCI is permitted to invest only in Venture Capital Undertakings (VCU) which are essentially unlisted domestic companies that are not engaged in certain restricted sectors such as real estate business and non-banking financial services. As an FVCI, a foreign private equity firm can invest directly in unquoted companies in India or through a domestic venture capital fund, typically structured as a trust, alongside domestic investors. Registration as an FVCI is not mandatory but it does offer certain advantages such as the freedom to remit monies into India for making investments in a VCU and the relaxation of entry and exit pricing restrictions.