# Private equity fund structures – the limited partnership

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## 1. Introduction

The ever-maturing private equity industry proved to have a more turbulent fundraising period in the latter part of 2008 and much of 2009 following the slowdown of the global economy. It remains to be seen what role private equity will play in the general global recovery. Nevertheless, with the market having shown exceptional support from investors based both in the United Kingdom and overseas in previous years, the industry is more than likely to continue growing in the long term. Private equity funds continue to be a significant source of funding for businesses in the United Kingdom and other European countries, and private equity is maintaining its role as an extremely important alternative asset class.

In the early days of private equity, many private equity organisations were initially wholly owned subsidiaries of large financial institutions, known as 'captives'. Over time, many of these organisations have spun out from their parent institutions and have become independent, raising their funds for investment from external sources – mainly institutional investors such as pension funds and insurance companies. One of the primary motivators for the spin-outs relates to the fact that the private equity teams become entitled to the entire upside of their fund's performance rather than a certain percentage. Additionally, in the event of downturns in the market, many investment banks, for example, chose to focus on their key areas and their private equity divisions were dispensed with. In certain circumstances, former captives now also raise funds from external sources and are known as 'semi-captives'. In the United Kingdom, a sophisticated market has emerged with a range of management teams able to raise an array of funds, including:

- generalist funds investing in both buy-out and venture capital transactions;
- specialist funds that invest in technology, healthcare or telecommunications, for example;
- buy-out funds;
- debt funds, which may prove to be more popular in the current market;
- secondary funds that acquire limited partnership interests in other funds, generally once the underlying fund has been operating for some time; and
- funds of funds that invest themselves in other private equity funds.

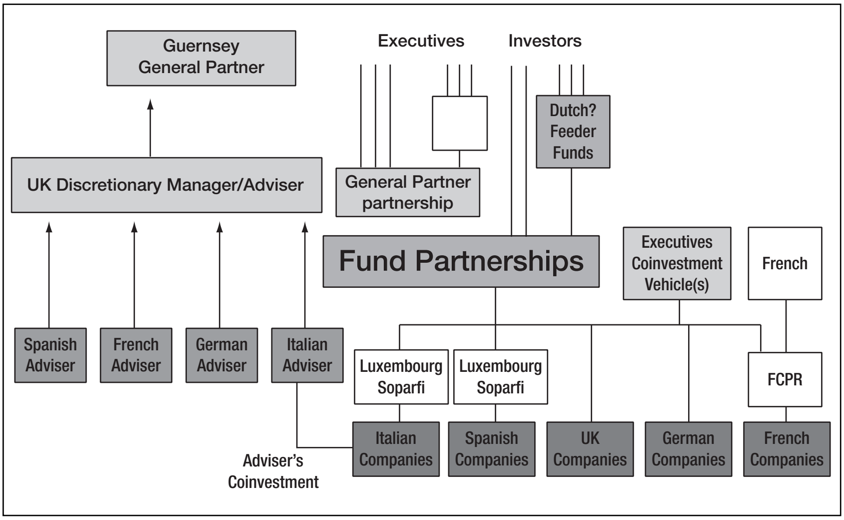
One would expect that in such a rapidly developing market, structures and their relevant key terms and conditions would also emerge and develop as quickly.

However, since May 1987, when Her Majesty's Revenue & Customs and the Department for Business, Innovation and Skills approved the guidelines which SJ Berwin LLP drafted on behalf of the British Venture Capital Association, the English limited partnership has become established as the largely standard structure in the United Kingdom and the favoured vehicle for institutional investors (although Guernsey, Jersey, Scottish and Delaware limited partnerships are also used in certain circumstances). Before May 1987, a number of different structures were historically used by the British private equity industry for raising funds, including investment trusts, offshore companies, unit trusts and direct investment plans (simply comprising parallel management agreements). Although in certain circumstances these structures are still used, they have now been largely superseded in the institutional private equity environment. However, some of these structures are discussed in summary later in this chapter. Venture capital trusts, which are specifically for investment by individuals, are also discussed.

The limited partnership has also proved attractive to pan-European fund management groups investing elsewhere in Europe, although often structures local to specific European countries may have to be used alongside a limited partnership for local reasons (e.g., some foreign tax authorities, such as the French authorities, do not recognise a limited partnership as being tax transparent).

This chapter seeks to explain the limited partnership structure for international investors in UK investment funds and some of the additional issues encountered when applying the structure to funds investing in other European countries. Further, discussion is given to the current status of the terms and conditions of private equity funds and the primary negotiations between investors and their management teams.

An example of a typical European private equity limited partnership structure is shown below. The various overseas entities in this example are required for either tax or regulatory reasons, depending upon the jurisdiction in which investors and/or carried interest holders are present.



### 1.1 Limited partnership funds – background

The limited partnership structure has been adopted by the majority of private equity institutions in the United Kingdom, whose investors include not only the traditional UK pension funds, insurance companies and local authorities, but also US pension fund investors and large overseas and multinational corporates. Marketing limited partnerships to individuals in the United Kingdom, however, is highly regulated by the Financial Services Authority (FSA) and is very difficult to do in practice. Therefore, investment in private equity by private individuals, with the exception of investments made by sophisticated or high net worth individuals, is mainly through publicly listed vehicles such as investment trusts and venture capital trusts.

Private equity funds have a typical lifespan of approximately 10 years, within which time the aim of the fund's management team is to maximise the return to investors by investing in and then realising successfully a portfolio of primarily privately held companies. Realisations or 'exits' may take the form of flotations, trade sales or sales to other funds. Commonly, investments are made in the first three to six years following closing, after which no further new investments may be made. Following the end of this investment period, drawdowns will be made from investors only to fund management charges, expenses or 'follow on' investments in existing portfolio companies.

In limited partnership funds, the partnership agreement is the primary document governing the relationship between the general partner (which manages the fund and has unlimited liability) and the limited partner investors (which specifically do not manage the fund and have limited liability). The track record of the management team is fundamental to an investor's decision to commit to a particular fund. As the investors in these funds are mostly financial institutions, the partnership agreement is negotiated by lawyers representing both sides. Once investors have agreed internally to make an investment, they typically seek to negotiate restrictions on the types of investment that may be made by the fund and the other activities of the fund management team (as well as management fees, carried interest and other economic and commercial terms).

## 2. Objectives

Traditionally there have been a number of key objectives in structuring private equity funds:

- In order to prevent double taxation, the fund must be exempt or transparent for the purposes of capital gains tax and income tax, so that tax is not suffered on the sale by the fund of its interests in portfolio companies and again on the distribution of those gains to investors.
- It is desirable for the expenses of management to be charged against income and gains arising within the fund, to prevent investors being liable to tax on income and gains without the benefit of a corresponding deduction.
- Management charges should be structured to eliminate or minimise value added tax.
- Withholding taxes on income, dividends and interest from portfolio companies should be minimised and no tax should be chargeable on capital

gains in the country of residence of the portfolio company.
- The fund should confer limited liability on investors.
- The fund should be capable of incorporating a suitable capital incentive for the management team, the 'carried interest', structured so as to minimise or defer income tax and capital gains tax.
- The fund should be suitable for all types of investor.
- The fund should be capable of being marketed to suitable investors under relevant securities legislation.
- The fund structure should be straightforward to operate.

## 3. Features of the structure

### 3.1 English limited partnership funds

Under English law, a limited partnership is a partnership comprising both general and limited partners and is established under the Limited Partnerships Act 1907. One or more persons are known as the 'general partners', which have responsibility for managing the business of the partnership and which are liable for all debts and obligations of the partnership. The general partner is usually itself structured as a limited liability entity.

Additionally, there are one or more persons called 'limited partners' – the investors – which contribute capital to the partnership at the time of becoming a partner and whose liability for such debts and obligations is limited to the amount contributed, provided they do not participate in the management of the business of the limited partnership. Once a capital contribution has been made, the limited partner must not draw out or receive back any part of this contribution. If it does, the limited partner is liable for debts and obligations of the partnership up to the amount drawn out or received back. In practice, a limited partner contributes a commitment to a limited partnership by way of a very small amount of partnership capital (often 0.001%), together with a large percentage of non-interest bearing loan (99.999%). This is to ensure that any loan returned to investors (e.g., upon realisation of an investment) does not fall within the remit of 'capital' and does not breach the prohibition on return of capital. This structuring should provide investors with confidence that such amounts returned cannot generally be drawn down again (subject to the terms of the limited partnership agreement). Once a limited partner has made a commitment to a fund, subject to the terms of the limited partnership agreement, it will generally not be entitled to withdraw from a fund or transfer its partnership interest.

Limited partners have no power to bind the partnership. In the event that limited partners take part in the management of the business of the limited partnership, they effectively become a general partner and will be liable for all debts and obligations incurred while acting as a general partner. The loss of limited liability should be restricted to the period in which such contravention occurred and the partner does not become constituted as a general partner.

In order to be an English limited partnership, a partnership must be registered with the registrar of limited partnerships in England and Wales under the Limited

Partnership Act 1907. On establishment, the general partner must have a principal place of business in England – that is, it must carry out some business in England or Wales; but it is not necessary for this to be maintained throughout the life of the limited partnership and, therefore, 'migration' by an English limited partnership to an offshore jurisdiction is possible.

The interests in a limited partnership may be quoted on stock exchanges in overseas jurisdictions. However, this is rarely seen because it is not a straightforward process and may not be commercially appropriate for a fund but it may be something undertaken more frequently in the future.

### 3.2 Management

In practice, the fund will generally be managed by a separate vehicle to the general partner, the fund manager, which will usually be owned by the management team. The fund manager provides the limited partnership with an investment management strategy and makes investment decisions on behalf of the limited partnership, and is regulated by the Financial Services Authority. By utilising this separate management structure, a private equity house will establish separate general partners for each successive private equity fund managed by that private equity house so that it needs only one vehicle, the fund manager, authorised by the Financial Services Authority; rather than authorising each general partner company per fund.

A management agreement will be entered into between the fund, acting by its general partner and the manager; this sets out the terms of the management vehicle's appointment. Separate to the carried interest structure, the fund's management company will usually be paid a management fee by the general partner on a quarterly or semi-annual basis. This fee is required to cover the managers' salaries and ongoing fund operating costs. The management charge is usually an amount between 1% and 2.5% per annum of the total commitments to the fund during the period which investments are made. These percentages have remained consistent for many years and continue to be so, with fees for larger funds generally lower than those for smaller funds. Following expiration of the investment period, this fee will often be reduced to a percentage of the commitments actually invested – additionally, in some cases the actual percentage rate itself is reduced. The amount of the management charge depends on the size of the fund, the strength and ability of the management team and the types of investment which the fund makes.

Pursuant to the terms of the limited partnership agreement, the general partner is entitled to a priority share of the profits of the partnership, which is usually utilised to pay the management fee. As there will be no profits initially, the general partner is entitled to draw down the required amount from the investors and take a loan from the partnership's cash funds, with such amount being 'repaid' by the general partner upon receipt of future proceeds of realisations.

Additionally, transaction fees paid to the manager by third parties, such as corporate finance fees, monitoring fees or underwriting fees, are often offset against the management charge either in whole or in part, depending on what is agreed in the limited partnership agreement for the fund.