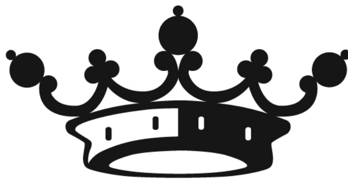
INSIDE THE MINDS

Raising Capital for Private Equity Funds



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Five Key Steps to Raising Capital for Private Equity Funds

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Pre-Fundraising Planning

It should come as no surprise that, as with any worthwhile endeavor, planning and strategy are critical to successfully raising a private equity fund.[1] An individual or group of individuals seeking to raise a fund should set aside significant time for detailed planning of the fundraising process. As an initial matter, it is important to have seed capital for expenses, such as legal and travel expenses, incurred early in the fundraising process. These organizational expenses are normally reimbursed by the fund once it is raised. However, expenses can be significant, and the fundraising process lengthy. Therefore, the principals should have sufficient cash on hand or readily available to carry them through to at least the initial closing of the fund, which could be a year or eighteen months after the initial fundraising steps. Some principals of first-time funds are backed with seed money from individuals or organizations that have a personal relationship with the principals. Seed backers of the principals could also include strategic investors in the fund. This seed money is given in exchange for a portion of the carried interest and/or the management fees to be received by the principals from the newly formed fund.

The principals must make several fundamental decisions at the outset, usually at an organizational meeting or series of meetings called for that purpose, and to outline the fundraising process. It is beneficial early in the process to retain legal counsel with fund formation expertise, knowledge of prevailing market trends, and insight as to the needs and desires of the principals' target investors. This holds true for future funds insofar as dynamics change from fundraising cycle to fundraising cycle, and experienced fund counsel will be cognizant of the changes that come out of each cycle. In certain cycles, limited partners will have more bargaining leverage and will ask for additional terms that benefit the limited partners, or address certain perceived "problems," from the limited partner's perspective, with the terms that came out of the last cycle of fundraising. In other cycles, general partners will have more bargaining leverage,

[1] The terms "private equity fund" and "fund" in this chapter are used generally in their broadest sense to describe various types of pooled investment vehicles, including venture capital funds, buyout funds, leveraged buyout funds, debt funds, real estate funds, and other similar investment vehicles, other than hedge funds and real estate investment trusts.

particularly if their returns from prior funds have been notably better than their peers' returns, and may have an opportunity to improve some of the terms of their new fund from the terms that were agreed to in the prior cycle. Experienced fund formation counsel will know which limited partners will try to raise which categories of issues so that the principals will be forewarned and prepared to address each request, or will know which terms general partners can attempt to improve upon, depending on the cycle in which the new fund is being raised.

A fund is a legal entity, most often a limited partnership, in which a limited number of sophisticated investors commit to invest designated amounts to be pooled and invested in portfolio investments[2] over a specified period of time. The fund is typically managed by the principals through a separate entity, known as the general partner of the fund. The investors in the fund largely cede control of their committed capital to the general partner, which will make the investment decisions on behalf of the fund. Each time a fund is raised, a new general partner is created as well. This is principally to limit liability exposure from one fund to the next, and it addresses the fact that the principals of the next fund may not overlap exactly with the principals of the prior fund.

The principals also typically form a management company to provide management and administrative services to the fund. A standalone management company provides for the continuity of the fund's name; buy/sell agreements between the principals to address situations where a principal leaves, dies, or becomes disabled; succession planning; health and welfare benefit plans for the principals and other employees of the fund; and other standard features from one fund to the next. A successful group looks forward to raising its next fund as soon as it closes its prior fund.

In contrast to a hedge fund, where an investor may redeem its interest in the hedge fund at any time or at certain periods (e.g., quarterly), investors' interests and capital commitments in private equity funds are not refundable or redeemable, except under very limited and extraordinary circumstances that are set forth in the limited partnership agreement of the

[2] Venture funds and buyout funds will typically make equity investments in portfolio companies, but other types of funds may invest in other types of investments, such as debt, or in other types of assets, such as real estate.

fund or in a side letter between the investor and the fund. Investors in a private equity fund must be prepared to commit their capital for ten to twelve years or longer.

If the fund is successful, investors will receive their original investment as well as gains on that investment via distributions by the fund. The timing of those distributions varies, but most often distributions are made in cash after a portfolio company that the fund has invested in is sold, or the fund sells its position in the portfolio company. In certain cases, the fund may make a distribution in-kind to its investors, usually in the form of stock in a publicly traded portfolio company.

Given the long-term commitment investors make to a private equity fund, convincing investors to commit capital to the fund is extremely difficult. Commitments are made only after long and careful consideration, due diligence, and negotiation of the investment terms by the investors and their advisers. The principals must be well prepared for close scrutiny and ready to justify the basic premises and assumptions underlying their fund.

Principals' prior transactions and returns, or track record, are of primary importance to attract commitments to invest in a fund. If a group trying to raise a fund does not have an adequate record to raise a pooled private equity fund, the group may consider forming a pledge fund or other non-committed investment vehicle as an initial step to create a track record. A pledge fund is a fund with conditional, rather than committed, investors. Each investor decides whether it wants to participate in each investment transaction proposed by the principals of the pledge fund, rather than ceding control of their capital and investment decisions to the general partner. The pledge fund structure is more work for the principals, as they have to convince each investor to participate in each deal, rather than making the investment decisions on behalf of all investors automatically. However, a pledge fund may be the only way a group of principals with no prior track record can build a track record that is successful enough to attract investors for a fully committed pooled private equity fund.

In addition to establishing the basic trust that will attract commitments from investors, typically by reference to the principals' prior record, principals should be prepared to identify the distinguishing characteristics

of their fund for potential investors. Investors often have internally mandated allocation guidelines that designate the minimum and/or maximum percentage of their invested capital that can be allocated to a particular investment profile, including private equity, venture capital, real estate, and non-U.S. Some of the critical components that distinguish a fund for potential investors include: targeted industries, types of companies targeted (early-stage, growth, later-stage, or public), targeted geographic area, fund size (aggregate amount of capital commitments), the principal's investment and industry experience, and track record.

The economic arrangements between the principals and the investors in the fund are also important. The principals, generally through a management company they control, typically earn an annual management fee of 1.5 to 2.5 percent of total committed capital of the fund. This annual management fee adjusts down after a certain period of time, such as when the active investment phase of the fund winds down and/or when the principals raise another investment fund. The management fee is intended to cover day-to-day operating expenses of the fund, such as finding and vetting potential investments, office leases, employee salaries, computer equipment, and other normal overhead expenses. The management fee is generally on the higher side of the range for smaller funds and first-time funds. Smaller funds need a higher percentage management fee in order to obtain enough annual fees to cover their costs. First-time funds also generally require a higher percentage management fee, as most such funds have high start-up costs and do not receive fees from prior funds to offset those costs.

In addition, the principals (through the general partner) typically receive a greater percentage of the fund's profits than would otherwise be warranted by their invested capital. For instance, principals of private equity funds typically commit 1 to 5 percent of the capital to a fund, and receive the returns associated with that capital plus approximately 20 percent of the fund's overall profits. This profit's interest is commonly referred to as a "carried interest" or "carry." The carry is intended to serve as compensation for the principals, and is intended to incentivize the principals to maximize the fund's returns.

Some funds may provide additional financial incentives for investors by offering a preferred return to investors prior to any payments of carry to

the principals. Preferred returns, when offered, are more common in buyout funds than venture funds. This is because buyout funds expect quicker exits from portfolio companies than venture funds, and therefore expect to pay any preferred return to investors more quickly.

When deciding to form a private equity fund, principals should be careful not to become too aggressive with the economic terms of their proposed fund, and risk losing investors because the economic and other terms of the fund are not within the range of what is market for the type of fund they are proposing. Anyone who is considering forming a private equity fund should consult with knowledgeable fund counsel to understand the market dynamics for the type of fund they are proposing to raise, and how non-market terms could affect fundraising for the fund.

After the principals make important threshold decisions in the early part of the planning, they, with the assistance of knowledgeable fund counsel, prepare a private placement memorandum. The private placement memorandum should set forth the investment philosophy of the fund, the relevant track record and biographical information of the principals, and a summary of the economic and other key terms of the fund such as the length of the investment period, the overall term of the fund, and so on. Principals often also assemble a "flip book" or slide presentation at this time, which they will use along with the private placement memorandum to make presentations to potential investors. Principals who cite experience or track record information from their time at a prior fund or employer in the private placement memorandum or other marketing materials may need to obtain the consent of the prior fund or employer to disclose such information. Consents may also be necessary to use logos or other marks in the private placement memorandum that are owned by prior companies in which the principals have invested.

Interested investors will often ask the principals to fill out detailed due diligence questionnaires about the fund and the principals. It is prudent to prepare for these submissions in advance by organizing typically requested materials (such as full, up-to-date résumés for each principal; spreadsheets outlining the proposed economic arrangements between the principals, on the one hand, and the investors, on the other hand; detailed financial performance information for each fund managed by the principals; detailed

investment strategy information, including breakdowns of prior investments by stage, industry, geography, etc.; information about litigation or investigations involving the principals or a prior fund; and summaries of all the material terms of the operative documents of the fund), drafting responses to common due diligence questions related to the foregoing materials, and collecting backup materials such as excerpts from third-party publications or articles to substantiate statements made by the principals in the private placement memorandum about their background, track record, and so on.

As the principals compile a list of potential investors to solicit for investment, attention should be given to the targeted investors' own investment strategies and restrictions, and whether the fund's investment criteria fits those strategies and restrictions. Principals will save time during the fundraising process by focusing on the types of investors who are most appropriate for the type of fund the principals intend to raise. Potential investors include public and private pension funds, corporations, high net worth individuals and family offices, endowments, foundations, and insurance companies.

Different categories of investors have distinct advantages and disadvantages as investors in different types of private equity funds. For example, public pension funds have significant capital at their disposal, but generally require more rights and impose more oversight of principals' day-to-day activities on behalf of the fund than other types of investors. In addition, because they are so large, public pension funds can generally only invest in larger-size funds and still meet internal diversification guidelines (e.g., the public pension fund must invest at least $25 million in each fund, but cannot represent more than 10 percent of the fund's investor base). Principals intending to raise a $100 million fund would waste their time pursuing such a public pension fund as an investor. In addition, investors that are public entities have their own oversight and internal regulations (including Freedom of Information Act requests) that often affect the funds in which they invest. Principals should consult with knowledgeable fund counsel to learn about the different characteristics, advantages, and disadvantages of different types of investors before compiling a list of investors to pursue during the fundraising process.

A fund's ideal investor base should be diverse so that issues affecting a particular class of investors do not unduly affect the fund itself, either

during the fund's operations or when the principals are raising their next fund. For example, a fund intending to make investments in the insurance industry that obtains investments only from insurance companies could suffer ill effects during fundraising if there is a downturn in the insurance industry. A fund intending to make investments in the insurance industry, but that obtains investments not only from insurance companies but also from public pension funds, endowments, and high net worth individuals, would be somewhat more insulated from the ill effects of such a downturn.

Fundraising for a private equity fund is a long and consuming process. Therefore, many principals consider using brokers, placement agents, or other intermediaries to assist in the fundraising process by making introductions to potential investors, helping to answer questions from potential investors, and so on. There are many individuals and companies that claim to have expertise in fundraising for private equity funds. Reputable individuals and groups will have good references from the specific types of funds and the specific types of investors targeted by the principals for their proposed fund. Reputable individuals and groups will also have all required state and federal registrations and licenses for the fundraising services they provide. Intermediaries expect to be compensated for their efforts, generally through a fee equal to 2 percent of the amounts they raise for the fund. Knowledgeable fund counsel can help principals decide whether a placement agent is appropriate for their particular contemplated fund and, if so, conduct appropriate due diligence and reference checks prior to an engagement. Certain investors prohibit the use of any intermediaries when soliciting an investment commitment from the investor, and knowledgeable fund counsel will know which investors have such prohibitions.

It is important to note that offerings of securities, such as interests in private equity funds, implicate many state and federal securities laws. Complying with these laws requires detailed consultations with knowledgeable fund counsel. Generally, for an issuance of securities (including an interest in the fund) to be exempt from public registration requirements, the offering and sale of the interests must be private (i.e., investors must not be obtained through any form of general advertisement or solicitation), and the investors purchasing the interest in the fund must satisfy certain requirements (i.e., investors must be accredited investors or

qualified purchasers or qualified clients based on the criteria specified by applicable regulatory agencies).

Tax planning is also crucial when deciding to form a private equity fund. Appropriate tax planning and structuring must be implemented for the principals (including from a trusts and estates perspective) and for the different categories of investors. For instance, non-U.S. investors may condition their investment on the fund adopting a legal structure that satisfies tax and/or regulatory issues applicable to such investors. This may require, for example, formation of an offshore vehicle that avoids detrimental tax treatment for foreign investors (e.g., a Cayman Islands fund) alongside a parallel U.S. fund for U.S. investors. Or, investors subject to certain investment restrictions (such as investors subject to Sharia law or other statutory, regulatory, or religious investment restrictions) may condition their investment on the fund adopting a legal structure that satisfies the investment restrictions applicable to such investors. For example, Sharia law prohibits direct or indirect investments in companies involved with money lending, pork production, or gambling, among other things. Certain state pension funds have statutory or other regulatory restrictions on their direct or indirect investments in companies that manufacture guns or tobacco products, or do business in Northern Ireland, Somalia, South Africa, or certain other jurisdictions. If an investor bound by these or other restrictions intends to invest in the proposed fund, these restrictions will need to be addressed in the fund's governing documents or in a side letter between the particular investor and the fund.

In addition, the fund or the principals may require certain investors to invest in the fund through a special purpose or feeder vehicle to address certain securities, tax or other laws or regulations, or other administrative issues. For example, all of a U.S. fund's non-U.S. investors may make their investment in a non-U.S. entity that is a direct investor in the U.S. fund, rather than into the U.S. fund itself. The use of such a non-U.S. entity as a feeder to the U.S. fund in this manner can act as a "blocker" to protect the non-U.S. investors from having to file U.S. federal income tax returns (and possibly U.S. state income tax returns) in the event that the U.S. fund generates certain types of income, such as income "effectively connected with a U.S. trade or business" (as defined in the U.S. income tax rules) that would be subject to tax in the United States even if the recipient of that

income is a non-U.S. investor in the fund. If the feeder or "blocker" entity is used, the U.S. tax return filings would still be required, but such filings would be done by the feeder entity and not by the non-U.S. investors in the feeder entity.

The principals also must attend to their internal economic and control arrangements before starting active fundraising. Potential investors will not tolerate squabbling among the principals in the middle of fundraising about what salaries are being paid to which principals, and how decisions regarding the fund will be made by the principals. Typically, the operating agreement for the general partner entity (through which the principals receive their carry) and the operating agreement for the management company (through which the principals receive their management fee) set forth the various roles and economics for each principal.

Fundraising

Once the initial steps outlined above have been completed, fundraising for the private equity firm can begin in earnest. The fundraising process begins with a list of targeted investors, a timeline for the initial closing on committed capital, a schedule of meetings with targeted investors, and the identification of goals for each meeting or series of meetings with potential investors. It is typical that at least four to six meetings will be required with each potential investor, and that is before the investor and its counsel and advisers begin reviewing the proposed limited partnership agreement and other governing documents of the fund.

Prospective investors who remain interested in the fund after receiving the flipbook and private placement memorandum and conducting due diligence on the principals will request copies of the fund's governing documents. These include a proposed limited partnership agreement (assuming the fund will be formed as a limited partnership, which is the most common form of fund vehicle) for the fund, a subscription agreement for investors, and a management agreement outlining the services the management company will provide for the fund and the management fees the management company will receive in return. Principals should expect many investors, and most institutional investors, and their advisers and counselors, to have questions about and comments on the proposed limited partnership

agreement. In addition, most potential investors will request changes or additions to the proposed limited partnership agreement before they will commit to invest in the fund. Certain investors may also request a side letter (i.e., a separate agreement between the investor and the fund) to address non-economic regulatory or legal issues particular to that investor. Future funds with repeat investors face fewer such requests and can justifiably cite the prior fund's terms as precedent, subject to appropriate updating, if the fund was successful.

As the fundraising process unfolds and prospective investors commit to invest, the principals will negotiate with investors regarding the language in the limited partnership agreement, the subscription agreement, and over the need for and language included in any side letters. Negotiating with multiple investors simultaneously is time-consuming and requires close attention to each investor's requests. It is quite common for certain investors' comments to conflict with comments from other investors, and/or with the principals' preferred terms.

As the negotiation process evolves, often the economic or other terms of the fund will be changed in a manner that differs from the terms initially outlined in the fund's private placement memorandum. In that case, a supplement to the private placement memorandum may be appropriate in order to keep all investors informed of the latest terms being offered by the principals. Similarly, if material new information comes to light, for good (e.g., a prior fund disposed of a portfolio company for a high return) or bad (e.g., a principal decides to leave the fund), the private placement memorandum may need to be supplemented or amended and restated. Any such supplement or amendment should be distributed to all recipients of the initial private placement memorandum, and it is good practice to obtain an acknowledgement from any investor that had already subscribed for an interest in the fund based on the initial version of the private placement memorandum that any changed terms are acceptable.

With respect to side letter negotiations, some investors will request a "most favored nation" provision in their side letter that will require the fund to offer such investor the benefit of any term offered to any other investor in a side letter. For example, if the fund offers one investor a right to co-invest in portfolio companies alongside the fund, then another investor who has

asked for and received a most favored nation provision in its side letter would be entitled to the same right. Other typical side letter provisions include the right of fund-of-funds investors or public pension fund investors to disclose specified fund information that would otherwise be confidential to the fund-of-funds investors or in response to a Freedom of Information Act request; codes of conduct to avoid conflicts of interest and kickback schemes associated with public pension fund investors; policies regarding gifts or other payments to investors; investment restrictions for state or foreign government agency investors; and the right to appoint a member of the fund's advisory committee of limited partners. For successor funds, the side letters from the prior fund are typically used and updated as necessary for repeat investors.

The principals should try to minimize the number of side letters and additional rights they grant to the fund's investors. The more side letters and additional rights the principals grant, the more confusing it will be to operate the fund on a day-to-day basis without violating one or more of the individual rights granted to particular investors. The best way to minimize the number of side letters and additional rights is for the principals to have a designated strategy for targeting and negotiating with likely investors. Standard paragraphs with the same language for certain rights (e.g., most favored nation provisions) should be used to avoid the confusion of conflicting language. In addition, most favored nation provisions should include exceptions so they do not apply to rights granted to other investors that are routine or unique to those investors. The principals must give careful thought to any requested side letter provisions, including understanding how burdensome any requested provisions will be to comply with and the likelihood of inadvertent failures to comply by the principals.

Initial Closing

A strong initial closing is critical to establish the fund's viability and signal to other potential investors that they should commit in subsequent closings after the initial closing. If the closing is for a new fund, commitments from the prior fund's large investors will serve as another illustration to the marketplace of the new fund's viability. Once the principals feel they have secured a sufficient amount of capital commitments from prospective investors to have a strong initial closing, the fund should hold its initial closing. There are no hard and fast

rules for determining when to hold an initial closing. As a general matter, principals should consider holding an initial closing when the amount of commitments that will be in the initial closing is sufficient to start to undertake the fund's investment activities. Because the principals can never count on the fund having subsequent closings, since general economic or other market downturns may scare additional investors away, the initial closing should be on sufficient commitments to carry out the full business plan of the fund if subsequent closings never happen. Depending on market conditions, a period of six to twelve months from the time of the initial closing may pass before the full target amount of the fund is raised and closed on in subsequent closings by the principals. If prospective investors assume there is a lack of interest in the fund because the amount raised at the initial closing is not significant, the fund will have a difficult time raising the entire targeted amount at subsequent closings.

The initial closing is an important milestone in forming a fund. It requires proper planning and preparation with knowledgeable fund counsel. The subscription agreements with each investor participating in the initial closing will contain a list of conditions that must be satisfied by the principals, the general partner, the management company, and the fund before the initial closing can be completed. After those conditions are satisfied, the subscription agreements and limited partnership agreement are formally signed at the initial closing by the general partner and each investor participating in the initial closing. At that point, those investors become limited partners of the fund, and the fund can begin to undertake its operations.

There is generally less (or no) negotiation of the limited partnership agreement with investors in subsequent closings, because the limited partnership agreement is viewed as largely settled at the initial closing. In addition, the principals can argue with subsequent closing investors that any changes to the limited partnership agreement will require the consent of the investors in the initial closing, the outcome of which is not certain. Similarly, the limited partnership agreement for a new fund is typically not negotiated as much as the limited partnership agreement of a first-time fund, but rather updated to bring it in line with how the market has changed since the prior fund, or to meet the requests of a new significant investor.

The initial closing may occur as a "wet closing" (with each limited partner contributing capital at the time of the closing) or a "dry closing" (with no capital contributions made at the time of closing). Most funds elect to undertake a dry closing, because it is administratively easier to deal with collecting signatures without also having to collect checks or wire transfers. In addition, deferring the capital contribution until the first portfolio company investment could improve the fund's internal rate of return, the most important metric of a fund's success, and simplify compliance with the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974), the Bank Holding Company Act, 70 Stat. 133 (1956) (codified at 12 U.S.C. § 1841 et seq.), or other regulations that restrict the ability of an investor subject to such regulation to contribute capital to a fund prior to the fund's first portfolio investment. In the case of a dry closing, the investors in the fund make their initial capital contributions when the general partner of the fund calls capital from the investors in the fund, typically in connection with the fund's first portfolio investment. At that time, capital to pay the fund's organization expenses and management fee is called at the same time.

Many funds choose to enter into a line of credit with a bank at or near the time of the initial closing of the fund. Such a line of credit can serve as a useful resource to cover any gap between the date of the fund's limited partners' capital contribution and the date the fund is required to invest in a portfolio company. Using a line of credit could reduce the time the fund's capital is outstanding, thereby also improving the fund's internal rate of return, a key metric that the fund will be judged on when investors are deciding whether to invest in a subsequent fund being raised by the same principals. Certain investors in a fund may be bound by various regulations or statutes, or have a certain tax status that could restrict or prohibit the fund from borrowing money. Therefore, principals should consult with knowledgeable fund counsel before undertaking any borrowing to understand the impact any such restrictions will have on that borrowing.

Each investor that participates in a closing should submit a subscription agreement to the fund. The subscription agreement contains the investor's agreement to commit the designated amount to the fund as and when called by the general partner, as well as various important representations and warranties that are necessary to ensure that the fund is complying with

applicable state and federal laws and regulations. It is typical for the fund's legal counsel to have to work one on one with investors and their counsel and advisers to make sure the subscription documents are filled out completely and accurately. Therefore, it is typical for principals to require that prospective investors in the fund submit their subscription documents to the fund's legal counsel well in advance of the initial closing so that the information in the subscription documents can be reviewed, verified, and, if necessary, corrected prior to the actual closing.

The principals should finalize their internal economic and control arrangements prior to the initial closing of the fund, and make sure those arrangements are fully reflected in final operating agreements for the general partner and the management company. Various complex issues will likely arise when forming the general partner entity and the management company, and it is best not to leave such issues until the last minute. In addition to the economic terms between the partners, there are also complex tax issues, voting rights, and separation issues to consider. Knowledgeable fund counsel will be able to help the principals move this potentially issue-laden process forward, and provide critical tax advice to preserve available tax advantages. For example, each of the principal's interests in the general partner and/or the management company is generally subject to certain ownership restrictions and vesting schedules. To avoid having taxable income on a vesting event, the principals should consider making 83(b) elections to avoid potential negative tax consequences. Such elections need to be made within thirty days of the granting of such interests. Knowledgeable tax counsel can advise the principals regarding making the elections and ensuring that such elections are timely made. The principals may consider holding all or a portion of their interests in an estate-planning vehicle such as a family limited partnership or trust. Knowledgeable estate counsel can advise the principals to ensure that any estate planning is done correctly and in a timely manner.

It is important to note that issuing a press release or making any other public statement (including on the fund's Web site or at an industry conference) regarding the initial closing of the fund (or any closing of the fund prior to the final closing) could be a violation of both state and federal securities laws. Therefore, the principals should delay all public statements regarding fundraising activities until after the final closing of the fund.

Operating the Fund

After the conclusion of the fundraising process, the principals' attention shifts to operating the newly formed fund. The principals should focus on their investment strategy and operating the fund to comply with the limited partnership agreement, side letters, the subscription agreements, and applicable regulations, rules, and laws.

For instance, one set of regulations that affect many private equity funds are the venture capital operating company rules under the Employee Retirement Income Security Act. If 25 percent or more of the limited partnership interests in the fund are held (or are expected to be held after future closings) by investors that are benefit plan investors, the fund will need to qualify as a venture capital operating company or face the unhappy reality of being subject to the extensive rules and regulations of the Employee Retirement Income Security Act. If the 25 percent threshold is met, the principals should consult with knowledgeable fund counsel prior to calling any capital from investors to ensure compliance with the venture capital operating company requirements. If the fund fails to qualify as a venture capital operating company at the time of its initial investment, it cannot qualify later. The fund must also take certain steps annually to maintain its venture capital operating company status, such as maintaining active roles in the oversight of its portfolio investments through service by one or more principals on the portfolio company's board of directors, or otherwise.

Immediately following the final closing, it is recommended that the principals have knowledgeable fund counsel draft a memorandum and/or create a chart summarizing the fund's investment restrictions contained in the limited partnership agreement, subscription agreements, and any side letters entered into with an investor. This memorandum should be distributed to the fund's internal investment team and the fund's internal and external investment counsel. Additionally, the principals should create a checklist of ongoing compliance items to avoid inadvertently breaching any limited partnership agreement, subscription agreement, or side letter provisions.

Occasionally, an investor in a private equity fund may subscribe for an interest in the fund and then later have difficulty meeting its capital call

obligations. The limited partnership agreement for the fund will typically include multiple remedies for the principals to choose from when faced with an investor that has defaulted on a capital contribution obligation. The principals can choose which remedy or remedies fit the particular situation. Such remedies typically include a default charge, reducing the defaulting investor's future interest in the fund, requiring the defaulting investor to sell its interest in the fund to a new or current investor, pursuing other specified legal remedies, or even doing nothing. If an investor defaults on a capital call, the principals should follow the procedures provided in the limited partnership agreement after careful consultation with knowledgeable fund counsel. Sophisticated investors often calculate whether default is preferable for underperforming funds based on the default penalties specified in the fund's limited partnership agreement. Such a calculation becomes extremely difficult if the principals have various options to select from in any particular situation. It is important to note that the principals have a fiduciary duty to all of the fund's investors to enforce the terms of the limited partnership agreement, and should therefore seek the advice of knowledgeable fund counsel before reacting to a default situation, or electing a remedy or remedies under the limited partnership agreement.

Disclosure of sensitive information of the fund or any of its portfolio companies by any of the fund's investors could harm the fund and its portfolio companies and cause lasting damage to the fund's and the principals' reputations. Therefore, confidentiality should be of paramount importance to a fund. The limited partnership agreement will typically contain confidentiality provisions restricting the use and disclosure of the fund's confidential information. In addition, the principals should be cognizant of all information they distribute to the fund's investors. For example, at annual and other meetings of investors in the fund, it is good practice to label all materials distributed as "confidential" to emphasize to the investors the sensitivity and confidential nature of the information provided. Also, it is a good practice for the principals to collect all materials distributed to investors at the conclusion of the annual or other meeting, especially from investors, such as public pension fund investors, who may be subject to the Freedom of Information Act, Pub. L. No. 89-487, 80 Stat. 250 (1966) (codified at 5 U.S.C. § 552).

Planning for the Next Fund

As previously mentioned, the principals will commence planning for their next fund as soon as they close their prior fund. Investors like to get frequent updates from the principals about the current fund's investment activities, plans, and prospects, and do not like to hear from the principals only when the principals need something from the investors (such as a commitment to invest in a new fund). During the years of the fund's operations, and prior to beginning active fundraising for a new fund, the principals should schedule regular meetings with major investors, as well as potential new investors in the new fund.

When it is time to raise a new fund, the principals should inform their current investors that they are contemplating raising a new fund as soon as they are aware of the timetable for the fundraising process. This will allow the investors to look ahead and reserve some of their investable capital to invest in the next fund, and will avoid a situation where an investor would have wanted to invest in the principals' next fund, but cannot because the investor's available capital has been allocated elsewhere.

It is important for a fund to keep its investors informed with respect to ongoing fund and portfolio company performance through quarterly updates, annual meetings, and individual meetings with major investors. As a result, this target group of investors will be up to date on the performance of the fund, which will require them to do less due diligence when contemplating making an investment in the next fund. These activities will not require any additional time from the principals as such activities are typically required pursuant to the fund's limited partnership agreement. Note that annual meetings are not only informative to limited partners, but can be a great marketing tool for the fund.

The timing of the next fundraising will be contingent upon market conditions and restrictions in the current fund's limited partnership agreement. Typically, the principals are not permitted to start raising a new fund until a certain percentage of their most recent fund has been invested. Principals should keep close track of this percentage in light of the timetable for fundraising. If the principals start to raise a new fund too

early, they will conflict with this restriction. If they start too late, they will run out of money to pursue investment deals with the current fund.

To the extent that the principals have had any successful exits in their prior fund, this will provide for a good track record for the next fund. However, if the prior fund has not had any exits or has had exits that have not been very successful, the principals will need to explain to the potential investors why their current fund has not had any exits or has had exits that have not been very successful. The internal rate of return on investments will be a key evaluator for potential investors. Therefore, the principals should operate their current fund to maximize the fund's internal rate of return.

The principals should maintain an up-to-date biography for each investment team member, the financial performance of each fund they manage, a summary of terms of the limited partnership agreement for the most recent fund, and a current investment strategy so that they are able to respond in a timely manner to due diligence questionnaires and save time preparing the private placement memorandum for the next fund.

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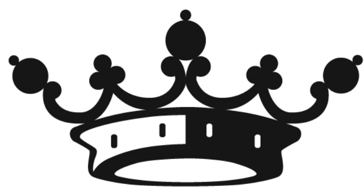

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