Lavery CAPITAL

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Legal newsletter to investment fund / venture capital fund promoters, managers and investors

LAVERY: A LEADER IN MONTREAL IN THE PRIVATE EQUITY, VENTURE CAPITAL AND INVESTMENT MANAGEMENT INDUSTRY

Creating and setting up private equity and venture capital funds are complex initiatives requiring specialized legal resources. There are very few law firms offering such services in Quebec. Lavery has developed enviable expertise in this industry by working closely with promoters to set up such structures in Canada and, in some cases, the United States and Europe, in conjunction with local firms. Through Lavery's strong record of achievements, the firm sets itself apart in the legal services market by actively supporting promoters, managers, investors, businesses and other partners involved in the various stages of the implementation and deployment of private equity and venture capital initiatives.

PRIVATE EQUITY FUND ECONOMICS IN CANADA: AN OVERVIEW OF THE ESSENTIALS

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Private equity fund economics play an important role in attracting investors to a given fund. Indeed, investors want to know how expenses will be shared, what fees are applicable and how profits will be allocated. The summary below provides a brief overview of the most common fund arrangements with respect to such considerations. That being said, no two funds are the same and a fund's organizational documents can be tailored to take into account a wide array of particularities unique to a given fund.

CONTRIBUTIONS, DISTRIBUTIONS AND ALLOCATIONS

THE GENERAL PARTNER CONTRIBUTION

Investors expect that either the private equity fund sponsor[1] (the "**General Partner**") or one of its affiliates will have a vested interest in the success of the fund. In most cases, investors expect that the General Partner, its affiliates or key executives will make an investment representing anywhere between 1% to 5% of the total capital contributions made by investors. This contribution is significant to investors as it ensures that the interests of the fund's management team are aligned with their own and also reduces the incentive for the General Partner to incur excessive risk in an attempt to generate greater returns for itself. This is one reason why the Institutional Limited Partners Association recommends that the General Partner itself be required to make a financial contribution to the capital of the private equity fund[2].

DISTRIBUTION WATERFALLS AND PROFIT-TAKING

A fund's basic economic structure will most often be set out in the "distribution waterfall" — a mechanism which dictates how profits are to be allocated and in what priority such payouts will be made. All distributions made are net of any fund expenses, liabilities and cash reserves and are done on a *pro rata* share basis among the investors according to their respective capital contributions to a given investment. Each tier must be satisfied in full before proceeding to the next priority tier.

The following is an example of a basic distribution waterfall that a fund may have in place:

- **First Tier:**
  Return of Capital Contribution to Investors
  The first distribution provides that investors are entitled to recuperate any capital contributed with respect to a given investment before any other distributions may be made.
- **Second Tier:**
  Preferred Return to Investors
  The next distribution also flows to investors until they have received an amount equal to the preferred return on their capital contributions. The *preferred return*, often referred to as the "hurdle rate" with respect to the investment in the fund, provides investors with a determined rate of return (often between 5% and 9% on any capital contributed by an investor to a given investment) before the General Partner is entitled to receive any of the proceeds of the fund's investments.
- **Third Tier:**
  Catch-up Tier
  Once investors have seen their capital contributions repaid and their preferred return paid out, the General Partner will benefit from a "catch-up" tier. At this stage, the General Partner will be entitled to share in the profits generated by the fund until it has received an amount equal to the carried interest split (discussed below) it would have otherwise been entitled to as part of the first and second tiers.
- **Fourth Tier:**
  Carried Interest Split
  The fourth tier entitles both investors and the General Partner to receive fund profits. At this stage, the investors and the General Partner split the pool of any remaining distribution funds payable according to the carried interest split stipulated in the fund's operating agreement (an 80/20 carried interest split whereby investors receive 80% of the distribution payable and the General Partner receives 20% is commonplace, although this range may vary significantly depending on market conditions and industry standards).

CLAWBACK

A fund's operating agreement may also include a "clawback" provision relating to the General Partner's carried interest. Such a provision, which may include a built-in escrow procedure, serves as an adjustment mechanism which requires the General Partner to hold back a certain percentage of its carried interest profit participation to guard against overpayment in the event that any given investment does not prove to be profitable. For example, a clawback may be triggered when, upon calculating the fund's aggregate returns from any such given investment, the investors have been distributed an amount of the profits that is less than the hurdle rate. In such instances, the General Partner will have to return any excess profits to the fund for re-distribution to investors.

FUND FEES AND EXPENSES

MANAGEMENT FEES

In connection with the establishment of a private equity fund, the General Partner will often either create an affiliated entity or appoint a third-party investment adviser or management company to provide investment advice with respect to the management of the fund. Such arrangements can be crystallized in the form of an advertisement advisory agreement or management services agreement, which will describe exactly which duties and responsibilities are delegated to the appointed entity.

The General Partner, or any manager or investment adviser appointed to act on behalf of the fund, will generally receive a management fee based on the aggregate capital committed to the fund (typically about 2%). Occasionally, the management fee will contain two components: one that is based on the capital committed but not yet invested, and the other that is based on the capital that has been invested by the fund. However, it is not uncommon to see a "flat" fee applied to all aggregate committed capital. The management fee is used by the General Partner (or any appointed entity) to employ investment professionals, cover costs associated with the daily functioning of the fund and evaluate potential investment opportunities. Such fees and expenses are borne by the fund (and therefore its investors) and are most often payable on a quarterly or semi-annual basis.

In addition to the fund economics, sales tax considerations and applicable dealer registration requirements in any given jurisdiction are considerations that must be taken into account when implementing any particular fee structure[3].

ORGANIZATIONAL OR ESTABLISHMENT COSTS

Those fees associated with creating and setting up the fund are most often paid for by the fund, but are also usually capped at an amount indicated in the fund's operating agreement. Occasionally, an operating agreement may instead provide that the General Partner will cover establishment costs up to an agreed upon amount. Such expenses include professional fees such as legal and accounting services, as well as administrative and marketing costs incurred at fund formation. Establishment costs will vary greatly depending on the complexity of the fund being created, and on whether any associated feeder funds, alternative investment vehicles or associated entities are being created simultaneously.

OPERATING EXPENSES

The fund will also be responsible for those fees and expenses related to the proper functioning and operation of the fund. Such fees may include ongoing professional or consultancy fees, administrative costs, any applicable taxes or regulatory fees, as well as the management fees payable to the General Partner, investment adviser or management company and any expenses incurred by such persons in carrying on their activities on behalf of the fund.

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[1] As a general rule, the promoter of private equity and venture capital funds is the general partner. Private equity and venture capital funds are most frequently created in the form of a limited partnership with a predetermined term.

[2] See «Private Equity Principles», (version 2.0), Institutional Limited Partners Association (available at: http://ilpa.org/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-version-2.pdf).

[3] For more information on this subject, please see our article entitled "Registration Requirements of Venture Capital and Private Equity Fund Managers in Canada : A Favourable Regulatory Framework" published in the May 2014 *Lavery Capital* newsletter.

RULES ON MARK-TO-MARKET PROPERTIES — A PITFALL TO AVOID

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The *Income Tax Act* (Canada) contains specific rules which apply to certain properties held by financial institutions known as the *mark-to-market properties* rules (hereinafter "**MTMP**"). These complex rules are often poorly understood and can result in unexpected tax consequences in various situations and, in particular, in the context of project financing involving the issuance of units in a limited partnership.

Generally when the MTMP rules apply, a financial institution must declare as income any increase in value not realized at the end of the taxation year on the MTMP held by such financial institution, whether or not such property was the subject of an actual disposition.

The expression "financial institution" is specifically defined for purposes of the MTMP rules and includes not only banks but insurance companies and entities controlled by insurance companies, as well as partnerships in which more than 50% of the fair market value of its interests are held by one or more financial institutions. In such a case, the partnership would automatically become subject to the MTMP rules to the extent that it holds MTMP. Such a partnership must therefore declare an income for the taxation year in question in respect of any increase in the value of the MTMP held by it, and allocate such income to all its unitholders, regardless of whether or not they are financial institutions.

Corporate shares will be considered to be MTMP where a financial institution holds less than 10% of the fair market value of the corporation's shares or of the voting rights attached to such shares. In addition, the definition of MTMP includes various other types of property the fair market value of which is attributable to MTMP. For example, mutual fund units, units in a limited partnership, insurance policies or other derivative financial instruments may be regarded as MTMP to the extent that the value of such investments is primarily attributable (more than 50%) to MTMP.

However, it should be noted that the ownership of shares of an "eligible small business corporation" (defined for purposes of the MTMP rules as being a corporation whose assets have a carrying value which does not exceed $50,000,000 and which employs 500 persons or less) will not be considered to be MTMP.

The MTMP rules apply to financial institutions such as banks and insurance companies or any entity controlled by such financial institutions. However, as noted above, because of the broad definition of "financial institution" in the context of the application of the MTMP rules, other entities may also inadvertently be considered to be financial institutions if the percentage of their unit or share ownership is held by one or more financial institutions. In this regard and specifically in the context of the formation of a limited partnership which may eventually make investments which could be considered MTMP, it is important to provide for a clause limiting the ownership of units by financial institutions so as to ensure that the limited partnership will not be considered to be a financial institution under the MTMP rules. In the event that such a restriction is not desirable, the limited partnership agreement and the limited parntership's investment policies should provide that the investments to be made by the limited partnership must not consist of MTMP. Thus, even if the limited partnership itself were considered to be a financial institution, the MTMP rules would have no impact since no investment made by the limited partnership would meet the definition of MTMP.

In conclusion, the MTMP rules must be taken into consideration in any major structured investment project, particularly in connection with a limited partnership in which financial institutions are likely to acquire a substantial interest.

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