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Client Alert

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Responding to Allocation and Liquidity Concerns of Investors in Private Equity and Venture Capital Funds

Recent economic events have raised a host of allocation and liquidity issues for investors in private equity and venture capital funds ("PE/VC funds"). First, many investors are now over-allocated to PE/VC fund investments because those investments have not been written down in value to the same degree as public investments (the so-called "denominator effect"). Second, many investors have suffered losses that significantly depleted their liquid capital reserves. Third, many PE/VC funds are making fewer or smaller distributions due to a lack of realization opportunities. Finally, many PE/VC funds must make additional capital infusions into their portfolio companies to help them through this difficult period.

Taken together, these factors suggest that some investors will be asked to contribute additional capital to PE/VC funds at exactly the time when they (i) prefer not to do so for asset allocation reasons and (ii) lack sufficient liquid capital to comfortably make the contributions even if they wished to do so.

Not surprisingly, PE/VC fund sponsors have begun to receive investor requests for relief. These include requests that the fund sponsor:

- Reduce or terminate the investor's future capital commitment
- Consent to a complete or partial withdrawal of the investor's interest in the fund
- Agree not to call capital from the investors in the near term
- Consent to a transfer of all or a portion of the investor's interest in the fund

The purpose of this alert is to highlight selected issues that PE/VC fund sponsors should consider when evaluating any such requests and to provide some thoughts on potential ways in which PE/VC fund sponsors may be able to address their fund's capital needs while being responsive to investor liquidity constraints.

What should a fund sponsor consider when responding to such investor requests?

It is critical that, prior to discussing alternatives with investors, a fund sponsor be well-versed in what it is permitted to do and the consequences of various actions under:

- The fund's organizational documents
- The partnership or other law governing the fund and the fund sponsor, in particular the fund sponsor's fiduciary duties

- Contractual obligations under side letters, bridge credit facilities and other agreements

- Securities, ERISA and tax laws

Each of these areas is discussed in more detail below.

Political/Precedential Considerations

While this alert is focused primarily on legal issues, fund sponsors also must confront the political and precedential effects of their actions.

In general, fund sponsors will desire to maintain the goodwill of their investors and, as a result, will be motivated to address their investors' concerns. The second portion of this alert describes a number of alternatives which fund sponsors could consider in this regard.

In any specific case, however, addressing one investor's concerns may create problems for another investor or for the fund as a whole. For example, even if allowing one investor to withdraw or reduce its commitment does not trigger a contractual "most-favored-nation" right on the part of other investors (as discussed below), other investors may nonetheless expect similar treatment and the fund sponsor may feel compelled to offer all investors the same rights of withdrawal or reduction in order to preserve investor goodwill. Permitting all investors to elect to withdraw a portion of their interest or reduce/defer a portion of their commitment may raise significant concerns with respect to the stability of the fund (e.g., whether there will be a "race for the exit") and whether the fund will have sufficient resources to carry out its investment program and meet its obligations to portfolio companies or other third parties. Alternatively, refusing to provide sufficient relief may encourage investors to exercise "no fault divorce" or other rights under the fund agreement that lead to a far greater disruption than a more measured response.

Default

Underlying the fund sponsor's consideration of investor requests is the consideration of potential investor defaults in satisfying their capital commitments. Fund sponsors should assess the ability of the requesting investors to satisfy future capital calls if their requests are not honored and should carefully review the default provisions in the fund's organizational documents (including the enforceability of such default provisions). Under many fund agreements, the implementation of default remedies is at the election of the fund sponsor; accordingly, a fund sponsor could agree not to exercise the fund's default remedies with respect to an investor for some period of time to help alleviate the investor's immediate-term liquidity constraints. Because any agreement not to enforce default remedies with respect to an investor has the same effect as an interest-free loan from the fund (i.e., from the other investors) to that investor, it raises many of the same concerns discussed elsewhere in this alert regarding fiduciary duties, most favored nation provisions, precedent, etc.

While many of the issues discussed in this alert are relevant to defaults, investor defaults also raise additional issues which are beyond the scope of this alert.

Fund Organizational Documents

The fund's organizational documents should be carefully reviewed to determine whether the fund sponsor has discretion to take any of the contemplated actions. For example, the fund agreement may not allow for capital calls other than on a pro rata basis and may not permit specific investors (as opposed to all of the investors) to reduce their commitment and thereby be overfunded relative to their revised commitment. The fund agreement may provide that investor withdrawals are prohibited except in limited circumstances, such as to avoid ERISA violations or to prevent the fund from holding ERISA plan assets. In some cases, the fund agreement may provide that if an investor (such as an ERISA investor) is permitted to withdraw a portion of its interest, then all other investors of the same type (such as all ERISA investors) may also be permitted to withdraw a pro rata percentage of their interests.

While the fund sponsor typically will have authority to permit transfers, the fund's organizational documents likely will contain provisions limiting the ability to effect a transfer if the transfer would adversely affect the fund's tax, ERISA or other status, and the fund sponsor will be subject to the fiduciary duties and liabilities discussed below in determining whether to permit a transfer. In addition, the fund agreement may grant other investors a right of first refusal in respect of the transferred interest.

Any proposed reduction in the capital commitments or contribution obligations of one or more investors may raise issues for a fund if the fund's partnership or operating agreement provides for liquidating distributions to be made in accordance with capital account balances. Unless amended as part of the reduction, the limitations inherent in these forms of agreements may prevent the investors from fully achieving the intended economic result of the reduction, potentially leaving too high or too low a balance in some investors' capital accounts vis-à-vis others. In other forms of partnership or operating agreements, reductions in capital commitments of some investors may result in an immediate "capital shift" and/or may require future income allocations to be made in a manner that adjusts the investors' capital accounts to be in proportion to their new commitment percentages (assuming the reduction is intended to apply to both pre-existing and future investments). Any capital shift could be immediately taxable or, if not, may cause additional taxable income to be allocated to either the investors that are having their commitments reduced or the remaining investors, depending on the circumstances. Any such adjustments may require amendments to the fund's organizational documents and therefore may require investor consent. Furthermore, withdrawals by certain investors at a discount to fair market value could raise tax issues for the non-withdrawing investors in the fund that are similar to those raised by reductions in commitments.

Legal Considerations: Fiduciary Duties, Broker-Dealer, Confidentiality, Disclosure

Fiduciary Duties

A fund sponsor is subject to fiduciary duties to the investors in its fund. The nature and scope of those duties are in large part defined by the laws under which the fund is organized and the terms of the fund's organizational documents. In addition, in the unlikely event that the fund's assets include "plan assets" subject to ERISA, the fund sponsor's decisions with respect to investor requests will be subject to the ERISA fiduciary standards applicable to such a fund. As a general matter, when considering a

request from any investor in this context, the fund sponsor should consider the interests of the fund as a whole. As a result, in considering whether to allow a particular investor to reduce its commitment or withdraw, to defer capitals calls, to waive default provisions or to permit a transfer, the fund sponsor should consider the effects of these actions on the other investors and on the fund as a whole, such as:

- How will this action affect the fund's ability to carry out its investment program, or to satisfy its obligations to portfolio companies, bridge lenders and other third parties?
- Will this action impair the diversification of the fund's assets?
- Will this action require other investors to effectively invest a greater portion of their capital in particular assets and thereby reduce their diversification in those assets?
- Is this action inconsistent with the expectations of other investors?
- Will this action expose the fund to risks of failing to qualify for securities law, ERISA or tax exemptions or failing to achieve certain intended benefits or otherwise have an adverse impact on any other investor?
- Is any proposed transferee qualified to be an investor and free of inappropriate business or other conflicts with the fund and its portfolio companies?

Because specific investors may be in different positions with respect to their own allocation issues and liquidity constraints, fund sponsors may receive conflicting requests for relief (or even requests that no relief be granted at all). In this regard, fund sponsors should consider all of the facts and circumstances and bear in mind their fiduciary duties to the fund as a whole.

In considering whether to allow a particular investor to reduce its commitment or withdraw, to defer capitals calls, to waive default provisions or to permit a transfer, the fund sponsor should *not* consider its own interests, such as the impact of such actions on the fund sponsor's ability to raise its next fund or the fund sponsor's personal relationship with a particular investor.

Broker-Dealer; Investment Adviser

In the case of transfers, fund sponsors need to be careful not to act as a "broker," which generally would require registration with the SEC and/or implicate state law requirements. Fund sponsors that rely on the exemption from SEC registration as an "investment adviser" available to investment advisers with fewer than 15 clients also need to be careful to avoid being deemed to provide investment advice to either the transferor or the transferee in connection with the transfer such that neither the transferor nor the transferee is deemed to be a "client" for purposes of such exemption. Accordingly, fund sponsors should consult with their counsel to address these issues prior to becoming involved in any transfers.

Confidentiality

In connection with a proposed transfer, the fund sponsor generally will be asked to agree that the transferor can disclose certain confidential fund information to the transferee. It is important to narrowly and precisely define the extent to which the transferor is permitted to disclose confidential fund information to the transferee and to require that each prospective transferee enter into a confidentiality agreement with the fund sponsor whereby it agrees to protect all such information it receives. The fund sponsor should also consider whether the transferee is subject to the Freedom of Information Act or similar laws that could require it to disclose confidential fund information notwithstanding the confidentiality agreement.

Disclosure Requirements; Anti-Fraud Provisions

In evaluating any of the investor requests discussed in this alert, fund sponsors should consider any resulting disclosure obligations to prospective and existing investors.

A fund sponsor is liable under federal and state securities laws if, in connection with selling securities, it makes an untrue statement of a material fact or omits to state a material fact that is necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Thus, in considering any investor request, the fund sponsor should consider whether granting the request would make it necessary to supplement the fund's private placement memorandum or other marketing materials. For example, a significant reduction in commitments to the fund may require a fund sponsor to disclose to prospective investors that the existing fund size and/or target fund size has changed. Moreover, a fund sponsor would need to consider how such a reduction in commitments and the prospect of a "race for the exit" may affect the future stability of the fund's resources and whether the actual and/or potential impact of these changes is a material fact that should be disclosed to prospective investors. Any agreement to defer capital calls from investors for a period of time, or to permit transfers of a substantial portion of all fund interests, would require a similar analysis. Any such disclosure may have a detrimental impact on fundraising efforts.

Investment advisers (whether or not registered) are subject to certain anti-fraud provisions under the Investment Advisers Act. With its adoption of an anti-fraud rule in 2007 targeting investment adviser conduct with respect to pooled investment vehicles (including registered funds and certain unregistered funds), the SEC served notice that it will be devoting particular attention not only to the conduct of fund sponsors and disclosures made in connection with fund offerings, but also to fund sponsor conduct and disclosures with respect to existing fund investors. Given the SEC's heightened sensitivity and the rule's relatively high standard of conduct (mere negligence may result in a violation), fund sponsors will want to consult with their counsel to analyze their proposed responses to investor liquidity needs in light of these anti-fraud provisions. For example, a fund sponsor that is subject to these anti-fraud provisions would need to consider whether a reduction in fund size or any agreement to not call capital from investors for a period of time or any other response to investor requests should be disclosed to existing investors. Any such disclosure may cause investors to consider exercising their rights (such as a no-fault divorce right) under the fund agreement or to request other relief.

Contractual Obligations

Side Letters

Certain fund investors may have side letters containing "most-favored-nation" ("MFN") provisions which enable such investors to elect to receive rights similar to those granted to other investors in their side letters (subject, in some cases, to size or other limitations). Those MFN provisions must be carefully considered when a fund sponsor is faced with a request from an investor in this context. Depending on the nature of the MFN provisions, permitting an investor to withdraw, reduce its commitment or transfer may allow other investors to exercise similar rights under their MFN provisions. As noted above, even if an investor is not able to elect a right to take similar action based on an MFN right, fund sponsors should also carefully consider the precedential effect of permitting an investor to take any of these actions and whether it will lead other investors to seek similar treatment.

Bridge Credit Facilities

Fund sponsors should review the terms of their bridge credit facilities to determine whether any of the requested actions could result in a default or breach of covenant under such credit facilities.

ERISA and Tax Considerations

Fund sponsors should carefully consider the effects of any proposed action on the fund's ERISA or tax status, or on any intended tax benefits.

ERISA

A proposed commitment reduction, withdrawal or transfer of an interest should be evaluated from the perspective of the fund's ERISA status. In particular, if the fund is relying upon the "less than 25% benefit plan investors" exception from plan assets status, the fund sponsor should take appropriate measures to ensure that the reduction, withdrawal or transfer will not threaten compliance with such exception. Any assignment documents should contain representations designed to confirm such compliance.

Under the "venture capital operating company" (or "VCOC") exception from ERISA, at least 50% of the fund's assets must constitute "good assets" for at least one day during the applicable annual testing period. A fund that is relying on the VCOC exception may hold a majority of assets which are not "good assets" with the expectation that it will acquire a sufficient amount of good assets by the testing date in order to satisfy the exception. The fund sponsor of any such fund should consider the potential effects of commitment reductions or withdrawals on the fund's strategy to acquire the requisite amount of good assets in time to satisfy the VCOC exception and more generally in respect of compliance with the VCOC exception.

In addition, transfers to or from an ERISA plan can potentially constitute a prohibited transaction under ERISA which, in turn, would typically require rescission of the transaction. Accordingly, fund sponsors should consider including representations in the transfer documents from both the transferor and the transferee to the effect that the proposed transfer will not give rise to a non-exempt prohibited transaction under

ERISA or Section 4975 of the Code or constitute a violation of any comparable law applicable to government plans.

Tax

Reductions in commitments, transfers and withdrawals all need to be evaluated in light of the fund's tax-related transfer restrictions and any other potential tax impact on the fund or the other investors in the fund (including the fund sponsor). The nature and extent of the potential tax issues will depend on the structure of the fund and the terms of its organizational documents. Fund sponsors should carefully review the tax implications of any such actions with their tax counsel and accountants.

For any fund that is organized as a partnership, transfers should be evaluated in light of the "publicly-traded partnership" rules and any transfer restrictions related thereto in the fund's organizational documents in order to ensure continued treatment as a partnership for federal income tax purposes. The applicable regulations provide certain "safe harbor" exemptions from the publicly-traded partnership rules, some of which are tied to the size of individual transfers and the nature of any intermediary used to facilitate fund transfers. Given the severe tax consequences of a fund losing its treatment as a partnership for federal income tax purposes (i.e., potentially being subject to corporate taxation), fund sponsors should carefully analyze each transfer to determine whether it qualifies for one of the applicable safe harbors or would otherwise affect the partnership's status as a partnership for federal income tax purposes.

If the fund has a built-in loss on its assets (i.e., its adjusted tax basis in its assets exceeds their fair market value), a transfer of interests in the fund may require the fund to adjust the tax basis of its assets under Section 743 of the Internal Revenue Code. To the extent the fund is a "fund of funds," invests through joint ventures or in operating partnerships or LLCs, or otherwise holds its investments through lower-tier partnerships, any such lower-tier partnerships may also be required to make a "743 adjustment" with respect to transfers of fund interests. These adjustments could result in significant additional accounting costs and complexity for the fund and for the lower-tier entities. Depending on the terms of any lower-tier partnership agreement, the fund may be liable for any such additional costs incurred by the lower-tier partnerships. In most fund agreements, the fund-level costs will be passed along to the transferee, but fund sponsors should review their fund documents carefully to understand the exact extent to which they may be entitled to pass along such costs, especially as it relates to lower-tier partnerships, and should discuss any potential 743 adjustments with their accountants.

Fund sponsors may consider utilizing, or increasing their utilization of, bridge credit facilities in order to defer the need to call capital from investors. The longer any borrowing on a credit facility remains outstanding, the greater the potential for the borrowing to result in "unrelated business taxable income" (or "UBTI") for U.S. tax-exempt investors. Fund sponsors should carefully consider the potential UBTI issues associated with borrowings under credit facilities, including a review of any limitations on the incurrence of UBTI that may have been agreed to in the fund's organizational documents.

For fund sponsors that utilize a capital contribution waiver/fee offset, any reductions in commitments may result in additional risk that the fund will not generate sufficient gains to permit the fund sponsor to fully recover the waived fees. Any such

arrangements should be carefully evaluated with tax counsel based on the applicable situation to determine the potential impact on the fund sponsor.

What can a fund sponsor do to address investor liquidity constraints?

There are a number of potential alternatives available to PE/VC fund sponsors to address investors' allocation and liquidity concerns. The following briefly highlights some of these alternatives; each alternative involves business and legal considerations that fund sponsors should carefully review and analyze with their advisers, including, in many cases, a number of the issues described above. These alternatives will be more or less appealing to specific fund sponsors depending on their particular circumstances and a fund sponsor may consider utilizing a combination of two or more of the following alternatives.

- *Assisting investors in transferring their fund interests.* As compared to reductions in commitments, deferrals or withdrawals, transfers generally do not expose the fund to the same risk of being unable to carry out its investment program, satisfy obligations, etc., or expose the fund sponsor to the same risk of claims by other investors that the fund sponsor is violating its fiduciary duties by not acting in the best interests of the fund as a whole. However, as noted above, fund sponsors need to consider a number of factors in permitting transfers, including the qualifications of the transferees, most-favored-nation provisions, precedent issues, protecting the confidentiality of fund information, the restrictions under the tax rules related to "publicly-traded partnerships" and the change in make-up of the fund's investors if institutional endowments, pension plans or foundations are replaced by secondary market investors.

- *Raise a side-by-side "annex" fund that would co-invest with the existing fund in follow-on investments and new investments.* This would reduce the amount that would need to be called from investors in the existing fund to make such investments while providing investors who are not experiencing allocation or liquidity constraints with the opportunity to own a larger piece of these investments through the annex fund. The fund sponsor would need to determine whether its organizational documents permit the formation of such an annex fund or whether it requires investor approval of an amendment to the organizational documents.

- *Agree to defer capital calls for the short term.* This strategy may be appealing if the fund sponsor does not perceive an immediate capital need (or has alternative sources of capital). Potential disclosure obligations to all investors should be considered if this strategy is pursued, as discussed above. In consideration for such deferral, the fund sponsor may desire to seek a benefit for the fund, such as extending the fundraising period, the investment period and/or the fund term.

- *Seek investor consent to amend the organizational documents to allow investors to elect to defer capital calls or to opt out of future deals*. A strategy that permits investors to elect to defer capital calls would likely include an economic benefit for investors who elect to fund capital calls relative to the investors who elect to defer (for example, an interest factor or a greater share of profits from investments made with such capital contributions). A similar alternative would be to seek investor consent to amend the organizational

documents to permit investors to elect to participate in future investments on a "deal-by-deal" basis. As noted above, these strategies may create potential tax issues (including UBTI issues), may raise issues with respect to ERISA compliance, may require substantially revising the fund's allocations and distributions to accommodate the differing treatment of investors, and may create additional administrative burdens in tracking contributions and returns from particular investments. In addition, the fund sponsor would need to consider potential implications with respect to its status (or exemption from registration) as an investment adviser.

- *Defer a portion of the management fees*. A deferral of management fees may be tied to achieving a certain threshold (e.g., management fees are deferred until a certain percentage of capital commitments are invested or a certain IRR is achieved). In consideration for such deferral, the fund sponsor may desire to seek a benefit for the fund, such as extending the fundraising period, the investment period and/or the fund term, or for the fund sponsor, such as an increased carry on future profits.

- *Re-examine the fund's portfolio and investment strategy*. For example, the fund sponsor may consider slowing the pace of future investments and/or selectively disposing of appropriate assets. In contemplating such actions, the fund sponsor needs to bear in mind its fiduciary duties to the fund as a whole and disclosure obligations as described above.

- *Aggressively work with portfolio companies to find alternative sources of capital.* In this regard, the fund sponsor would need to be sensitive to any dilution of the fund's interest in such portfolio companies.

- *Distributing proceeds to investors rather than reserving such proceeds*. This strategy may be appealing in cases where the fund has the ability to recall such distributions and the fund sponsor does not have an immediate need for such cash. In the event that the fund's organizational documents do not permit a recall of distributions, the benefit to investors of making current distributions may be an opportunity for fund sponsors to seek to amend the fund's organizational documents to permit or expand upon the fund's right to recall distributions. Of course, this strategy is dependent on the fund receiving proceeds from its investments. In addition, a fund sponsor may determine that it is more prudent to retain proceeds it receives rather than count on being able to recall such proceeds at a later date.

- *Utilize, or increasing the utilization of, bridge credit facilities in order to defer the need to call capital from investors.* As noted above, in the ERISA and Tax Considerations section, this raises potential UBTI issues that should be examined.

- *Permit investors to reduce their capital commitments by some percentage.* Two very large buyout funds, TPG and Permira, have recently reported that they have permitted all investors to reduce their remaining capital commitments to their latest funds (approximately $20 billion and $14 billion respectively) by up to 10% in the case of TPG and up to 40% (with an overall cap of $1.9 billion) in the case of Permira. In the case of Permira, investors taking advantage of the reduction would reportedly have their distributions reduced by 25% and would

continue to pay management fees on their original commitments. While giving all investors the option to reduce their commitments would generally be expected to be an alternative of last resort and needs to be considered in light of the fiduciary issues and other factors discussed above, this approach may be attractive to larger funds that expect difficulty in putting all of the capital commitments to work in the current environment, particularly if the fund sponsor's economics are not significantly damaged, as in the case of Permira.

For further information about the issues raised in this alert, please contact any of the attorneys listed below.

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