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Family law news: Legal review of private placement materials

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LUXURY ASSETS

Buyer Beware

In the post-Madoff world, ever more effort is being expended to understand what a particular hedge fund or private equity fund is doing with investors' money. A great deal of attention has been directed to investment strategies and accountability. But while investors strive with renewed interest to understand different managers' investment methodologies and the general integrity of their portfolios, the investors' more technical legal rights can get overlooked.

When someone buys a company, the purchase typically is the culmination of an extensive negotiation between the buyer and seller. But when investors commit capital to a privately placed fund, especially when they are not the lead investors, it's a much more one-sided proposition. Meetings might occur between the fund's managers and these investors, but such meetings generally do not have the flavor of negotiating sessions. Likewise, the comment period, after prospective investors receive a thick package of draft offering documents prepared by fund counsel, rarely offers a chance to successfully renegotiate fundamental deal terms, but instead focuses on narrower items.

Because the process limits efforts by ordinary investors to bring about major term-sheet changes, it is tempting to see the careful review of offering materials as the legal equivalent of jousting at windmills. Yet this ignores investors' power to "vote with their feet" and take their investment dollars to a different fund. More temperately, the investor who fails to consider the legal details of fund offering documents, in addition to evaluating the fund manager's investment record, proceeds at needless financial peril. When the investor is a trustee, there may be fiduciary peril as well.

A methodical review of offering materials can yield valuable information for your investment program, as three important examples should make clear.

1. Discretion and the Purpose Clause

Hedge funds' purpose clauses typically grant managers very broad investment discretion that often goes far beyond the specific strategies mentioned in the initial offering memorandum. The tension here lies between rendering a manager accountable to its investors for undertaking what the investors expect, while acknowledging that certain hedge fund strategies may have limited useful lives or be difficult to define with precision in the context of a limited partnership agreement.

Similar issues arise in private equity funds, where an offering memorandum may suggest that a portfolio will focus on a particular geographic or market sector while the purpose clause in the limited partnership agreement ends up too softly drafted to compel strict adherence to that promise. Fund managers will then be able to make portfolio acquisitions that fall outside of the promised guidelines as long as they fall within the drafted purposes clause. They may do this for reasons as pure-hearted as the desire to capture an investment opportunity or as self-interested as the desire to keep new hires busy pending the launch of a new fund with a different sectoral focus.

Are these good things or bad things? The answer may well depend on the precision of your asset allocation and your particular tax posture. The important point is that these things should not come as a surprise.

2. Key Men, Access and the Golden Rolodex

At the core of virtually every fund's sales pitch are the geniuses-in-residence: either the quant guys whose understanding of markets is so advanced that their hedge fund's models won't get arbitraged into uselessness or the private equity guys whose contacts and industry knowledge began with the first Eisenhower administration. How much of these fellows' time do you get? How easily can you get out of the fund if these key people end up going to that big country club in the sky?

Do the fund documents promise you access only to the general partner—a faceless entity—or to the named individuals you want? Do those individuals commit their full time to the fund or just "reasonably sufficient" time, which may mean something different to them than it does to you? Do the real stars hide within a larger "management group," so that their death or departure won't entitle you to terminate the relationship? If there are two superstars and five lesser managers, and you don't have exit rights until a majority of the entire group leaves, it could mean that the two reasons you put money into the fund in the first place are long gone before you have a right to get out yourself.

Do the managers also run other funds that compete for the same investment opportunities? For example, if you are in a global private equity fund, your documents may allow your manager to launch a regional private equity fund. How do the two funds allocate opportunities that arise in the common region?

How are the investment activities of the firm's own principals regulated? What about their one-off, nonfund, investment banking activities? Can the best deals be cherry-picked before they reach your fund?

Here again there is no "right" answer, but a prospective investor who proceeds without relevant information puts his capital at a needless disadvantage.

3. Clawbacks

As part of the manager's compensation, a management-related entity often takes a "carried" share of the profits generated by the deal's investment program, some or all of which is often paid out during the course of the deal instead of being accumulated for payout at the fund's end. In practice, too much may have been paid out on this carry over the life of the fund, if its winning investments are realized early in the deal and its losing investments are realized later in the deal. It is customary for private equity funds to acknowledge this by providing for a "clawback" payment, pursuant to which the entity that received the carry payments during the fund's life undertakes to repay an amount at deal's end equal to some measure of the excess distribution.

Whether this clawback can actually be collected is obviously of interest to would-be investors. However, private equity funds vary widely in their efforts to assure the creditworthiness of the entity that owes clawback money. Some funds do nothing at all, leaving investors to rely on the good faith of the fund group, since the entity that technically owes the clawback is likely a thinly capitalized limited liability vehicle.

Other private equity funds require that the owners of the legal entity that is liable for the clawback payment guaranty their proportionate shares of the clawback liability. While these owners could conceivably, en masse, undertake asset protection planning to render themselves judgment-proof, that clearly would be a large scale undertaking.

Still other private equity funds limit distributions to the carried interest entity during the course of the fund, retaining a portion of the carry within the fund itself as a buffer against potential clawback liabilities.

Once more, the point is not that one approach is right and another is wrong. The message is simply that fund documents are not homogeneous. A responsible investor should undertake a legal review of the offering materials as well as an investment review of the manager's performance to gain a full risk/reward profile.

While these three items offer a fairly meaty introduction to the sorts of issues that can crop up when an investor is reviewing an offering package, they are far from a comprehensive list. Many questions lurk in the 1.5 to 3 inches of paper that fund counsel sends you. If you were to receive a sheaf of similar thickness when buying a business, you would go through it carefully before signing. Offering materials warrant similar attention.

Most investors would not purchase an active business without a legal adviser reviewing the deal. The same should be true with a private placement.

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