Private Equity Fund Expenses

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Expenses, Generally

Generally, a private equity fund will incur the following expenses:

- Organizational Expenses—relate to establishing and organizing the fund and its infrastructure.
- Operational Expenses—relate to the operation of the fund. Include:
  - expenses relating to the management company's management of the fund;
  - acquisition, holding, and disposition of investments expenses; and
  - fees and expenses of service providers (*i.e.*, fees of attorneys, consultants, custodians, administrators, and accountants).
- Extraordinary Expenses—include litigation and indemnification costs and expenses.
- Tax-related Expenses.

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Organizational Expenses

- Organizational expenses include expenses in forming the fund, the general partner, the management company and any fund-related vehicles.
- These include printing, travel and accounting, legal and other expenses.
- A fund's operating agreement will provide that the fund will cover its organizational expenses, but typically a cap will be set forth in the operating agreement regarding these expenses.
- Paid with investor capital commitments.
- Organizational expenses of private equity funds have risen significantly in recent years due to increasingly complex fund structures and increases in the costs of preparing marketing documents.
- The formation of the general partner, the investment manager, and other control entities has also become more complex and therefore, more costly.

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Operational Expenses

Operational Expenses include:

- Expenses relating to the management company's management of the fund;
- Acquisition and disposition expenses;
- Holding expenses; and
- Fees and expenses of service providers.

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Operational Expenses – Management Fee Expenses

- A fund's management company generally receives a management fee for the management services and investment advice which it provides to the fund and the fund's general partner.
- The market rate for management fees of private equity funds is approximately 1.5%–2% of the fund's aggregate capital commitments during the fund's investment period (*i.e.*, the first three to five years of a fund during which it is allowed to invest in new portfolio companies). Often, after the end of the fund's investment period, the management fee is reduced.
- Management fees are typically funded out of investors' capital commitments or the fund's operating cash flows.
- However, management fees may be charged to investors directly in addition to their capital commitments.

Operational Expenses – Acquisition and Disposition Fee Expenses

- Acquisition and disposition fees may be charged by fund managers to funds or to portfolio companies for structuring and negotiating documentation of investments.
- If the fee is payable by the portfolio company, it may be subject to management fee offsets.

Broken Deal Expenses

- Break-up fees are paid by a target company of a buyout fund when the target company wishes to terminate the purchase agreement between itself and the fund in order to accept a higher purchase price from another party.

Finder's Fee Expenses

- Finder's fees are typically paid in cash but may be paid in the form of equity in the target investment.

Operational Expenses – Holding Costs

Holding costs refer to costs associated with third-party service providers and contractually required expenses relating to an investment during its holding period.

Travel Expenses

- Some operating agreements provide for investment-related travel expenses to be borne by the fund, but this varies.
- Some funds only cover travel expenses that are incurred as part of the acquisition or disposition of an investment.

Service Provider Expenses

- Legal costs represent a large portion of service provider costs prior to the launching of the fund.
- Costs of auditors also have risen significantly.
- More private equity funds also are retaining the services of custodians and administrators.

Extraordinary Expenses

- Extraordinary expenses incurred by a fund (for example, indemnity obligations and litigation costs) can substantially impair its performance.
- As a result, the extent to which a fund may be obligated to indemnify its managers has been curtailed significantly over recent years.

Partner Meeting Expenses

- A fund can incur substantial costs for its annual partner meetings.
- These meetings are considered an important part of fund communications.

Tax Expenses

- Funds are typically structured as limited partnerships, limited liability companies, or offshore vehicles that do not pay entity-level U.S. federal income taxes.
- However, funds can have tax liability under state, local, or foreign laws, and may use taxable blocker corporations to hold certain investments.
- Additionally, a fund may need to withhold amounts from certain partners to address tax liabilities of those partners. For example:
  - *Effectively Connected Income (ECI) of Certain Foreign* Partners—If a foreign person engages in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business is considered to be Effectively Connected Income (ECI).
  - Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)—The disposition of a U.S. real property interest by a foreign person is subject to FIRPTA income tax withholding.

General Partner and Management Company Expenses

Unlike permitted fund expenses (e.g., operational and organizational expenses), investors' capital contributions and deal proceeds cannot be used to cover those expenses which the general partner and the management company must bear.

General Partner Expenses

- Expenses of the general partner outside of the fund are generally limited—typically limited to auditing and legal expenses.
- This is because the general partner does not have employees (and therefore does not have salary expenses).
- Also, the general partner will generally be able to look to the fund indemnity to cover litigation or extraordinary expenses.
- The general partner's source of cash to cover its expenses is limited to distributions it receives from the fund and capital contributions from its partners.
- The management company or its principals will often advance the payment of the general partner's expenses with the expectation that such payments will be repaid in the future.

General Partner and Management Company Expenses

Management Company Expenses

- The management company of a fund is required to cover the overhead expenses of the fund, including salaries, benefits, rent, health insurance, and the cost of fund-related hardware and software.
- The management company may be required to:
  - bear travel and entertainment expenses for monitoring investments;
  - pay fees for consultants for specialized or technical services related to the business of issuers of securities held by the fund;
  - bear broken deal expenses (although break-up fees are typically expenses of the fund).
- The management company covers the majority of its expenses out of the management fees it collects.
- Transaction fees may also provide sources of expense coverage.

SEC Presence Examination Initiative

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 eliminated various client exemptions which investment advisers could use to avoid registration under the Investment Advisers Act of 1940.
- The SEC staff has been carrying out “Presence Exams” of these newly registered advisers.
- Every registered investment adviser is subject to examination by the SEC through the Office of Compliance Inspections and Examinations (OCIE) and its National Exam Program.
- As part of these on-site examinations, the SEC staff requests and reviews the books and records of the adviser, interviews various personnel, and attempts to determine if the adviser is complying with the numerous rules and regulations of the Investment Advisers Act.

SEC Presence Examination Initiative

- As of May 2014, the OCIE had initiated examinations of over 150 newly registered private equity advisers, and had found certain “concerning trends” regarding private equity expenses.
- The OCIE identified violations of law or material weaknesses in controls with respect to the fees and expenses of at least half of the investment advisers it reviewed.
- Some of the most common deficiencies occur in the investment advisers’ use of consultants, also known as “Operating Partners.” Many of these Operating Partners are paid directly by portfolio companies or the funds without sufficient disclosure to investors. Further, Operating Partners are not usually treated as employees or affiliates of the manager and, therefore, their fees rarely offset management fees.
- The OCIE also noted that there appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund’s life without disclosure to limited partners.

Effect of Management Fees and Organizational Expenses on Distributions to Investors*

The question is whether the amount of profits which are distributed to a fund's investors should be reduced by the management fees and organizational expenses that are incurred by the fund.

- *Institutional Limited Partners Association (ILPA):* ILPA takes the position that profits should not be reduced by management fees and organizational expenses incurred by the fund prior to distributing the same to the fund's investors. Further, all management fees and organizational expenses incurred by the fund should be returned to the fund's investors as quickly as possible (as opposed to pro rata as discussed below).
- *U.S. Market Standard:* Like ILPA, the U.S. market standard is that profits should not be reduced by management fees and organizational expenses. However, unlike ILPA, the U.S. Standard is that these fees/expenses should be returned to investors pro rata on a deal by deal basis. That is, if an investment of a fund is sold, then investors will only receive their pro rata share (based on their relative capital contributions attributable to the realized investment) of the management fees and organizational expenses that are attributable to the investment which was sold.

* Note: For additional information regarding the effect of fund expenses on fund distributions, please see the presentation entitled: "Private Equity Fund Distribution Waterfalls."

Further information

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