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## Minimising Legal Risk in Private Equity Investments – Key Protections

Investment in private equity funds has for a number of years constituted a viable asset class for many superannuation funds. However, private equity funds remain a relatively unregulated and potentially high risk form of investment. Consequently, as part of their due diligence process, trustees are obliged to ensure that investment documents contain certain fundamental protections for both the trustee and the superannuation fund. To assist trustees in minimising their legal risk, this paper provides a basic guide to these investor protections.

**Limited liability:** agreements must clearly express that an investor's liability is limited to their investment and that investors are not personally liable to the fund or its creditors for any debts and obligations. Agreements should provide that the activities of the fund will be conducted in a manner that protects the limited liability of investors.

Trustees also need to be aware of common exceptions to limited liability that may apply. These exceptions include the provision by investors of an uncapped indemnity in respect of: tax incurred on their behalf by the fund; losses resulting from a breach of any warranty or representation made by the investor; breaches of fund confidentiality and losses resulting from any default on paying a capital call. There may also be a liability to return distributions of both income and capital to the fund in certain circumstances.

**Investment strategy:** funds need to adhere to a coherent investment strategy. Agreements should provide for a proper diversification of investments, appropriate restrictions on borrowing and specify the permitted uses of derivatives. Information Memorandums often make representations as to investment criteria or restrictions and these should be accurately reflected in the agreements.

**Valuation:** valuation policies should be clearly expressed. Preferably such policies should be anchored to recognised standards and allow for a regular update of asset valuations. Provision should also be made for investor advisory boards to review and, if necessary, object to valuations with recourse to an independent expert.

**Commitment Periods:** in respect of partly paid interests, agreements should specify a commitment period and the basis on which capital calls can only be made after the expiry of such periods. Consideration should also be given as to the circumstances in which calls and the making of new investments can be suspended.

**Subsequent closings:** investors need to be adequately compensated for the admission of additional investors at subsequent closings or if initial investors increase their investment in the fund. Conversely, if investing as a part of a subsequent close, investors should ensure that any premium payable is commercial and not inflated. Investors should also be aware that interest and management fees will generally accrue from the date of the first close.

**Conflicts of interest:** funds must demonstrate a fair and equitable process of resolving conflicts. Ideally, all material conflicts of interest should be submitted to an independent investor advisory board for resolution. Investors should be cautious of any terms that attempt to eliminate fiduciary duties of the fund operators.

To avoid undue competition for portfolio investments, it is also appropriate that fund operators be restricted from promoting, establishing or operating successor funds with similar investment strategies or objectives. Generally, successor funds should not be established until at least the expiration of the fund's commitment period or when the fund has become fully invested.

**Transfers:** transfers should not be unduly restricted. This is especially the case in respect of transfers to any affiliate, successor trustee or successor custodians of the investor. Such terms frequently require inclusion in a side letter as European and US funds are less familiar with the specific needs of Australian superannuation funds.

**Key People:** key people should be required to devote a substantial amount of their time to the fund's business. Provision should be made for suspension of commitment periods if key people are no longer actively involved and for appropriate replacements to be made.

**Operator's Duties:** it is common for the fund operators to exclude their liability in very broad terms. However, at a minimum they should remain liable for their negligence, fraud, breach of duty and material breach of agreement. To avoid liability for agents, fund operators must select and monitor such agents with reasonable care and skill. Terms such as "acting in good faith" or "good faith judgment" should be reviewed carefully as interpretation may differ between foreign jurisdictions.

**Indemnities:** indemnity clauses should be drafted so that any indemnified loss is directly attributable to the fund and its activities. Fund operators should also be able to demonstrate that they hold appropriate insurance for directors and officers.

**Information:** funds need to provide a detailed level of reporting as well as audited accounts and financial statements sufficient to meet any SIS obligations. Investor's reasonable requests for information should be permitted and investors should also have the right to inspect the funds registers and books of account at any reasonable time. At a minimum the fund should be required to hold at least annual investor meetings.

Investors should also look to receive additional information such as the level of Australian fund participation to confirm whether the Controlled Foreign Corporation income attribution rules will apply. Further, investors should seek information sufficient to allow the investor to satisfy its Australian tax compliance obligations. This may include seeking by a permanent request to provide specific information regarding the fund's sources of income, capital gains or losses and any foreign taxes withheld.

**Investors' Rights:** investors should always look to maintain the right by special resolution (or other majority) to remove and replace fund operators or to terminate the fund. Consideration should be given as to what level of investor support is required to convene meetings.

**Investor Advisory Boards:** advisory boards should consist of investors' representatives who are independent from the operators of the Fund. Advisory boards need to meet regularly and have powers that include the right to review and object to asset valuations and resolve conflicts of interest. Investors should also be able to ascertain to what extent investment restrictions can be undermined by an advisory board's ability to agree to such transgressions.

**Amendments:** amendments to agreements that increase liability or have an adverse economic effect on the investor should not be permitted without the investor's consent.

**Fees:** fees and expenses disclosed in information memorandums need to be properly reflected in the agreements. Any clawback from fund operators should be secured by individual guarantees provided by the members of such operator. Investors also need to ensure that agreements properly encapsulate the fund's policy on "soft dollars", placement fees and other types of commissions.

**Side Letters:** agreements must state that side letter terms are legally binding and will prevail notwithstanding the terms of any agreement. Investors are sometimes able to seek a "most favoured nation" clause whereby terms offered to other investors are disclosed and offered to them. Investors should be able to ascertain from agreements that they will be entitled to the same material rights as other investors.

**Investor Questionnaires:** Because answers to Investor Questionnaires are given as representations and warranties by the investor, investors need to exercise due care when answering, especially, in respect of the investor's capacity to invest in certain jurisdictions. This is particularly the case if an investor wishes to participate in US "new issues". Because of amendments to NASD Rule 2790 which have significantly broadened the category of people who are now restricted from participating in new issues, Trustees will need to evaluate whether or not their members fall inside the category of restricted persons.

**Subscription Agreements:** investors should review subscription agreements in their entirety as they may contain further material terms and will require the investor to make a number of warranties and representations.

### **Borrowing and Charges**

Trustees should be aware that there is still some uncertainty as to whether borrowing by a fund structured as a foreign limited partnership will constitute a borrowing by a superannuation fund that

is prohibited by section 67(1) of the Superannuation Industry (Supervision) Act 1993 (**SIS Act**). Currently, there is no definitive precedent on this question. However, in our view it can be argued that the borrowing of a properly formed limited partnership can not be attributable to a limited partner because a limited partner is not jointly and severally liable for the debts and obligations (including borrowing) of a limited partnership. This will be the case as long as the limited partnership continues to conduct its activities in a manner that protects such limited liability.

To avoid potential breaches of SIS Regulation 13.14, trustees need to be satisfied that the fund agreements do not give rise a charge or other encumbrance over the assets of a superannuation fund once the interest is purchased.

To obtain more definitive protection from any potential breach of section 67(1) of the SIS Act and SIS Regulation 13.14, trustees may wish to consider investing through an interposed feeder entity such as a unit trust.

**Termination:** agreements need to exhibit a clear exit strategy and provide for the orderly and efficient liquidation of the fund's assets.

**Conclusion:** superannuation funds have now established private equity as a viable asset class. Trustees being wholesale clients should be proactive in negotiations with fund managers to ensure that investor protections are included in their agreements with private equity funds. Trustees will also need to maintain evidence of due diligence performed including investment adviser recommendations, investment committee signoffs, legal and accounting signoffs.

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