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Chapter 109

Private Equity

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§ 109:1 Scope note

This chapter seeks to educate readers concerning issues that commonly arise in litigation involving private equity firms and their investments. Private equity firms face a multiplicity of litigation issues, from civil to regulatory to criminal; we will focus on commercial litigation issues that commonly arise in the private equity context.

Most private equity firms are structured as limited liability partnerships ("LLPs") or limited liability companies ("LLCs"). In addition, private equity firms generally set up one or more funds as LPs or LLCs with sponsors controlling the general partner or managing members and investors receiving limited partnership or membership interests.[1] The sponsor and its affiliated investment manager—the entity that employs the investment professionals who manage the fund's investments—are also typically structured as LPs or LLCs. Thus, this chapter addresses disputes that arise between the founders or members of the private equity firm,[2] as well as between investors and the general partner or manager.[3]

Many disputes involving private equity firms concern investment professionals seeking to start a new firm, often employing a similar investment approach. Accordingly, this chapter addresses litigation between established firms and their spin-offs or former employees,[4] in particular where the former employers are accused of using the investment track record[5] or confidential and proprietary information[6] of the established firm without its permission.

Finally, many private equity firms invest in or acquire a portfolio of businesses that can be improved and sold at a profit. This chapter also discusses the firm's litigation arising out of the

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[Section 109:1]

[1] See § 109:3.

[2] See §§ 109:5 to 109:8.

[3] See §§ 109:9 to 109:13.

[4] See §§ 109:14 to 109:19.

[5] See § 109:16.

[6] See § 109:18.

acquisition, management, and sale of portfolio companies,[7] including litigation over earn-out provisions in purchase agreements,[8] director liability for private equity representatives on the board of portfolio companies,[9] and other issues that arise from the investment life cycle of a private equity investment.

§ 109:2 What is a private equity firm?

While there is no single definition of a private equity firm, generally speaking, a private equity firm is an investment vehicle in which investment professionals amass a pool of money or commitments in one or more funds from investors, to make equity or debt investments in business enterprises.

The scale of the private equity industry today is staggering. In fact, in 2019 private equity fundraising was at an all-time high in the United States, with over $300 billion raised.[1] This represented nearly a 55% increase over the approximately $195 billion raised in 2018.[2] In connection with the increase in overall private equity funding, the average private equity fund size also increased from approximately $900 million in 2018 to nearly $1.5 billion in 2019.[3]

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[7] See §§ 109:21 to 109:26.

[8] See § 109:21.

[9] See § 109:26.

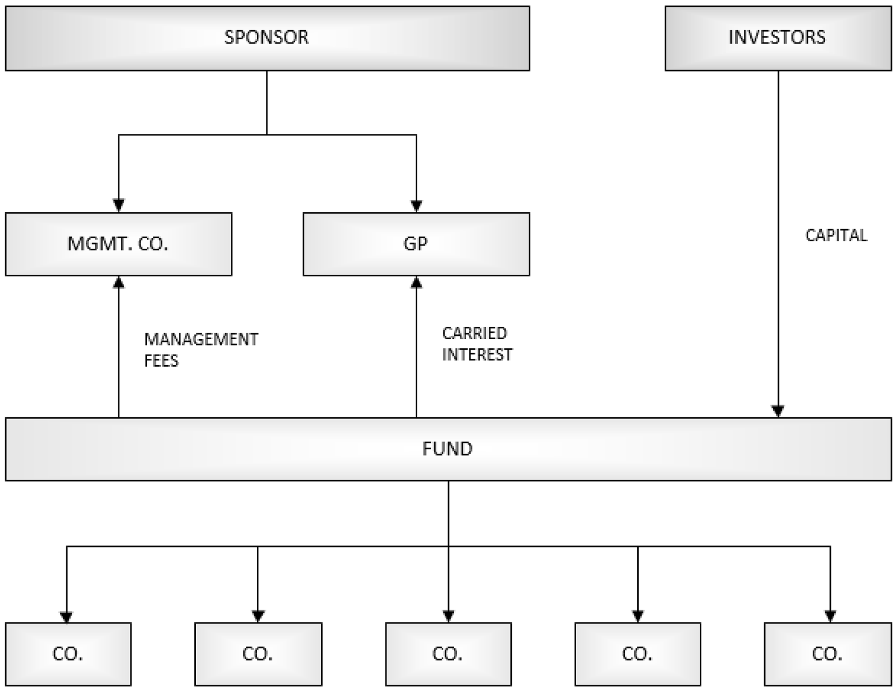
[Section 109:2]

[1] Pitchbook 2019 Annual US PE Breakdown. See also Melissa Karsh, Private Equity Is Starting 2020 With More Cash Than Ever Before, Bloomberg (Jan. 2, 2020).

[2] Pitchbook 2019 Annual US PE Breakdown. See also Melissa Karsh, Private Equity Is Starting 2020 With More Cash Than Ever Before, Bloomberg (Jan. 2, 2020).

[3] Pitchbook 2019 Annual US PE Breakdown. See also Melissa Karsh, Private Equity Is Starting 2020 With More Cash Than Ever Before, Bloomberg (Jan. 2, 2020).

§ 109:3 Structure of a private equity firm



The structure of a private equity firm typically includes several key entities.

The Investment Fund: The investment fund is a pool of capital that has no direct operations. Investors acquire interests in the investment fund, which makes the actual investments for their benefit. Each investment fund typically has a predetermined "investment period" or "commitment period," usually between three and five years, during which the fund is permitted to make investments on behalf of the investors. Investment funds are typically formed as non-traded limited partnerships or limited liability companies[1] to suit the needs of investors (i.e. institutional investors such as pension funds, trusts and endowments, family offices, insurance companies, banks, etc.) and to optimize tax treatment using a "pass through" structure and avoiding double taxation of income and gains to investors—once at the corporate level and a second time at the investor level.

Sponsors: The "sponsors" (also sometimes called "founders," "principals," "partners," or "managing directors") refer to the individuals or entities that own or control the general partner and/or the investment manager of the fund. Sponsors are responsible for organizing and managing private equity funds, including by raising the capital to start the firm. As part of raising capital, sponsors typically participate in the preparation of marketing documents, including the "pitch book" the fund's private placement offering memorandum, the partnership agreement of the fund, investor side letters, and organizational documentation governing the general partner and the investment manager.

The General Partner ("GP"): Each of the PE firm's investment funds has a general partner. The GP is a special purpose vehicle used by the sponsors to control and administer each fund. The GP has the legal power to act on behalf of the investment fund and is ultimately responsible for the firm's operations and expenses. The GP and management company usually share common ownership and control. Typically, the GP provides 1% of the committed capital for the private equity fund and receives 20% of the profits.

The Management Company or Investment Advisor: A management company or investment adviser is typically appointed by the GP to provide investment advisory services to the fund. This is the operating entity that employs the PE firm's investment professionals, evaluates potential investment opportunities and

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[Section 109:3]

[1] See generally Chapter 104, "Limited Liability Companies" (§§ 104:1 et seq.).

incurs the expenses associated with day-to-day operations and administration of the fund. Often, but not always, the GP and the management company are owned and controlled by the same group of individuals or sponsors.

The Limited Partners ("LPs"): The investors who provide a substantial portion of the capital to a private equity fund in exchange for an interest in the fund up to a specified limit are typically limited partners in the limited liabilities companies through which the fund is organized. Historically, LPs have provided as much as 99% of the capital of a private equity fund in exchange for 80% of the profits. LPs are not expected to provide the total amount of their commitment up front. Rather, when the fund is raised, the LPs each commit to invest capital in the fund up to a specified limit as investments are identified or expenses are incurred. As and when additional capital is needed, the GP issues a "capital call notice" to limited partners indicating that additional funds are required to pursue certain investments or to pay expenses. LPs are then obligated to provide such funds, up to the total amount of committed capital.

§ 109:4 Economics of a private equity firm

The two driving forces behind the economics of a private equity firm are management fees and carried interest.[1]

First, in exchange for managing the day to day activities of the fund, evaluating potential investment opportunities, employing the investment professionals, renting office space, and other operational activities, the management company typically receives a management fee. The management fee usually is a set percentage of total capital commitments to the PE fund during an initial period (the "investment period") and then a fixed percentage of invested capital after the investment period. Management fees for PE funds range from anywhere between 1.5% to 2.5% of committed capital (traditionally 2.0%), with larger funds charging less than smaller funds.[2] For example, a fund with $1 billion in committed capital with a 2% management fee would generate $20 million in annual fees for the management company ($1 billion under management × 2% management fee = $20 million annual payment).

[Section 109:4]

[1] See § 109:19 for discussion of distribution of carried interest.

[2] Schell, Private Equity Fund, Business Structure and Operations, § 1.04[3][c] (2006); Kocis et al., Inside Private Equity: The Professional Investor's Handbook, 22–23 (2009); Ramsinghani, The Business of Venture Capital Insights from Leading Practitioners on the Art of Raising a Fund, Deal Structuring, Value Creation, and Exit Strategies, 7 (2011).

Second, the general partner ("GP") receives carried interest (also known as a "carry" or "success fee.") Carried interest is calculated as a percentage of the profits of the private equity fund. Carried interest can range from 15% to 25% (traditionally 20% and, in conjunction with the standard 2% annual management fee, such arrangements are referred to as a "2 and 20" structure).[3] For example, a $1 billion fund with a 20% carried interest that invested in portfolio companies which yielded $3 billion in profits would provide the GP with $400 million of carried interest ($3 billion proceeds—$1 billion invested capital = $2 billion profit × 20% carried interest = $400 million payment of profit to the GP; the limited partners would receive payments of $1 billion for return of invested capital plus $1.6 billion of profit).[4]

The timing and calculation for carried interest are often heavily negotiated and spelled out in considerable detail in the organizational documents of the fund. Tax implications can often play a factor. Generally, partnerships are a pass-through entity for income tax purposes. That is, for income tax purposes, it is the partners and not the partnership who is responsible. This can sometimes result in negative short term tax implications for private equity partners. For example, the owners of the GP can sometimes have so called "phantom" income where the GP is allocated a portion of the profits of the fund despite the fact that the GP has not actually received a carried interest distribution. Accordingly, most private equity funds allow for "tax distributions" to the general partner sufficient to cover any tax liability, which are treated as an advance against future income.

§ 109:5 Disputes between founders

Disputes between founders of a private equity fund often include disputes over compensation,[1] business opportunities,[2] and investment track record.[3]

[3]Schell, Private Equity Fund, Business Structure and Operations, § 1.04[3][a] (2006); Cendrowski et al., Private Equity: History, Governance, and Operations, 8 (2008); Kocis et al., Inside Private Equity: The Professional Investor's Handbook, 22–23 (2009); Ramsinghani, The Business of Venture Capital Insights from Leading Practitioners on the Art of Raising a Fund, Deal Structuring, Value Creation, and Exit Strategies, 94–95 (2011).

[4]This example is simplified for the sake of the clarity and does not fully account for certain expenses.

[Section 109:5]

[1]See § 109:6.

[2]See § 109:7.

[3]See § 109:8.

§ 109:6 Disputes between founders—Compensation

The most common type of dispute between the founders of a private equity firm are disputes over compensation. In some cases, lawsuits are initiated by partners of a private equity firm, or individuals claiming to be a partner under a written or oral agreement with the other partners of the firm, alleging that they have been deprived of their partnership interest in violation of the governing fund documents. For example, in *Foster v. Kovner*, the plaintiff—formerly a senior partner at McKinsey & Co., Inc.—alleged that he entered into both a written and oral agreement to start a private equity fund with the other partners and was entitled to a 10% equity interest in the fund.[1] Upon leaving McKinsey, the plaintiff alleged that he began to establish business relationships with key investors for the firm and alleged that he personally brought in more than $350,000,000 from various investors.[2] Subsequently, the other partners of the fund denied entering into any agreement with the plaintiff and withheld his partnership distributions.[3] The court ultimately granted the defendants summary judgment and dismissed the case in its entirety, finding that the plaintiff had failed to substantiate the core allegation of his breach of contract claims—that the parties reached a final agreement that he would receive a 10% equity interest in the fund.[4]

Similarly, in *Powers v. Cent. Therapeutics Management, L.L.L.P*, a putative partner brought suit alleging that his former partners terminated his position when they withheld his carried interest, in violation of their written employment and oral partnership agreements.[5] He asserted 12 causes of action, ranging from breach of written and oral partnership agreements to breach of fiduciary duty to unjust enrichment. While several of the claims were dismissed as untimely under the applicable statute of limitations, other claims survived and, as of the time of this publication, are unresolved. Finally, in *Campbell v. Mckeon*, a partner of a private equity firm alleged that his co-partner breached their oral agreement and refused to pay him his share

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[Section 109:6]

[1] Foster v. Kovner, 2006 WL 4804738 (N.Y. Sup 2006),order rev'd, 44 A.D.3d 23, 840 N.Y.S.2d 328 (1st Dep't 2007).

[2] Foster v. Kovner, 2006 WL 4804738 (N.Y. Sup 2006), order rev'd, 44 A.D.3d 23, 840 N.Y.S.2d 328 (1st Dep't 2007).

[3] Foster v. Kovner, 2006 WL 4804738 (N.Y. Sup 2006), order rev'd, 44 A.D.3d 23, 840 N.Y.S.2d 328 (1st Dep't 2007).

[4] Foster v. Kovner, 2012 WL 251568, at *6 (N.Y. Sup 2012).

[5] Powers v. Cent. Therapeutics Management, L.L.L.P, 2018 WL 452014, at *4 (N.Y. Sup 2018).

of the partnership distributions related to two of the funds' investments.[6] He brought suit alleging that, by depriving him of the economic benefits to which he was entitled to under an oral contract, his co-partner breached an oral contract and/or was liable under a theory of quantum meruit. Such claims were sufficient to withstand a motion to dismiss, and the parties later entered into a stipulation of discontinuance with prejudice, an indication that that dispute had been settled.[7] These cases illustrate that it can be difficult to prevail in a dispute regarding private equity partnership compensation without a clear writing and that it is often difficult to enforce oral agreements in such cases.[8]

Other common disputes among founders or members of a firm concern the clawback of partnership distributions. Depending on the carried interest model employed, it is possible for the general partner ("GP") to have received a greater portion of payments than it is due. Under a clawback provision, distributions previously made to the partners of a private equity fund can be recalled by the GP to satisfy liabilities of the fund. In *Resurgence Asset Mgmt., LLC v. Gidumal*, for example, a private equity firm successfully brought a breach of contract action against a former partner who had breached the clawback provision of his termination agreement when he did not repay his pro rata share of overpayments of his partnership interest.[9]

Yet other cases regarding compensation involve claims by a private equity firm, or its partners, that one of the partners has misappropriated partnership income for their own personal benefit. For example, in *Storper v. WL Ross & Co., LLC* several partners of a private equity fund alleged that other partners "improperly utilized their control over the GPs and breached the fiduciary duties that they owed to the GPs and the non-managing members by siphoning away more than $48 million in improper and unreasonably high management fees charged to the GPs, by taking those fees for themselves."[10] The plaintiffs asserted three

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[6]Campbell v. Mckeon, 2009 WL 9122514, at *4 (N.Y. Sup 2009), order aff'd, 75 A.D.3d 479, 905 N.Y.S.2d 589 (1st Dep't 2010) and aff'd in part, modified in part, 82 A.D.3d 529, 918 N.Y.S.2d 448 (1st Dep't 2011).

[7]Stipulation of Discontinuance, Campbell v. Mckeon, No. 6006732008, ECF No. 56.

[8]See Chapter 89, "Contracts" (§§ 89:1 et seq.); see also Chapter 50, "Admissibility Issues" (§§ 50:2 et seq.) relating to the parol evidence rule.

[9]Resurgence Asset Management, LLC v. Gidumal, 176 A.D.3d 520, 111 N.Y.S.3d 7 (1st Dep't 2019); see also Resurgence Asset Management, LLC v. Gidumal, 2018 WL 5823649 (N.Y. Sup 2018), aff'd, 176 A.D.3d 520, 111 N.Y.S.3d 7 (1st Dep't 2019).

[10]Storper v. WL Ross & Co., LLC, 2018 WL 4334218, at *1 (N.Y. Sup 2018).

causes of action for an equitable accounting, restitution, or disgorgement of the allegedly improper management fee. However, the court found that all claims were fatally defective on a variety of grounds and dismissed the case in its entirety. Similarly, *Fremuth v. Stetson* involved a case brought by one partner of a private equity firm alleging that another partner allocated the fund's management fees for himself to fund a lavish lifestyle and shore up his own personal finances.[11] When the plaintiff partner learned of this activity, the partner who diverted the funds allegedly seized control of the fund's bank accounts and terminated the other partner.[12] The former partner then brought suit for breach of contract, breach of fiduciary duty,[13] and breach of the implied covenant of fair dealing.[14] However, because both the breach of fiduciary claim and the breach of the implied covenant of fair dealing claim were duplicative of the breach of contract claim, the court found that the only claim sufficient to withstand dismissal was the breach of contract claim and the parties subsequently entered into an stipulation of discontinuance, signifying that the matter had been confidentially settled.[15]

[11] Fremuth v. Stetson, 2017 WL 119761, at *1–2 (N.Y. Sup 2017).

[12] Fremuth v. Stetson, 2017 WL 119761, at *1–2 (N.Y. Sup 2017).

[13] See generally, Chapter 117, "Fiduciary Duty Litigation" (§§ 117:1 et seq.).

[14] Decision & Order, Fremuth v. Stetson, No. 650593/2016, ECF. No. 114.

[15] Fremuth v. Stetson, 2017 WL 119761, at *3–6 (N.Y. Sup 2017).