

# Venture Capital Private Equity Tax Practices

## Identifying Key Trends Driving Venture Capital and Private Equity in 2006

October 24, 2006

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# Agenda

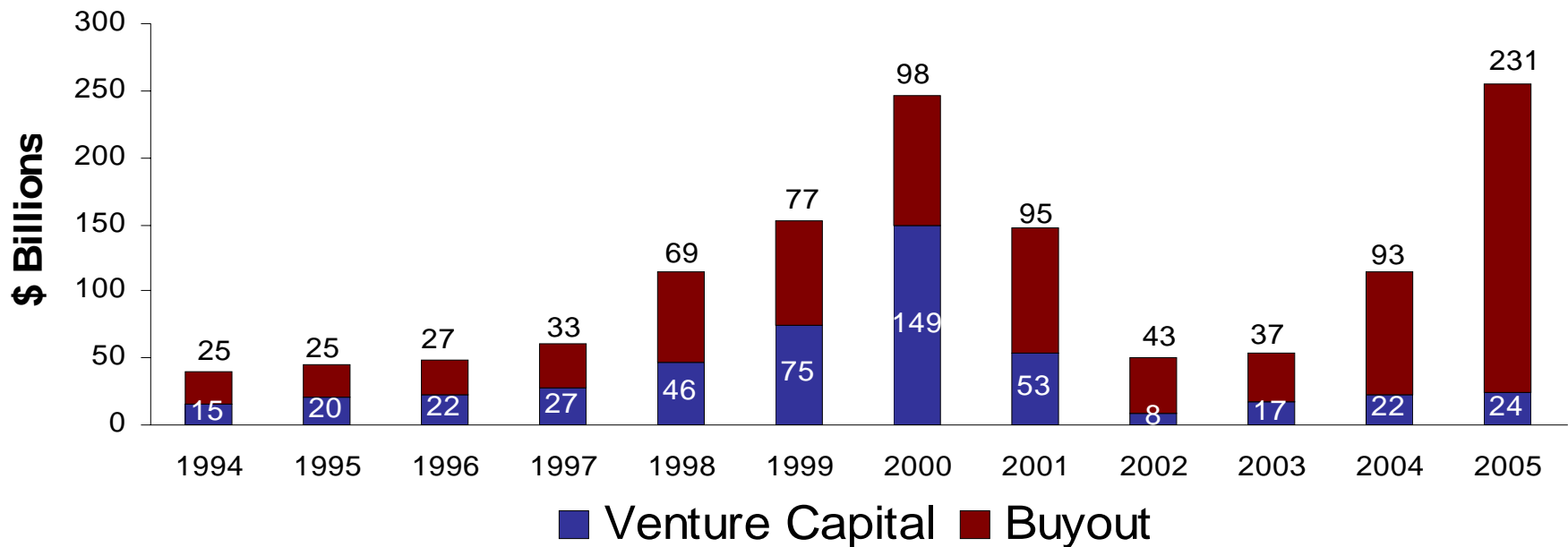
- Market Overview
- Terms and Conditions
- Secondary Market

# Market Overview



# Market Overview

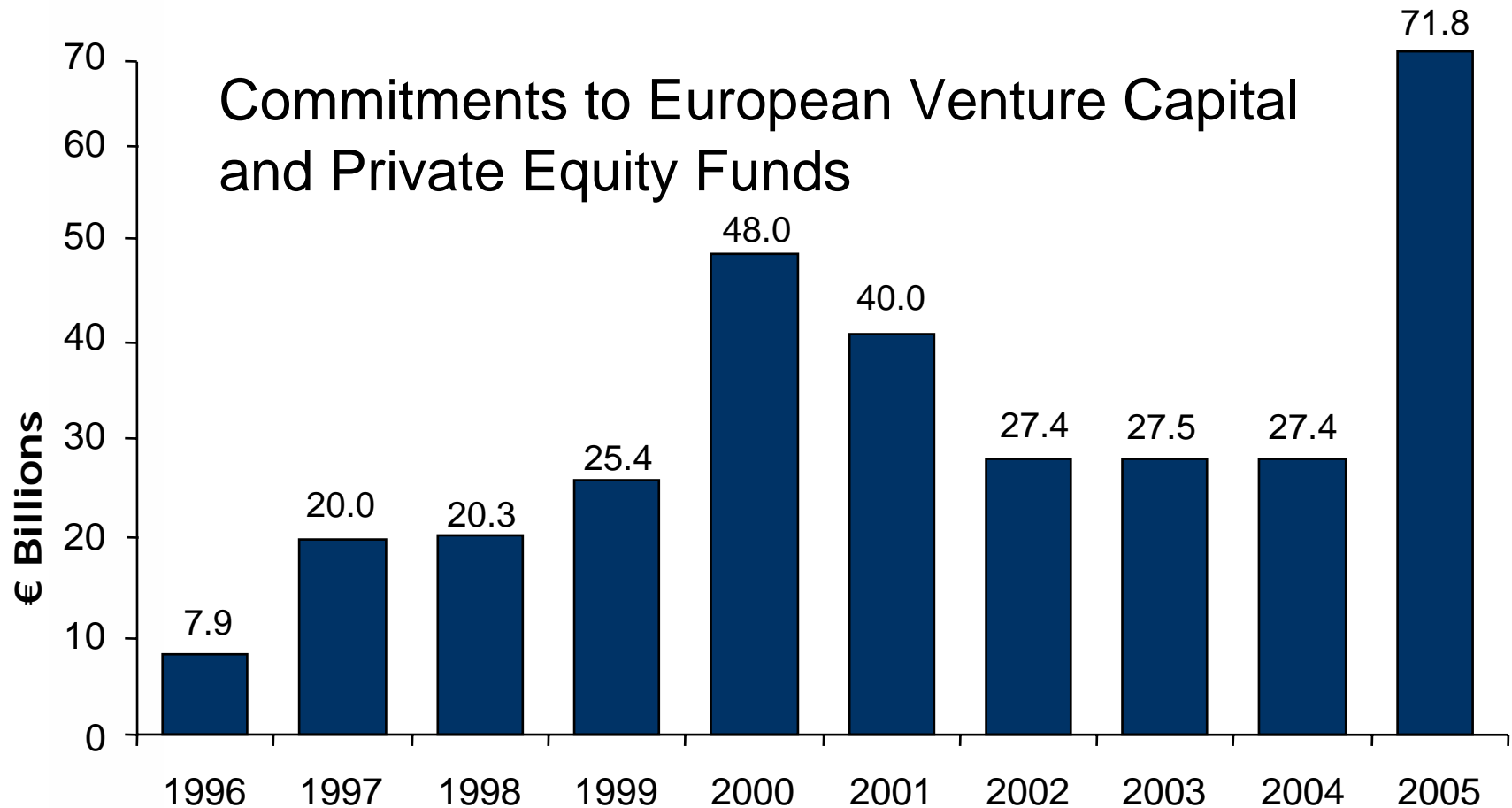
## Global Commitments to Venture Capital and Private Equity Funds



*Source: Thomson Financial, AVCJ, Adveq*



## Market Overview

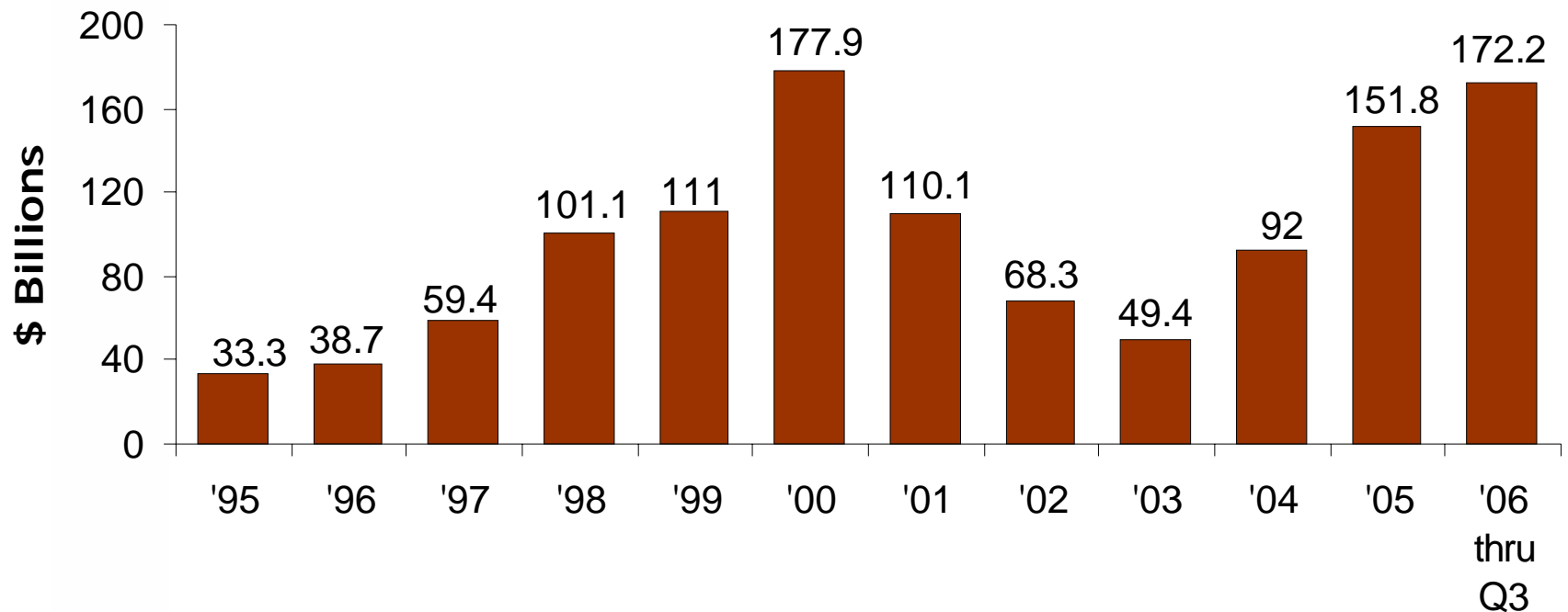


Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers



# Market Overview

## Commitments to U.S. Venture Capital and Private Equity Funds



*Source: Private Equity Analyst*



# Market Overview

## Fundraising in 2007

- Three-tiered Market
- Market Shifting Away From Large Buyout Funds
- Sector Funds and Niche Strategies
- Venture is Still Favorable on an Absolute Dollar Basis
- Increased Pressure on Terms



# Terms and Conditions

- Economics
  - Carry Percentage and Distribution Waterfall
  - Management Fee and Offsets
  - GP and LP Clawbacks
- Governance
  - Time and Attention
  - Key Person, No Fault and GP Removal
- Operations
  - Reporting and Confidentiality
  - Valuations



# Terms and Conditions - Economics

## Carry Percentage/Distribution Waterfall

- Understand the Basic Economic Deal
  - 20% vs. 25% vs. 30%
  - Return Multiples and IRR Hurdles
- Distribution Timing Issues; Cash-on Cash Hurdles
  - Committed Capital / Contributed Capital / NAV Cushions
  - “Disposed of” Capital With or Without All or Some Attributed Expenses
  - Cash-on-Cash Preferences (“True” or “Disappearing”)
- Escrows and Interim Clawback



# Terms and Conditions - Economics

## Management Fee

- Fee Period
  - Investment Period
  - Post-Investment Period
  - Extension Periods and Beyond
- Typical Investment Period Fee
  - Venture Fund – 2.0% to 2.5% of Committed Capital
  - Buyout Fund – 1.5% to 2.0% of Committed Capital
- Early Termination of Investment Period
  - Successor Fund
  - Key Person Event
  - No Fault Termination of Investment Period



# Terms and Conditions - Economics

## Management Fee (cont.)

- Typical Post-Investment Period Fee
  - Sliding Scale; Declines In Later Years
  - Venture vs. Buyout
  - “Assets Under Management”



# Terms and Conditions - Economics

## Management Fee Offsets

- Types of Offset Remuneration
  - Transaction Fees, Monitoring Fees, Broken Deal Fees, Director Options, etc.
- Venture vs. Buyout
- Negotiated Split
  - Move to 80/20 (or even 100/0)
  - Caps
  - Types of Remuneration
- Other Issues
  - Options Never Exercised
  - Remuneration in Excess of Management Fees



## Terms and Conditions - Economics

### Management Fee / GP Capital Contribution

- Convert Fee Income into Capital Gains
- 1:1 Capital Contribution Credit for Fee Reduction (“Cashless Contribution”)
- Payment Conditioned on Future Net Realized Gain
- Now Standard in Venture Funds



# Terms and Conditions - Economics

## GP Clawback

- Interaction with Distribution Scheme
- Timing
  - At Dissolution
  - End of Each Year
- Amount
  - Gross or Net of Taxes
  - Carryover of Losses
  - Assumed Taxes on Distributions In-Kind
  - Tax Rate
  - Tax Benefit to GP
  - Non-U.S. Tax Jurisdictions



# Terms and Conditions - Economics

## GP Clawback (cont.)

- Personal Liability
  - All or Some Carry Holders
  - Several Liability vs. Joint and Several Liability
  - Limitations on Joint and Several Liability
    - By Individuals
    - By Dollar Amount of Exposure
- Stand Alone Guarantees; Enforcement



# Terms and Conditions - Economics

## LP Clawback

- Use of Clawed-back Amounts
- Limitations on Amount
- Limitations on Time
- Interaction with Fund Economics
  - Changes in entitlement to carry
  - Effect on GP clawback



# Terms and Conditions - Governance

## Time and Attention

- Who is Obligated?
- How Much Time?
- Other Obligations
  - Legacy Funds
  - Other Product Lines
- Reduced Time Commitment Post-Investment Period



# Terms and Conditions - Governance

## Key Person, No Fault and For Cause Removal

- Key Person
  - Establishes Expectations
  - Two-tier Approach
    - Specific Individuals
    - Percentage of Organization
  - Triggers
    - Failure to Spend Requisite Time
  - Consequences
    - Dissolution
    - Suspend Investment Period
    - Automatic or LP Action (what %)
    - Replace General Partner



# Terms and Conditions - Governance

## Key Person, No Fault and For Cause Removal (cont.)

- No Fault
  - Terminate the Fund
  - Terminate the Investment Period
  - Remove the GP
  - Percentage Vote Required



# Terms and Conditions - Governance

## Key Person, No Fault and For Cause Removal (cont.)

- For Cause Removal
  - For Cause Triggers
    - Sometimes Linked to Indemnification Carve-outs
    - Who determines?
    - Application to General Partner and Principals
    - Cure Ability
    - Percentage Vote Required



# Terms and Conditions - Operations

## Reporting and Confidentiality

- Negotiation of Confidentiality Provisions in LPA
  - Stricter Controls on Fund Information
  - Harsher Remedies for Disclosure
- Modified Delivery of Portfolio Company Information
  - Segregating Top-Line versus Portfolio-Level Data
  - Password Protected, Web-Based Read Only/Print Only Format
  - Stamping Information as Confidential or Trade Secret
  - Redaction of Confidential Information and Trade Secrets



# Terms and Conditions - Operations

## Valuations

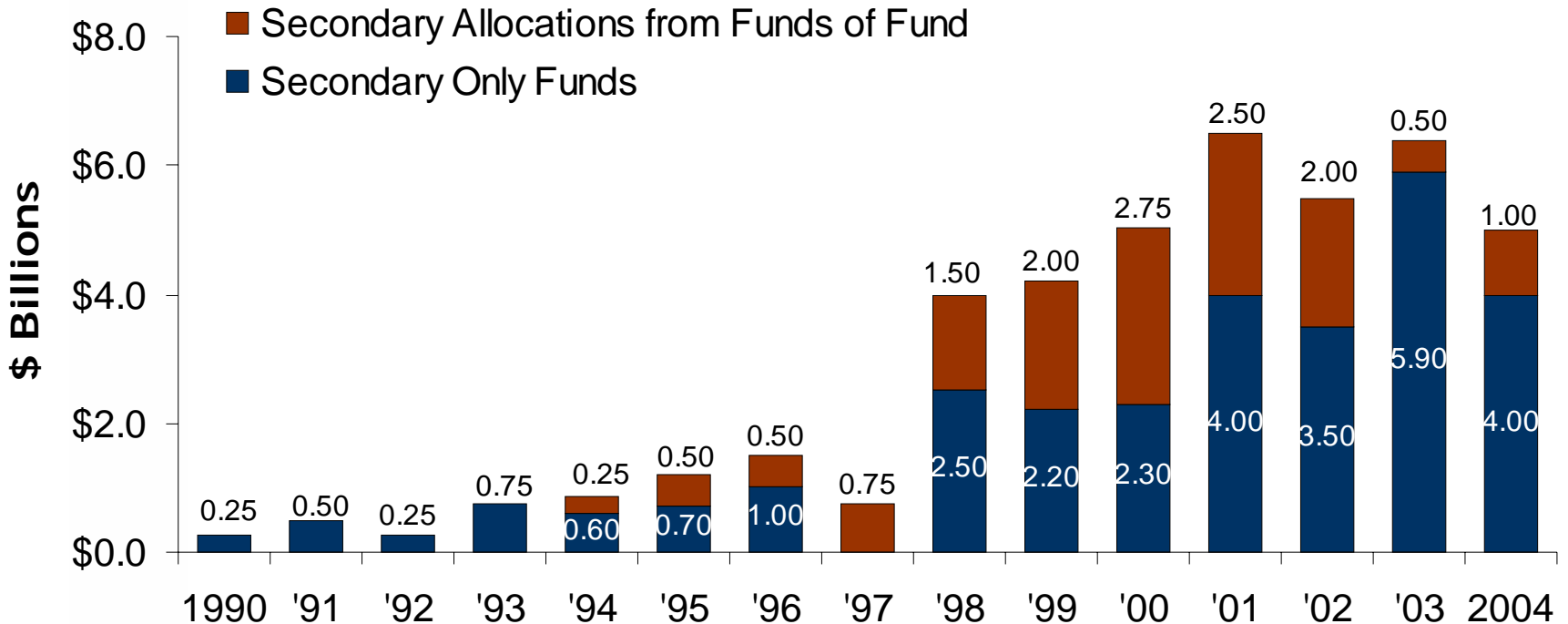
- Role of LP Advisory Board
- In-kind Distribution Valuations
- GAAP vs. Conservative Values
- UK/European Standard; PEIGG; FASB
- Move Away from GAAP by Some in VC Community
- Third-Party Valuation Services

# Secondary Market



# Secondary Market

## Secondary Capital Raised



Source: *VentureXpert; assumes 10% allocation to secondaries from fund of funds in aggregate.*



## Secondary Market

- Efficient Market
- Asset Realignment Tool
- Effects of Increased Liquidity:
  - Less Relationship Oriented
  - More Oriented to Short-Term Results



# Secondary Market

- Growth of Secondary Direct Market
- Tool for GPs to Trim Portfolios
- Fate of 1998-2001 Funded Companies

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