The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

Application of the CRC to private equity funds

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of Application of the CRC to Private Equity Funds has been prepared by the CLLS Planning and Environmental Law Committee.

The Carbon Reduction Commitment (CRC) is an organisation based scheme in which parent undertakings will be grouped together with their subsidiaries (using Companies Act 2006 definitions) to form the CRC participant. The composition of the CRC participant group in the context of private equity houses and their funds will therefore depend on the extent of the parent–subsidiary relationships that are determined to exist within the structure, both at the level of the private equity house, and within each fund.

Parent–Subsidiary relationship

The parent–subsidiary analysis proposed by the draft CRC Order broadly follows that set out in section 1162 Companies Act 2006, which requires any one of the following conditions to be met:

- a parent holds or control alone (through a shareholders' agreement) more that 50 per cent. of the voting rights of the subsidiary, or has a contractual right (for example through the subsidiary's articles) to exercise dominant influence over the subsidiary;
- the parent is a member of the subsidiary and has a right to appoint or remove a majority of its directors;
- the parent has a right to or does exercise dominant influence or control over the subsidiary; or
- the parent and subsidiary are managed on a unified basis.

Private equity house

A typical UK fund structure comprises one or more English limited partnerships, each having a general partner, together with an FSA-authorised manager to which the general partner may delegate its day-to-day operational duties. In this context, the references in section 1162 Companies Act to "dominant influence" and "control" may cause issues in relation to the role of the general partner, the fund manager and individual limited partners, with respect to the CRC participant group.

For the purposes of compliance with the CRC, it will be necessary to determine whether a general partner can be said to exercise dominant influence or control over a limited partnership, which will demand a careful analysis and interpretation of the limited partnership's constitutional documents, including the limited partnership agreement together with any side letters. This analysis could prove complex and difficult to undertake and cause uncertainty. For example, a general partner that can be removed, in practice, at the discretion of the limited partners (so-called 'no-fault divorce') clearly has less control over the limited partnership than a general partner that cannot be removed in this way. A general partner of a limited partnership that has no third-party investors may be said to control the limited partnership, irrespective of whether there is a no-fault divorce provision available. A similar analysis will also be required where the fund has appointed a separate manager.

Where a general partner or a manager is deemed to exercise control over one or more of a private equity house's limited partnerships, including where a fund comprises two or more parallel partnerships, it will be necessary to group each of those limited partnerships (together with their subsidiaries – see below) into a single CRC participant.

Fund

Within each individual limited partnership it will be necessary to identify any parent–subsidiary relationships that might exist between the limited partnership and its investee companies. In a typical fund however, ownership of an investee company may be structured in a number of ways. Where a limited partnership has taken a majority stake in, or can otherwise exercise significant control over, an investee company, the limited partnership will be a parent and will be grouped together with the company to form the CRC participant. Where a limited partnership holds a minority stake in an investee company it is unlikely to be able to exercise the requisite degree of control for it to be a parent.

However, a fund may comprise a number of parallel limited partnerships that invest alongside each other. If the general partner or manager of the parallel partnerships is determined to be the parent, then it will need to consolidate its ownership of an investee company across each of the parallel partnerships to determine whether that investee company is its subsidiary, even where investee companies have no other connection to each other. This could result

in considerable administrative difficulties in collating the necessary data. In the event that each parallel partnership – or individual funds belonging to a single private equity house – is determined to be the relevant parent, their separate holdings in an investee company will not need to be consolidated in this way before the subsidiary analysis is applied. In this scenario, in the event that two or more partnerships are eligible to be the investee company's parent, and between them they hold a majority of the voting rights in the investee company, but each of them holds an equal number of those voting rights, the investee company will not be a subsidiary of any of them, and will be a CRC participant in its own right.

Limited partners

A limited partner in an English limited partnership is precluded from taking part in its management, and is unlikely to be held to be a parent. However, where a single investor is able to exert dominant influence – whether through specific provisions in the limited partnership agreement or in a side letter, or due to the size of its investment in the partnership – it may become a parent undertaking. If such investor is itself a subsidiary, its ultimate parent will need to consolidate its entire group with the fund and any subsidiary investee companies.

Overseas funds

The CRC also applies to private equity houses in which the highest parent undertaking is not located in the UK. In this scenario, the parent will be grouped together with its UK subsidiaries to form the relevant CRC participant, and the overseas parent will be required to nominate a UK-based group member – or a proxy/agent for service – to administer CRC compliance.

Summary

It will be necessary for all private equity houses to carry out a careful analysis of the voting and other control provisions that exist between all the relevant entities: manager, general partner, limited partnership, limited partners and investee companies, in order to determine correctly the composition of the CRC participant group. This analysis is likely to be complex and could cause uncertainty as to the precise CRC participant. Further investee companies that would be well below the threshold for CRC, might be caught because of one investee company whose energy usage is such that it brings all other investee companies into the CRC regime.

Legal issues

Private equity houses also will need to clarify how payments for purchases of allowances under the CRC scheme are to be funded, and the nature of any recycling payments that may be received. This is a considerable administrative burden for entities, many of which have a small staff. Whether

or not the cost of complying with the CRC can be deemed to be an investee company expense will require a careful analysis of the investment agreement relating to each investee company. If the costs cannot be recovered from investee companies, they may be deemed to be an ongoing expense of the partnership itself. Private equity houses will be keen to ensure that the costs of complying with the CRC are not interpreted as being part of the general partner's overheads which are typically borne by the general partner itself. It is likely that any recycling bonuses received will be returned to the original payee. However, where the limited partnership itself has borne the costs of compliance, the limited partnership agreement may require these bonuses to be returned to investors as profits.

2nd JULY 2009