Following the US Approach on Private Equity Structures in Serbia

by Nemanja Simić

LL.M. SHORT THESIS
COURSE: US Partnerships and Corporations
PROFESSOR: Dr. Jessica Lawrence
Central European University
1051 Budapest, Nádor utca 9
Hungary

Abstract

Private equity is a concept that encompasses many related disciplines, like business, economy, financing, management, etc. This thesis aims to provide a clear overview of one of its layers – the legal one. Out of several branches of law affected by this concept, the research will focus primarily on structuring, *i.e.* on the choices of corporate vehicles for business operations and legal consequences that such choices brings with them. In addition, special attention will be paid to tax considerations of such options as they by default heavily affect both the choice of business vehicles and operations of private equity industry in general. The primary reason for making such analysis lies in the fact that up to date scholarly works on legal aspects of private equity in Serbia are essentially descriptive. They do not give the answer as to why private equity industry in the country has not made a substantial progress for more than a decade after its regulation. Nor do they establish a comparative model upon which the industry can look upon. In this research, it is suggested that the US system may serve as such model. For these purposes, it explores the characteristics of the US system and the options it offers. The thesis will conclude that having a choice between several business vehicles and tax treatments is beneficial for the development of private equity industry in a country. Notably, the system needs to provide the possibility for private equity funds and firms to operate as flexible entities that are also fiscally transparent. This conclusion outlines the need for the developing countries to constantly reexamine their approach when it comes to the legal treatment of private equity. Overall, the research shows that civil law systems have many lessons to adopt from the American experience with the regulation of private equity industry. Out of it also comes the recommendation for future scholarly works on alternative models for the development of the industry in Serbia.

Table of Contents

List of Abbreviations

CFR – Code of Federal Regulations (US)

DLLCA – Delaware Limited Liability Company Act

DOO – Serbian limited liability company (*društvo sa ograničenom odgovornošću*)

DRUPA – Delaware Revised Uniform Partnership Act

ERISA - Employee Retirement Income Security Act

ICA – Investment Company Act (US)

LLC – Limited liability company (US)

LP – Limited partnership (US)

PIF – Serbian Private Investment Fund (*privatni investicioni fond*)

ULLCA – Uniform Limited Liability Company Act

ULPA – Uniform Limited Partnership Act

SEC – Securities Commission

ZIF – Serbian Investment Funds Act (*Zakon o investicionim fondovima*)

ZPD – Serbian Companies Act (*Zakon o privrednim društvima*)

Introduction

Private equity is a form of equity financing. In simplest terms, it operates in the following manner. Investors will place their capital into a private special purpose vehicle. The fund invests into the shares of another non-public company and provides the same with financial and business assistance. After a certain period of time, the investment will mature and the investors will collect their profit by selling off their shares at the point of their highest value.

This simplistic picture leads to peculiar scientific problems. Having a two-sided nature, private equity can be qualified as both a legal and business phenomenon. This can raise doubts as to whether one can make a distinctly legal or economic analysis of the phenomenon. Put under scrutiny, such analyses can be deemed as not sufficiently encompassing. Conversely, combining both approaches can obscure the chance of having a clear picture of either aspect of private equity. Hence, it is difficult to fully understand private equity without analyzing both of its aspects. However, this presents a major challenge for any lawyer or economists, as both are inevitably forced to extend their research out of their primary scientific field and into a one where their knowledge may be less than perfect. The only viable solution for this problem is to approach the subject-matter from one scientific field and try to acquire as much in-depth knowledge about the other as it is possible without losing from sight the primary field of analysis. This is exactly what this thesis will attempt to do.

For lawyers, studying private equity leads to a further problem. Being an acclaimed business phenomenon, private equity tends to be the object of interest for mainly business debates. Naturally, such debates do not focus on legal aspects of the phenomenon. The outcome of such approach is that in the better part of the literature the analysis of the legal aspects of private equity is either rudimentary or fragmentary. A legal scholar making a research on private equity will often find himself or herself being deeply in the fields of exploring how private equity works but still with vague knowledge on what type of business entity works or

may work in this way.[1] Looking from the other side, as a consequence of such approach jurisprudence may restrict its inquiry into private equity by simply describing its business forms present in the country without making a critical analysis.[2] Alternatively, they may aim their attention on private equity governance models without paying sufficient level of attention to the corporate forms onto which these models are to be applied.[3]

This study has a focus on a particular problem. Private equity industry in Serbia is badly undeveloped. Even after more than a decade from the regulation of the subject-matter, there is no substantial development of the domestic private equity industry. Currently, there are only two private equity funds registered in the country, both of them operated by the same management company.[4] Even for the standards of other countries in the Southeast Europe, such development is unsatisfactory.[5] Moreover, due to such exceptionality of private equity funds in Serbian business landscape, these entities and their operating companies seldom get the attention of the scholarly works in the country. As an indicator of the oddity of current position of Serbian private equity industry, one should look upon the figures that circulate about a behemoth in private equity industry such as the United States. Evidently, there is a need to determine the reasons for such disinterest in Serbia for an industry that is globally performing better than ever. This thesis will analyze the problem from a legal standpoint.[6]

[1] Taking for example Serbian and foreign authors alike, the same problem is being repeated. For example, see: Nikola Stefanović, *Privatni Investicioni Fondovi – Vrste, Organizacija i Poslovanje Na Brzorastućim Tržištima*

[2] For example see: Vladimir Todorović and Ratomir M Slijepčević, *Privredno Pravo* (Projuris 2016); Mirko Vasiljević, *Kompanijsko i Trgovinsko Pravo* (8th edn, Službeni glasnik 2017).

[3] For example, see: Harry Cendrowski and others, *Private Equity: History, Governance and Operations* (2nd edn, John Wiley & Sons 2012).

[4] Those are WMEP-1 and WMEP-3 funds operated by the FIMA Invest AD Belgrade. Both of these funds operate are related to WM Equity Partners. For the up-to-date information on investment funds in Serbia, see: http://www.sec.gov.rs/index.php/en/market-participants/investment-funds. In addition, see: http://wmep.rs/fund-raising-and-investing/?lang=en.

[5] In 2014, there were 35 private equity firms and 24 private equity funds in Southeast Europe. Out of private equity firms, 16 of them were located in Greece with further 7 each in Bulgaria and Croatia. Luke Goldsmith, 'The Rapid Decline of Private Equity Fundraising in the Balkans' <https://www.preqin.com/blog/0/10124/pe-fundraising-balkans> accessed 6 April 2018.

[6] In 2017, the US private equity industry raised $453 billion from investors with a median fund size of $275 million. Apollo Global Management LLC's (APO.N) Investment Fund IX, the largest private equity fund in the US, had the value of $24.6 billion. Joshua Franklin, 'Global Private Equity Funds Raise Record $453 Billion in

The thesis will address this problem by taking the US as the model country for organizing private equity system. Hence, the primary purpose of this thesis is to establish the characteristics of the US private equity legal framework that are conducive to the success of the industry. The thesis will make a comparative study of the US and Serbian systems in order to determine the points where Serbian solutions have proven to be inadequate for private equity activities. Therefore, the study will have compare two systems which lie on the opposite ends of the private equity spectrum. The approach this thesis will adopt is to disassemble private equity business into its legal components and then to analyze each segment of the concept in both of the jurisdictions. It will start with the legal framework of both countries, followed by the analysis of private equity funds and their management companies. Portfolio companies will not be a special point of interest as their variety does not affect the legal aspects of private equity financing. Conversely, the study will pay attention to tax considerations in both of the systems as they heavily influence the appeal of a given system for private equity industry. Essentially, the thesis purports to identify where the limits to private equity structuring in these two radically different systems are. The way this research is going to answer this question is by examining relevant regulations, scholarly works, individual and company publications, followed by conclusions reached by contacting relevant persons in the industry. Overall, the thesis will set out a clear definition of what private equity is from a legal standpoint and how the given legal solutions affect it. The legacy of the thesis will be that it will provide a foundation for further research on what can be changed in a typical structure of private equity and what the consequences of such changes could be.

2017: Preqin' <https://www.reuters.com/article/us-privateequity-fundraising/global-private-equity-funds-raise-record-453-billion-in-2017-preqin-idUSKBN1ET23L> accessed 6 April 2018; In addition, see: Kevin Dowd, '2007 vs. 2017: A US PE Fundraising Throwdown' <https://pitchbook.com/news/articles/2007-vs-2017-a-us-pe-fundraising-throwdown> accessed 6 April 2018.

CHAPTER ONE – The Concept of Private Equity

In order to determine how is private equity structured, one should first define what the concept is in general. The Chapter One serves for this purpose. In this chapter, the thesis will examine what are the essential characteristics of private equity from a legal standpoint. The chapter will conclude by analyzing paradigm forms of private equity and dealing with the recurring problem of how to categorize those forms in the broader scheme of private equity.

1.1 The role of private equity industry

Private equity bears many ambiguities with it. One of the more common ones has to do with the terminology. Although the term "private equity" relates to a number of concepts, the authors sometimes fail to stress which of the concepts they have in mind. First of all, private equity is an investment activity (*i.e.* private equity financing). As such, it is a source of financing and managerial assistance to the investee. Such investment is particularly characterized by "1) equity participation, 2) long-term investment orientation and 3) ongoing active involvement in the company."[7] Secondly, the term can refer to private equity investors (or venture capitalists), usually stressing the role of the leading investor in the process (as a management company of a fund – the private equity firm). Thirdly, the term can relate to private equity funds. This application has in mind "financial intermediaries between sources of funds (typically institutional investors) and high-growth and high-tech entrepreneurial firms" (if one is dealing with venture capital as a sub-class of private equity).[8] Finally, private equity can be used as private equity capital. This designation refers to "equity capital provided to firms not quoted on stock exchanges."[9]

The purpose of private equity is to provide solution for two major problems that companies may face. On the one hand, private equity provides the access to finance. On the other hand,

[7] Joseph W Bartlett, *Venture Capital: Law, Business Strategies and Investment Planning* (John Wiley & Sons 1988) 3.
[8] Cumming J. and Sofia A. (n 1) 3.
[9] Darek Klonowski, *The Venture Capital Investment Process* (Palgrave Macmillan 2010) 3.

private equity enables the companies the access to know-how. In this respect, private equity aims to overcome the incumbent management's inexperience and lack of proper managerial attributes as well as shortcomings when it comes to the employment of financial specialist and development of adequate marketing strategies.[10] Depending on the type of the investment, know-how will be provided to ensure business survival and development (venture capital) or sustainability and expansion of the business (private equity).[11] Both of these problems are heavily dependent on each other. "The provision of capital without proper management is likely to result in a lack of development for firms (lack of know-how often leads to limited investment, which in turn, leads to the limited growth of the business), more sensitivity of external factors, and a business potential that is unlikely to be captured."[12] Conversely, the provision of know-how without capital may well extinguish the entrepreneurial risk-taking spirit crucial both to the profitability of the investment and the development of the investee. Therefore, the risk of chain reaction caused by the lack of support on either field is what drives the investors to protect their investment by providing the support on both of the fields.[13]

Defining private equity puts forward a question of what drives the parties to enter into a private equity financing agreement. For the investors, the answer is rather simple. Investors want to profit from the development of the portfolio companies willing to give a substantial part of the control over the enterprise. For the investees, private equity is the option of choice when it is the most appealing source of financing in given circumstances. In general, all sources of financing are either internal or external. The internal sources are generated by the firm itself and include notably the use of company's accumulated profit, the adequate management of working capital and additional contributions of current shareholders to the

[10] ibid 1–2.
[11] ibid 2.
[12] ibid.
[13] ibid.

share capital of the company.[14] External sources of financing come into play when the internal ones are either not present or not sufficient for the company's needs. Private equity stands out among other external sources as it supplements their deficiencies. Firstly, bootstrapping (using personal capital of founders, their associates and relatives) suffers from the same imperfections as internal sources of capital. Secondly, private placement of shares comes with the cost of personally finding the right investor with sufficient means (*e.g.* a strategic investor from the same business sector) and the risk of losing the control over the business to that investor.[15] Thirdly, public placement of shares in the stock exchange through primary (IPO) or secondary emission of shares is "an option unavailable to most firms."[16] Such placement is expensive, carries with it a number of information delivery obligations and usually does not provide small or troubled companies with large amounts of money.[17] Lastly, providers of debt financing can have conflicting motives with the motives of the investees. This is due to fact that "banks do not tolerate risk well."[18] Banks are not renowned for being open to high risk investments, whether that be in startups willing to develop or mature companies in need for a turnaround or expansion financing. Moreover, approving the loan is time consuming and can come with the request of providing a security sometimes far greater in value than the amount of the actual loan.[19] During the term of the loan, often the bond between the lender and the borrower will be lost.[20] Furthermore, the debt financing can be fatal for young or troubled companies. This is due to fact that "when firms get into financial troubles, banks are often quick to 'pull the plug'" (*i.e.* to request the acceleration and payment of the debt

[14] ibid 5–6.
[15] Therese H Maynard and Dana M Warren, *Business Planning: Financing the Start-Up Business and Venture Capital Financing* (2nd edn, Wolters Kluwer Law & Business) 434.
[16] Klonowski (n 9) 6.
[17] Maynard and Warren (n 15) 437.
[18] Klonowski (n 9) 6.
[19] ibid.
[20] ibid.

outstanding).[21] Compared to all above mentioned financing methods, private equity usually provides rational or better alternative.

1.2 The features of private equity

Referring simultaneously to investment activities, investors, funds and capital, private equity proves to be difficult to be subsumed under one all-encompassing definition. Hence, the more viable approach to defining private equity is to identify the paradigm components of this business structure.

Firstly, private equity is an equity investment business.[22] The investor invests in the investee. The primary aim of the investor is to earn a return on his or hers investment. In addition, the investor may pursue other goals, such as building a foundation for future business endeavors or following the quest of social philanthropy.[23] Looking from the perspective of the investee, it contemplates to attract the investments in order to finance the operations and growth of its business and subsequently to increase its profit from the business.

Secondly, what can be said to be a defining feature of the private equity is the nature of the investee. The investment will always be targeted at a non-public entity.[24] The shares or other emanations of equity interests of such entity may not be listed on public capital markets.[25] The investees that are listed on capital markets can attract other types of investors, such as mutual funds. Due to fact that the investors invest in a number of companies and hold their equity interests in their portfolio, the investees are referred to as portfolio companies. Major categories of private equity are usually nominated with regard to the business circumstances of the investee (*e.g.* venture capital, cross-over funds, buyouts, etc.).

[21] ibid.
[22] Cendrowski and others (n 3) 4.
[23] Harvey Koh, 'Building Powerful Agents of Change: A Perspective from Venture Philanthropy' <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/78910/Harvey-Koh_2.pdf> accessed 6 April 2018.
[24] Alexander Ljungqvist and Matthew Richardson, 'The Cash Flow, Return and Risk Characteristics of Private Equity' <http://www.nber.org/papers/w9454> accessed 6 April 2018., 6.
[25] Cendrowski and others (n 3) 4.

Thirdly, private equity is a collective investment scheme. The capital of several investors is raised and invested into various types of property with the aim of making the profit and minimizing the risk of investing.[26] Within this hallmark of private equity, a line of distinction can be drawn between two categories of investors. On the one side, private equity business serves to pool the financial resources of many individual investors into the jointly owned fund. As a typical kind participants in this type of financing, one can find high-net individuals (the so-called "angel investors"), institutional investors (*e.g.* investment banks, pension funds, insurance companies, investment companies and investment funds) and institutions that are somewhat closer to not-for-profit organizations (*e.g.* endowment fund).[27] It should be noted that different private equity companies and their funds are allowed to invest into each other's equity, although national legislations may seek to put restrictions on such investments. What binds together this group of investors is that in regular circumstances they do not make the decisions on investments or manage the pool of funds. On the other side, in this kind of collective investment scheme one participant will always stand out – the leading investor. This kind of investor is categorized by the fact that in normal circumstances it not only pools the money into the fund but it also operates the fund. However, depending on the legislation and business forms available to the fund, this type of investor can pull out from participating in equity of the fund and instead focus solely on operating it.

Fourthly, the finances of the investors are pooled into a jointly-owned private equity fund. In the ordinary course of action, the leading investor will organize a fund and try to attract as much as possible of capital to it. The individual investors can participate in the investment scheme by acquiring equity interests in it. What is common for these kinds of funds is that they are organized as non-public legal entities. "The 'private' in private equity refers to the fact that the companies owned by PE firms are not publicly traded, and for the majority of the

[26] Todorović and Slijepčević (n 2) 105.
[27] Klonowski (n 9) 15.

industry's existence, it also applied to the firms doing the buying and selling."[28] It is this feature that makes private equity funds different from other types of investment schemes, like open-end mutual funds (which by default are not legal entities) or close-end funds (which are organized as public entities). However, this is not a strict rule and many major private equity firms are organized as public companies.[29] The fund as an entity is a type of special purpose vehicle (SPV) as it cannot serve for any other action than for making investments in portfolio companies. Depending on the national legislation, the private equity fund may (*e.g.* in Serbia) or may not (*e.g.* in the United States) be a legal person.

Fifthly, instead of operating the fund by themselves, the individual investors entrust the management of the fund to the leading investor. By the virtue of this fact, the leading investor operates the fund in the status of a management company, commonly known as the private equity firm. "Fund manager takes on the responsibility of the day-to-day operations and management of the fund and assumes total liability in return for negligible buyin."[30] The leading investor will always have a separate legal personality from the rest of the investors and the fund itself. Usually it will opt for a legal entity with limited liability. Moreover, the leading investor will by default be an investment company – a special type of company dedicated solely to investing in other companies by acquiring equity interests. In the role of the management company, the leading company will generally define the investment policy of the fund and manage all of its affaires.

Sixthly, the investment itself will by default be a hybrid investment. The investor will not only supply the investee with the fresh capital but will also provide it with necessary business

[28] Kevin Dowd, 'Private Equity Goes Public: A History of PE Stock Performance' <https://pitchbook.com/news/articles/private-equity-goes-public-a-history-of-pe-stock-performance> accessed 6 April 2018.
[29] ibid; Klonowski (n 9) 1. For example, this includes the Apollo Management Group and Blackstone Group. Kohlberg Kravis Roberts and Co. (KKR) includes both publicly held and privately held firms.
[30] Cumming J. and Sofia A. (n 1) 4.

support. This support is commonly described as the value added service.[31] It comes in many forms. Notably, the investor will participate in the management of the investee and try to improve the performance of the company within the company itself. Moreover, it will provide the investee with the financial support needed to obtain further financing through loans or other investments. It may also attract skilled workforce to the company and provide it with business and advertising strategy. Essentially, the mere cooperation with a private equity fund will inevitably increase goodwill and reputation of the portfolio company. This can multiply the effects of any kind of assistance to the portfolio company. And the possibilities for such business assistance are countless.

Seventhly, private equity investments are limited in time.[32] Externally, the fund itself does not acquire the shares of the portfolio companies for the perpetual ownership of them. Instead, it calculates the rate of return on investment, most frequently by using the internal rate of return (IRR) method. Based on these findings, the firm will calculate the duration of its involvement with the portfolio company. Critical for this calculation is the arrangement between the fund and the portfolio company. Usually, the fund will plan its so-called exit strategy by relying on the type of equity interests owned in the portfolio company (*e.g.* preferred stock) and the shareholder agreement with the other owners of the company. Internally, private equity fund as a SPV is usually limited to ten years in time with an option to continue the operations for the following three years.[33] Out of this time span, the investment period in a portfolio company will last from two to seven years.[34] Moreover, the membership of individual investors in the fund fluctuates, although less than in some other funds (*e.g.* open-end funds). Therefore, the members of the fund will inevitably have to exert

[31] Klonowski (n 9) 214.
[32] Cumming J. and Sofia A. (n 1) 145.
[33] ibid 5.
[34] ibid.

due diligence when setting out the rules on entry and exit from the fund in order to stabilize this kind of high-stakes and high-value type of investment.[35]

Eighthly, the private equity business is by default limited in number of participants. Its scheme of operations does bear similarity with hierarchical structures. The business is being led by one management company which operates a limited number of funds. As these SPVs are non-public entities, the membership in them will be relatively limited. Private equity is not a massive business enterprise like publicly listed mutual funds. Furthermore, private equity funds will invest only in a limited number of companies. This is due to fact that investing in such companies is regularly a high-risk endeavor.[36] Hence, private equity investor shall be "highly selective in its choice of investee firms."[37] The business is full of proverbs stating the ratio between the number of portfolio companies and the number of successful ones among them.

Ninthly, the investment in portfolio companies is characterized by limited acquisition of ownership. Private equity funds do not regularly purport to obtain the ownership of the total share capital of the companies.[38] Total acquisition can be even highly counterproductive, as in many variants of private equity financing, the fund relies on cooperation with the original management of the portfolio companies.[39] Therefore, private equity funds focus on obtaining the necessary amount of influence on the management of the portfolio companies. This can be done not only by possessing the shares of common stock but also by using the rights from preferred stock or notably by a shareholders agreement with other members of the company.

[35] ibid 176.
[36] Ljungqvist and Richardson (n 24).
[37] Klonowski (n 9) 8.
[38] Joseph A McCahery and Erik PM Vermeulen, *Corporate Governance of Non-Listed Companies* (Oxford University Press 2008) 181.
[39] ibid.

Tenthly, the private equity financing is a contractual network. The relation between the investment company and the investors depends on the nature of the private equity fund. In cases whereby the SPV is an unincorporated business entity, the leading partner will become the manager of the fund by the virtue of a partnership agreement with the other investors. In other cases where the SPV is a non-transparent, incorporated business entity, the leading partner, acting in the role of the management company, will conclude a separate control agreement with the fund. When it comes to the relation between the investor and the investee, it will also be heavily influenced by the contracts signed with the company (*e.g.* shareholders agreements).

Finally, private equity financing is a goal-orientated endeavor. On the one side, the private equity investors invest in order to "make money from the growth in the value of a business rather than through a pre-negotiated return with preset timing for the repayment of capital."[40] Sometimes this main objective is followed by other non-business aims such as philanthropic intentions or the initial objective of not-for profit investors (*e.g.* university endowments). On the other side, the investee enters the bargain in order to stabilize and further develop his or hers enterprise. In the ideal development of the situation, the goals of both parties will be fulfilled and the fruitful cooperation will come to an end.

1.3 Classification

When it comes to the categories of private equity, two problems arise. On the one hand, there is no general emphasis on the difference between private equity and venture capital. The industry often uses the terms interchangeably and some authors simply acquiesce to such situation.[41] This thesis will follow the approach whereby the term "private equity" refers to all

[40] Klonowski (n 9) 9.
[41] ibid 3. Although the author is well aware of the difference between private equity and venture capital, he uses the later term to refer to the general concept of private equity.

private investment stages.[42] On the other hand, private equity itself is a very precise form of investment funds. As such, any attempt to categorize it may lead the author into the fields of business, financing and economics. However, out of all divisions of private equity, one clearly stands out due to both of its reach and its flexibility. All forms of private equity can be grouped on the basis of the stages of development of the portfolio company and thus on the aim of the investment itself.

Although the classification may differ between authors, the following phases are generally included. In the seed stage, the investees have not yet been able to develop a workable business plan.[43] They do not have to be established as business entities and receive a rather moderate investment in order to deal with technical issues. Start-up stage refers to "financing provided to firms for product development and initial marketing."[44] The benchmark of this phase is that the investee has not yet been able to sell its product commercially.[45] In the following stage, first-stage financing is provided to support production and sales of the products. This may cover "building production facilities, hiring necessary staff and management personnel, developing distribution structures, engaging into marketing and promotional campaigns and more."[46] Subsequent phases are the object of later stage or expansion financing which supports many of aspects of the business, such as working capital, business expansion, initial public offerings, turnarounds, refinancing, etc.[47]

In light of this classification, two categories arise. One part of the spectrum consists of early-stage financing.[48] It is commonly referred to as venture capital. It subsumes under it the first three nominated stages without precluding the inclusion of the expansion financing. This

[42] Cumming J. and Sofia A. (n 1) 5.
[43] Klonowski (n 9) 13.
[44] Cumming J. and Sofia A. (n 1) 5.
[45] ibid.
[46] Klonowski (n 9) 14.
[47] ibid; Cumming J. and Sofia A. (n 1) 6.
[48] Arnd Plagge, *Public Policy for Venture Capital: A Comparison of the United States and Germany* (Deutscher Universitätsverlag 2006) 4.

designation enables the author to include under it both the financing of young companies aiming to further develop and the financing of already established companies that seek the resources for their further business endeavors. Venture capital provides investments that are "are meant to help grow the business: they go either into expense investments (*e.g.* manufacturing, marketing) or into the balance sheet (providing fixed assets and working capital)."[49] The opposite part of the spectrum is late-stage financing.[50] In contrast to venture capital and when not used as a general category, this kind of financing is referred to as private equity financing.[51] This category can be further subdivided into "bridge or mezzanine financing, the buy-out sector with management buy-outs, management buy-ins, and leveraged buy-outs, as well as into specific forms of refinancing of distressed debt and turnaround financing."[52] This kind of financing does not purport to further develop the business but instead "often fill a void where other forms of financing are not readily available from other outside investors, who shy away from the above average risks associated with investments like turnaround financing."[53] Yet again this classification shows its flexibility as it encompasses a quite broad range of business endeavors without losing from sight their common denominator.

Having in mind the above mentioned, the following division of private equity can be deemed as more or less the traditional one. It should start with venture capital (now as an exact form of business endeavor), as it probably the best defined concept in the private equity as a general category. Venture capital is commonly associated with investments into young companies in seed, start-up and expansion stages. Venture capital is also heavily sector-orientated. It is most associated with financing of companies in the fields of computer

[49] Plagge (n 48).
[50] ibid.
[51] Cumming J. and Sofia A. (n 1) 5.
[52] Plagge (n 48).
[53] ibid.

technology, biotechnology, green energy, medicine, pharmaceutics and agricultural innovations. However, sometimes this kind of investment can be found in less high-tech fields (*e.g.* fast-food chains).

The second concept is private equity *in stricto sensu*. When venture capital is defined, it is relatively easy is to outline what private equity is – it is more or less everything that venture capital is not. It is an investment into mature private companies that are not focused on major expansions and are not in need for financing of their growth. Defined as such, any list of exact forms of private equity *in stricto sensu* has to be a non-exhaustive one. Moreover, the approach to such has to be a non-exclusive one, as many of the forms can also be found in the world of venture capital or even as a separate concept within private equity as a general category. Among the forms, the following groups stand out.

The first group consists of bridge and mezzanine financing. It provides quick short-term loans for temporary purposes and with substantial collateral.[54] The classical representative of this form is known simply as bridge financing. It is usually associated with businesses that need a short-term infusion of capital in order to go through a major business endeavor. In addition, the bridge financing is sought in the process of going public. In this process, the companies need the bridge loan "well before they can obtain listing on the stock exchange."[55] Bridge financing is also a key element in the process of leveraged buyouts. A more elaborate temporary financing is known as mezzanine financing. In a similar fashion, it is intended to cover an intermediate period. However, mezzanine capital comes in a hybrid combination of debt and equity financing. Therefore, a mezzanine financing investor will find himself in the position of both the owner and creditor of the portfolio company. The investor will seek a return not only from the subsequent payments of interests but also from an overall potential

[54] Cumming J. and Sofia A. (n 1) 11.
[55] Klonowski (n 9) 14.

that holding an equity stake in the portfolio company offers.[56] "This type of financing is provided to the borrower very quickly with little due diligence on the part of venture capital firm and with limited collateral from the borrower. It is also aggressively priced and expensive to the borrower firm."[57] As it is usually associated with financing of expansion projects, mezzanine financing provides the investor with an opportunity to have a permanent presence in the portfolio company if the project proves to be successful. As a side note, due to fact that this kind of private equity investment combines both debt and equity financing, it can easily be deemed as a separate, third concept of private equity as a general category.

The second group refers to the so-called buyout sector. The benchmark of this group is that it is associated with "specific situations where the management is leading the purchase of shares."[58] Here the private equity investor provides the capital to enable the management of an existing business to acquire existing product lines or the entire business. If the management is the incumbent management of the portfolio firm, this type of financing will be known as management buyouts (MBOs). Alternatively, if the management is an external one, it will be referred to as management buy-ins (MBIs). Whilst MBOs encompass many situations, MBIs are mostly associated with larger international firms purporting to sell off parts of their business.[59] Both MBOs and MBIs can come in the form of leveraged transactions. These are the transactions that are referring to situations whereby the capital structure of the portfolio company is built on the basis of securing the debt "against the assets of the company (or sometimes assets and shares)."[60] While these situations are usually associated with MBOs, they are nevertheless an option for MBIs too. Hence, external managers can opt for taking a bridge loan in order to obtain the assets of the portfolio company. After they have been

[56] ibid 4.
[57] ibid.
[58] ibid.
[59] ibid 14.
[60] ibid.

successful with this, they will switch from bridge to leveraged financing by securing the debt against the assets of the obtained portfolio company.

The third well-known group is targeted at companies in specific financial situations. Notably, it refers to so-called turnarounds. This type of investments aims at troubled or underperforming companies. The investors will thus involve with the management of the portfolio company in order to take necessary steps "to minimize the loss from the deal and maximize the return."[61]

In the light of the above mentioned, the investment funds will be set up as either private equity or venture capital funds (or even as both). They will engage in financing operations like the ones described above. As such they will be subjects of notably economic analysis and will be classified into categories that out of the reach of jurisprudence. However, some concepts bordering private equity should be taken in account. On the one side, individual investors (known as "angel investors") can invest into portfolio companies in almost the exact fashion as private equity firms. However, due to fact that these investors are not a part of a collective investment scheme, angel investors should be left out from the concept of private equity. On the other side, in practice private equity funds can overlap with other types of investment funds. This can commonly lead to confusion that has been exacerbated "by the emergence of cross-over funds (*i.e.*, owning shares in public and private firms) and integrated funds (*i.e.*, investment accross different classes of assets, including debt, real estate, derivatives, etc.)."[62]

[61] ibid 223.
[62] ibid 222.

CHAPTER TWO – Legal Framework of Private Equity

The US and Serbian systems have diametrically opposed approaches to the regulation of private equity. In the American system, depending on the qualities of the participants, a private equity endeavor may or may not be exposed to the rules of a myriad of different legislation. This results in having two exclusive regimes under which private equity investors may find themselves. Conversely, the Serbian system offers much simpler regulation of private equity. Although one may infer that due to the number of regulations the American system is more restrictive, this simplicity can be deceptive.

2.1 Legal Framework in the US

The American regime of private equity is somewhat difficult to comprehend. Essentially, it requires that the private equity firms and funds obey either the rules or more importantly the exemptions from the rules found in the relevant legislation. Hence, if a private equity wants to retain the main characteristics of the business, the firm and fund must "stay below the radar" of the following acts. However, the rules do not mandate many important aspects of the business that are prevalent in the European systems (business form, minimum capital requirement, etc.).

2.1.1 *Investment Company Act*

The starting point is the Investment Company Act which "regulates mutual funds and other companies that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public."[63] The subject-matter is regulated by requiring the companies to either register with the Securities and Exchange Commission (SEC) as an investment company or qualify for an exemption from the registration rule.[64] As a rule, private equity funds will seek to be structured in manner that enables them to bypass

[63] Scott W Naidech, 'Private Equity Fund Formation' [2011] *Practical Law Publishing Ltd.* 13 <https://www.msaworldwide.com/Naidech_PrivateEquityFundFormation_Nov11.pdf> accessed 6 April 2018.
[64] ibid.

the registration requirement under the Act (*i.e.* not to qualify as an investment company).[65] This is due to the fact that "registration would subject them to numerous regulations that would make it impracticable for a sponsor to properly administer a fund (*e.g.*, Section 13 of the ICA limits the ability of a registered investment company to borrow money or issue securities)."[66] The most commonly employed exemptions can be found in the sections 3(c)(1) and 3(c)(7) ICA, both of them being applicable to private equity companies that do not publicly offer their interests.[67] The difference is that while the section 3(c)(1) refers to private equity companies that are beneficially owned by not more than 100 persons, the section 3(c)(7) deals with funds that are beneficially owned exclusively by qualified purchasers (generally, a person owning at least $5 million or more of investments, or an entity with at least $25 million or more of investments).[68] The application of both sections requires the fund to look through certain investors to determine their ultimate beneficial owners.[69] For example, each exemption requires a fund to disregard, and look through to the beneficial owners of, any entity formed for the purpose of investing in the fund.[70] Moreover, section 3(c)(1) requires the fund to look through "any investor that is itself an investment company" (or a company exempted from the application of the Act by the virtue of sections 3(c)(1) or 3(c)(7) ICA) and "which has more than 10 percent of the voting securities of the fund."[71] In addition, both exemptions allow "non-US issuers to count only US investors for purposes of counting the total number of beneficial owners.[72] This will be the case especially when the fund is

[65] Patrick Fenn and David Goldstein, 'Tax Considerations In Structuring US-Based Private Equity Funds' <https://www.akingump.com/images/content/9/7/v4/974/376.pdf>.
[66] Naidech (n 63) 13.
[67] ibid 11.
[68] ibid.
[69] ibid 13.
[70] ibid.
[71] ibid.
[72] ibid.

established in a foreign jurisdiction. Unlike with the US-based entities, non-US investors are absolved from the 100-person limit if the fund is a foreign entity.[73]

2.1.2 *Investment Adviser Act*

Unlike the previous act, the Investment Adviser Act deals with private equity firms and advisors to a private equity fund. Historically, the Act was known for its private investment advisor exemption. This was an exemption for investment advisers "with fewer than 15 clients (with each fund advised counting as only one client)" that have not presented themselves publicly as investment advisers.[74] This exemption was eliminated by the Dodd-Frank Act of 2010. This act is applicable to private funds, i.e. funds subject to the exemptions of the Investment Company Act.[75] The Dodd-Frank Act has broadly expanded the scope of application of the registration provisions. "Essentially, most US managers of private equity funds with assets under management of $150 million or more must register with the SEC as investment advisers. In addition, foreign advisers with US investors or US personnel may be required to register or to make certain basic filings to take advantage of exemptions from registration in light of the act's narrowing of the foreign private adviser exception. For advisers required to register, the Dodd-Frank Act imposes additional record-keeping and reporting requirements as well as the new examination and audit obligations."[76] Dodd-Frank Act leaves space for further regulation of subject-matter by state legislation of an advisor's principal office and place of business.[77] This applies if an advisor manages assets worth between $25 million and 100 million USD. "However, many US states have their own

[73] Fenn and Goldstein (n 65).
[74] Naidech (n 43) 13.
[75] Cendrowski and others (n 3) 17.
[76] Naidech (n 63) 14.
[77] ibid 13.

exemptions from state registration, so a private equity fund manager with assets under management of $100 million or less may be exempt under both US federal and state laws."[78]

2.1.3 *Securities Act*

The third selected act affects the securities offered by the parties involved in a private equity business. The Securities Act of 1933 imposes a general condition for offering and selling securities in the US in the form of filing a registration statement with the SEC and obtaining a declaration of effectiveness from the Commission.[79] However, this registration is costly and time-consuming. Private equity funds seek to avoid this constraint by relying on the private placement exemptions found within the Act. These exemptions will be in force if the offerings are made solely to "sophisticated investors who have the knowledge and experience in financial and business matters to evaluate the risks and merits of the proposed offering."[80] Hence, they focus on parties that are not in need of special protection by the SEC (unlike the general public). The most commonly used exemption, found in the section 4(2) of the Act, requires that the offers and sales are made only to a limited number of buyers, without general solicitation or advertising and "only to institutions and individuals that qualify as qualified institutional buyers (QIBs) or accredited investors."[81] In addition, Regulation D of the Act stipulates many exemptions, each with its own offeree qualifications and limitations. The application of these exemptions requires that "securities or funds interest are offered only to accredited investors" (within the meaning of the Act) or "a maximum of 35 unaccredited investors."[82] Moreover, Regulation D also limits the methods of raising the capital for the fund. In essence, it directs funds to "engage in solicitation with investors with whom they

[78] ibid 14.
[79] ibid.
[80] ibid.
[81] ibid.
[82] Cendrowski and others (n 3) 16.

have preexisting business relationships and with investors who are believed to be accredited."[83]

2.1.4 *Securities Exchange Act*

The Exchange Act is yet another statute that causes American private equities to have a rather peculiar and predictable number of investors. The Act imposes the obligation of registration with the SEC of any class of equity securities if the worth of the issuer's total assets exceeds $10 million and the securities are held by at least 500 (in the case of a US issuer) or 299 persons (in the case of a non-US issuer).[84] For this reason, most of the US private equity funds keep the number of record owners below 499 investors. Crossing the limit will not only oblige the fund to register its securities but will also subject the fund to "to onerous reporting and record-keeping requirements, as well as Sarbanes-Oxley Act of 2002 compliance requirements."[85] In addition, regardless of the registration duty, the Act prohibits the issuers to make any manipulative or deceptive practices in the fund's offering materials and gives the private right of action to investors and the Commission against the fund, the firm and any third party that was involved with the such schemes and practices.[86]

2.1.5 *Employee Retirement Income Security Act*

Being an endeavor that regularly seeks to include pension funds into the pool of investors, private equity funds needs to observe the provisions of the ERISA. Beside standard compensation and fee disclosure obligations (applicable to all funds dealing with benefit plan investors), the Act may limit the activities of the fund if it considers that the fund holds "plan assets".[87] For this purposes, the Act looks through the private equity fund and focuses on the private equity firm. The firm will be deemed as "directly managing the plan assets of any

[83] ibid 17.
[84] Naidech (n 63) 15.
[85] ibid.
[86] ibid. See: CFR § 240.10b-5.
[87] ibid.

benefit plan investors, unless the fund meets one of the exceptions from these look-through rules under the ERISA and applicable regulations."[88] There are three recurring exceptions. The fund may qualify as a venture capital (VCOC) or real estate operating company (REOC).[89] Alternatively, the fund may meet the so-called 25 Percent Test if "less than 25 percent of the value of any class of the fund's equity is held by 'benefit plan investors'."[90] Failing to be exempted from the ERISA means that the fund will be a subject of a number of fiduciary duties. A breach of these duties may lead to severe sanctions including the duty of restoring losses to the investors, disgorgement of the profits, personal liability of the fund manager, as well as equitable remedies (*e.g.* removal of the fund manager from the fiduciary position), civil and even criminal sanctions.[91] Due to risk of invoking such severe liabilities, many private equity firms seek to avoid the application of the ERISA by limiting the volume of investments by benefit plan investors in the operating agreement itself (*i.e.* by putting the upper limit of such investments below 25 percent).[92]

2.2 Legal Framework in Serbia

As opposed to the American system, Serbian regulation of the subject-matter is much simpler. Essentially, all aspects of private equity activities are regulated under the Investment Funds Act.[93] In addition, Serbian law stipulates supplementary application of the Companies Act and the Capital Market Act.[94] As a result, all regulation of private equity funds and investment companies follows the same two-layered pattern. Hence, one can find the edifice made from the provisions of the Companies Act and the superstructure of the Investment Funds Act

[88] ibid.
[89] ibid.
[90] ibid. See: ERISA sec. 3(40).
[91] ibid.
[92] ibid 16.
[93] Investment Funds Act, *Official Gazette of the Republic of Serbia*, Nos. 46/2006 - 5/2015 (Zakon o investicionim fondovima, *Службени гласник Републике Србије*, br. 46/2006 - 5/2015).
[94] Companies Act, *RS Official Gazette*, Nos. 36/11 - 5/15 (*Zakon o privrednim društvima, Službeni glasnik RS, br. 36/11-5/15*); Capital Market Act, *RS Official Gazette*, Nos. 31/2011 - 108/2016 (*Zakon o tržištu kapitala, Službeni glasnik RS, br. 31/11 – 108/16*).

provisions. One layer will regulate most of the subject-matter (the Companies Act) and the other layer (Investment Funds Act) will deal only with the essential characteristics of each type of a fund. This legal regime applies not only to domestic endeavors but also to any foreign investment fund or firm willing to raise capital in the Republic.[95] *Argumentum a contrario,* other activities of foreign companies (including making the investments into portfolio companies) are not subjected to this regime.

From a Serbian standpoint, the regulation of private equity can be qualified as fairly liberal and comprehensive. It has been recognized that private equity funds are made for powerful and professional investors whose capital is collected without any public offering. Relying on the presumption that such investors have adequate skills, the Act offers more flexible legal framework for its operations. This is a sharp contrast to open-ends funds whereby the Act protects small investors by imposing strict rules of trade. Therefore, the Investment Funds Act essentially has only two articles dealing specifically with the private investment funds. They only deal with few benchmarks of private equity funds, thus restraining the intervention of the law to the minimum. Moreover, when defining private equity funds, the legislator has opted for a relatively business friendly and easy to operate form. This is quite an opposite to the extensive regulation of mutual funds. Finally, the Investment Funds Act itself restricts the implementation of many of its provision when it comes to the private equity funds and firms. However, looking from a wider perspective, Serbian legal framework on the matter of private equity is unsatisfactory. It has been generally qualified as on the one hand less detailed in regulation and on the other hand, nevertheless more restrictive.[96]

[95] ZIF, art. 84.
[96] Stefanović (n 1) 80.

CHAPTER THREE – Private Equity Funds

Following the clarification of what private equity is and the manner of its regulation in the subject jurisdictions, the analysis will focus on the building blocks of private equity structure. First and the most important element to be observed is the special purpose vehicle of the undertaking, *i.e.* the private equity fund. Nature of this vehicle will inevitably have a massive influence on how the whole private equity business is structured and how it operates. This is the point of major divergence between common and civil law systems. Therefore, this chapter will separately examine the structure of private equity funds in the United States and in Serbia.

3.1 Private equity funds in the United States

3.1.1 *Limited partnerships as special purpose vehicles*

When it comes to the liberty of choosing the business form for private equity funds, legal systems can be classified into three categories. Firstly, the most restrictive systems will prescribe the use of a particular legal form for the business (*e.g.* Serbia). Secondly, the moderate ones may offer a palette of specialized forms for investment funds (*e.g.* Luxembourg or Netherlands). Thirdly, the system may give a full freedom of choosing the desired business form. This will be the result of the system which only regulates conduct of funds and not their form. The US system is the prime example of the third group. It does not mandate the use of any particular corporate form for the private equity fund. However, there is a general understanding that limited partnership (LP) is the paradigm form for organizing private equity business in the US.[97] Most often these funds will be established in the State of Delaware.[98] As limited partnerships may substantially differ from system to system, this

[97] Cumming J. and Sofia A. (n 1) 145; Klonowski (n 9) 15; Cendrowski and others (n 3) 6.
[98] Thomas H Bell and others, 'Private Equity (Fund Formation)' <https://gettingthedealthrough.com/area/28/jurisdiction/23/private-equity-fund-formation-united-states> accessed 6 April 2018.

entity is usually called common law partnership.[99] Such choice of business form may be somewhat of a surprise for civil law scholars, as this form is due to its simplicity usually out of the scope of the industry and jurisprudence alike.[100] This is especially true for Serbia where companies taking such form have only a miniscule portion in the overall business landscape. Although the US system provides for more advanced business forms (*e.g.* LLCs), the choice of LPs is usually justified with the fact that the limited partnerships are well-known worldwide (which is also true for corporations). In addition, the popularity of partnerships relies on "a well-established body of laws and practices concerning this organizational form."[101] However, the most persuasive reason lie with the tax issues, domestic and foreign alike.[102] "There is a risk that LLCs, operating outside the USA, could be treated as a non-transparent foreign entity and taxed as a corporate body".[103]

In Delaware, limited partnership is defined as "a partnership formed under the laws of the State of Delaware consisting of 2 or more persons and having 1 or more general partners and 1 or more limited partners."[104] By default, LPs are formed by filing a certificate of limited partnership with the Secretary of the State.[105] The strength of this form lies in their simplicity, flexibility and fiscal regime. This comes from a number of its characteristics. Firstly, common law limited partnerships are unincorporated business entities, *i.e.* one having no separate legal personality. In this view, a limited partnership is essentially a congregation of their members. However, although they are not legal persons, LPs are still legal entities with their own powers, such as the power to sue and be sued or to start proceedings against their own

[99] In order to differentiate it from *e.g*. Serbian limited partnership (*komanditno društvo – KD*) or the Dutch form (*Commanditaire Venootschaap* – CV).
[100] In Serbia it is quite of an ordeal for scholars and businessmen alike just name a single limited partnership that operates in the country. Recently, the German supermarket chain Lidl expanded its business to Serbia. Being a limited partnership in Germany (*Kommanditgesellschaft – KG*), it opted for the same form in Serbia (*KD*).
[101] Cendrowski and others (n 3) 12.
[102] Maynard and Warren (n 15) 124.
[103] McCahery and Vermeulen (n 38) 186.
[104] DRUPA, § 17-101(9). See also: ULPA, sec. 102(11).
[105] DRUPA, § 17-201(a); ULPA, sec. 201.

members.[106] As opposed to it, Serbian law defines all companies as incorporated entities. The consequence of this is that Serbian limited partnerships are incorporated entities, separate in identity and responsibilities from their members. Although unincorporated limited partnerships are known in a number of European legislations, Serbian law does not allow the formation of such enterprises.[107]

Secondly, the bedrock of the entity consists of partnership agreement, concluded between all partners. It establishes the partnership, its bodies and sets out the main rights and duties of all members. It is usually a long lasting contract setting up the fund for a period of 10 years with the additional 3 years required to complete the operations and wound up the fund.[108] Being an unincorporated business entity, US limited partnerships are essentially contractual creations. As a result, the act that governs it must be more flexible to suit the different desires of the diverse membership than the articles of incorporation of typical corporate forms.[109]

Thirdly, the membership in the entity is divided into two classes – general and limited partners. In private equity funds, the leading investors (private equity firms) will take the role of general partners while the passive investors may enter into the class of limited partners.[110]

Fourthly, general partners are by default exclusively empowered to manage general affairs of the entity. In private equity, they are the managers of the fund. However, this power comes with a substantial cost. General partners have joint and several unlimited liability for the activities of the company.[111] Moreover, a general partner is bound by the fiduciary duty of loyalty and care toward the rest of the partners.[112] Nevertheless, general partners pursue

[106] ULPA, sec. 105.
[107] For example in Luxembourg (*Société en Commandite Spéciale – SCSp*) or in the Netherlands (*commanditaire vennootschap – CV*).
[108] Cumming J. and Sofia A. (n 1) 147.
[109] ibid 145.
[110] ibid 4.
[111] See: ULPA, sec. 404(a).
[112] ULPA, sec. 408.

employ typical tactics to curb this risk. To start with, general partners usually have a business form with a limited liability (as corporations or LLCs). Moreover, they can perform their role via an SPV and thus add another layer of protection to their assets.[113] Furthermore, their investment into the fund tends to be minimal compared to the limited partner's investment. Usually it is around one percent, which satisfies the tax requirements for the LPs in the US.[114] This participation still needs to be a meaningful one for the limited partners. This is due to the guiding principle of all partnerships – "wining together or losing together."[115] If it were not so, then only the limited partners would bear the financial risk of the fund's activities. Finally, general partners usually bargain for "a more favorable allocation of ownership and profits than otherwise would be possible".[116]

Fourthly, limited partners are members which in normal circumstances do not govern the affairs of the partnership and are liable only to extent of each member's share in the capital of the fund. Usually, these members contribute up to 99 percent of the capital of the fund. However, limited partners do not invest all of the committed capital at once. Instead, by default they only invest a portion of the capital at first. This benefit is followed by the duty to invest the remaining part of the capital in case of the "capital calls" from the general partners. The cost of having such benefits is that limited partners are regularly restrained from governing the affairs of the investment fund. Moreover, they are even generally prohibited from interfering with the affairs of the partnership as it may lead to the loss of the liability shield for the limited partners.[117] This kind of balancing the interests creates the situation where the leading investor takes directly or indirectly the role of the fund manager, while limited partner are effectively "purchasing investment management services from the general

[113] This is typical for LPs in general. See: Preparatory Note to Uniform Limited Partnership Act (2001), xiii.
[114] Klonowski (n 9) 15.
[115] ibid.
[116] ibid.
[117] Cumming J. and Sofia A. (n 1) 147.

partners."[118] Nevertheless, limited partners preserve the influence over general partners by the virtue of numerous restrictive covenants found in partnership agreements. These clauses will typically limit the discretion fund managers have when they make an investment decision, co-invest with other funds or acquire debt capital for the partnership.[119] Conversely, they may also benefit the general partners by limiting their liability in certain cases. However, this will have the effect only on internal relations between the partners (without effect toward third parties). All in all, these covenants serve to regulate internal conflicts, *i.e.* to mitigate the potential for agency problems that can arise in the relationship between the partners.

Fifthly, due to high sensitivity of the endeavor, it is vital for limited partnerships to properly regulate the matter of dissolution and disassociation. As a general rule, LP may be dissolved after the occurrence of an event specified in the partnership agreement (*e.g.* the end of the partnership's term) or by the consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the consent is to be effective.[120] Additionally, a LP may be dissolved if it is left without general or limited partners.[121] When it comes to the question of disassociation, the most important issue is to regulate coming and going of limited partners to and from the partnership. As investments into private equity funds need to be illiquid investments (*i.e.* locked within the capital of the fund for a given period of time), the disassociation of limited partners will inevitably have to be subject to the fund manager's approval.

Finally, common law limited partnerships are fiscally transparent (the so-called pass-through or flow-through entities). This means that for tax purposes, the partnership is not a tax subject. Instead of it, each member of the partnership is taxed separately. There are two implications

[118] Klonowski (n 9) 16.
[119] Cumming J. and Sofia A. (n 1) 147–149.
[120] ULPA, sec. 801(1) and 801(2).
[121] See: ULPA, sec. 801(3) and 801(4).

of this status. On the one hand, LPs enable partners to bypass additional tax burden associated with incorporated entities.[122] On the other hand, flow-through entities enable each of their members to preserve their own, special tax status (if they have it). "Investors in a private equity fund may be natural persons, foreign corporations, pension funds, and endowments that are exposed to different tax regimes and able to take advantage of different tax credits and benefits."[123] The outcome of this regime is that, due to the exclusivity of these tax benefits, partners may obtain different profit levels despite that the fact that the total profits of the fund are equally shared among the members of the partnership.[124] This vital characteristic limited partnerships is currently unknown to Serbian company and tax laws.

3.1.2. *Alternative business forms for private equity funds*

What makes the American system quite different from its continental counterparts (including Serbia) is that it does not put restrictions on the choice of business forms for private equity. Instead, the choice is directed more by legal restrictions that are inherent to a form, as well tax reasons and business conventions. Being a non-restrictive system, the US law does allow the investors to organize their fund in forms other than typical limited partnerships.[125]

What is to true for any US private equity fund is that the investors will favor a business form that is "treated as partnership for US federal income tax purposes."[126] From the start, this preference eliminates standard C-corporations due to their taxation at the entity level. From the remaining forms, the most popular alternative business form is the limited liability company (LLC). This form enables the investors to organize just like a partnership but with some benefits of corporations, like adding limited liability also to the private equity firm. In addition to it, LLCs are highly flexible entities, especially in the matter of governance and tax

[122] Cumming J. and Sofia A. (n 1) 143.
[123] ibid.
[124] ibid.
[125] Surprisingly, these alternative options are rarely discussed in scholarly works.
[126] Fenn and Goldstein (n 65).

status.[127] However, LLC can be a questionable choice of business form as "equity investments in LLCs can cause tax problems for the funds' tax-exempt and foreign partners."[128] Similar effects can also be achieved by establishing the fund as an S-corporation. However, this alternative business form comes with many statutory restrictions.

Besides opting for alternative business forms, the investors have the freedom of organizing a listed private equity fund (LPEQ). This departure from the rule has its own rationale. "Private equity has traditionally been offered to institutional investors through private placements. Private placements are seen by the private equity industry as an efficient structure through which funding can be obtained from a specific type of investor with corresponding investment goals, more quickly and more cheaply, while taking advantage of exemptions from registration with relevant securities regulators."[129] The reasons why some investors have not taken part in these arrangements notably have to do with the minimum size of participation in the investment fund and with the illiquidity of the participation during the lifetime of the fund.[130] The answer to these problems are LPEQs. This form is more popular with smaller, non-listed investors (typically pension funds) which favor "liquidity, quick access and administrative and cash flow management simplicity."[131] In addition, LPEQs are favored by (passive) investors coming from the UK, Switzerland, Sweden and the Netherlands.[132] What LPEQs can offer to these investors is an opportunity to make a return of a type commonly associated with large participants in the private market.[133] This comes with the benefit of having an improved liquidity and lower transaction costs when compared to ordinary funds.[134] As a part of their investment strategy, "institutions can invest in both listed and limited

[127] Due to their importance for private equity firms, the matter of LLCs will be discussed in detail in the following chapter.
[128] Maynard and Warren (n 15) 124.
[129] Cumming J. and Sofia A. (n 1) 239.
[130] ibid.
[131] ibid 30.
[132] ibid 240.
[133] ibid 239.
[134] ibid.

partnership private equity and can dynamically adjust exposure to listed private equity over time as their limited partnerships draw down commitments.[135]

3.2 Private investment funds in Serbia

In general, Serbian Investment Funds Act defines an investment fund as "the collective investment undertaking (*i.e.* institution, legal entity) which serves to raise capital funds and invest them into various types of property with the purpose of making profit and curbing the risk of investing."[136] Compared to the American system, Serbian Investment Funds Act sets out highly restrictive legal framework for investment funds in general. The investment funds can operate only under three types of legal forms known under the Act - open-end and close-end mutual funds, as well as private equity funds. Moreover, for each of these funds there is but one exact legal form at their disposal. Furthermore, albeit not being detailed enough when regulating private equity funds, the rules of the Investment Funds Act (and its supplementary laws) must be observed by all funds, regardless of their size or other characteristics. This is a sharp contrast to the American laws, which leave out a large leeway for private equity funds to operate freely when they are "below the radar" of the relevant federal or state laws.

In Serbia, private equity funds must be organized as private investment funds (*privatni investicioni fondovi - PIF).* Essentially, these funds represent a modified version of the most popular business form in the country - limited liability company (*društvo sa ograničenom odgovornošću – DOO*).[137] As with all investment funds and companies, the regulation of *PIF*s can be found in both the Investment Funds Act and Companies Act. This two-layered approach produces an investment vehicle that has the following characteristics.

[135] ibid.
[136] ZIF, art. 2(2).
[137] Note that although LLCs and *DOO*s are homonymic in English, these forms are very different in nature.

3.2.1 *The Companies Act regulation of private investment funds*

The provisions of the Companies Act are relatively straightforward. The limited liability company is defined as a business entity whereby one or more members have their equity interests in the registered capital of the company and who are not liable for its obligations.[138] Being defined as such, Serbian limited liability companies and PIFs are incorporated business entities. Having in mind the palette of incorporated and unincorporated business forms found in common law and continental legal systems, this exclusive choice of a single incorporated form for the fund can be deemed contrary to the practices established in other jurisdictions (*e.g.* in the US or Luxembourg). Especially since the most common form for the fund is usually an unincorporated limited partnership. This form is also present in Serbian general business law, although not in the unincorporated variant. However, one must have in mind that while the Investment Funds Act has failed to provide an unincorporated form for private equity fund it has nevertheless provided for a similar type of entity for open-end funds.

From the standpoint of Serbian general company law, this choice of form is rational as its guiding principle in the Investment Funds Act is the freedom to contract. Hence, the members are empowered with substantial powers to organize the relations between themselves and their relations with the company.[139] However, in the case of PIFs, the effects of such proclamation are questionable as their management is vested with the management companies which itself is heavily regulated as a corporation in the Companies Act.

Being a limited liability company, *PIF*s can be established by a unilateral decision of a single founder or a contract between multiple incorporators.[140] This is different from the US system whereby a limited partnership naturally requires one general and one limited partner in order to set up a limited partnership. The investment fund is deemed to be incorporated on the day

[138] ZPD, art. 139.
[139] ibid art. 140.
[140] ibid art. 11(1).

of its registration in the Investment Funds Registry operated by the Securities Commission.[141] The incorporator (the operating company) needs only to provide the Commission with the proof that it has concluded account agreement with the custody bank and has deposited the required minimum registered capital at its account.[142] This is nevertheless a major addition from the general rule that limited liability companies are formed at the moment of registration with the Companies Registry.[143]

The fund is established and governed by a single act, without making the difference between the instrument and the articles of association (as it is typical for corporations). The charter has to be made in written form and filed with the Registry.[144] In addition, the Investment Funds Act stipulates Business Rules *(pravila poslovanja)* as the additional mandatory document. It contains a number of provisions specific to private investment funds. First, the rules have to contain the description of investment goals, investment policy and the main risks associated with it.[145] Secondly, they contain information about the minimum value of the investment of a member into the company, the value of each member's share in the fund and the rules of its transfer.[146] Thirdly, they have to include rules on determination of net value of the fund and on reporting to the Commission.[147] Fourthly, they have to set the duration of the fund (if it is set up for a limited period of time) and the rules on dissolution procedure.[148] The rules must be made available to all prospective investors. Any change of the rules can be made only with

[141] ZIF, art. 27(2).
[142] Ibid.
[143] ZPD, art. 3.
[144] ibid art. 11(6).
[145] ibid art. 75(2).
[146] Ibid.
[147] Ibid.
[148] Ibid.

the written consent of all the members of the fund.[149] In addition, the Rules must be submitted to the Commission after any of modification of their provisions.[150]

The benchmark of Serbian limited liability companies is that their members (*članovi društva* – a specific *DOO* term) have their own equity interests in the registered capital of the company. They represent the member's ownership percentage in the company. Such interests (*udeo*) are not securities in nature, as it is the case with shares of corporations (*akcija*).[151] They are the product of investments (*ulog*) of members into the company. As such, they represent the percentage of ownership in the equity of the company corresponding to the total value of the registered capital.[152] Each member possesses a single, unitary equity interest.[153] If he or she obtains additional ownership over the company, the interests will merge into a single equity interest.[154] Naturally, the size of these interests will be different if the size of the members' contributions is not the same in value. In addition, the size of the participation is presumed to correspond equally to the size of the investment unless the corporate charter stipulates differently.[155] The equity interest gives the member the proportionate rights to vote on general assembly, to participate in the profits and in the remaining assets in the liquidation and other rights set out in the Companies Act.[156] The management company exerts its voting rights on the basis of its equity interests in the private investment fund.[157] The funds itself can legally own a separate interest in its own equity. However, the law allows this only in certain cases, *e.g.* donation, exclusion or expulsion of member from the company, redemption in certain cases, etc.[158] However, these self-owned interests do not grant the right to vote or receive

[149] ibid art. 75(4).
[150] ibid art. 75(5).
[151] ZPD, art. 150(1).
[152] ibid art. 151(1).
[153] ibid art. 151(2).
[154] ibid art. 151(3).
[155] ibid art. 151(1).
[156] ibid art. 152(2).
[157] ZIF, art. 5(7).
[158] ZPD, art. 157(2).

dividends.[159] Furthermore, one of the guiding principles of the limited liability company form is the freedom of transfer of equity interests.[160] However, the law or articles of association can set otherwise.[161] The same applies for the statutory preemptive rights of other company members.[162] One further limitation to the freedom to transfer equity interests is the rule that these interests cannot be publicly offered (essentially, they cannot be listed on the stock exchange).[163] The membership in the fund is not limited in number. It lasts until the member leaves the fund, transfers the whole of equity interest to third persons, ceases to exist or is expelled from the company.[164] The fund may also withdraw and annul an individual interests (*e.g.* in the case of self-owned equity interests of the fund).[165]

When it comes to the governance and management of the private investment funds, the regime established by the Investment Funds Act is highly problematic when it comes to the application of the Companies Act. Article 74 paragraph 7 stipulates that the power to manage the fund be shall be exclusively vested in the management company by the virtue of the control agreement concluded with the fund.[166] Here the Act is not only silent on the matter of what the terms "manage" and "control agreement" mean but also on the question what happens with the standard company bodies of the fund (as a *DOO*). Does a fund need to form its bodies if the control over the entity is exclusively vested in another entity? The reasonable interpretation should be that while the management of the fund is entirely vested with the management company, the law does not prevent the formation of corporate bodies of the investment fund. If anything else, this standpoint should be supported by comparative practices in other countries whereby funds always have their own separate corporate bodies

[159] ibid art. 158.
[160] ibid art. 160.
[161] Ibid.
[162] ibid art. 161.
[163] ibid art. 150.
[164] ibid art. 186.
[165] Ibid.
[166] ZIF, art. 74(7).

(*e.g.* in the US, Netherlands and Luxembourg). However, in Serbia the remaining power of such bodies is highly questionable. It can be claimed that while the members' assembly remains a vital structure of the fund, the presence of directors and supervisory board is in this case may be deemed as excessive, as their roles will be mostly overtaken by their counterparts in the investment company. All in all, compared to the freedom of the American LPs to fully regulate their internal affairs, the Investment Funds Act sets out ambiguous, complex and highly questionable system governing structure form the mere outset.

The members' assembly is comprised of all members of the *DOO*/*PIF*.[167] Their powers are proportionate to the size of their participation in the registered capital of the company.[168] The Act contains an exhaustive list of the powers of the assembly. Firstly, the assembly can change the articles of association.[169] Secondly, in normal circumstances it appoints the directors, supervisory board, auditors and bankruptcy trustees.[170] Thirdly, the assembly oversees the work of the directors and approves their reports, as well as the reports of the supervisory board. It also approves the financial reports and the auditors' reports.[171] Fourthly, it decides on the matter of increase or decrease of the registered capital, as well as on the question of issuing any kind of securities.[172] Fifthly, it must approve any disposition of the high-value property.[173] Finally, it settles all the issues regarding the membership in the fund (acceptance of new members, withdrawal and expulsion) or the continuation of the fund (dissolution, changing of the legal form, mergers and acquisitions).[174]

[167] ZPD, art. 199(1).
[168] Ibid art. 199(2).
[169] Ibid art. 200(1).
[170] Ibid art. 200(7)-200(9) and 200(11).
[171] Ibid art. 200(2)-200(4).
[172] Ibid art. 200(5).
[173] Ibid art. 200(24).
[174] Ibid art. 200(14), 200(16), 200(21) and 200(22).

In regular circumstances, a limited liability company has at least one director who acts as a legal representative of the company.[175] The director is appointed by either by the assembly (one-tier system) or by the supervisory board (two-tier system).[176] He or she will have two general roles. The first one is to act as a legal representative of the company and thus to be able to communicate and take actions in the name of the company.[177] The second one is to manage the affairs of the company in accordance with the company charter, decisions of the assembly and instruction of the supervisory board.[178] It is an undisputable legal presumption that the directors have all the remaining management power that is not reserved for the general assembly or supervisory board.[179] When it comes to the supervisory board (in a two-tier system), due to nature of the limited liability company, its powers are slightly different that the one can find with the joint-stock companies. Notably, it determines business strategy, elects the directors and supervises their and company's operations.[180] It also approves some of the major transactions that the company may perform (*e.g.* acquisition, disposal and encumbrance of real estate as well as equity interests and shares held by the company in other legal entities; Borrowing and lending and giving of sureties, guarantees and collateral for the liabilities of third parties).[181]

3.2.2 *The Investment Funds Act regulation of private investment funds*

As previously noted, this Act only succinctly adapts *DOO*s for the role of PIFs. It starts with a general proclamation of the freedom to invest.[182] Domestic and foreign natural and legal persons are free to invest in the private equity funds, in compliance with the provisions of the

[175] ZPD, art. 218.
[176] Ibid art. 219.
[177] Ibid art. 221.
[178] Ibid art. 224(1).
[179] Ibid art. 224(2).
[180] Ibid art. 232(1). Note that in joint-stock companies the supervisory board only suggests the appointment of executive directors to the shareholders.
[181] Ibid art. 232(2).
[182] ZIF, art. 24.

Act.[183] The Act sets much higher threshold for minimum capital requirement – 50.000 EUR (as opposed to 100 RSD or less than 1 EUR needed for regular limited liability companies).[184] This solution is contrary not only to the one found in the US (where there is no minimum capital requirement) but also the contemporary European practices. For example, in the Netherlands the legislator has removed the minimum capital requirement for all private limited liability companies (*bepekerte aansprakelijkheid – BV*) which happens to be one of the favorite vehicles for private equity funds in the country.[185] In addition, the management company is explicitly allowed to hold equity interests in the fund.[186]

Unlike with the other types of funds, the Securities Commission supervision over private funds is more or less formal in nature. The operating company only has the obligation to deliver to the Commission the Control Agreement, Business Rules and annual financial reports.[187] The differences continue as there is no application of the general rules of the Investment Funds Act on private equity funds regarding the relations with the Commission (mandatory licensing and reporting) and the limitations on investments in portfolio companies.[188] Furthermore, unlike other funds, private fund has the unrestricted freedom of acquiring debt capital, in accordance with its Business Rules.[189]

[183] Ibid.
[184] ZIF, art. 74(2); ZPD, art. 145.
[185] 'Investment Funds in the Netherlands' *The Dutch Fund and Asset Management Association (DUFAS),* http://www.dufas.nl/site/assets/files/1304/rapport_ifitn-ey-dufas.pdf.
[186] ZIF art. 74(3).
[187] Ibid art. 74(5) and 74(7).
[188] Ibid art. 74(4) and 74(8).
[189] Ibid art. 74(6).

CHAPTER FOUR – Private Equity Firms

Private equity firms are the part of private equity structure that receives far less attention from the industry and scholars than the funds they operate. American authors hate the tendency to completely focus on the governance structure of the private equity without giving any substantial attention to the question of choice of adequate legal form for the management company. Therefore, in this matter the general conventions of American business law apply. As a result, like with private equity funds, one may single out the most popular business form for the firm out of the general palette of American business entities. Conversely, Serbian law follows the same pattern as with private investment funds and opts for a single business form.

4.1 Private Equity Firms in the US

There is an agreement that limited liability companies (LLCs) dominate over the US business landscape.[190] This is also true for private equity firms. Due to the nature of their purpose, private equity firms simply do not mandate the use of any particular form (like private equity funds do). The most common sources of law are not very descriptive when giving the general definitions of this entity.[191] However, LLC stands out as a business form in industry and scholarly works due to the combination of following characteristics.

Firstly, LLCs owe their name to the limitation of liability of their members. "All LLC statutes provide for limited liability of the members (*i.e.*, the owners of the LLC), similar to the shield of limited liability extended to shareholders (*i.e.*, the owners of the corporation)."[192] Or as the law puts it "a debt, obligation, or other liability of a limited liability company is solely the debt, obligation, or other liability of the company."[193] Defined as such, this shield is imposed by the law and as such not subject to members' agreement. Unlike limited partnerships, this shield protects all members of the entity. This trait is also shared with the Serbian choice of

[190] Maynard and Warren (n 15) 137.
[191] See: ULLCA, sec. 102(8) or DLLCA, § 18-101(6).
[192] Maynard and Warren (n 15) 87.
[193] ULLCA, sec. 304.

business form for private equity firm. However, both of the entities can be subjected to the veil piercing and hence invoke personal liability of their members.[194][195]

Secondly, although LLCs are formed by filing the certificate of incorporation with the Secretary of State, the bedrock of LLCs consists of operating agreements. These charters give LLCs their reputation of the extraordinary flexibility.[196] "Thus, the LLC can have the corporate-like attributes of centralized management, free transferability of interests, and unlimited life (…). On the other hand, the LLC can have the partnership-like attributes of equal management rights in every owner, no transferability of interests, and automatic dissolution upon the request of any owner. Or, alternatively, the LLC can have whichever combination of these attributes that the founders may desire."[197]

Thirdly, in the light of the above mentioned, LLCs are renowned for the flexibility of their management structure. As a default rule, LLCs will be managed directly by the members, unless the firm decides to be managed by managers.[198] By allowing the LLCs to be either "member-managed", the statutes essentially allow all members of the entity to have the opportunity to participate in business management.[199] Alternatively, or "manager-managed" variant of the form provides for the centralization of the management of the company.[200] This centralization is also typical for limited partnerships and corporations. The choice between two possibilities will also determine who has the authority to bind the LLC in third-party transactions and who has the fiduciary duties.[201]

[194] Larry E Ribstein, *Unincorporated Business Entities* (2nd edn, Anderson Publishing Co 2000) 346.
[195] See ZPD, art. 18.
[196] Maynard and Warren (n 15) 86.
[197] ibid 87.
[198] Ribstein (n 194) 342.
[199] Maynard and Warren (n 15) 87.
[200] ibid.
[201] Ribstein (n 194) 364.

Finally, LLCs are characterized by a favorable federal income tax treatment.[202] Its default regime is to be taxed as a partnership (or sole proprietorship in the case of a single owner). Yet the flexibility of this form stretches to the tax issue and thus LLCs can select to be treated as C corporations (by following the so-called "check-the-box" procedure).[203] Therefore, LLCs are by default flow-through entities protected from double taxation.[204]

Having in mind the above mentioned characteristics, an LLC clearly possesses advantages over competing business forms. This comes from its prevailing nature as "a form of organization that has the corporate characteristic of limited liability, but is treated as a partnership for purposes of federal income taxation."[205] Compared to limited partnerships, LLCs offer not only better liability shield but also significantly greater flexibility when it comes to management and tax issues. As opposed to S corporations, LLCs are not subjects of many of its restrictive provisions inherent to S corporations, *i.e.* "an LLC may have multiple classes of owners (…), and may include entities and foreigners among its owners."[206] When it comes to C corporations, LLCs have the advantage on the fields of management and avoidance of double taxation. Moreover, compared to both types of corporations, LLCs have a far greater liberty to convert into other business forms without triggering tax consequences.[207] The same advantages can be observed when comparing an LLC to the Serbian form for private equity firm which is neither as flexible nor fiscally transparent as an LLC can be.

Having in mind the above mentioned advantages, one may question why have not all entities converted into this superior business form? Reasons can be numerous. To start with, there is

[202] Maynard and Warren (n 15) 87.
[203] Ribstein (n 194) 349.
[204] Maynard and Warren (n 15) 128.
[205] William A Klein, John C Coffee and Frank Partnoy, *Business Organization and Finance: Legal and Economic Principles* (11th edn, Thomson Reuters/Foundation Press 2010) 103.
[206] Maynard and Warren (n 15) 127.
[207] ibid.

the already mentioned problem of tax classification of an LLC in foreign jurisdictions. Additionally, the increased flexibility usually comes "at the price of added complexity."[208] Moreover, LLCs cannot issue shares to the public and thus are not the desired vehicles for companies planning to "go public".[209] In case when a participating owner of an S corporation receives not only corporate distributions but also reasonable wage payments, only the wage payments will be subjected to self-employment tax.[210] However, his or hers counterpart in an LLC will be incur the same tax liability on the total income from the enterprise.[211] Finally, being a relatively new business form, "the common law surrounding has not begun to develop the depth and robustness that exist in most states with respect to corporations and partnerships."[212]

4.2 Fund management companies in Serbia

Like with private funds, Serbian regulation of private equity firms follows the same two-layered pattern. All investment funds are managed by the same type of business entity - the investment fund management company (*društvo za upravljanje investicionim fondovima*). The law stipulates that this is a private corporation.[213]

4.2.1 *The Companies Act regulation of management companies*

Being a private corporation leads to an idiosyncratic problem – the Companies Act does not precisely differentiate between public ("open") and private ("non-public" or "closed") corporations.[214] Instead, in addition to general corporation rules, the Act contains some rules that are applicable only to public corporations (which are inapplicable to private equity firms). The Act defines corporation (or joint-stock company) as an entity "the share capital of which

[208] ibid.
[209] David Carnes, 'Is a Corporation the Same as an LLC?' <http://info.legalzoom.com/corporation-same-llc-3183.html> accessed 6 April 2018.
[210] Maynard and Warren (n 15) 126.
[211] ibid.
[212] ibid 87.
[213] ZIF, art. 4(1).
[214] Vasiljević (n 2) 98.

is divided into shares held by one or more shareholders who are not liable for the company's obligations, except in the case provided for in Article 18 of the Act."[215] It is based on two documents. The instrument of incorporation (*osnivački akt*) is an inalterable decision (single-member entity) or contract of the founders necessary for setting up the entity.[216] It contains data about the incorporators, the identity and core activity of the corporation, as well as information about the investment (*ulog*) of the incorporators and the shares (*akcije*) issued in return.[217] As opposed to it, the articles of association (*statut*) dictate the management of the corporation.[218] The simple majority of shareholders have to revise the articles at least one time per year if the data from the articles have changed.[219] The investment company is set up once the incorporators have signed both documents and registered them with the Registry.[220]

The shares of private equity firms have the following characteristics. Firstly, they are dematerialized and deposited with the Central Securities Depository.[221] The owner of a share is the one who is registered as such with the Depository.[222] Secondly, the shares can be issued with par or book value. Par value of a share cannot be less than 100 RSD.[223] Naturally, the determination of issue price of shares is fully within the discretion of the assembly (or with the board if such authority is delegated to it).[224] Thirdly, the shares of a private company are by default freely transferable in private placement. The transfer must be in the form of a written contract certified by a notary public.[225] The charter can restrict the transfer of shares with a pre-emption right of other shareholders or a requirement for prior consent of the

[215] ZPD, art. 245. Note that the mentioned art. 18 refers to veil piercing provisions.
[216] ibid art. 12(3), art. 11.
[217] ibid art. 265.
[218] ibid art. 11(1).
[219] ibid art. 246(1) and 246(2).
[220] ibid art. 264.
[221] ibid art. 248(1).
[222] ibid art. 249(1).
[223] ibid art. 258(3).
[224] ibid art. 260.
[225] ibid art. 261(1) and 261(2).

company.[226] These techniques can be used to "lock" the membership in the company. Fourthly, the Act differentiates between the shares of common and preferred stock. Ordinary shares can offer only the standard bundle of rights (voting rights, dividends, pre-emption rights and right to participate in the liquidation of the company's assets).[227] As opposed to them, preferred stock usually exchange voting rights for a number of special rights (by setting out a fixed value of dividends, priority on their payments, convertibility, redeemability etc.).[228] In addition, the investment company has the ability to grant call options and convertible bonds.[229] Issuing preferred stock (as well as call options and convertible bonds) can prove to be quite useful for the private equity firm, as they offer the opportunity to attract capital without shifting the balance in the ownership of the company.

When it comes to the management of private equity firms, the Companies Act allows a choice between two models of organization.[230] In one-tier model, the corporation has to have at least one director.[231] If it has three directors, they automatically form the company's board of directors.[232] In two-tier model, the company is governed by one or more directors and a supervisory board.[233] As with one-tier model, if the company has three or more directors, they automatically form the executive board. However, private corporations are allowed to operate with a single director (one-tier) or with a single executive director (two-tier model).[234] In both of the models, the supreme governance body is the shareholders' assembly.[235]

The shareholders' assembly is made of all shareholders who have the right to vote on the matter that affects their shares. Essentially, the assembly settles all issues of "constitutional"

[226] Vasiljević (n 2) 117.
[227] ibid art. 251.
[228] ibid art. 253(1).
[229] ibid art. 262.
[230] Note that the Companies Act does not differentiate between terms management and governance and uses a single term to refer to them both (*upravljanje*).
[231] ZPD, art. 326.
[232] ibid art. 383(2).
[233] Vasiljević (n 2) 129.
[234] ZPD, art. 383(4), art. 417(3).
[235] ibid art. 326.

value for the company. This includes amendments to the corporate charter, changes of the business form, mergers and acquisitions, dissolution.[236] The assembly also decides on the volume of registered capital, issuing of shares and other securities, the volume of authorized stock, distribution of profits, covering of losses and disposition of high-value assets.[237] It also appoints the directors, members of the supervisory board and auditors, adopts their reports and decides on their remuneration.[238]

In a single-tier system, the board of directors is tasked with essentially all of the day-to-day management of the company. It sets the business strategy, internal organization, manages the company and oversees its functioning.[239] In addition, it organizes shareholders' meetings and implements their decisions. It emits the authorized stock, and determines the values of the shares and dividends.[240] The directors' term is maximum four years long, with the possibility of re-election.[241] The Act differentiates between several categories of directors. The executive directors are the stable category in the corporation. They jointly manage the affairs of the company and hold the position of its statutory representatives in relations with third parties.[242] Among the optional categories of directors, the executive directors can select one of them to serve as a Director General. He or she will coordinate the work of other directors and organizes the company's operations.[243] Other types of directors are only statutory options for private corporations. Non-executive directors are not employees of the company.[244] They supervise the performance of executive directors, decide in the case of conflict of interests, suggest business strategy and oversee its implementation.[245].[246] Independent directors are the

[236] ibid art. 329.
[237] Vasiljević (n 2) 124.
[238] ibid.
[239] ZPD, art. 398(1).
[240] ibid.
[241] ibid art. 385.
[242] ibid art. 388(1).
[243] ibid art. 389.
[244] ibid art. 391.
[245] ibid art. 390(1).

directors that do not have a financial, proprietary or employment connection with the company in the past two years prior to their appointment.[247]

In case of a two-tier structure, the supervisory board determines the business strategy, supervises the directors and the management and suggests the appointment of executive directors to the shareholders.[248] It can schedule shareholders' meetings, issue the authorized stock and determine the par value of the shares.[249] Additionally, on the number of high-value questions, the members of the executive board have to obtain the approval of the supervisory board.[250] The rest of the powers of the board of directors from the one-tier system lie with the executive directors or the executive board.

4.2.2 *The Investment Funds Act regulation of private equity firms*

The Act stipulates that management companies can only manage private funds.[251] Unlike with other funds, they cannot organize (open-end) or establish (closed-end) funds. While the meaning of words "to organize" and "establish" is not to be found in the Act, a holistic approach would suggest that private equity firms have to incorporate the fund like a separate, fully functional entity. The Act exclusively empowers the firm to manage the private fund on the basis of a control agreement.[252] In practice, private equity firms are primarily tasked with making investment decisions, as well as to administer and advertise private funds (or to entrust these two activities to third parties).[253] The investment company can administer many private investment funds, but it cannot perform other types of business activities.[254] In addition, it cannot have equity and management in other businesses. However, it may have a limited equity in other management companies (up to the 20 per cent of the net value of its

[246] ibid art. 390(2).
[247] ibid art. 392(2).
[248] ibid art. 441.
[249] ibid.
[250] ibid.
[251] ibid art. 5(1).
[252] ZIF, art. 74(7).
[253] ibid art 5(4).
[254] ibid art. 5(2) and art. 5(5).

own assets).[255] Every management company must maintain the equivalent of 200.000 euros on its account with the custody bank.[256] This amount of registered capital has to be deposited on a temporary bank account even before the company starts to operate. This is something quite contrary to the American system, where instead of mandatory minimum capital there are only business conventions as to the minimal participation of an investor in a fund. In addition, the firm has to have at least one full-time portfolio manager for every fund it manages.[257]

Private equity firms are under substantial supervision of the Securities Commission. It manages the Registry of Management Companies and issues management licenses.[258] Both Serbian and foreign individuals and companies are free to start a management company.[259] However, there are some limitations. Firstly, domestic companies with a majority of state ownership and companies associated with them may not set up an investment company. This does not apply likewise to domestic banks and insurance companies.[260] Secondly, an individual, company or connected entity cannot have a qualified ownership in more than one management company.[261] The threshold is set at 10 per cent of ownership of share capital or the equivalent voting rights.[262] Thirdly, the Commission is entrusted with moderate discretion as to whether or not it will grant the license. This depends on the assurances given to the Commission - the origin of the starting capital has to be clear, entities with the qualified percentage in equity have to be able and trustworthy for the task, the necessary documents have to convincing and the structure of entities cannot be such as to prevent the effective

[255] ibid art. 6.
[256] ibid art 7.
[257] Todorović and Slijepčević (n 2).
[258] ZIF, art. 10(1) and 10(6).
[259] ibid art. 10(2).
[260] ibid art. 10(3) and 10(4).
[261] ibid art. 10(2).
[262] ibid art. 2(1).

control over the future operating company.[263] However, the Commission has only 30 days at its disposal to make the assessment.[264]

Besides the company itself, its management is put under the same scrutiny of the Commission. The Director General and the board members have to have a university degree. They have to independent from the custody bank and other management companies.[265] Moreover, the leading director and at least half of the members of the board have to have at least three years of experience of working with securities (in a bank, insurance company, brokerage etc.).[266] When the conditions are fulfilled, the Commission will grant the consent on the election of the management and simultaneously issue an operating license.[267] However, the Commission has the power to revoke the consent if it is proven that the person in question has submitted false documentation, stopped fulfilling the necessary requirements or committed an offense under the Act. Such acts include major violations of the provision of the Act, undertakings contrary to the rules of business moral or the risk management rules or if he or she has made a major transgression against the interest of the members of the contracted investment fund.[268]

After the Commission has granted the license, the investment company has 30 days to register with the Companies Registry (managed by separate Business Register Agency).[269] When the Agency has issued a registration certificate, the company has 8 days to submit the same to the Commission.[270] With this act, the setting up of the firm is done. However, the company will still have to provide the Commission with annual reports, together with the auditor's report

[263] ibid art. 11(1).
[264] ibid art. 11(2).
[265] ibid art. 12(3), art. 12(4).
[266] ibid art. 12(5).
[267] Todorović and Slijepčević (n 2).
[268] ZIF, art. 14.
[269] Law on the Procedure of Registration with the Business Registers Agency, *RS Official Gazzette*, Nos. 99/11 and 83/14 (Zakon o postupku registracije u Agenciji za privredne registre, *Službeni glasnik RS*, br. 99/11 and 83/14).
[270] ZIF, art. 19.

issued by an external auditor. The company also has to furnish regular quarterly reports, containing the information about the assets of the company, its securities, accounts and cost incurred in dealing with the brokers, custody banks and other associates.[271] It also has to provide the data about the value of the investment fund and the outstanding stock.[272]

Overall, Serbian legal framework for private equity firms is substantially more restrictive than the American system. It stipulates only one business form where the US framework provides for many. Unlike American or European systems, it subjects all private equity firms to the supervision of the regulatory body despite their size or nature. Moreover, it imposes many requirements on the company and gives a wide discretion to the supervisory body on the issue of granting and revoking the operating license. Having in mind that main business activities and risks are associated with private equity funds and not with the management companies, one may questions the logic behind such approach of the legislator.

[271] ibid art. 22.
[272] ibid.

CHAPTER FIVE – Private Equity Network

After separately analyzing each participant of the private equity financing, it should examined how these participants interact within the network of their relations. For expositional simplicity, the network will be segregated into relations between the private equity firms and funds and relations between the investor and investee.

5.1 Relationship between private equity firms and funds

The relationship between the investment fund and its sponsor is twofold. On the one hand, the leading investor will regularly be a member of the fund. Hence, in common law limited partnerships the leading investor will have the status of a general partner on the basis of the partnership agreement. Alternatively, in other entities such as LLCs it may opt to qualify as the manager of the manager-managed entity. In Serbia, the law explicitly allows that the fund managers to have equity interests (*i.e.* the ownership and membership) in the fund itself.[273] On the other hand, the external relationship between the private equity firm and the fund will be regulated in a separate management agreement. This contract serves to determine the rights and duties of private equity firms toward the funds they manage. Notably, it outlines the roles and scope of duties of two monitoring bodies of the partnership.[274] The investment committee is the body that after receiving recommendations from general partners or fund managers recommends the investment into portfolio companies to be taken. It also raises critical questions for further investigation. In addition to it, the supervisory body usually meets quarterly and oversees the financial aspects of the operation.[275] Naturally, the limited partners will be more than interested in having a seat in both of these company bodies.

[273] ZIF, art. 74(3).
[274] Klonowski (n 9) 16.
[275] ibid.

In Serbian law, the management agreement is a nominated contract under the Companies Act whose application is mandatory under the provisions of the Investment Funds Act.[276] The Control and Management Agreement from the Companies Act must be concluded in a written form.[277] In addition, it has to be approved by the general assembly of both companies with a three-quarters majority.[278] It can enter into force only after it is registered with the Companies Registry.[279] The presumption is that this agreement is concluded for an indefinite period of time, with the possibility of termination of the contract on the last day of the accounting period (*e.g.* the accounting year) by giving a written notice of termination at least 30 days in advance.[280] The main effect of this contract is to give the right to the controlling company (the investment company) to issue binding instructions to the controlled company (the investment fund).[281] When giving such instructions, the controlling company must take into account the group's interest and act with due diligence.[282] The Act makes it clear that the directors' fiduciary duties extend to their relationship with the controlled company.[283] Moreover, the investment company is liable for any damage sustained by the investment fund as a controlled entity due to compliance of its employees with the controlling company directors' binding instructions.[284]

Another important aspect of the firm-fund relations are the compensation agreements. Essentially, there are two sources of the private equity firm's compensation. The first one is the management fee representing a percentage of fund size.[285] In the US, this fee goes "around

[276] See ZIF, art. 74(7) and ZPD, art. 554-566.
[277] ZPD, art. 554. Note that although this part of the Companies Act is applicable to all companies, the Act rather clumsily uses the terminology associated primarily with the corporations (*e.g.* shareholders and shareholders' meetings).
[278] ZPD, art. 555(1).
[279] ibid art. 555(6).
[280] ibid art. 556(2).
[281] ibid art. 557(1).
[282] ibid art. 557(2), art. 557(1).
[283] ibid art. 558.
[284] ibid art. 560.
[285] Cumming J. and Sofia A. (n 1) 176.

1-3 percent of the committed capital of the fund."[286] The second one is the so-called carried interest, *i.e.* the performance fee. This fee serves to align the interest of fund managers and fund investors. Unlike the management fee, the carried interest represents a portion of the returns obtained from the portfolio company. Usually it goes around 20 percent.[287] Hence, the profits from the investment are usually shared between general and limited partners in 20:80 percent ratios. In addition, the compensation agreements usually provide for the so-called hurdle rate, *i.e.* the preferred return of the investors. Hurdle rates stipulate that the fund manager must deliver certain return (usually 8 percent) before he or she can receive "a share of the surplus."[288] Furthermore, clawback provisions can further incentivize the performance of fund managers. These provisions function by enabling the investors "to lower the fee received by the fund manager in the event of poor performance of the fund."[289]

By mandating the supplementary application of the Companies Act, the Investment Funds Act has invoked the application of the Control and Management Agreement provisions that put some statutory restrictions on the compensation agreements. Hence, the consideration agreed under the Agreement cannot be paid if the investment fund has operated with losses.[290] However, it can be transmitted and paid in the period when the fund has generated profit.[291] Moreover, the Act introduces the concept of external shareholders. These are the shareholders of the controlled company (the private equity fund) who are not shareholders or subsidiaries of the controlling company (the private equity firm).[292] The Agreement must determine the appropriate amount of consideration per share that the private equity firm must

[286] ibid.
[287] ibid.
[288] Ian Prideaux, Marc Hendriks and Simon Paul, 'Hurdle Rate Should Apply to Hedge Fund Industry as It Does in Private Equity' [2015] *Financial Times* <https://www.ft.com/content/6446e5cc-c29f-11e4-a59c-00144feab7de> accessed 1 April 2018.
[289] Cumming J. and Sofia A. (n 1) 180.
[290] ZPD, art. 561(1).
[291] ibid art. 561(2).
[292] ibid art. 562(1).

pay on an annual basis to the external shareholders of the private equity fund.[293] The only exception to this rule is the case when the private equity firm is the sole shareholder of the fund.[294] Somewhat complicated formula for calculating this consideration contains a guarantee that it will be at least equal to the average dividend per share in the three preceding accounting years.[295] The actual amount paid will be equal to the estimated average value of the dividend per share in the following three years.[296] Following the registration of the Agreement, the external shareholders of the controlled company have three months to ask for a judicial review of appropriateness if they believe the consideration not to be adequate.[297] If they are disinterested in further participation in the fund, the Act offers the external shareholders *a variant of exit rights*. The Agreement must contain the right of the external shareholders to sell their shares in the controlled company to the controlling company at current market price.[298] Alternatively, the Agreement may provide for a right to convert these shares the shares of the controlling company, at a ratio stipulated in the Agreement.[299]

5.2. Relationship between private equity funds and portfolio companies

There are two legal aspects of the relationship between the investors and the investees that stand out among the others. The first aspect is embodied in the investment process itself. It relates to the question of how private equity investors "enter" into the business of the investee. In the same time, this aspect relates to the question of control of the private equity fund over the portfolio company. The first method is the acquisition of ordinary shares of the investee. The most ubiquitous situation is that the investor will obtain only a minority equity interest in the company. "To be sure, venture capitalists will not typically depose an entrepreneur by acquiring a majority of the corporation's common shares. This is usually

[293] ibid art. 562(2).
[294] ibid art. 562(4).
[295] ibid art. 562(3).
[296] ibid.
[297] ibid art. 563.
[298] ibid art. 564(1).
[299] ibid art. 564(2).

counter-productive, as discrepancies between them and the entrepreneur, implying an increase in agency costs, would augment."[300] The second method is the acquisition of preferred shares.[301] Especially, the combined use of convertible preferred shares and staged financing simultaneously provides protection for investors and incentive for investees.[302] The third option is to conclude a shareholder's agreement with the incumbent shareholders of the investee. These agreements are valid as long as they relate to issues within shareholders' scope of competence.[303] In addition, some states may place additional requirements for its validity such as deposition of the agreement with the principal office of the company or limitation of its term.[304] By using this instrument the investors will typically bargain for the continuing membership in the supervisory bodies of the investees, as well as the privilege of class voting that will grant the fund a veto power over relevant issues.

The second aspect goes into opposite direction. It is concerned with divestment process, *i.e.* the exit methods of the investors from the equity participation in the investee. These methods may be divided into three groups. The first group consists of preferred modes of exit.[305] They include initial public offerings (IPO), as well as private sales to strategic or financial investors. The attractiveness of an IPO lies in their ability to provide the highest price possible.[306] As such, it is attractive for the shareholders of the portfolio company (including the private equity investors) as it provides both a liquidity event and an opportunity for them and the management to obtain full control over the enterprise.[307] However, the IPO option comes with the risk of negative shifts in the stock value and high cost of listing. In addition,

[300] McCahery and Vermeulen (n 38) 181.
[301] Maynard and Warren (n 15) 124.
[302] McCahery and Vermeulen (n 38) 181.
[303] Robert W Hamilton, *Corporations* (2nd edn, West Publishing Co 1986) 208.
[304] ibid 209.
[305] Klonowski (n 9) 243.
[306] ibid 244.
[307] ibid.

an IPO in most cases will present only a partial exit.[308] Thus, a private equity investor will be "allowed to sell only up to one-third of their holdings at the time of the IPO while the remaining shares can be sold only after a period of twelve-eighteen months."[309] An alternative way to follow is to sell the shares or selected assets to a strategic investor. The offer can be made to one strategic investor or to a number of them in a tender process.[310] While this process is simple and offers a chance for a complete exit, it also may include the duty to provide warranties to the strategic investor and to allow him to withhold a portion of the agreed price in an escrow arrangement.[311] The final alternative is to sell the enterprise to a financial investor. This avenue is usually pursued "when the business generates repeatable cash flows and pays regular dividends, but has limited growth potential (making it less attractive to strategic investors)."[312] This kind of sale can also be a "recycling" transaction to an another investment fund which may different plans for the business (*e.g.* to combine it with an existing portfolio firm).[313] The second group consists of compromised modes of exit. These are usually a result of either underperformance of the portfolio company or an internal conflict between the owners and the management of the company.[314] This group includes notably buyback (the re-acquisition of ownership by the founders of the company) and MBOs (the purchase of the company by the incumbent management).[315] Finally, the last group of options relates to the undesired modes of exit such as liquidation and bankruptcy. These are consequences when the portfolio company is underperforming but there is no other viable exit strategy.[316]

[308] ibid 247.
[309] ibid.
[310] ibid 246.
[311] ibid 244.
[312] ibid 248.
[313] ibid 249.
[314] ibid 249–250.
[315] ibid.
[316] ibid 250.

CHAPTER SIX – Tax Aspects of Private Equity Financing

Due to their recurring importance for all segments of the private equity system, tax considerations should be analyzed separately. This is yet another major point of divergence between the two analyzed systems.

7.1 Tax considerations in the US

By giving the freedom to tailor their own business vehicles, the American system offers private equity firms and funds to opt for the desired tax treatment. Essentially, there are two main tax regimes that a company may follow. One is to be taxed at the entity-level. In this regime, corporate taxes are being paid by the company itself, before the profits are distributed to their members. Thus, the tax treatment will follow the characteristics of the company and not of its members. With this comes the fact that the shareholders of these entities may benefit from the legal regime of the company, but not from their own personal status. In addition, these entities will usually be subjected to double taxation, both as profits of the company and as dividends of the shareholders. In the US, the subjects of this regime are standard corporations (C-corporations) and LLCs which have chosen the C corporation-tax status. The alternative solution is to opt for a "pass-through" or "flow-through" entity. These entities are fiscally transparent. A pass-through entity presents an accounting entity which maintains company records for the purpose of taxation.[317] On the basis of these records, the company profits are determined, accredited to the company's members and then taxed "from their hands".[318] Hence, the tax treatment will depend on the status of a company's members and not of the company itself. US companies that are subjects to this regime are partnerships, S corporations and LLCs that have opted to be taxed as partnerships or S-corporations. As private equity industry aims to attract a limited number of investors which often enjoy their

[317] Gordana llić Popov, *Pravni i Računovodstveni Aspekti Poreskog Savetovanja* (University of Belgrade Faculty of Law 2012) 163.
[318] ibid.

own special tax status (*e.g.* pension funds), it will heavily rely on fiscally transparent entities. Only they allow for the investors to preserve their tax benefits.

Understandably, private equity funds will favor flow-through entities. Traditionally, they would be organized as limited partnerships with a corporation serving as the general partner.[319] Hence, partners would not incur double taxation while the partnership would be a pass through entity for both profits and loses.[320] In that manner, even if the partnership suffers loses, those loses could "serve as deduction on each partner's own tax return."[321] However, this structure is also complex and carries with it a substantial risk of piercing the veil of the fund manager.[322] In addition, it raises the issue of fiduciary duties of the fund manager's officers who own such duty not only to the corporation they serve but also to the partnership they operate.[323] With their combination of full liability shield and fiscally transparency, S corporations are more resilient to some of these problems. However, these entities suffer from restrictions affecting the number and nature of their owners, the class of stock that may be issued and the type of business they can operate.[324] As a result, LLCs offer the most viable alternative for private equity funds. These pass through entities offer the liability shield without the risks and limitations associated with partnerships and S corporations. They are particularly better suited than corporations when it comes to "investments in assets such as real estate or securities."[325] However, these entities can cause negative tax implications if the fund includes tax-exempt and foreign partners.[326]

[319] Maynard and Warren (n 15) 122.
[320] ibid.
[321] ibid.
[322] ibid.
[323] ibid.
[324] Scott S Jones and Arnold P May, 'Management Company Structuring' <http://www.proskauer.com/files/News/e52911f9-9c95-4505-a4b1-1f3b23530770/Presentation/NewsAttachment/038095dc-b4bc-4a1f-89a5-33fdac93b20d/Proskauer%20040108%20PEI%20Fund%20Structures%20Supplement.pdf> accessed 6 April 2018.
[325] Maynard and Warren (n 15) 128.
[326] ibid 124.

Tax considerations have also influenced private equity firms to convert to fiscally transparent entities. "Historically, the C-corporation was the entity of choice for management companies. The thought process was simple: (1) although a C-corporation is taxable at the entity level, management fees were barely enough to cover expenses so there was no net taxable income, and (2) the notion that an investment firm would continue beyond the working years of its founders was inconceivable."[327] With the development of the industry, LLCs have become the main choice when it comes to private equity firms. Although the situation may differ when it comes to state and local taxes, for the purposes of the US federal income tax, LLCs are fiscally transparent and may issue new interests without immediate tax consequences.[328] "This distinction is significant and has resulted in a number of management company conversions from corporations to LLCs, often at considerable tax cost."[329]

In addition, portfolio companies may be advised to take into account tax consideration if they want to attract private equity financing. Out of the available business vehicle for portfolio companies, C corporations may be favored by private equity investors. First of all, due to their partnership status, private equity funds may not make equity investments in S corporations.[330] Alternatively, equity financing of LLCs "can cause tax problems for the funds' tax-exempt and foreign partners."[331] Secondly, C corporations offer the simplest regime for equity based compensation agreements. Unlike LLCs, C and S corporations may offer tax favored "incentive stock options".[332] Furthermore, unlike S corporations, C corporations can issue preferred shares which are the typical equity interests held by private equity funds.[333] Thirdly, only C corporation shares may be "qualified small business stock" capable of fulfilling the

[327] Jones and May (n 324) 1.
[328] ibid 11.
[329] ibid.
[330] Maynard and Warren (n 15) 124.
[331] ibid.
[332] ibid.
[333] ibid. (fn. 2.)

criteria for tax reliefs.[334] Fourthly, "at any time that C corporate tax rates are lower than individual rates, reinvested income of a C corporation may be taxed at a lower effective rate than reinvested income of an S corporation or LLC."[335] Finally, the use of entities other than C corporations will require that the owners file tax returns "in all the states and other jurisdictions in which the business has a tax presence."[336]

7.2 The tax treatment of private equity funds in Serbia

The legal treatment of the activities associated with private equity financing in Serbia may offer some answers as to why the law has regulated the business with some major differences from the solutions seen in the US law. To start with, Serbian law does not have special regulation about the tax treatment of investment funds. Therefore, their activity falls within the general corporate tax treatment. Secondly, Serbian tax law follows the so-called dependent (indirect) corporate tax treatment.[337] In this approach, the tax law automatically imposes the corporate tax on any entity which the company law defines as a legal person. Hence, if an entity is an incorporated one, it will be taxed at the entity level and subject to double taxation. The fact that the Companies Act does not regulate unincorporated bodies partially explains the rationale behind some of the solutions of the Investment Funds Act. By being a legal person, limited partnership in Serbia simply loses the main advantage it has in common law systems – the fiscal transparency. In such situation, the traits of limited liability companies in the field of company law outweigh the ones of limited partnerships.

The fiscal non-transparency creates the problem of double taxation, *i.e.* the situation where the company is paying the corporate tax and the investor is paying the capital income tax. However, here the tax law partially supplements the deficiencies of the company law. By

[334] ibid 125.
[335] ibid.
[336] ibid.
[337] llić Popov (n 317) 163; Dejan Popović, *Poresko Pravo* (University of Belgrade Faculty of Law 2016) 357–358.

using the method of corporate tax integration, the tax authority grants the shareholders the benefit of partial withholding of the tax paid on dividends.[338] In practice, after the corporate tax has been paid by the private equity fund, the portion of the tax on dividends will be withheld. Therefore, the shareholders will only have to pay the remaining portion of the capital income tax. The level for that tax must be in any case lower than the corresponding level of the special, global income tax of citizens, *i.e.* lower than the annual income tax to be paid by the residents of Serbia which have obtained an income higher than the triple amount of average earnings of employees in the previous year in the country.[339] Despite the benefit of tax integration, this solution may not be satisfactory for private equity investors. It sets out the tax treatment of the investment undertaking without providing any tax alternative. Hence, a foreign private equity investor will not be able to enjoy tax benefits from his or her national jurisdiction and will have to be satisfied with the benefits that Serbian law provides. Hence, it goes against the basic tax considerations of the US investors - to offset the tax paid on the payments of the fund to the foreign subsidiary with the tax paid in the US through foreign tax credits.[340]

[338] Gordana Ilić Popov, 159.
[339] Gordana Ilić Popov, 118; Dejan Popović, 338 – 341.
[340] Jones and May (n 324) 11.

CHAPTER SEVEN – The Advantages of the US Private Equity Model

Taking everything into consideration, the US model shows a number of advantages that may be beneficial for the Serbian system to follow. To start with, the US model regulates the activities of private equity industry only when it presents a systemic risk to the economy.[341] Unlike it, Serbian system would prefer to regulate private equity at the outset. The outcome of this difference is that while Serbian private equity companies have to register and report with the financial authority in any case, their US counterparts have such duties only when a certain requirements are fulfilled (*e.g.* number of participants or the value of the fund). Moreover, while Serbian system stipulates mandatory minimum capital requirements, in the US the size of the investments into the fund is simply a matter of business conventions.

The US model does not impose any mandatory business form for the activities of private equity funds. In this manner, it leaves a large leeway for the investors to organize their fund in accordance with their business strategy. In this matter, Serbian system neither gives the benefit of such choice nor does it introduce special business forms for private investment funds like more successful European countries. Essentially, it has selected only one business form of the general company law and made some modifications to it.

The approach of the US system has given an opportunity to shape a number of key features of private equity funds. Firstly, private equity funds may or may not be incorporated, with all the consequences that each status includes. In Serbia, like all other companies, private investment funds are incorporated entities. Secondly, in the US private equity funds may or may not have a full liability shield. This choice enables private equity firms to bargain for a more favorable position when it comes to the rights and returns from the fund. Serbian law on this matter offers only one type of liability shield. Thirdly, the American funds have the full liberty to define and distribute management rights among their members. Hence, private equity

[341] Klonowski (n 9) 258.

investors may retain a number of rights when it comes to management or supervision of the fund. As opposed to it, the Serbian system exclusively vests management rights into private equity firms. By default this solution prevents investors other than the fund manager to have a word when it comes to many material issues for private equity funds. Finally, the US private equity funds may become listed entities. This is something unavailable for Serbian private funds, due to the limitation of their business form and nature of their equity interests.

The pattern repeats with private equity firms. While the US regulation and business practices give even greater leeway for organizing management companies, the Serbian approach goes into opposite directions. It opts for a business form that is more restrictive than the one chosen for private funds and adds further restrictions (*e.g.* higher minimum capital requirements). These restrictions are even more perplexing, as capital and risks associated with private equity lies mainly with private equity funds and not with their management companies.

However, the main advantage of the US system encompasses tax considerations. By not mandating the use of any particular entity for private equity funds and firms, the US system enables the investors to choose their own tax treatment. This has proven to be a vital option as different entities carry with them different combinations of company and tax law solutions. Notably, this possibility revolves around the choice of fiscally transparent entities. Having the possibility to opt for a flow-through entity helps the investors not only to avoid double taxation, but also to preserve the benefits of their own tax status. Essentially, this option can make a substantial difference between the levels of returns obtained from the investment.[342] Conversely, by incorporating all business entities and using the so-called indirect corporate taxation model, the Serbian system prevents any possibility of structuring private equity funds and firms in a fashion similar to the one of common law limited partnerships.

[342] For example, different tax treatment of C Corporations and LLCs can lead up to a 28 percent difference in effective tax rate (in favor of LLCs). See: Maynard and Warren (n 15) 129.

CONCLUSION

Taking everything into consideration, the thesis has shed light on traits of the US systems that enable private equity industry to excel. Although many of those advantages lie in the field of economy, company law issues also have their own role. The US system provides protection to both the economy and the investors. This is being done by requiring private equity investors to cooperate with the regulatory authority only when certain conditions are met. In absence of them, the investors have the full liberty to structure and operate their endeavors in accordance with their preferences. This has resulted in private equity industry in the US following the structuring pattern which includes limited number of participants, liability shield, organizational flexibility and fiscal transparency. Evidently, Serbian system has failed to adopt many of these positive characteristics of the US private equity system. It subjects private equity industry to mandatory requirements and constant supervision regardless of the nature of the enterprise. Moreover, it compels private equity industry to use business forms that do not have the qualities required for the successful organization of the business and transfer of profits. Notably, it does not allow the use of forms that are structurally adaptable and do not adversely affect the tax benefits that the investors may have in their home jurisdictions. In the light of these differences, Serbian legislator should be advised to provide for a system that follows the company and tax law principles that are present in the US system. In particular to offer the choice between several business entities which would enable the investors to structure their operations in accordance with their needs. Furthermore, this choice should enable the investors to opt between Serbian and their own home jurisdiction tax regime. In the end, this thesis has fulfilled its role by paving the road for future studies of investment funds in Serbia, especially in the context of setting out a better framework for the development of the industry in the country. Their outcome should offer even more alternatives in which investment funds could be structured in the given jurisdiction.

Bibliography

Bartlett JW, *Venture Capital: Law, Business Strategies and Investment Planning* (John Wiley & Sons 1988)

Bell TH and others, 'Private Equity (Fund Formation)' <https://gettingthedealthrough.com/area/28/jurisdiction/23/private-equity-fund-formation-united-states> accessed 6 April 2018

Carnes D, 'Is a Corporation the Same as an LLC?' <http://info.legalzoom.com/corporation-same-llc-3183.html> accessed 6 April 2018

Cendrowski H and others, *Private Equity: History, Governance and Operations* (2nd edn, John Wiley & Sons 2012)

Cumming J. D and Sofia A. J, *Venture Capital and Private Equity Contracting - An International Perspective* (2nd edn, Elsevier 2014)

Dowd K, 'Private Equity Goes Public: A History of PE Stock Performance' <https://pitchbook.com/news/articles/private-equity-goes-public-a-history-of-pe-stock-performance> accessed 6 April 2018

Dowd K, '2007 vs. 2017: A US PE Fundraising Throwdown' <https://pitchbook.com/news/articles/2007-vs-2017-a-us-pe-fundraising-throwdown> accessed 6 April 2018

Fenn P and Goldstein D, 'Tax Considerations In Structuring US-Based Private Equity Funds' <https://www.akingump.com/images/content/9/7/v4/974/376.pdf>

Franklin J, 'Global Private Equity Funds Raise Record $453 Billion in 2017: Preqin' <https://www.reuters.com/article/us-privateequity-fundraising/global-private-equity-funds-raise-record-453-billion-in-2017-preqin-idUSKBN1ET23L> accessed 6 April 2018

Goldsmith L, 'The Rapid Decline of Private Equity Fundraising in the Balkans' <https://www.preqin.com/blog/0/10124/pe-fundraising-balkans> accessed 6 April 2018

Hamilton RW, *Corporations* (2nd edn, West Publishing Co 1986)

'Investment Funds in the Netherlands' *The Dutch Fund and Asset Management Association (DUFAS)* <http://www.dufas.nl/site/assets/files/1304/rapport_ifitn-ey-dufas.pdf> accessed 6 April 2018

Jones SS and May AP, 'Management Company Structuring' <http://www.proskauer.com/files/News/e52911f9-9c95-4505-a4b1-1f3b23530770/Presentation/NewsAttachment/038095dc-b4bc-4a1f-89a5-33fdac93b20d/Proskauer%20040108%20PEI%20Fund%20Structures%20Supplement.pdf> accessed 6 April 2018

Klein WA, Coffee JC and Partnoy F, *Business Organization and Finance: Legal and Economic Principles* (11th edn, Thomson Reuters/Foundation Press 2010)

Klonowski D, *The Venture Capital Investment Process* (Palgrave Macmillan 2010)

Koh H, 'Building Powerful Agents of Change: A Perspective from Venture Philanthropy' <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/78910/Harvey-Koh_2.pdf> accessed 6 April 2018

Ljungqvist A and Richardson M, 'The Cash Flow, Return and Risk Characteristics of Private Equity' <http://www.nber.org/papers/w9454> accessed 6 April 2018

llić Popov G, *Pravni i Računovodstveni Aspekti Poreskog Savetovanja* (University of Belgrade Faculty of Law 2012)

Maynard TH and Warren DM, *Business Planning: Financing the Start-Up Business and Venture Capital Financing* (2nd edn, Wolters Kluwer Law & Business)

McCahery JA and Vermeulen EPM, *Corporate Governance of Non-Listed Companies* (Oxford University Press 2008)

Naidech SW, 'Private Equity Fund Formation' [2011] *Practical Law Publishing Ltd.* <https://www.msaworldwide.com/Naidech_PrivateEquityFundFormation_Nov11.pdf> accessed 6 April 2018

Plagge A, *Public Policy for Venture Capital: A Comparison of the United States and Germany* (Deutscher Universitätsverlag 2006)

Popović D, *Poresko Pravo* (University of Belgrade Faculty of Law 2016)

Prideaux I, Hendriks M and Paul S, 'Hurdle Rate Should Apply to Hedge Fund Industry as It Does in Private Equity' [2015] *Financial Times* <https://www.ft.com/content/6446e5cc-c29f-11e4-a59c-00144feab7de> accessed 1 April 2018

Ribstein LE, *Unincorporated Business Entities* (2nd edn, Anderson Publishing Co 2000)

Stefanović N, *Privatni Investicioni Fondovi – Vrste, Organizacija i Poslovanje Na Brzorastućim Tržištima* (Institut ekonomskih nauka 2009)

Todorović V and Slijepčević RM, *Privredno Pravo* (Projuris 2016)

Vasiljević M, *Kompanijsko i Trgovinsko Pravo* (8th edn, Službeni glasnik 2017)