NEGOTIATING PRIVATE EQUITY FUND TERMS

The Shifting Balance of Power

By Albert J. Hudec

The balance of power has shifted from the investment managers who create private equity funds to the pension plans and other folks with money that invest in the private equity asset class.

Investors now have the upper hand in negotiating fund agreements, and they are itching to exert their new-found bargaining power. Many are unhappy with the high fees and poor performance of their existing investments; and annoyed by the governance transgressions and shoddy reporting practices of the problem child in which they have invested.

The ILPA Principles

The publication by the Institutional Limited Partners Association (ILPA) of recommended best practices for structuring private equity funds (ILPA Principles) is an effort by the leading industry organization to shift negotiating leverage in favor of investors.

The ILPA Principles recommend a significant retooling of the key terms in the limited partnership agreements used to establish private equity funds, all in an effort to more closely align managers' pay with performance. This alignment is the value driver in the private equity business model. Given proper incentives, fund managers can lead in economic recovery by doing what they do best—restructuring underperforming businesses by motivating management, imposing cost efficiencies, and divesting noncore assets.

The ILPA Principles provide guidance on recommended deal terms in three distinct areas: management fees and profit sharing, governance and conflicts of interest, and reporting obligations.

Management Fees and Profit Sharing

The first major area in which the ILPA Principles make detailed recommendations is with respect to management fees, transaction fees, and carried interest. These are the three ways that fund managers are compensated under the private equity model. Under the original "2 and 20" model, managers receive a 2 percent management fee on committed capital and 20 percent of the profits made on investments.

Management Fees. One of the big issues this year is management fee percentages. Management fees have fallen in recent years as a percentage of assets under administration and are now being pushed into the 1.5 percent range. Nevertheless, they can be extremely lucrative to fund managers because of the economies of scale in operating a larger fund. Allowing managers to profit from management fees in advance of generation of economic return to investors distorts incentives, encouraging managers to maximize fund size rather than perform.

The ILPA Principles state that management fees should be set on the basis of a disclosed fee model that reflects the manager's budgeted expenses to cover professional and staff salaries, rent, and operating and overhead expenses.

Management fees should step down significantly (50 percent) after the investment period or after the manager closes a successor fund, with fees from that point on calculated on invested rather than committed capital.

Transaction Fees. Transaction fees

Hudec is a partner at Farris, Vaughan, Wills & Murphy, LLP in Vancouver, British Columbia. His e-mail is ahudec@farris.com.

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are another problem area addressed by the ILPA Principles. Fund managers typically provide an array of services to portfolio companies. These services can generate significant advisory fees to directors, consultants, and advisors.

In recent years, there has been a clear shift in the market away from a 50-50 sharing of these transaction fees between general partners and limited partners, with 80–100 percent now being credited against management fees. The ILPA Principles approve of this trend. They recommend that 100 percent of transaction fees go to the fund as this reduces the conflict inherent in managers working for companies in which the partnership they are managing holds an investment.

Carried Interest. Profit-sharing formulas are the principal tool used in private equity funds to align interests and drive incentives. Typically, the manager receives its profit participation through a "carried" interest share of fund profits, so called because the manager is not required to pick up a corresponding share of the fund's costs. The mechanics governing payment of the carried interest are set out in something called a distribution "waterfall," which describes the sequence in which proceeds from the sale of portfolio companies are distributed between the general partner and the limited partners.

The "Return All Capital First" Approach. The ILPA Principles recommend a "return all capital first" approach to carried interest waterfalls. In this model, common in Europe, the general partner does not receive payout of its carried interest until investors have received back all of their contributions, including the amount invested in both realized and unrealized investments, together with management fees and other expenses of the fund.

In addition, the ILPA Principles recommend that carry should not be paid on ordinary income generated by portfolio companies. Also, it should be calculated net of withholding tax regardless of whether investors are eligible for offsetting tax credits.

The ILPA Principles further suggest that carried interest should be streamed predominately to the professional staff responsible for the success of the fund, who should be prohibited from transferring those interests.

The U.S. House of Representatives recently passed legislation that, if also passed in the Senate, would hit the pocketbooks of fund managers by taxing carried interest as ordinary income. In response, managers are negotiating "gross up" provisions to hold them whole or are trying to insert language allowing them to restructure their funds if tax laws change. Sensibly, the ILPA Principles recommend that all such efforts to pass on the economic effect of tax law changes to limited partners be resisted.

> Another way to align manager and investor interests is to require that the management team have significant "skin in the game."

The Deal-by-Deal Approach. In North America, the current market standard for payment of carried interest is the manager-friendly deal-by-deal waterfall. The general partner's carried interest is paid out on a deal-by-deal basis as soon as the fund begins generating profitable exits from investments.

This approach has two problems. First, the early payment of carry takes money off of the table and is a drag on investor returns. Second, it creates the need to include complicated claw-back provisions in the limited partnership agreement.

Claw Back. Where the deal-by-deal carry waterfall is used, the ILPA Principles recommend that the limited partnership agreement include detailed claw-back provisions requiring the general partner to pay back profit distributions if losses subsequently arise from the sale of portfolio companies or from asset write-downs.

The ILPA Principles include detailed recommendations for such claw-back clauses:

- all realized portfolio losses and all write-downs on unrealized investments should be recovered before any distributions;
- all fees and expenses should be recovered before any distributions, not just a portion of total expenses equivalent to the proportion that such distribution is of total invested capital;
- there should be significant carried interest escrows (30 percent or more);
- there should be joint and several liability of the fund's management team and their family trusts for the claw-back repayment obligation;
- paybacks should occur within two years of the date that the liability arises;
- paybacks should be gross of taxes, even if the manager is left in a negative cash position because a refund is not available or there is a mismatch of capital gains and ordinary income; and
- the fund's independent auditors should certify all carried interest calculations.

Management Investment. Another way to align manager and investor interests is to require that the management team have significant "skin in the game." Accordingly, the ILPA Principles suggest that managers should make a significant (3.5–5 percent) investment of their own money in each fund that they manage.

The ILPA Principles suggest that this "management profits" interest should be paid in cash rather than by way of set-off against management fees. Given that this approach is tax inefficient compared to waiving management fees, it is unlikely that the ILPA approach will find favor among managers.

Improving Fund Governance

The second major thrust of the ILPA Principles is in the area of fund governance and accountability. These are topics very much on the minds of fund investors.

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Too frequently in the past, portfolio managers have chosen to invest in funds managed by the hottest fund managers without paying sufficient attention to how the fund is governed and deals with conflicts of interest.

In the current economic environment, this has changed. Investors are looking for ways to say no to funding proposals. With increasing frequency, they are deciding not to reinvest in a manager's new funds (so-called re-ups) for reasons other than a poor performance track record: for example, because they are unimpressed by the fund's governance and reporting practices.

Conflicts of Interest. Fund agreements too frequently fail to address conflicts of interest in a comprehensive fashion. For example, many agreements require only that the general partner disclose conflicts of interest at the end of each year rather than seek advance consent to conflicts prior to their occurrence.

This can result in the indignity for an investor of standing by and watching helplessly as a less-than-scrupulous manager abuses the fund by cherry-picking the best investment opportunities for itself or for its successor funds, or by using the fund to prop up companies held by other funds managed by the manager. The ILPA Principles recommend that all conflict-of-interest and self-dealing transactions be predisclosed and preapproved by the fund's limited partner advisory committee.

The Role of LP Advisory Committees. The ILPA Principles recommend an enhanced role for limited partner advisory committees, or LPACs. In 2010, expect a continuation on the trend toward greater reliance on LPACs made up of representatives of the "big dogs"—the largest investors in a fund.

Key responsibilities of an LPAC include oversight of conflicts of interest and the valuation of investments. Other duties may include waiving certain investment restrictions and approving new management hires.

The ILPA Principles provide useful guidance for best practices with respect to the formation of LPACs and meeting protocols that every LPAC should be adopting.

Fiduciary Duties. The ILPA Principles are premised on the notion that limited partnership agreements should reinforce rather than dilute the fiduciary duties of general partners to limited partners. Self-dealing and conflicts of interest should not be tolerated. Unfortunately, the language in fund agreements has often fallen short.

The ILPA Principles recommend that investors push back against inappropriate terms such as provisions that allow the general partner to reduce all fiduciary duties to the fullest extent allowed by law. They also recommend that general partner behavior constituting "gross negligence, fraud or willful misconduct" be excluded from the protections of indemnification and exculpation clauses, even if the governing law would permit it.

Style Drift. The ILPA Principles recommend that investors guard against style drift (managers digressing from their investment strategies) by clearly and narrowly outlining the investment strategy of the fund. The investment strategy should encourage time and industry diversification and set specific concentration limits. Deviations from the investment strategy should be permitted only if the LPAC consents.

No-Fault Divorce Terminations. Many fund agreements permit termination of a manager "for cause" only by some extremely high majority (e.g., 85–95 percent) following a nonappealable judicial decision. This is often unworkable. It may be difficult to prove cause even where the manager's conduct is egregious; and it may be impossible to assemble a required majority of outraged limited partners.

The ILPA Principles recommend that the limited partners, by simple majority (and not by the super majority, which is the current market standard), should have the right to suspend or terminate the commitment period. Two-thirds majority in interest of limited partners should have the right to remove the general partner or terminate the fund under the "no fault divorce" provisions of the limited partnership agreement without cause; for example, if they do not see the returns they expected.

Key Man Provisions. The experience and performance track record of a manager's professional team are among the most important factors considered by investors in deciding to invest in a private equity fund. Yet it is not uncommon for key

Glossary of Terms

All-of-fund carry waterfall—The GP is not paid carry until LPs receive distributions equal to their total contributed capital, preferred return, and expenses.

Carry—A variable performance fee paid to the GP for positive performance; for example, 20 percent of profits.

Claw-back—The mechanism by which overpaid carry is returned to LPs.

Deal-by-deal carry waterfall—The GP's carry is calculated and paid out on a deal-by-deal basis as each investment is realized.

Escrow account—An account in which a GP's carry is held to secure future claw-back obligations.

General partner (GP)—A subsidiary of the manager that acts as general partner of the fund.

Limited partner (LP)—An investor that invests in a fund organized as a limited partnership.

Preferred return—The minimum return that must be achieved by LPs before the GP is paid a performance fee, usually 8 percent.

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management personnel to leave a fund manager, particularly if the fund is underwater and management feels that there is little prospect of ever earning their carried interest.

The ILPA Principles recommend that the result of the departure of a key person should be severe: the automatic suspension of the commitment period, which becomes permanent unless the limited partners vote by two-thirds majority in interest within 180 days to reinstate it.

A similar result should apply in the event of a breach of fiduciary duties, material breach of the limited partnership agreement, bad faith, or gross negligence. Perhaps even more importantly, investor rights should be triggered upon a preliminary nonappealable determination, not by a final court decision.

Limits on Indemnification. Fund agreements usually contain indemnification and give back obligations requiring limited partners to return prior distributions in various circumstances. For example, in today's buyer-friendly deal environment, private equity funds selling their portfolio companies are often required to provide exhaustive indemnities for breach of representations and warranties in the purchase agreement. Where a buyer invokes these indemnification rights, limited partners may be required to give back prior distributions.

The ILPA Principles recommend that indemnification be capped in amount and limited in duration. A typical clause would cap the obligations available at the level of remaining unfunded commitments plus 25–50 percent of distributions received for a period of two years from the date of distribution.

Extension of Fund Term. Currently, the venture funds established in the years leading up to the technology industry collapse of 2001 are reaching the end of their 10-year terms. Many are lingering on with a residual portfolio of illiquid investments in private companies that have not generated exit opportunities.

The ILPA Principles should increase the bargaining power of limited partners in negotiating fund terms.

The ILPA Principles recommend that maturing funds be wound up after no more than one one-year extension. This is good advice and should encourage investors to make the tough but pragmatic decision to write off low prospect residual investments rather than continue to pay fees and expenses of maintaining losing investments.

Improving Information Flows

The third major topic addressed by the ILPA Principles relates to reporting and information flows. Bad reporting practices by fund managers are an irritation to investors in private equity funds.

A diligent and resourceful portfolio manager can usually cobble together most of the required information by asking questions at annual and quarterly meetings, at LPAC meetings, and by way of repeated special requests. This is less than ideal. Traditional limited partnership agreements do not have expansive information rights and tricky confidentiality obligations make robust information flow difficult to come by.

The ILPA Principles provide detailed recommendations on general partner reporting. Investors should be provided detailed information about all activities of the manager, including all of its consulting arrangements and other dealings with portfolio companies and information about its economic arrangements with its principals, placement agents, and third-party investors. Investors should receive regular limited partnership financial statements; quarterly schedules of fund-level leverage, including commitments; details of fund expenditures; and contact information for the other investors. Investors should receive detailed valuations of portfolio companies (along with a discussion of the valuation methodology) as well as selected financial performance information including earnings, burn rates, and debt levels on a quarterly and annual basis. Investors should receive details of fee and carry calculation with each distribution and annual internal rate of return calculations (with a description of the methodology for determining the internal rate of return).

Additional Resources

In recent months the Institutional Limited Partner Association, the Oregon Investment Council, and Watson Wyatt Worldwide have released three similar sets of principles for negotiating private equity fund deal terms. Copies of these reports can be obtained at the following URLs:

- *www.ilpa.org/ilpa-private-equity-principles*
- *www.ost.state.or.us/News/Releases/2009/042909%20OIC%20adopts%20principles%20for%20private%20equity.pdf*
- *www.watsonwyatt.com/asia-pacific/pubs/investbriefing/pdf/PE_fees_terms_final.pdf*

Also, IOSCO, the International Organization of Securities Commissions, has recently (November 2009) released a consultative report on private equity conflicts of interest. A copy of this report can be obtained at

- *www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf*

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Conclusions

Portfolio managers devote a disproportionate amount of their time and effort to the administration of investments governed by poorly negotiated or poorly drafted fund agreements. Poorly drafted economic terms drag on return performance and misalign incentives. Inadequate governance clauses and poorly drafted reporting provisions make it hard to deal with conflicts and other abuses, or to gather the information needed to assess performance.

The release of the ILPA Principles, together with the severely reduced flow of institutional money into new funds, should increase the bargaining power of limited partners in negotiating fund terms and help remedy these historical problems.

Some of the terms recommended by the ILPA Principles, particularly those dealing with fees and carry, deviate from current market norms and are unlikely to be welcomed by managers. Nevertheless, expect investors to assert their bargaining power on these issues and for fund managers with less than stellar performance records to agree to more investor-friendly terms.

Also, expect that the publication of the ILPA Principles will hasten the shift in market norms that has already been occurirng toward better governance and conflict-of-interest terms and improved reporting provisions.

The ILPA Principles rightfully point the way toward reestablishing investor confidence in private equity as an attractive asset class, for the ultimate benefit of both investors and managers.

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