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Negotiating Private Equity Fund Terms in 2010 - Will the ILPA Principles make a difference?

Al Hudec, CFA*

This client alert discusses recent developments and “at market” terms for 2010 vintage private equity funds. Under current market conditions, expect a shift to more investor-friendly deal terms. The recent efforts of the *ILPA* to educate investors on “best practices” will focus negotiations on improving performance through closer alignment of investor and manager interests.

The publication by the Institutional Limited Partners Association (“ILPA”) of recommended best practices (the “ILPA Principles”) is a reminder that multiple provisions of the limited partnership agreement governing a private equity fund impact on the alignment of investor and manager interests. Fund terms must be carefully structured and vigorously negotiated to achieve the careful alignment of manager and investor interests that is the value proposition in the private equity business model.

Introduction

There is a widespread view among institutional investors that private equity fund terms became too “manager friendly” during the recently ended era of cheap and easy credit that fueled the leveraged buyout boom of 2002-2007¹. Current market conditions will give limited partners greater leverage

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¹ A recent (September, 2009) study by Watson Wyatt modeled the split of excess return (alpha) in a typical private equity fund and supports the proposition that current deal terms are overly manager-friendly. The Watson Wyatt model assumes a simplified set of deal terms: a management fee of 1.75% reduced to 1.5% after a five year investment period with set off of all transaction and monitoring fees, a 20% European-style carried interest after an 8% preferred return with 100% general partner “catch up”, capital draw downs on a straight line basis over five years, and an average four year hold period for investments. Assuming alpha of 10% over an 8% benchmark adjusted for leverage 50% higher than public company averages and a 5% cost of debt capital, the model generated an approximate 60%/40% split of alpha between the general partner and the limited partners. This equates to a 20% gross IRR (prior to deduction of management fees) and a 13.7% net IRR, far too low to compensate investors with an appropriately risk adjusted rate of return. Under the Watson Wyatt model, a 32.5% gross return would be necessary to generate a more reasonable 2/3 to 1/3 split between the limited partners and the general partner.

in negotiating fund formation documentation. The private equity groups within the major pension funds, disappointed with investment returns on their existing funds, are rejecting far more funding proposals this year than in the past².

Industry funding activity is significantly down from prior years. A recent Prequin study reports that there were only 23 buyout fund closings raising \$68 billion in the first nine months of 2009 compared to 131 buyout fund closings raising \$144 billion in the first nine months of 2008. A broader study by the Dow Jones Private Equity Analyst (including not only buyout, but also venture, secondary and other funds) shows that 265 private equity funds raised \$80 billion in the first three quarters of 2009, a 60% decline from the same period last year. A recent Credit Suisse First Boston survey indicates that re-ups this year are down 84% from last year.

The ILPA Principles

The release of the ILPA Principles is an effort by the leading industry organization (representing 220 institutional investors, 50 of whom have already expressly endorsed the ILPA Principles) to shift the balance of power between investors and sponsors as we enter the 2010 fund raising season. In some respects, the ILPA Principles deviate quite dramatically from current “at market” deal terms. In negotiations with quality established managers with the best track records, they are unlikely to result in more than incremental changes to market norms. For newer funds trying to enter the market in these difficult times and for existing funds with less than stellar track records, their publication may force a shift towards more investor-friendly terms.

Examples of areas where the ILPA Principles differ significantly from current market norms include the following:

- (i) The reduction of management fees to the manager's reasonable operating and overhead costs, as modeled by the general partner at the time of fund formation;
- (ii) A shift from the deal-by-deal carried interest distribution model to an aggregate or whole fund distribution approach;
- (iii) Tough claw-back terms including very significant escrows (starting at 30%) and joint and several liability of the general partner and its principals;

² OMERS (the Ontario Municipal Employees Retirement System) is dramatically reducing its investments in externally managed funds. OMERS' goal is to reduce Fund investments from 65% to 20% of its private equity investments and to correspondingly increase their direct investment activity.

“Release of the ILPA Principles, together with a significant reduction in available funding, will give LPs the upper hand in negotiations in 2010”

- (iv) Cash funding of the manager's investment in the Fund, rather than the more tax-efficient method of funding by way of waiver of management fees;
- (v) Termination of the general partner for cause upon a preliminary determination, rather than upon a final and non-appealable court decision; and
- (vi) An end to the contracting out of the fiduciary duties otherwise applicable under Delaware law.

Several other of the ILPA Principles reflect the already significant movement of the market norm towards the “best practice” in recent years and are at or close to market:

- (i) 100% crediting of transaction and other advisory fees to the fund (80% is probably the current market norm);
- (ii) A 50% or more step down of management fees upon the formation of another fund;
- (iii) Narrowly drafted investment objectives (to forestall style drift);
- (iv) Automatic suspension of the investment period in the event of “key man” departures; and
- (v) “No fault” divorce by super majority vote, and termination of the investment period by majority vote (although a super majority vote is still frequently required).

Management Fees

One of the big issues in 2010, as in recent years, will be management fee percentages and related terms. In the view of many industry participants excessive management fees are the most significant factor in misaligning manager and investor interests. The concern is that managers that earn fees significantly in excess of their salary expenses may not be sufficiently motivated to enhance fund performance to earn their carried interest. Simply put, the investor view is that managers should profit by earning their carried interest through performance and not through their management fees.

Lead investors will have success this year in negotiating down management fees payable to less established fund managers and managers with less than top quartile performance records; but even in a relatively depressed market it is likely that the most sought after managers with the best reputations will continue to attract premium compensation³. One of the reasons for

³ Witness, for example, the recent successful closing of the KPS III Fund with terms that included a 25% management carry and a 50-50 sharing of transaction fees.

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the resentment over high management fees has been the recognition that, during the 2002 – 2007 credit “bubble”, a large portion of the return generated by fund managers was attributable to excessive leveraging rather than to superior performance. A 2009 academic study by Acharya, Hahn and Kehoe showed that only about one third of the returns generated by large private equity deals were based on pure value creation. Going forward, in a world where credit will be less available, investors may be more willing to reward the general partner for returns if they are based on pure value creations rather than an over exploitation of debt.

Although management fees have fallen in recent years as a percentage of assets under management as funds have become exponentially larger, most private equity investors believe that these fees are still far too high given the significant economies of scale in operating a larger fund. Generally, management fees are now in the range of 1.5 - 2.5% of commitments, stepping down to around 1.0% of invested capital at the end of the investment period or upon the establishment of a successor fund.

The ILPA Principles make the case that management fees should be set at a level that reflects the manager’s budgeted expenses to cover salaries, rent and other overheads and normal operating expenses; and should not provide material upside compensation to managers. Set at a proper level, management fees should allow the manager to pay competitive salaries and cover its other expenses, but should not make the managers wealthy in advance of generating an economic return to investors.

This year, look for limited partners to push general partners to justify their proposed fee structures by tabling detailed information about their cost structures. Specifically, the ILPA Principles suggest that prospective limited partners should insist that the manager provide them with a fee model based on reasonable operating expenses and reasonable salaries at the time of fund formation to be used as a guide to set management fees. This detailed level of transparency can be difficult to achieve, however, particularly where the manager may be simultaneously managing other funds or offering other products; judgments will be required to decide how to allocate costs and overheads among the manager’s various activities.

Also as recommended by the ILPA, there should be a significant (e.g. 50% and in some cases as high as 75%) step-down in management fees after the investment period or after the manager closes a successor fund, with the calculation from that point on based upon invested capital. Although not specifically recommended by the ILPA, management fees should be deducted in the calculation of preferred return. Placement agent fees and general partner insurance should be expenses borne by the general partner. Generally today, most (i.e. probably 80%) of side letters provide that the general partner either warrants that it has not paid placement agent fees in respect of an investor’s investment, or if it did, that it is a general partner’s expense. It is the rare fund that actually charges placement agent fees to

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the limited partners globally; rather, if the general partner wants to be compensated for those fees, it charges them directly to the investor sourced by the placement agent. With regard to general partner's insurance, general partners typically argue that their insurance is for the limited partner's benefit and that the investors should foot the bill. Limited partners argue the opposite and propose that advancement of indemnification costs be prohibited where limited partners are upset with the general partner or the general partner is fighting with its affiliates, as without that advancement, pressures to settle are increased.

One fundamental change, which is not part of the ILPA Principles, but which would significantly reduce the drag of management fees or returns is the phasing in of management fees over the investment period. For example, a 1.75% management fee could be phased in over three years, with 0.875% in the first year and 1.3125% in the second year. Paying a full management fee on committed but uninvested capital significantly and negatively impacts on the internal rate of return performance generated for investors from fund investments. For example, depending on the rate of investment, a 1.75% management fee levied on committed capital can equate to an effective 3.5 - 5% fee on capital actually invested.

Transaction Fee Offsets

Investors have made significant progress in requiring managers to turn over to the fund the directors' advisory, monitoring, transaction and exit fees that they earn from investee companies. In recent years, there has been a clear shift in the market away from 50 - 50 sharing of transaction fees. The ILPA Principles recommend that 100% of transaction and other advisory fees should be credited against management fees. Expect continued hard bargaining on this point in 2010.

In a typical deal, 100% of directors' fees and 80% or more of other transaction and advisory fees will be credited against management fees otherwise payable.

Typically, transactions fees will be offset against management fees rather than allocated directly to investors, many of whom are tax-exempt entities for whom fee income has negative tax consequences. Placement fees, which would otherwise have to be amortized by the manager for tax purposes, are typically initially paid by the fund but credited against management fees.

Management Capital Commitments

In 2010, look for investors to exert continued pressure on sponsors to make a significant investment in the fund as a way of further aligning sponsor and investor interests. In accordance with the ILPA Principles, managers should have significant skin in the game, at least 2.5 - 3.5% of the

“At market transaction fee offsets are now at 80% or more”

fund or more. Also, principals of the manager should be restricted from transferring their interest in the general partner in order to ensure ongoing alignment with the interests of the limited partners.

Normally, this “management profits” interest is initially paid for by way of a promissory note which is then retired by set-off against management fees otherwise payable. Although this approach offers tax benefits to the general partner, it is fundamentally inconsistent with the conceptual approach of basing management fees on the manager’s reasonable overhead and operating costs. Accordingly, the ILPA Principles suggest that a high percentage of the general partner’s commitment should be in cash rather than being contributed through the waiver of management fees. Given that this approach is tax inefficient compared to waiving management fees, it is unlikely that the recommended ILPA approach will find favour in the market.

Carried Interests

The carried interest is the principal tool used to align interests and drive incentives in a private equity fund. The mechanics governing payment of the carried interest are set out in a “waterfall” describing the sequence in which proceeds from the sale of portfolio companies are distributed between the general partner and the limited partners.

In North America, the current market standard for established funds is the deal by deal waterfall. The general partner’s carried interest is paid out periodically on a deal by deal basis as soon as the fund begins generating profitable exits, with the general partner receiving a share of profits (carry) as soon as it has returned the drawn down capital and paid a preferred return on the particular investment being realized (and also the amount of any investment write downs). In sharp contrast to the aggregate European approach, the deal-by-deal approach is general partner friendly and can accelerate payments to the general partner by many years since carry payments start before the return of capital on investments that have not yet been realized. In the European model, the general partner does not receive payout of its 20% carried interest until investors have received back all of their contributions (including the amount invested in both realized and unrealized investments, management fees and other expenses of the fund) as well as their preferred return. In fact, sometimes in the European model, carry payments are deferred until the end of the fund’s investment period.

The ILPA Principles suggest that an aggregated European style “return all capital first” approach is best practice. Most established U.S. private equity sponsors that have a good performance record and some bargaining leverage will resist this approach arguing that it is non-market and that it results in a disincentivizing delay of carry payments to general partners. At the same time, however, expect lead investors to insist that both new and

“Expect aggregate waterfall provisions to be imposed on new fund managers”

less sought over fund managers adopt an aggregated waterfall approach. Expect aggregate waters in half or more of this later category of deals.

There are at least two serious problems with the North American approach to “carry waterfalls”. First, the early payment of carry to general partners on a deal by deal basis has an opportunity cost since it takes money “off of the table” which could have been invested elsewhere and is a drag on investor returns. Second, as discussed below, it creates the need to include complicated “claw-back” provisions in the partnership agreement. Experience in the last couple of difficult years has shown that in practice “claw-backs” can be hard to collect.

The ILPA Principles also recommend that carried interest generated by the fund should be directed through the general partner predominately to the professional staff responsible for the success of the fund. In practice, this may be more easily said than done and may not be realistic under a variety of scenarios such as where the manager has already agreed with now inactive founding partners to pay them a share of carry on the first one or two funds established after their retirement, or where the manager has already agreed with a parent company or with passive minority shareholders to give them a share of the carry.

Other details that should be considered in the drafting of a carried interest clause include the following: (i) carried interest should be calculated on the basis of profits net of the management fee; (ii) carried interest should be calculated on an after-tax basis after the deduction of foreign and other taxes (whether or not there is the possibility of offsetting foreign tax credits); (iii) no carry should be taken on current income; and (iv) unless they become permanent, financing “bridge loans” should typically be excluded from the waterfall.

Preferred Returns and Hurdle Rates

The market standard is to commence payment of the general partner’s carried interest once payments to the limited partners have exceeded a *preferred return* (e.g. an 8% internal rate of return, calculated from the day on which capital was contributed), with up to 100% catch up by the general partner after the preferred return has been paid and before further payments to the limited partners.

Such preferred return provisions in carried interest clauses provide a perverse incentive for general partners to hold onto otherwise poor investments in the hope that general improvements in the market will generate the preferred return. Although it would be a fundamental shift in typical deal terms, a preferred alternative would be to trigger the management carry only after limited partners had earned a *hurdle rate of return*, with no subsequent catch up by the general partner.

“Preferred returns rather than hurdle rates are still market standard”

Another alternative event that more closely aligns incentives would be to provide for a ratcheted carry relating to superior performance over a hurdle rate; e.g. a 10% carry when a hurdle rate is achieved; a 20% carry when double the hurdle rate is achieved and a 25% carry when triple the hurdle rate is achieved.

Taxation of Carried Interest

President Obama's fiscal year 2010 budget proposal, submitted to Congress in February 2009, proposed legislation to tax carried interest as ordinary income (maximum 35% federal rate) rather than as long term capital gains (maximum 15% federal rate) beginning in 2011. If enacted, this proposal could significantly impact deal structures.

Given the absence of specifics, and the fact that prior similar proposals have not been enacted into law, it is probably premature to seek alternative structures that can be adopted on a pre-emptive basis. Currently, details on the scope of the U.S. proposal are unclear. Resulting legislation could tax the grant of a carried interest, treat allocations in respect of a carried interest as ordinary income rather than long-term capital gains or take some other form.

Sensibly, the ILPA Principles recommend that all efforts to pass on changes in tax law impacting fund managers to limited partners should be resisted. This is probably already market. Sponsors currently entering into new fund agreements are routinely endeavoring to negotiate "gross up" provisions that hold them whole with respect to the new tax or are trying to negotiate covenants requiring that the fund be restructured to minimize the impact of the new taxation regime if and when implemented. Sponsors are trying to insert language permitting the general partner, in its sole discretion, to amend the terms of the limited partnership agreement if the law taxing carried interests is changed. Generally, limited partners are successful in resisting this language or in neutralizing its effect by providing in side letters that it cannot be implemented if to do so would have a negative economic impact on limited partners.

Claw-backs

Claw-backs will remain a significant issue so long as the deal-by-deal payment of carried interests remains the norm. When carried interests are paid out on a deal-by-deal basis, claw-back mechanisms must be put in place requiring the general partner to pay back profit distributions already received if subsequent losses arise from the sale of portfolio companies at less than acquisition cost or from the write down of investment assets.

In the recent market environment, where most investment assets have fallen significantly in value, it is inevitable that some general partners will be subject to claw-back. This year, watch for limited partners to insist on

“Expect GP interest claw-backs to be heavily negotiated in 2010”

tough claw-back clauses in accordance with the ILPA Principles, including significant escrows. In particular, expect that new funds with unproven management teams will be required to offer large escrows, together with joint and several liability, as in effect an “insurance policy” against reversals of fortune.

One of the most important drafting exercises of counsel to limited partners is to ensure that a tough but workable claw-back mechanism is imposed on the general partner and its principals. The clause should provide that overpayment of carry should be calculated and paid back at regular intervals (i.e. within two years of the date that the liability arises) rather than waiting until the termination of the fund.

The ILPA principles include detailed recommendations for claw-back clauses:

- (i) Significant escrows (e.g. a base 30% of carry distributions, increasing as claw-back obligations increase);
- (ii) the fund’s management team and their family trusts should be made jointly and severally liable with the general partner for the claw-back repayment obligation;
- (iii) All unrealized investments should be valued at the lower of cost or market;
- (iv) All costs of the investment being sold should be returned;
- (v) There should be a continuous makeup of partial impairments and write-offs and a return of all fees and expenses to date (as opposed to pro rata for the exited deal);
- (vi) Reserves should be required to cover potential claw-back liabilities; and
- (vii) Carried interest calculations should be certified by the fund’s independent auditors.

In extreme cases, the difficult economy may have resulted in losses so large that they have permanently distorted the usual management incentives in some funds – creating an environment in which management will either be driven to take extreme risks in order to recoup early losses or to give up entirely because their carried interest is so deeply under water as to make the situation hopeless. This is a problem that requires creative solutions.

Claw-backs from Limited Partners

Fund agreements usually contain claw-back obligations applying to limited partners as well, and these are also likely to be triggered more frequently in 2010. To date this year, the pace of bankruptcies of private equity-backed

“Expect more LP give backs in 2010 to honour indemnification obligations”

portfolio companies is well ahead of last year, with U.S. statistics showing 64 such bankruptcies in the first 9 months of 2009 compared to a total of 62 for all of last year. Experience is showing that in most cases where a portfolio company goes bankrupt, unsecured creditor committees and other unhappy creditors are examining the role of the private equity fund and its management in precipitating the company's financial difficulties. It is now not uncommon to see law suits against the general partner (with recourse to limited partners under indemnification provisions) for over-leveraging the portfolio company, for aggressive transactions such as dividend recapitalizations, for excessive transaction fees, and generally over a variety of self-dealing transactions.

Also, in today's "buyer friendly" deal environment, buyers of assets from private equity funds are negotiating more exhaustive indemnities for breaches of the representations and warranties in the purchase agreement. Over the past few years it has become more common to include "give back" obligations in private equity documentation, requiring limited partners to return prior distributions where such a buyer invokes these indemnification rights.

As limited partner claw-back becomes a more significant issue, watch for limited partners to bargain hard to cap the amount (typically up to 50% of commitments plus 25% of distributions received for a period of two years from the date of the distribution, or sometimes 2-3 years from the date of dissolution of the fund) of their claw-back obligations. In Europe, investors protect themselves against claw-back by advancing capital to the fund as debt rather than as equity. In a limited partnership, limited partners remain liable for the amount of their committed capital even if it is returned to them, but if capital is advanced by way of loan there is no lingering liability once the loan is repaid.

Capital Call Defaults

There have been fewer capital call defaults in the last year than most observers expected. Although, there have been some well publicized examples (eg. Hulton Collins Partners), an expected broader wave of problems failed to materialize largely because funds have been doing fewer deals and issuing fewer drawdown requests. Still, some investors are asking managers to defer capital calls to help with their cash flow issues or to reduce the size of their total commitments. Funds are finding out that they may not have as much committed capital as they believed.

Capital call default remedies will continue to receive close attention in 2010. Private equity money is patient money; that is one of its strengths. In a typical private equity fund the manager has 4-6 years to invest committed capital. "Re-up" provisions often allow the re-investment of capital returned within the first 14-18 months of the commencement of the fund. Investors advance this capital on a "just in time" basis when called upon by

"Expect creative solutions to capital call defaults in 2010"

the general partner. These advances are funded, in part, from distributions paid to investors in earlier vintage funds.

In the current environment, however, exits are rare and these distributions have all but dried up. Also, many investors are required under their investment mandates to rebalance their portfolios and to redirect investment funds to their traded equity portfolios which have suffered significant losses due to the recent collapse of stock market prices (the so-called “denominator effect”).

Fund documentation typically gives the sponsor several draconian tools to deal with defaulting limited partners. Remedies include penalty rates of interest, forfeiture of the limited partners’ interest in the Fund, cessation of future distributions or the commencement of a legal action to pursue a full range of possible legal remedies. Before invoking these remedies the cautious manager will discuss the situation with the limited partner’s advisory committee and, in many cases, may choose to implement alternative solutions to the problem. For example, in the current economic climate, some fund managers are offering up reductions in fund size (and correspondingly of management fees) to cash starved limited partners.

Capital call lines of credit have become very common. They are usually set up as revolving secured credit facilities that can be used repeatedly over time, with a cap on borrowing set at some percentage of unfunded commitments to the fund. That cap varies, but 50% would be typical. The security is usually an assignment to the lender of the general partner’s right to make capital calls from the limited partners, together with a security interest on the proceeds from such capital calls. Generally, security is not granted on existing portfolio assets, as typically the lender regards itself as ill-suited to manage or dispose of these illiquid investments. In some cases, lenders will require the limited partners to acknowledge the assignment of the capital call right. Care must be taken not to cause UBTI problems.

“Key-Person” Clauses

The experience and performance track record of a manager’s investment management team are two of the most important factors considered by limited partners in deciding to invest in a private equity fund. Accordingly, the result of the departure of a key person and the triggering of a “key person” provision of the limited partnership agreement should be severe. As frequently drafted, the investment period is suspended upon a key person departure, but revives after six months if the general partner and the limited partners cannot agree on another conclusion. The ILPA Principles recommend 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. An emerging trend, although not an ILPA Principle, is the extension of these “key man”

“Expect agreements to impose severe consequences for ‘key man’ departures”

provisions to second tier professional personnel where a significant proportion of such junior investment professionals leave the manager.

A similar result should apply in the event of a breach of fiduciary duties, material breach of the agreement, bad faith or gross negligence. Investor rights should be triggered upon a preliminary determination, not by a final court decision not subject to appeal and the termination of the individual responsible for the bad acts should not be deemed to be a cure or remedy. Management fees should also be suspended during this period. Release of the general partner from all liabilities should not be a pre-condition to its removal. The general partner should be required to pass on all documentation to the new general partner.

In cases where the termination for cause is permitted only upon a final and non-appealable court decision, there should be no advancement of funds from the partnership where it is the general partner's conduct that is at issue, or its affiliates' conduct, or where the suit is between at least 55% of the limited partners and the general partner, or where the dispute is between the general partner and its affiliates. That way, if the general partner doesn't have money to fund its law suit, the limited partners have more leverage in settlement discussions.

2010 is likely to see a continuation of a changing of the guard in private equity firms in addition to ongoing significant consolidation in the industry. Many funds that are under cost pressures have been scaling back their management teams to achieve operational efficiencies. Also, with the end of the boom period in private equity many members of the "boomer" generation of managers are deciding to take an early retirement as industry prospects deteriorate rather than re-tool for the new world order.

Smart managers will take care to ensure that their investors are informed and on side with their succession plans; and that the "key person" provisions of fund documentation are sufficiently flexible to accommodate the anticipated management changes.

Expect more industry consolidation this year. Sponsor mergers typically trigger the change of control provisions in fund documentation permitting investors to terminate the fund or its investment period. Expect, however, that investors will generally accommodate industry consolidation as they focus their investment activity on "branded" sponsors with the longest track record of success or specialized expertise in attractive market niches.

Termination

The ILPA recommends that a majority in interest of the limited partners (and not a super majority as is the current market standard) should have the right to suspend or terminate the commitment period; and a two thirds majority in interest of limited partners should have the right to remove the general partner or to terminate the fund.

“Investor rights should be triggered upon a preliminary determination, not a final court decision”

In accordance with the ILPA Principles, investors should also insist on “no fault” divorce provisions applicable in the event that they simply become unhappy with fund management; they may choose to terminate the partnership by super-majority vote under the “no fault divorce” provisions of the limited partnership agreement.

Fund Governance

The provisions of the limited partnership agreement should reinforce rather than dilute the fiduciary duty of the general partner to limited partners. Self-dealing and conflicts of interest should not be tolerated.

In Delaware, where most investment partnerships are formed, the fiduciary duty includes an obligation to act in good faith and with due care and loyalty. The duty of care requires a general partner to act for the partnership in the same manner as a prudent person would act on his own behalf. The duty of loyalty prohibits a general partner from taking any action or engaging in any transaction that is not in the best interests of the partnership where a conflict of interest is present.

However, Delaware law also provides that these duties can be restricted or eliminated in the partnership agreement. Many sponsors take advantage of the opportunity to both restrict and eliminate fiduciary duties.⁴

The ILPA Principles recommend a push back against the erosion of fiduciary duties and a “reinforcement” of the fiduciary duties of the sponsor community. The ILPA’s recommended governance “best practices” should be strictly adhered to and provisions of the following sorts should be rigorously resisted by limited partners:

- (i) Provisions that allow the general partner to reduce all fiduciary duties to the fullest extent allowed by law (the “gross negligence, fraud and willful misconduct” indemnification and exculpation standard should be the floor in terms of what is agreed to by limited partners);

⁴ The prospectus filed by KKR & Co. LP last year when it tried to go public illustrates the lengths to which sponsors will go to restrict or eliminate any fiduciary duty to investors. In the prospectus, KKR disclosed that it fully eliminated the core fiduciary obligation to put the interests of investors ahead of its own interests, and to act solely in the best interest of investors where a conflict is present. The disclosure further revealed that in making any discretionary decision, the KKR general partner would be allowed to take into account whatever factors it wishes, including its own interests, and does not have any duty or obligation to consider any factors affecting investors. Moreover, the KKR general partner would not be liable to investors for any act unless there has been a final and non-appealable judgment by a court determining that it has acted in bad faith or engaged in fraud or wilful misconduct. KKR starkly but frankly disclosed that: “These modifications are detrimental to our unitholders because they restrict the remedies available to our unitholders for actions that without those limitations might constitute breaches of duty, including a fiduciary duty, and they permit our Managing Partner to take into account the interests of third parties in addition to our interests when resolving conflicts of interest.”

“Agreement provisions should reinforce rather than dilute fiduciary duties. Expect LP push back against the erosion of fiduciary duties.”

- (ii) Provisions that allow the general partner and its affiliates to be exculpated or indemnified for conduct constituting a material breach of the agreement, breach of fiduciary duties or other “for cause” events;
- (iii) Provisions that allow the general partner to use its sole discretion and weigh its own self-interest against the interests of the fund; and
- (iv) Provisions where limited partners acknowledge and waive broad categories of conflicted or affiliate transactions.

In addition, in accordance with ILPA Principles, the general partner and its principals should be prohibited from closing or acting as general partner for another fund with substantially equivalent investment objectives and policies until after the investment period ends, or the fund is fully invested, expended, committed or reserved for investments and expenses. The general partner should be prohibited from investing in opportunities that are appropriate for the fund through other investment vehicles unless such investment is made on a pro-rata basis under pre-disclosed co-investment agreements established prior to the close of the fund.

Investment Mandates

The ILPA Principles recommend guarding against “style drift” in the management of a private equity fund by clearly and narrowly outlining the investment strategy of the fund in the investment purpose clause of the limited partnership agreement and by charging the Limited Partner Advisory Committee with monitoring of compliance. Any changes or modifications to the investment strategy should be disclosed and approved by a supermajority in interest of the limited partners.

Also consideration should be given to limiting the amount of capital that can be called on an annual basis during the investment period so as to avoid over-concentration of investments in short time periods. Explicit limitations or restrictions should be placed on investments in debt instruments, publicly traded securities and pooled investment vehicles.

With credit conditions still tight, buyout funds will focus on transactions that require little or no incremental leverage. In 2010, expect a continued emphasis on transactions such as private investments in public equity (PIPEs), portfolio company add-on acquisitions that can be funded with existing credit facilities or additional equity and acquisitions that are structured to preserve existing leverage by avoiding the change of control provisions in existing loan agreements. Watch also for partnering deals between private equity and strategic buyers and for the reorganization of portfolio companies into partnerships or other flow-through entities where borrowing constraints limit the ability of the portfolio entity to borrow to shelter income with interest expense.

“Investment mandates should be narrowly defined to forestall styles drift”

Responsible Investing

Socially responsible investors insist that the funds in which they invest adhere to principles of ethical investing with a focus on environmental, social and good governance principles. The Private Equity Counsel and its membership have recently adopted a comprehensive set of responsible investing principles in consultation with the world's major institutional investors.

Maximization of long term return on investment is not inconsistent with acting as a “good corporate citizen”. As the Supreme Court of Canada made clear in the seminal BCE decision in satisfying their fiduciary duties to act in the best interests of the corporation, directors exercising their business judgment may consider the interests of all of the corporation's stakeholders, including employees, the environment and the community in which the company does business.

LP Advisory Committees

The ILPA Principles provide useful guidance and best practices with respect to the formation of LPACs and LPAC meeting protocols.

This year expect increased reliance on advisory committees, made up of representatives of the largest investors in a fund, to oversee potential conflicts of interest and the valuation of investments. Other duties of the advisory committee may include waiving certain investment restrictions, substituting investment team members and terminating the investment period early.

The role of an advisory committee is intended to remain strictly advisory so that its members do not endanger the limited liability status of the member investors. The advisory committee members generally have no fiduciary duties to the fund. It is not expected that they will accrue liability for serving on the committee; they will expect indemnities for everything but bad faith; and they will expect an acknowledgement they can act in their own self interest.

Fund Entity

Most private equity is structured as Delaware limited partnerships, both as a means of attaining pass-through status for tax purposes, and as a means of preserving limited liability status for limited partners. Specialized parallel or feeder entities are used to accommodate special categories of investors such as U.S. non-taxable and foreign investors.

Although there are advantages to the use of Delaware limited liability corporations there is still a lack of experience with the governance structure of LLCs and a lack of familiarity and comfort with limited liability

“Expect a wider role for LP Advisory Committees in 2010”

company statutes which, to date, have received little judicial interpretation. Watch for an increased focus on the benefits of the LLC structure in 2010.

Tax Provisions

Most funds are organized as Delaware limited partnerships which, under the “check the box” provisions of U.S. tax law, elect to be taxed as partnerships.

If the fund contains Canadian pension funds or other non-taxable entities the limited partnership agreement will contain specific provisions requiring the general partner to use reasonable efforts to minimize the earning of any “unrelated business taxable income” (“UBTI”), which is essentially active business income, or any “effectively connected income” (“ECI”) by the non-taxable entities.

A variety of structures can be utilized to ensure that a Canadian pension plan has a U.S. tax exemption available on its U.S. source income. The most common of these structures are: (1) the use of home country blocker corporations for all fund investments in LLCs; (2) obligating the general partner under the main fund agreement or a side letter agreement to create separate parallel funds and alternative investment vehicles (“AIV’s”), one for investors indifferent to UBTI and ECI, and the other for UBTI and/or ECI sensitive investors; and (3) investing in the main fund, but ensuring that the fund has the flexibility to create alternative investment vehicles to invest in LLCs pursuant to which a blocker corporation becomes a partner in the AIV and UBTI and ECI sensitive investors participate through the blocker while other partners in the fund are direct investors in the AIV.

Secondary Sales

Historically, successful funds have achieved investor liquidity during their term through periodic distributions funded by the sale or initial public offering of portfolio companies. In the recent economic downturn such exit opportunities all but disappeared and distributions have been reduced dramatically.

In the absence of distributions, sponsors have shown an increasing willingness to accommodate the portfolio rebalancing and liquidity concerns of their investors by facilitating the secondary sale of fund interests. Pricing in the secondary market, however, has reflected uncertainty over investment valuations as well as a significant supply-demand imbalance between sellers and buyers.

Side Letters

Side letters continue to proliferate. In these letters investors negotiate special terms (e.g. reduced managed fees) reflecting their greater bargaining power or contract for special terms reflecting their particular circumstances

“The secondary market is becoming more significant”

e.g. particular rights to facilitate their compliance with special legal or reporting requirements.

Investors should negotiate the right to receive prompt notice of all side letters issued by the Fund or parallel Funds, the right to review a compendium of such side letters and a most favoured nations clause entitling investors to the extension to it of the benefits negotiated by other investors, subject only to limited carveouts that pertain solely to the particular circumstances of particular investors.

Information Rights

The ILPA Principles recommend more transparency in reporting to limited partners including, for example, presentation of details of the carry with each distribution, annual internal rate of return calculations clearly setting forth the methodology for determining the IRR; quarterly schedules of fund-level leverage, including commitments and outstanding balances on subscription financing lines or any other credit facilities of the fund; a build up to the carry calculation and details of the profit sharing splits among principals of the sponsor, including vesting schedules.

Portfolio company reports should include valuations, along with a discussion of the valuation methodology, as well as selected, but relatively detailed, financial performance information on a quarterly and annual basis. All payments from the portfolio companies to the general partner and its affiliates should be disclosed and audited. This includes not only director's fee and monitoring fees, but also items like travel expenses.

It is now routine to exclude investors subject to legislation such as the Freedom of Information Act (U.S.) from the receipt of sensitive information so as to preserve confidentiality. Generally, there are carve-outs for the kind of information and agreements to give some of the information in other ways.

Winding-up of Maturing Funds

The problem of maturing funds has become a significant industry problem. The large number of venture funds established in the years leading up to the technology industry melt down of 2001 are starting to reach the end of their ten year terms. Their portfolios often include a significant residual collection of investee companies that have not performed well and which have not generated exit opportunities. Generally, limited partnership agreements provide for the winding up of a fund at the end of its term and one or more annual extensions, with a liquidating distribution in cash or in kind of residual assets. The ILPA Principles recommend that not more than one annual extension be granted.

“The wind-up of 1998-2001 vintage funds is a growing industry issue”

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In practice these residual assets are illiquid securities of private companies. Receiving an in-kind distribution of assets for which there is no market is not an attractive proposition for pension fund managers who have a fiduciary duty to actively manage their portfolios. Yet it is expensive in terms of auditing and monitoring costs to extend the life of these expiring funds solely to continue to hold these low prospect residual investments. This is an industry problem that calls for an industry solution. In many cases, the pragmatic solution will be to make the tough decision and to write-off poor investments rather than allow the fund to linger on and continue to pay management fees.

Conclusion

The release of the ILPA Principles, together with severely reduced flow of institutional money into new funds, should increase the bargaining power of limited partners in negotiating fund terms in 2010. This, in turn, should improve the alignment of investor and sponsor interests and enhance the private equity business model in 2010.

Private Equity funds, a major provider of capital, will play a leading role in recovery of the world's economies. The industry worldwide still has more than \$1 trillion of uninvested capital. With this capital, together with the management guidance that fund managers provide to portfolio companies and the clear direction and accountability that they impose, private equity funds will contribute significantly to the current economic recovery⁵.

A major study on the management and performance of private equity owned businesses presented at the World Economic Forum in 2008 concluded that firms owned by private equity are better managed and experience greater productivity growth than other businesses. Private equity management is particularly adept at achieving cost efficiencies, restructuring businesses and divesting their non-core assets. These are exactly the skills needed as we emerge from the current economic downturn.

Although the level of private equity investing will undoubtedly be down this year, sophisticated institutional investors are keenly aware that hard times breed extraordinary buying opportunities. They appreciate the fact that the funds that have had their investment periods during difficult market conditions are, over time, among the best-performing vintages. My bet is that when the performance of the private equity funds formed this year is assessed a decade from now, 2010 will rate as a very fine vintage year.

⁵ For more on this theme, see the comments of Lord Myners, Financial Services Secretary to the U.K. Treasury to the recent BVCA Private Equity Summit.