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Negotiating Private Equity Fund Terms

Key Provisions for PE Sponsors and LP Investors and the New ILPA Model Limited Partnership Agreements

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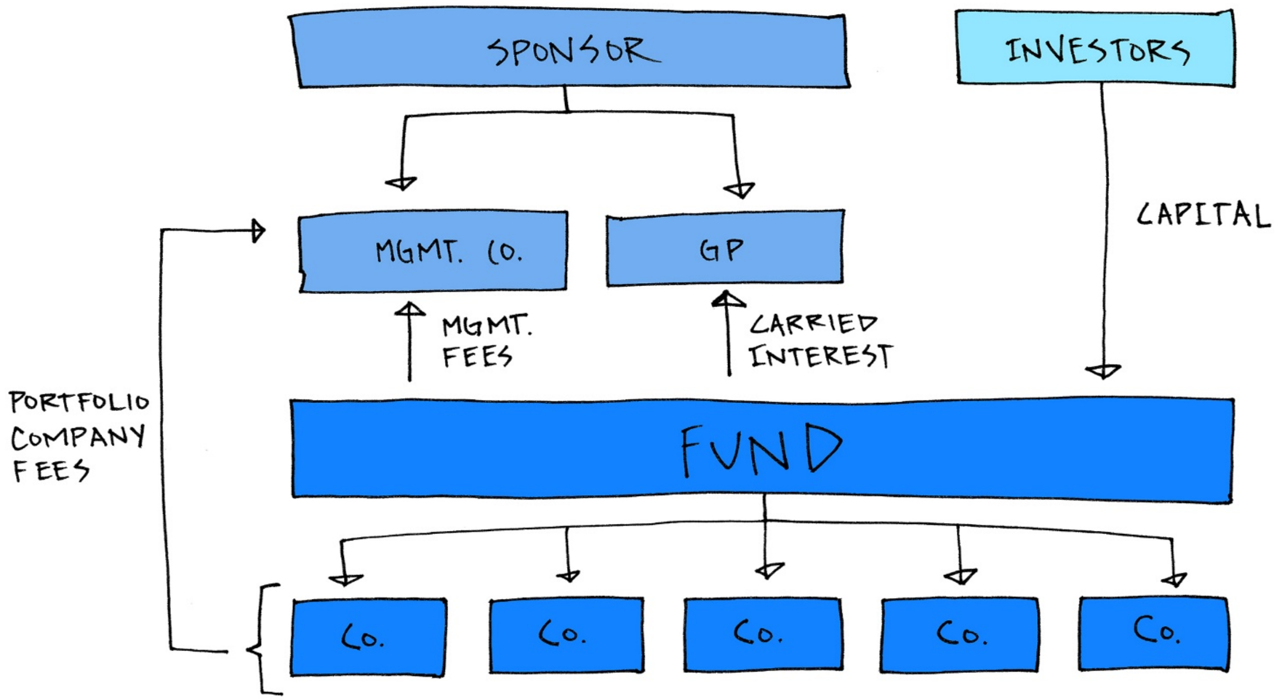
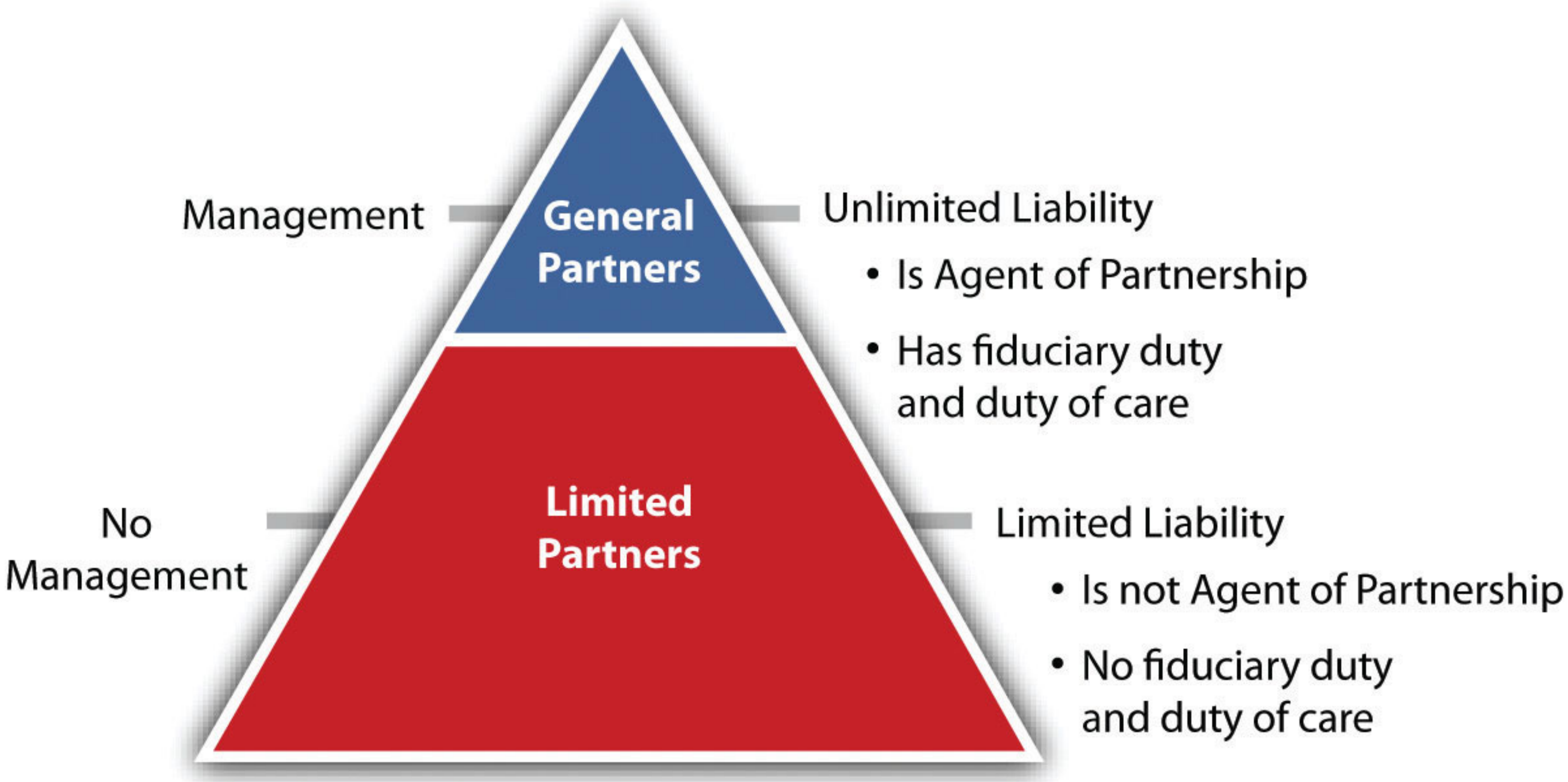
What we're discussing today:

- Considerations involving structuring and negotiating fund document terms for PE sponsors and limited partner investors (LPs) in PE funds
- Current trends and hot issues in private equity (PE) fund terms
- How are key issues addressed in the Institutional Limited Partners Association's (ILPA) Model Limited Partnership Agreements (LPA) relative to how they are addressed elsewhere in the marketplace?

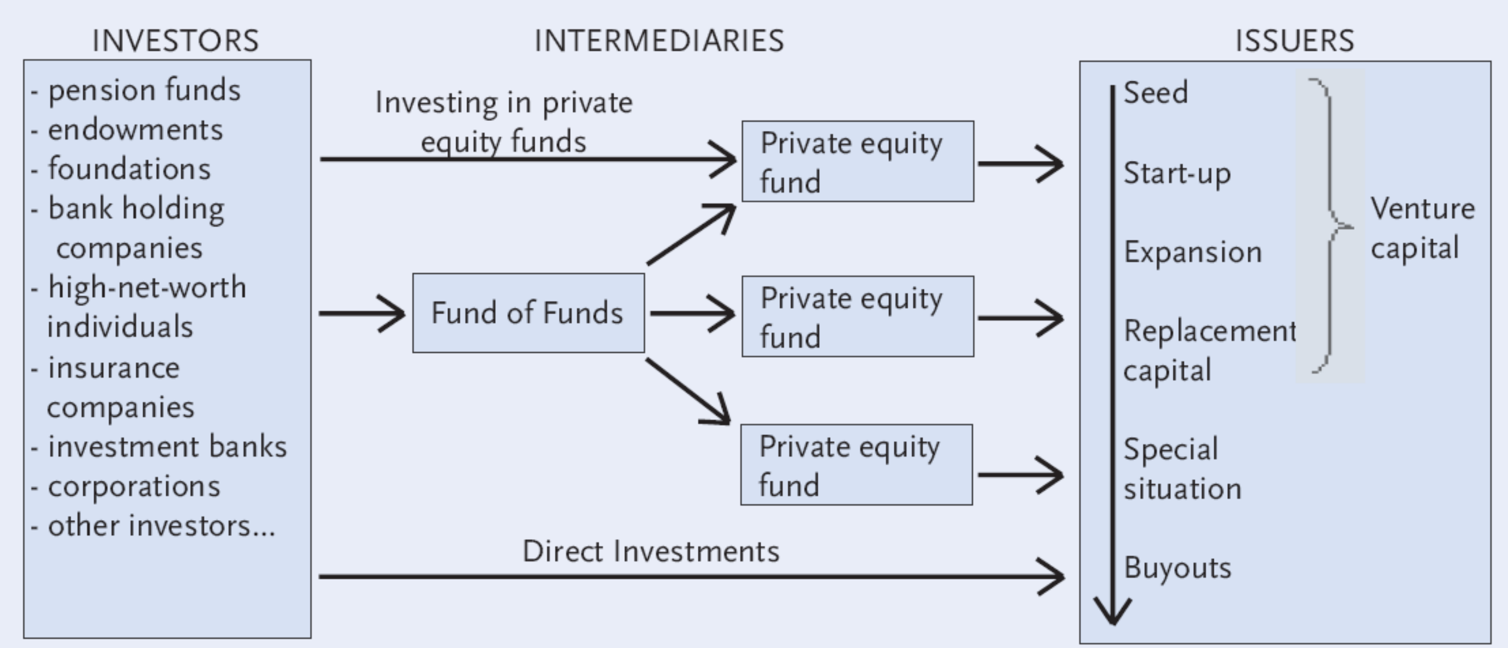
Simple model of PE / VC fund



Partnerships: basic framework



Private Equity Market – Overview



Source: Federal Reserve Bank of Dallas, IFSL, EVCA/Thomson Venture Economics/PricewaterhouseCoopers

Trends in play

- Tighter integration of business professionals with fund counsel has resulted in broader array of fund terms, increasing complexity, and creative partnership provisions—increasing costs for investors to understand and negotiate terms.
- Rise of complex, huge sponsor groups managing multiple asset classes that are raising ever larger sums of capital and presenting increasing conflicts of interest related challenges to alignment of interest between GPs and LPs.
- Low borrowing rates have resulted in surging popularity of subscription lines of credit. IRR performance-boosting effect has lead to new kind of “Line Dance,” distorting true performance of a fund.
- Complex capital structures, complex allocation / distribution models: opportunities abound for confusion and misunderstanding

Who are ILPA?

- ILPA is a trade group for institutional LPs such as:
  - Pension funds
  - Endowments
  - Foundations
  - Insurance companies
  - Family offices
  - Sovereign wealth funds
- Over 500 members representing more than $2 trillion USD of private equity assets under management
- Though GPs are not members of ILPA, ILPA does network with GPs and seeks their perspectives

Goals of ILPA's Model LPAs

- Simplify LPA so that
  - General Partners ("GPs") can reduce the length of side letter agreements, providing fundraising certainty, and lowering their fund formation costs.
  - Fee range to negotiate side letters: $25,000 ~ $100,000.
  - Limited Partners ("LPs") have fair and transparent terms that explain rights and obligations, while also lowering their legal negotiation costs

Benefits to LPs

- **Core LP Negotiation Tool:** The Model LPA is useful for negotiation by LPs and LP Counsel with established managers that have an existing LPA. Individual provisions in this document can be easily negotiated or adopted, with draft language that LPs know will be acceptable to them, and familiar to GP counsel.
- **ILPA Benchmarking Tool:** The Model LPA will be useful to LPs as a benchmarking tool to compare against existing LPAs they have signed, and funds they are evaluating, allowing them to have verified legal language they can compare against terms in the marketplace.
- **LP Emerging Manager Program Utilization:** The Model LPA is an excellent starting point for programs that seek to seed or provide capital to new managers as part of a designed program.
- **LP Education:** Model LPA helps to educate LPs about reasonable terms, and LPs can also use this document in their own internal training programs to share which terms are fair to LPs and which are problematic.

Benefits to GPs

- **Starting Point for LP-friendly Fundraise:** All GPs who are interested in a fair, equitable LPA for their fund can use this document as a starting point to ensure they will be attractive from a terms perspective to the LP community.
- **Emerging Manager Roadmap for LP Capital/Terms:** New and emerging managers or managers in the emerging markets, who wish to attract LP capital and establish best practices for their fund, can adopt this document with reduced legal costs, lower the organization expenses of the fund, and send a signal to LPs about the importance of a strong partnership between the GP and the LP.
- **Market Signaling to Established Managers and their Counsel:** GPs and GP counsel can use this document as a baseline to what terms are important to LPs and what they believe is reasonable in the negotiation.
- **Reduction of Side Letter Negotiation Costs and Time:** GPs and GP counsel can seek to implement provisions from the ILPA Model LPA into their own form for forthcoming funds to minimize the number and scope of side letter agreements with their LPs and the cost of negotiation.

Introduction to waterfalls

- The "waterfall" provisions constitute the central economic deal of a PE fund – the allocation of profits
- Waterfalls typically provide that LPs receive their contributed capital, plus a preferred return at a stated IRR (the "hurdle"), before the PE sponsor shares in profits on investments made by the PE fund through "carried interest" payments (subject to a "GP catch-up")
- The carried interest share of PE fund profits is the "20%" component of "2 & 20" compensation traditionally paid to PE sponsors (the "2%" component is the management fee)

How a waterfall works

- Waterfall can be pictured as a set of buckets or phases or tiers
- Each bucket contains its own allocation method
- When each bucket is full, the capital flows into the next bucket
- First buckets generally allocated to LPs, while buckets further away from the source are more advantageous to the General Partner
- Is there any limit to the number of buckets?

Waterfalls:
"Whole Fund" vs. "Deal-By-Deal"

- European "whole fund" waterfalls
  - PE sponsor does not receive carried interest until all of an LP's capital contributions – including contributions towards unrealized investments – have been recovered and the preferred return threshold has been met
- American "Deal-by-deal" waterfalls
  - PE sponsor may receive carried interest from individual investments in the PE fund before the LPs have been fully compensated for their contributions

Whole fund simple model

Investment	Year 1	Year 2	Year 3	Year 4	Year 5
Company 1	$ (20.00)				
Company 2	$ (30.00)				
Company 3	$ (50.00)				$ 60.00
Cash Flow	$ (100.00)	$ 60.00			$ 60.00

Whole Fund Carry. In our example, the LPs have contributed $100 million in capital. Under whole fund carry, the GP is entitled to carry only after the LPs have received their contributed capital plus any preferred return (if any, and none is assumed in this example). It is only in year 5 when the fund receives $60 million on the sale of Company 3 that the fund can return the contributed capital of $100 million back to the LPs. In our example, over the five-year life of the fund, the fund invested $100 million and realized $120 million, representing a $20 million profit. It is from this $20 million profit that the GP receives its 20% carry, which totals $4 million. The GP receives its carry in year 5. The LPs receive their $100 million in contributed capital back plus their share of the profits, which is $16 million. Example courtesy of Alan Latta, CFA, CAIA, Campton Private Equity Advisors

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DBD simple model

Investment	Year 1	Year 2	Year 3	Year 4	Year 5
Company 1	$ (20.00)				
Company 2	$ (30.00)				
Company 3	$ (50.00)				$ 60.00
Cash Flow	$ (100.00)	$ 60.00			$ 60.00

Deal-by-Deal Carry. In deal by deal carry, each transaction is looked at and carry is paid on the profits of each transaction. In our example, the fund invested $20 million in Company 1 and in year 2 realized $60 million, for a profit of $40 million. Under deal-by-deal carry, the GP is entitled to its 20% carry from this $40 million profit, for a total carry paid to the GP in year 2 of $8 million. Compare this to whole fund carry – under whole fund carry the GP receives its carry in year 5, and receives total carry of $4 million. Under deal-by-deal carry, the GP receives carry in year 2, and because its investment in Company 1 was very successful, the GP receives $8 million in carry. We will see that ultimately the GP is only entitled to $4 million in carry, and so the GP has been overpaid carry and will have to return the excess to the fund.

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LLPA's Whole Fund Waterfall

14.3 **Distributions of Distributable Proceeds**. Subject to 6.5 (*Use of Distributable Proceeds to Fund Drawdowns*), Distributable Proceeds (other than Temporary Investment Income) from any Portfolio Investment shall be initially apportioned among the Partners in proportion to their Sharing Percentages with respect to the applicable Portfolio Investment. The amount so apportioned to any Affiliated Partner shall be distributed to such Person and, except as otherwise provided in this Article 14 (*Distributions; Allocations*) and Section 6.6 (*Defaulting Partners*), the amount so apportioned to each other Partner shall be distributed between the General Partner and such Partner as follows:

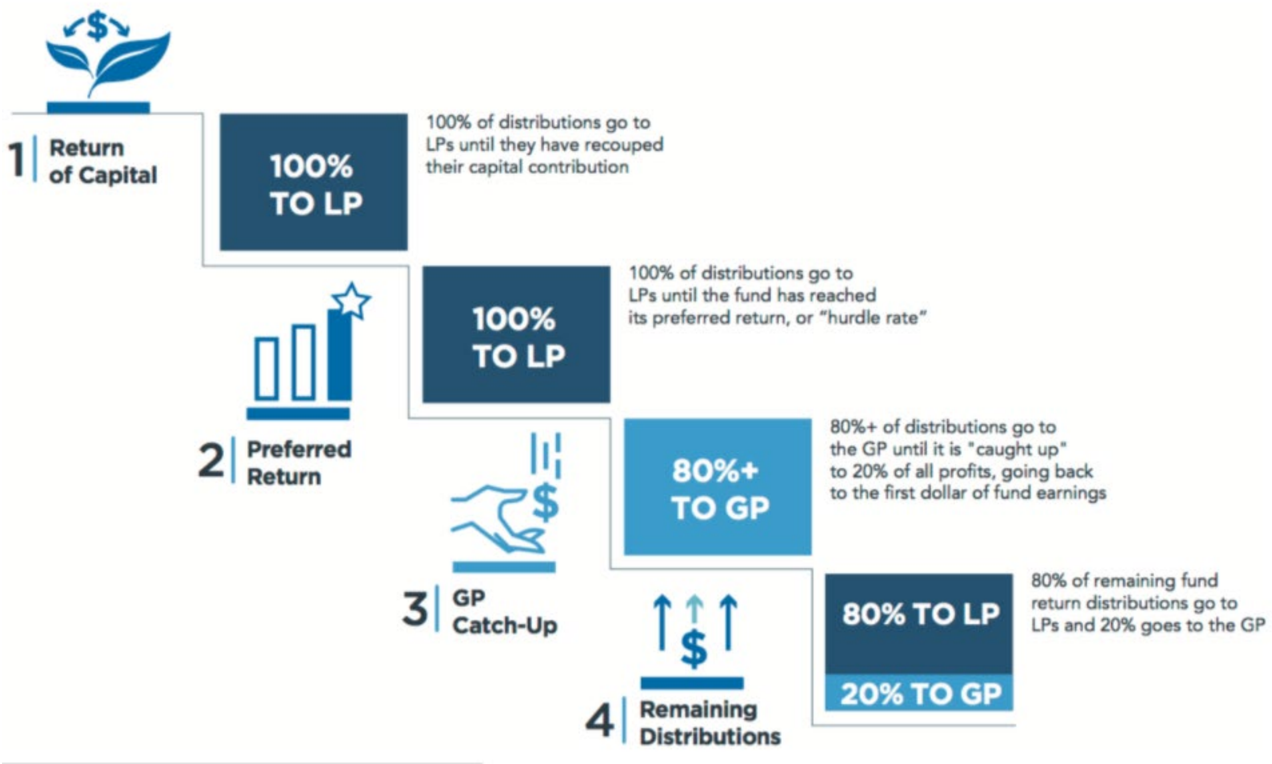
14.3.1 First, 100% to such Partner until such Partner has received cumulative distributions pursuant to this Section 14.3.1 equal to such Partner's aggregate Capital Contributions;

14.3.2 Second, 100% to such Partner until the cumulative amount distributed to such Partner pursuant to this Section 14.3.2 is equal to the Preferred Return for such Partner;

14.3.3 Third, [80]% to the General Partner and [20]% to such Partner until the General Partner has received cumulative distributions with respect to such Partner pursuant to this Section 14.3.3 equal to [20]% of the cumulative amount of distributions made or being made to (i) such Partner pursuant to Section 14.3.2 and this Section 14.3.3 and (ii) the General Partner with respect to such Partner pursuant to this Section 14.3.3; and

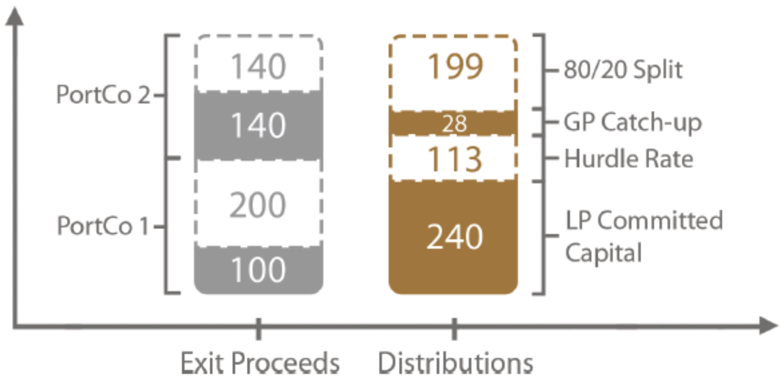
14.3.4 Fourth, thereafter, (i) [20]% to the General Partner and (ii) [80]% to such Partner.

Illustrative Model Of Whole Fund



https://www.icapitalnetwork.com/insights/education/pe-distribution-waterfalls-and-their-impact-on-client-returns/

Whole fund math



Carry Distribution—All Capital First:

- **Exit PortCo 1:** ($300 million) → funds are used to:
  - Step 1: return all of the LP capital drawn by the fund ($240 million).
  - Step 2: part one of the $113 million[6] hurdle rate paid to LPs ($60 million).
  - No carry for the GP—all proceeds from the exit have been distributed.
- **Exit PortCo 2:** ($280 million) → funds are used to:
  - Complete step 2: part two of the $113 million hurdle rate paid to LPs ($53 million).
  - Step 3: GP entitled to carried interest ("catch-up" $28 million).
  - Step 4: remaining proceeds from exit are divided between LPs and the GP on an 80/20 basis (total: $199 million; LPs: $159 million; GP: $40 million).

Note that this example assumes that both investments are realized in the same year. Otherwise, the pref would have increased!

Claudia Zeisberger, Mastering Private Equity, Chapter 16, 2017

Whole fund basics

Generally this type of waterfall is most favorable to limited partners, since it defers distributions of carried interest to GPs. Which means that limited partners receive more distributions of fund profits sooner.

Whole fund complexities

A whole fund waterfall is simpler than a deal-by-deal waterfall, but it can result in some complexities, particularly at the GP level.

- If the GP allocates carry among its team members on a whole fund basis, it may be **more cumbersome to track** than in the case of a deal-by-deal waterfall, because carry earned on early deals will often be distributed to limited partners to repay preferences, to be made up out of proceeds from later deals. This could complicate dealings with team members who enter or leave in the middle of the life of a fund.
- Some fund managers seek to (1) reward individual investment professionals for the performance of specific investments they had a hand in sourcing or closing and (2) align the interests of younger employees with more senior principals. Many younger employees have a shorter frame of reference than more senior principals. If carried interest is distributed on a whole fund basis, younger employees may not assume that they will be employed long enough to get carry.

ILPA's deal by deal waterfall

14.3 **Distributions of Distributable Proceeds.** Subject to 6.5 (*Use of Distributable Proceeds to Fund Drawdowns*), Distributable Proceeds (other than Temporary Investment Income) from any Portfolio Investment shall be initially apportioned among the Partners in proportion to their Sharing Percentages with respect to the applicable Portfolio Investment. The amount so apportioned to any Affiliated Partner shall be distributed to such Person and, except as otherwise provided in this Article 14 (*Distributions; Allocations*) and Section 6.6 (*Defaulting Partners*), the amount so apportioned to each other Partner shall be distributed between the General Partner and such Partner as follows:

14.3.1 First, 100% to such Partner until such Partner has received cumulative distributions pursuant to this Section 14.3.1 equal to the sum of (without duplication):

14.3.1.1 the Capital Contributions of such Partner used to fund the cost of (i) such Portfolio Investment, (ii) each Realized Investment, and (iii) aggregate Unrealized Losses; and

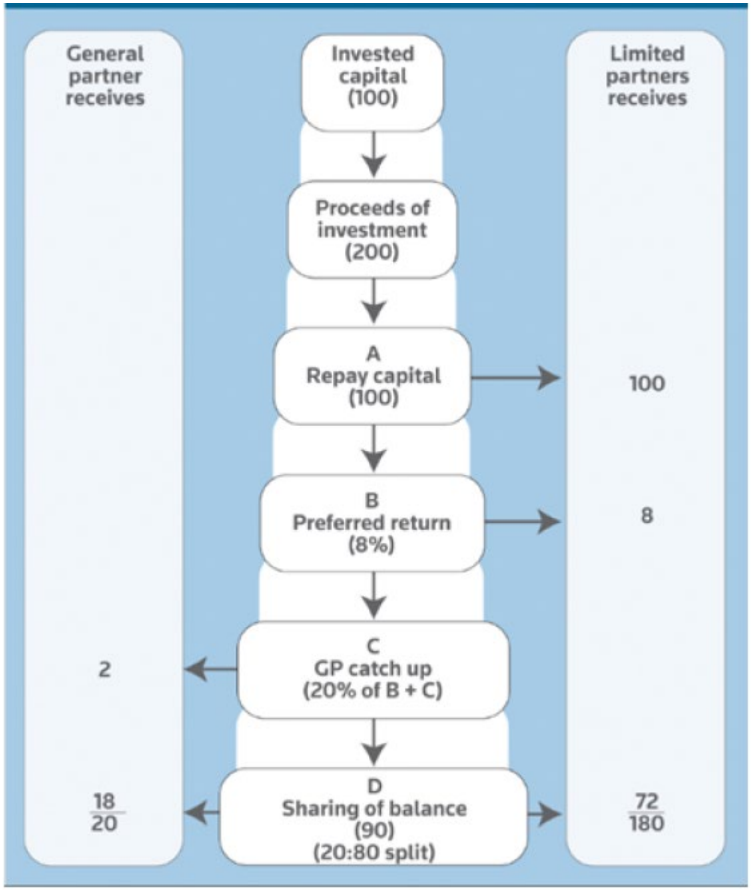
14.3.1.2 the Capital Contributions of such Partner used to fund Fund Expenses including the Management Fee;

14.3.2 Second, 100% to such Partner until the cumulative amount distributed to such Partner pursuant to this Section 14.3.2 is equal to the Preferred Return for such Partner;

14.3.3 Third, either (i) [80]% to the General Partner and [20]% to such Partner or (ii) 100% to such Partner, as appropriate, until the cumulative distributions received by the General Partner with respect to such Partner pursuant to Section 14.3 equal to [20]% of the excess of (x) the cumulative amount of distributions made or being made to such Partner and to the General Partner with respect to such Partner pursuant to Section 14.3 over (y) the Capital Contributions of such Partner described in Section 14.3.1; and

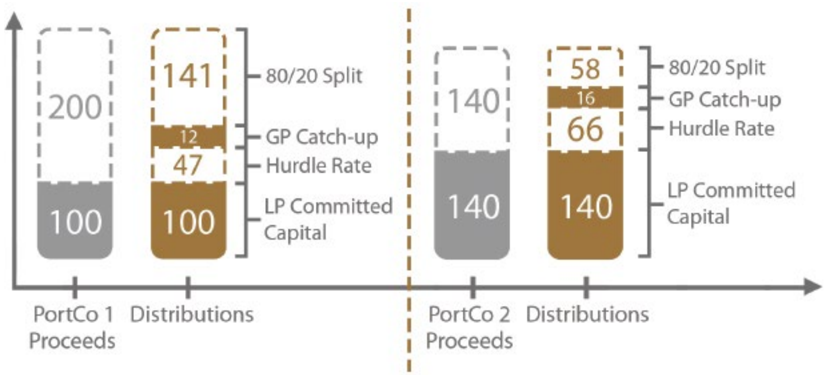
14.3.4 Fourth, thereafter, (i) [20]% to the General Partner and (ii) [80]% to such Partner.

Simple DBD model



English and US private equity real estate funds: key features, Practical Law UK Practice...

DBD math



Carry Distribution—Deal-by-deal:

- **Exit PortCo 1** ($300 million) → funds are used to:
  - Step 1: return all of the LPs' capital invested in PortCo 1 ($100 million).
  - Step 2: hurdle rate for PortCo 1 is paid to LPs ($47 million[7]).
  - Step 3: GP entitled to carried interest ("catch-up" $12 million).
  - Step 4: remaining proceeds from exit are divided between LPs and the GP on an 80/20 basis (total: $141 million; LPs: $113 million; GP: $28 million).
- **Exit PortCo 2** ($280 million) → funds are used to:
  - Step 1: return all of the LPs' capital invested in PortCo 2 ($140 million).
  - Step 2: hurdle rate for PortCo 2 is paid to LPs ($66 million[8]).
  - Step 3: GP entitled to carried interest ("catch-up" $16 million).
  - Step 4: remaining proceeds from the exit are divided between LPs and the GP on an 80/20 basis (total: $58 million; LPs: $46 million; GP: $12 million).

Within the setting of our straightforward example, the fund GP receives the same amount of carried interest, independent of the model applied; yet, the timing under the deal-by-deal waterfall is more favorable to the GP (carry is received earlier).

Claudia Zeisberger, Mastering Private Equity, Chapter 16, 2017

Carried Interest – Pressure Points

Trends:

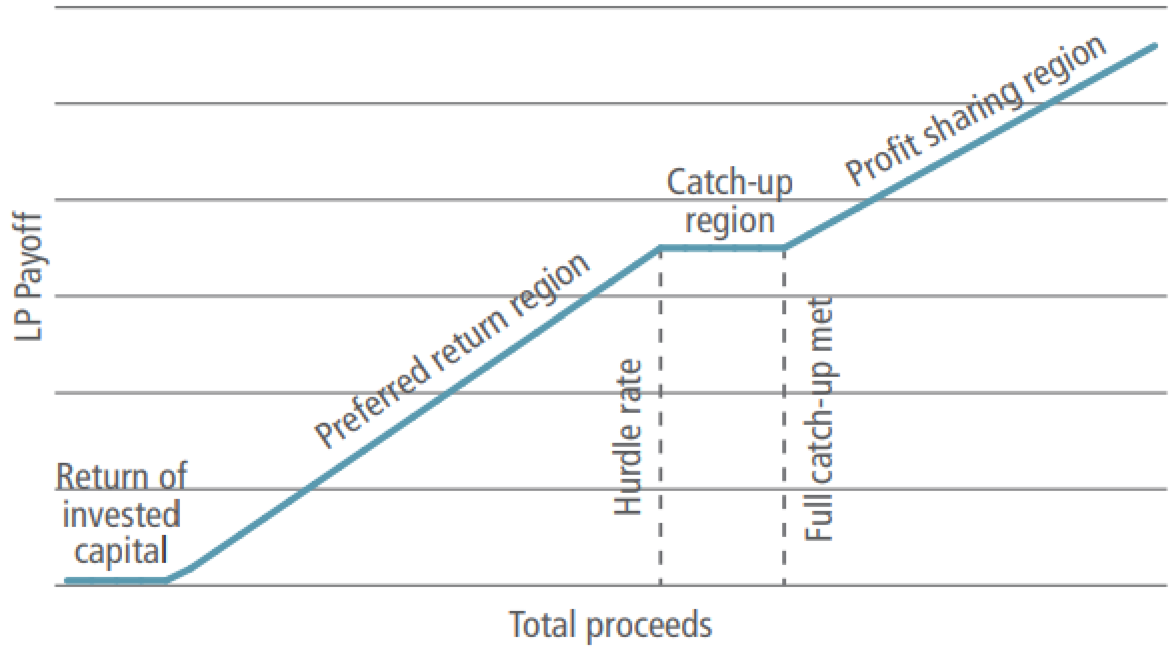
- Pressure to convert deal-by-deal waterfalls to "European style" waterfalls
- Alternatives to European Style waterfall to avoid overpayment:
  - Inclusion of all (not pro rata) deal related costs, fees, taxes and write offs
  - **Prudent valuation** policies
  - Interim **clawbacks** supported by NAV coverage test (generally at least 125% of unreturned invested capital) are recommended to ensure sufficient "margin of error" on valuations
  - **Escrow** as clawback guarantee **-** all or some portion of carried interest otherwise distributable to the GP during the investment period (e.g. 30% of carry distribution or more)
  - Fund has **over performed** by some specified percentage before distributing carry
  - "**Modified" deal by deal**

DBD—fading away?

- True deal by deal waterfall for multiple investment funds is not common. There are exceptions: smaller Asian funds; Asian VC; where GP has the upper hand.
- Cumulative "realized" deal by deal waterfall is more typical.

What is a Preferred return?

A preferred return is a profit distribution preference whereby profits, either from operations, sale, or refinance, are distributed to one class of equity **before** another until a certain rate of return on the initial investment is reached. The pref is stated as a percentage, such as an 8% cumulative return on initial investment; however, it can also be stated as a certain equity multiple. This preference provides some comfort to investors since it subordinates the sponsor's profits participation or "promote."



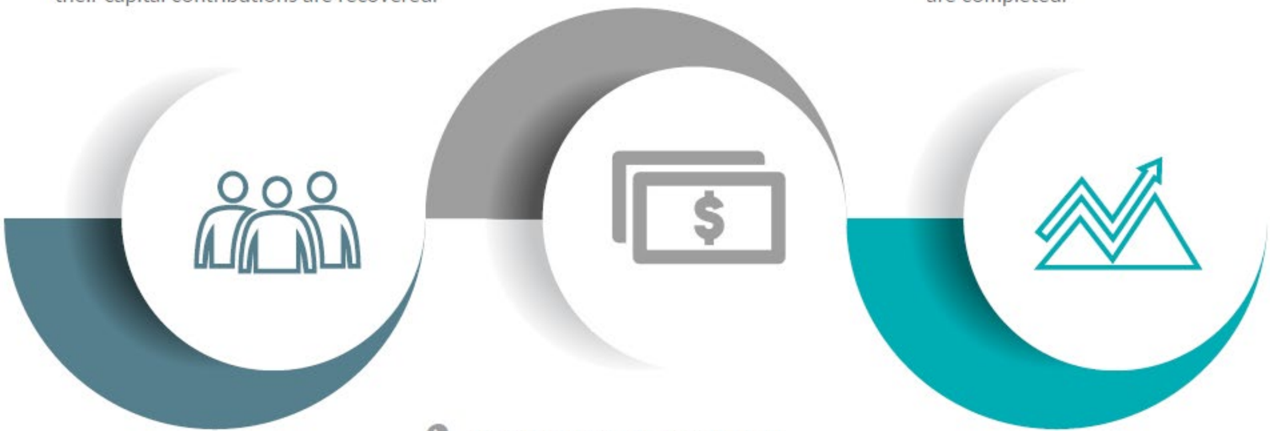
Pref operates like a hurdle

1. RETURN CONTRIBUTIONS

This is generally the first step in the waterfall. All distributions go to LPs until their capital contributions are recovered.

3. CARRIED INTEREST

The carried interest is to be allocated to the GP after the first two components are completed.



2. PREFERRED RETURN

This is distributed after capital contributions are recovered. The time period typically starts on the due date of the capital call (rather than the actual payment date) and ends on the distribution date.

Rationale for Preferred Return Hurdle

Why does preferred return hurdle exist?

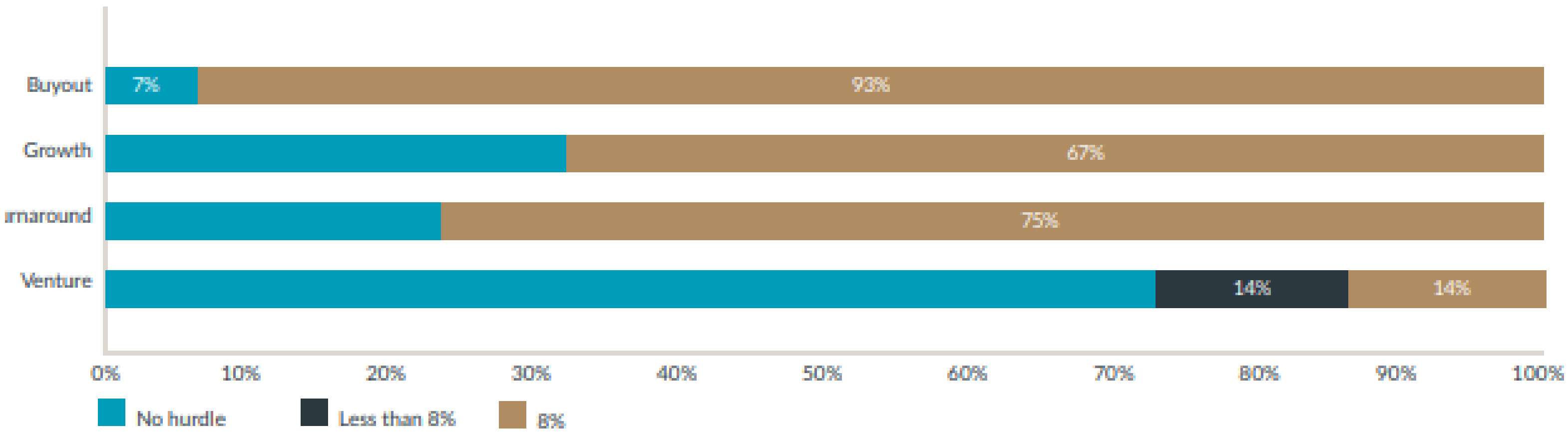
- *First*, investors in private equity funds have return expectations of 15% or more (higher for venture capital), and the preferred return allows LPs to achieve this "minimum return" before the GP can take any profit participation (carry). This aligns the interests of the GP with the LPs – LPs must earn a minimum return before the GP can take carry.
- *Second*, a preferred return hurdle as an annual percentage rate injects the time value of money into the carry calculation. If carry was calculated only on money-on-money returns, the GP might be incentivized later in a fund's life to let marginally-performing portfolio companies stay on the fund's balance sheet in case the company's performance later improves or the company is acquired. As most LPs use an annualized return metric as part of their portfolio performance evaluation, including an annualized preferred return hurdle better aligns GP and LP interests.

Which Funds Have Preferred Return Hurdles?

- Virtually all buyout funds and many growth equity funds have an 8% per annum preferred return hurdle.
- Venture capital funds often don't have a preferred return hurdle.
- I've heard from venture capitalists that that the reason why venture funds don't have preferred return hurdles is that early-stage venture investments take so long to exit that adding a preferred return hurdle would push back by years the time when venture capital fund managers could earn carry. A different view argues that that the return profile of early stage companies is so volatile that having a pref makes little sense.
- Developing trend: about 30% of PE funds have no hurdle.
- *Multiples*. Some funds (such as fund-of-funds and VC funds) use a multiple of contributed capital as the preferred return hurdle instead of an annualized percentage rate. In this case, the GP doesn't take carry until the LPs have received, for example, 2x (3x for VC) of their contributed capital.

Hurdle rate by fund strategy

M.J. Hudson survey



Hard hurdles

With a ‘true’ preferred return, also called a ‘hard’ hurdle rate, gains realized from the fund’s investments are allocated as follows:

- First, 100% to the limited partners until they have received back their initial contribution of capital.
- Second, 100% to the limited partners until they have received an amount equal to the preferential return rate (typically 8%), compounded annually, on their initial contribution of capital.
- Thereafter the gains are distributed according to the carried interest split, i.e. usually 80% to the limited partners and 20% to the general partner.

This arrangement is also sometimes called a ‘floor’, because the general partner receives no carried interest until reaching the 8% return. The annual compounding of the preferential return rate is what makes it an important contractual term.

Hurdle rate distortion (1 / 2)

The following example includes math. Please do not be alarmed. The math will not harm you.

High hurdles can tempt the fund managers to focus on clearing the hurdle rather than maximizing returns for the limited partners. In other words, there could be a so-called 'hurdle rate distortion', as illustrated by the following example. Assume that fund managers have the choice between three different strategies for a hurdle rate of 8%, full catch-up and 20% carried interest:

- ❑ A low-risk, low-return strategy that achieves $107 after one year on $100 investment. In this case, the fund's performance will be 7% and the limited partners would receive $7 whereas the fund managers always walk away empty-handed.

- ❑ A medium-risk, medium-return strategy with an 80% chance of achieving $115 and a 20% chance of getting back $105 after one year. In this case, the fund's performance will be 13% and limited partners would receive:

  (80% x $15 x 80%) + (20% x $5 x 100%) = $10.6

  whereas the fund managers' expected pay-off would be:

  (80% x $15 x 20%) + (20% x $5 x 0%) = $2.4

Hurdle rate distortion (2 / 2)

- A high-risk, high-return strategy with a 20% chance of getting back $155 and an 80% chance of achieving $105 after one year. In this case, the fund's performance will be 15% and limited partners would receive:

  (20% x $55 X 80%) + (80% x $5 x 100%) = $12.8

  whereas the fund managers' expected pay-off would be:

  (20% x $55 x 20%) + (80% x $5 x 0%) = $2.2

In this example fund managers would be inclined to go for the medium-risk, medium-return strategy to the detriment of their investors. However, the scenarios are certainly artificial and unlikely to be of relevance in practice. Firstly, the medium-risk, medium-return scenario's pay-off distribution function is upward sloping, i.e. the chance of generating a higher return is larger than the probability of achieving a low return. A downward-sloping distribution function is likely to be more realistic. Secondly, even the most sophisticated fund managers are unlikely to have such detailed insights into the expected return profiles to deliberately trade-off their preferences against limited partner objectives.

Example: the disappearing hurdle

Assume a fund with a 10% hurdle rate, a 60% catch-up and a 20% carried interest. Here the catch-up zone ends, when

$$\text{IRR} = \frac{60\% \times 10\%}{60\% - 20\%} = \frac{6\%}{40\%} = 15\%$$

That means, after the fund has reached a 15% return, further cash flows will be split according to the 80/20% carried interest split, and the hurdle rate as well as catch-up do not have to be taken further into account. It simply “disappears”.

Additionally, this particular limited partnership agreement foresaw that the general partner’s share of the carried interest increased to 25% once the IRR passed a threshold of 25%. This arrangement protected the limited partners on the downside through the higher hurdle and through the deferral of the catch-up. In return, the general partner would have been able to take more of the upside in the case of outstanding performance.

Hurdles that use IRR

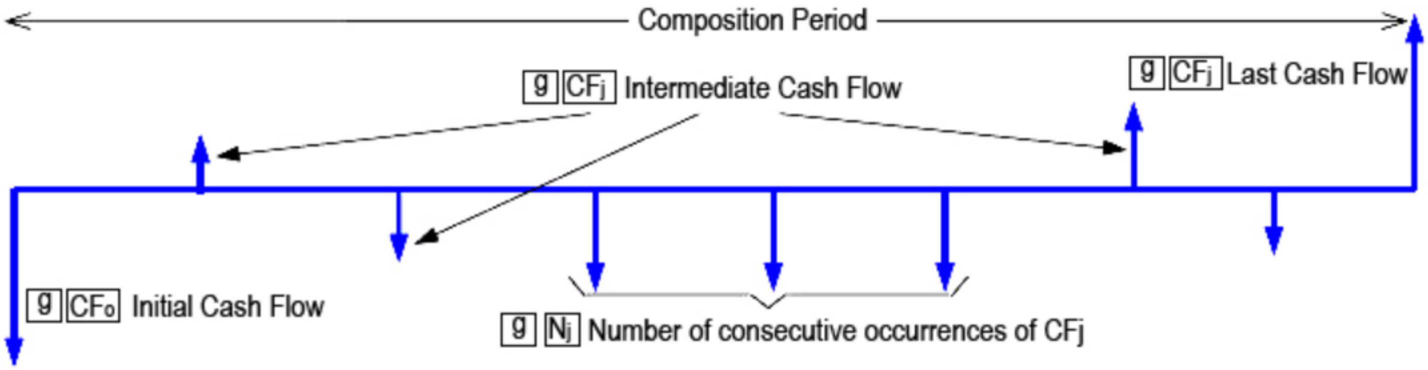
- Preferred return IRR calculation is time-sensitive
  - IRR decreases if there is a longer duration between when capital is called from LPs to make a portfolio company investment and when it is ultimately returned to LPs upon sale of the portfolio company
- Relationship between credit facilities and PE fund IRR
  - Credit facilities cause LP capital to be deployed for shorter period of time than otherwise would be the case
  - Preferred return IRR increases as the duration of LP capital deployment is shortened, unless the IRR formula is modified to take into account the use of credit facilities
- IRR-based Hurdles have lots of issues! See https://www.americanbar.org/groups/business_law/publications/blt/2016/01/04_borden/
- Fixing an IRR-based Hurdle:

$$D = \sum_{i=1}^{N} P_i \times \left(1 + \frac{rate}{y}\right)^{\frac{d_1 - d_i}{365} \times y}$$

where:

- d_i = the *ith*, or first, cash-flow date.
- d_1 = the current distribution date.
- P_i = the *ith*, or first, cash flow.
- y = the number of compounding periods per year.
- D = the distribution required to satisfy the IRR hurdle.

IRR cash flow diagram



ILPA LPA does not use IRR

- ILPA Model LPA features a modified preferred return formula that addresses the impact of credit facilities on IRR. Preferred return formulae that use IRR are common, but controversial. ILPA LPA does not use.
- In contrast to a traditional PE fund waterfall, its preferred return runs from the date of draw on the credit facility or the date of LP capital call (if no credit facility is used)
- Credit lines improve performance by 4% on average. *See* https://www.privatefundscfo.com/big-impact-credit-lines-fund-performance-really/

ILPA pref definition

- "**Preferred Return**" means, with respect to each Partner (other than an Affiliated Partner), as of any date of determination, such amount as is equal to an annual rate of return of [8]%, compounded annually and calculated daily on the Capital Contributions made by such Limited Partner described in Section 14.3.1, calculated from the date of receipt of each such Capital Contribution by the Fund and accrual of the Preferred Return, and ceasing on the date of distribution or deemed distribution by the Fund to such Limited Partner. {same definition for WOF and DBD LPAs}
- If the Fund uses a subscription line of credit, the preferred return should be calculated from the date on which the subscription line of credit was drawn. Please refer to ILPA's Subscription Lines of Credit and Alignment of Interest: Considerations and Best Practices for Limited and General Partners: https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf

PART 2

Clawbacks: the price for early carry

- Form and function of clawbacks
- Types of clawbacks
  - "End of fund life" clawbacks
  - Interim clawbacks
- 2-tier / 2-prong clawbacks
  - In funds that require investors to receive a preferred return before the general partner receives carried interest distributions, investors will want the clawback to be "two-tiered" to protect the economic value of the preference, as well as the overall profit split
- Other types of LP protections
  - Escrow accounts / guarantees

ILPA clawback

- ILPA Model LPA requires that a portion of each carried interest distribution made to the GP must be deposited in an escrow account available to satisfy any clawback obligations of the GP.
- **WOF and DBD**: An (DBD only —interim) clawback calculation is made on the first anniversary of the end of the commitment period, upon the removal of the GP, at the time of the fund's final liquidating distribution, and when any distributions are required to be returned by the LPs.
- ILPA Model LPA approach is arguably “belt and suspenders”
  - “Whole fund” waterfall
  - Optional escrow of carry
  - End of fund life basic clawback
  - Interim clawbacks—DBD only

Clawback – Best Practices

- Best way to avoid clawback: “whole fund” model
- ILPA: *clawbacks returned “**gross of taxes paid.”*** Model LPAs provide that any adjustment for taxes is limited to the cap on the GP’s obligation to return carried interest, and not the actual clawback amount. In other words, the clawback amount is the lesser of (1) the excess carried interest distributions (calculated gross of taxes) and (2) the total amount of carried interest distributions net of taxes
- Other middle grounds:
  - Applying **individual tax rates** to each manager (not hypothetical, highest marginal tax rate)
  - Accounting loss carry-forwards and carry-backs
  - Character of fund income, deduction and losses
  - Tax changes between formation of fund and clawback date

Clawback – Best Practices

Regular reporting to LPs
annual audited financial statements (minimum)

Return clawback amount **within 2 years**
following recognition of liability

Clawback period beyond the term of fund

including liquidation and mirroring any limited partner distribution giveback obligations

Clawback guarantees
enforce against individual GPs (at GP's costs)

Clawback – Market Data

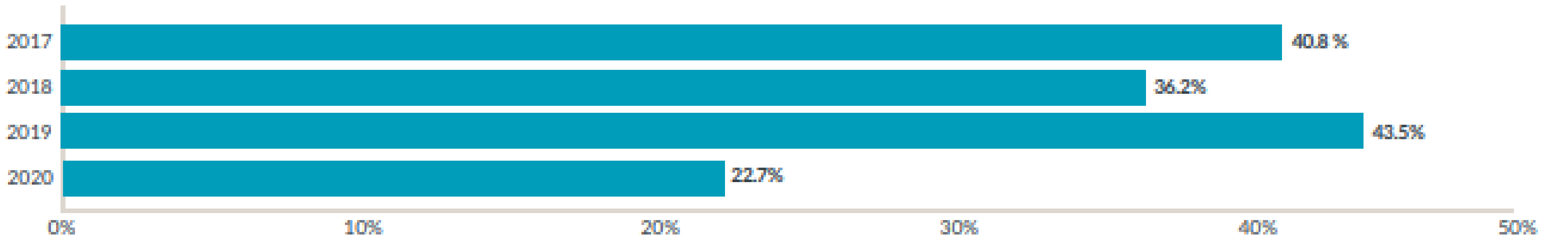
Source: Private Equity Fund Terms Research (2020) -- MJ Hudson

As ILPA notes in its Principles, a GP clawback mechanism – backed by a significant escrow (see below) – is especially important in deal-by-deal waterfalls. Despite the ubiquity of the GP clawback mechanism, in practice its efficacy is somewhat blunted by the limited adoption of clawback protections, recommended by ILPA:

- 36% of all funds with a GP clawback include interim clawbacks (the percentage for deal-by-deal funds only is 64%)
- ILPA strongly recommends joint and several liability of individual GP members as best practice, as LPs contract with the GP, as a whole, rather than with individual members. In cases where joint and several liability is not provided, a potential substitution, per ILPA, would be a creditworthy guarantee of the entire clawback repayment. 64% of all funds with a GP clawback have a guarantee in place backing up the GP's obligation to return carried interest (deal-by-deal funds only: 90%)
- 6% of all funds with a GP clawback place an obligation on the GP to repay the whole deficit, including taxes (deal-by-deal funds only: 0%). However, it should be noted that the current version of the ILPA Principles no-longer requires that all carry clawbacks should be gross of tax
- ILPA recommends that (where clawback amounts to be paid are net of tax), instead of assuming the highest hypothetical marginal tax rate in a designated location, the rate should be based on the actual tax situation of the individual GP members. In 38% of funds where clawback amounts to be paid are net of tax, the tax deducted is calculated based on a hypothetical maximum (the numbers for deal-by-deal funds are 14% - actual amount of tax paid and 86% - hypothetical maximum)

Escrow

Source: Private Equity Fund Terms Research (2020) -- MJ Hudson



The amounts deposited in an escrow range from 10% of carry, all the way to 100%, with the latter being prevalent in 33% of the funds with an escrow arrangement in this year's sample.

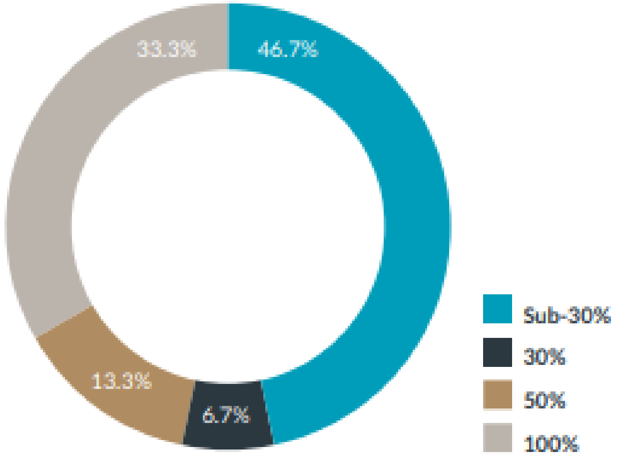
The actual share of carried interest deposited in escrow, per se, may not be quite as straightforward as the headline numbers suggest, however, as the conditions of release and the valuations allowing earlier release of carried interest may have a significant bearing on the actual amounts retained in escrow.

Escrow

Source: Private Equity Fund Terms Research (2020) -- MJ Hudson

ILPA recommends the use of carry escrow accounts with significant reserves (generally of at least 30% of carry distributions), to provide an effective mechanism for a clawback guarantee. This is particularly necessary, per ILPA, in deal-by-deal waterfall structures, where there is an increased risk of carry being paid to a GP that it has not, in fact, earned. It is, therefore, perhaps paradoxical that only 13% of all funds surveyed with a deal-by-deal waterfall had any escrow arrangements at all (a decrease from 23% last year), with a mere 4% withholding the ILPA recommended 30%+ of carry distributions.

FIG.24 WHAT PERCENTAGE OF CARRIED INTEREST DISTRIBUTIONS ARE WITHHELD IN AN ESCROW ACCOUNT? (BY NUMBER OF FUNDS)



LP Clawback

Source: Private Equity Fund Terms Research (2020) -- MJ Hudson

To cover indemnity and other obligations of the fund (particularly with respect to deal exits), most private equity funds nowadays include provisions allowing for LP giveback of distributions – the so-called "LP clawback".

PERCENTAGE OF FUNDS WHERE:	2020	2019
LP clawback limited to no more than 25% of committed capital	61% ▼	82%
LP clawback limited to no more than 2 years following date of distribution	32% ▲	31%
LP clawback limited to both no more than 25% committed capital and 2 years following distribution	19.7% ▼	31%
Funds with no time limit on clawback post distribution	23%	23%
Funds with no time limit on clawback post fund termination	24% ▲	19%

LP clawback provisions can combine to place an onerous burden on LPs, with (potentially) no limits on the percentage of capital commitments that are subject to clawback, and an open-ended (i.e., non-time limited) clawback obligation. Whilst no funds in our survey placed no limit on the percentage of committed capital that is subject to clawback, some 23% had no limit on when the clawback could happen, post distribution, and 24% had no limit on when the clawback could happen, post fund termination.

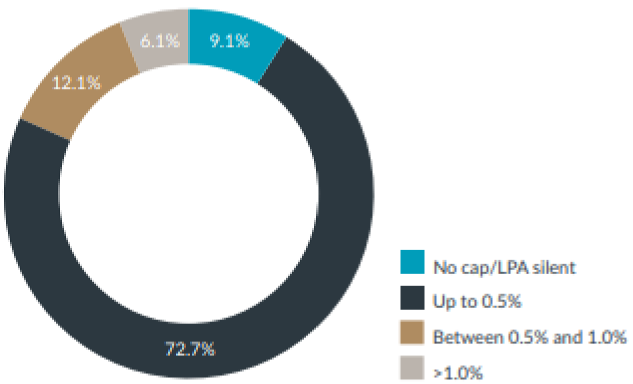
Organizational expenses

Source: Private Equity Fund Terms Research (2020) -- MJ Hudson

The costs incurred in raising a new private equity fund can be substantial and include not only legal and structuring costs, but also the travel expenses incurred during marketing roadshows, costs relating to preparing the marketing and due diligence materials that will support the raise, the cost of an electronic data room, and so on. It is now established practice that these costs are ultimately borne by the fund and, therefore, its investors, but subject to a cap. 91% of the funds surveyed in this year's sample had some form of cap on organizational expenses. The chart below compares such caps expressed as a percentage of total commitments of the funds in our sample. In practice, such caps are often expressed as a cash amount.

"**Organizational Expenses**" means all fees, costs and expenses reasonably and properly incurred by the General Partner or its Affiliates in connection with the formation of the Fund, including travel, meals and lodging/accommodation related thereto (but not including entertainment expenses or the costs of private air travel) and the costs of compliance with a "most favored nations" process, and excluding the fees or expenses of any placement agents.¶

"**Organizational Expenses Cap**" means an amount equal to the lesser of [ ]% of aggregate Commitments and [ ].¶



GP Commitment and Ownership – Best Practices

Type of Contribution?

One way of doing it: “The General Partner agrees to contribute capital to the Partnership in an aggregate amount equal to 1.5 % of the aggregate Capital Contributions of all. This amount is payable by the General Partner upon Distributions (but only to the extent of such Distributions) made by the Partnership to the General Partner, and in any event these amounts are payable by the General Partner (whether out of Distributions or otherwise) no later than the end of the Partnership’s taxable year in which the General Partner’s interest in the Partnership is liquidated (or, if later, within 90 days after the date of such liquidation).”

Should GP be allowed to co-invest?

- No cherry picking
- Equity interest via pooled fund vehicle
- GP sharing % should not decrease

GP Commitment and Ownership – Best Practices

What should GP disclose to LPs?

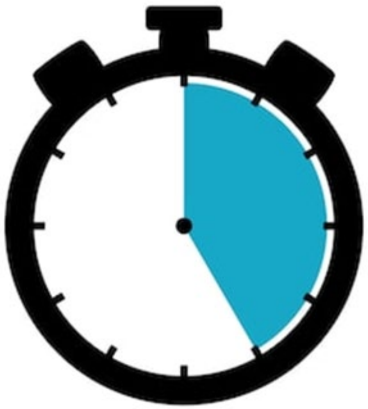
- Ownership of management company
- Transfer of ownership of management company
- Intention to transfer GP interests to a third party (however small), including:
  - the goals and rationale for the transfer;
  - impact on distributable and long term cash flow; and
  - how fund- and GP-level economics will change after the transfer

However, GP should be restricted from transferring their economic interest in the GP to ensure continuing alignment with the LPs

Fund Term Extensions – Best Practices

<u>Duration</u>

- Permitted only in one-year increment
- Limited to a maximum of 2 extensions



<u>If GP intends to extend the fund term</u>

- GP should notify LPAC and LPs at least **<u>1-2 quarters in advance</u>** of the fund's term expiration
- To be approved by LPAC and a majority of LP interests

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Fund Term Extensions – Best Practices

The GP should fully liquidate the fund within one year following expiration of the fund term **unless** the LPs approve the extension

Should the Manager be entitled to fees during the extension?

- Generally, no
- Except when there is a need to incentivize the Manager to liquidate assets
  - If the Manager is entitled to fees during the extension:
    - the LPA should be amended; and
    - since is a lower expense burden during extension, fees should be adjusted to reflect lower expense burden

Key Person – Time and Attention
ILPA Model LPA

"**Key Person**" means each of [__] and any replacement for any of them approved by a Majority in Interest following a Key Person Event.

"**Key Person Event**" means at any time during the Commitment Period (i) [__] ceases to devote time and attention for any reason, including death, disability or retirement, as required under Section 9.2 (Time and Attention) to the Fund[, the Prior Funds] and any Successor Fund permitted in accordance with this Agreement; or (ii) there is a Change of Control.

Section 9.2 Time and Attention. Prior to the termination of the Commitment Period, the General Partner shall cause each of the General Partner, Fund Manager, and the Key Persons to devote substantially all of such Person's business time to the affairs of the Fund, the General Partner, the Investment Manager, any Alternative Vehicles, any Parallel Vehicles, any co-investment, Prior Funds, or other investment vehicles permitted by this Agreement. After the termination of the Commitment Period, the General Partner shall cause each of the General Partner, Fund Manager, and Key Persons to devote that portion of their time to the affairs of the Fund as is necessary for the management of the Fund.

Key Person – Time and Attention

- Key persons should devote substantially all their business time to the fund and its parallel vehicles
- Situations impacting a principal's ability to meet the "time and attention" standard should be disclosed in a timely manner to all LPs and discussed with the LPAC
- Key persons must not act as GP for a separate fund managed by the same firm with substantially equivalent investment objectives and policies **until** the investment period ends, or the fund is substantially invested or committed
- Important to consider how the key person provisions would operate during the harvest period

Key Person – Changes to Key Person

- LPs should be notified immediately of:
  - any change to key persons **and**
  - potential impact to the fund performance due to change to key persons
- After key person provisions are triggered, the ramifications should be discussed in full with LPs, or at least the LPAC
- Any change to key person provisions should be approved by majority of interest of LPs

What triggers Key Person Provisions?

- “For cause”:
  - Fraud
  - Material breach of fiduciary duties
  - Material breach of agreement
  - Bad faith
  - Gross negligence
  - Illegal activities
- Death, disability, retirement
- Permanent suspension within 180 days unless and until a super majority of LPs affirmatively vote to reinstate

Suspending the investment period

- If there is a suspension of the investment period, the GP should not use fund assets, including:
  - recycling of capital
  - borrowing against fund assets or uncalled commitments
  - making new investments or other expenditures
- The GP should consult the LPAC if the decision to close a deal committed was made prior to a key person event
- Any vote to reinstate the investment period or to remove the GP should exclude the LP interests held by the GP or its affiliate

Various Termination Rights: General Partner Removal

- “For cause” vs “no-fault” divorce provisions
- General issue: percentage of LPs required to remove the GP
  - Majority vs supermajority
  - “For cause” vs. “no-fault”
- Standard formulation for removal: fraud, gross negligence, willful misconduct, material breach of LPA, criminal misconduct, moral turpitude
  - Historical trend: require a final, non-appealable ruling by a court of competent jurisdiction
  - Takes too long
  - LP push for no final ruling
  - Pressure to lower the LP vote required to implement the provision

Other Termination Rights

- Other formulations of termination "for cause" or "no-fault"
  - Dissolution right, ability to terminate or suspend the investment period
  - Appointment of third-party liquidator
- Overall trend:
  - Successful institutional pressure
  - Lower thresholds, lower votes, less final rulings
- Reverse trend:
  - Limited flow of good deals
  - Management can demand stronger terms

Indemnities/General Partner Standard of Care

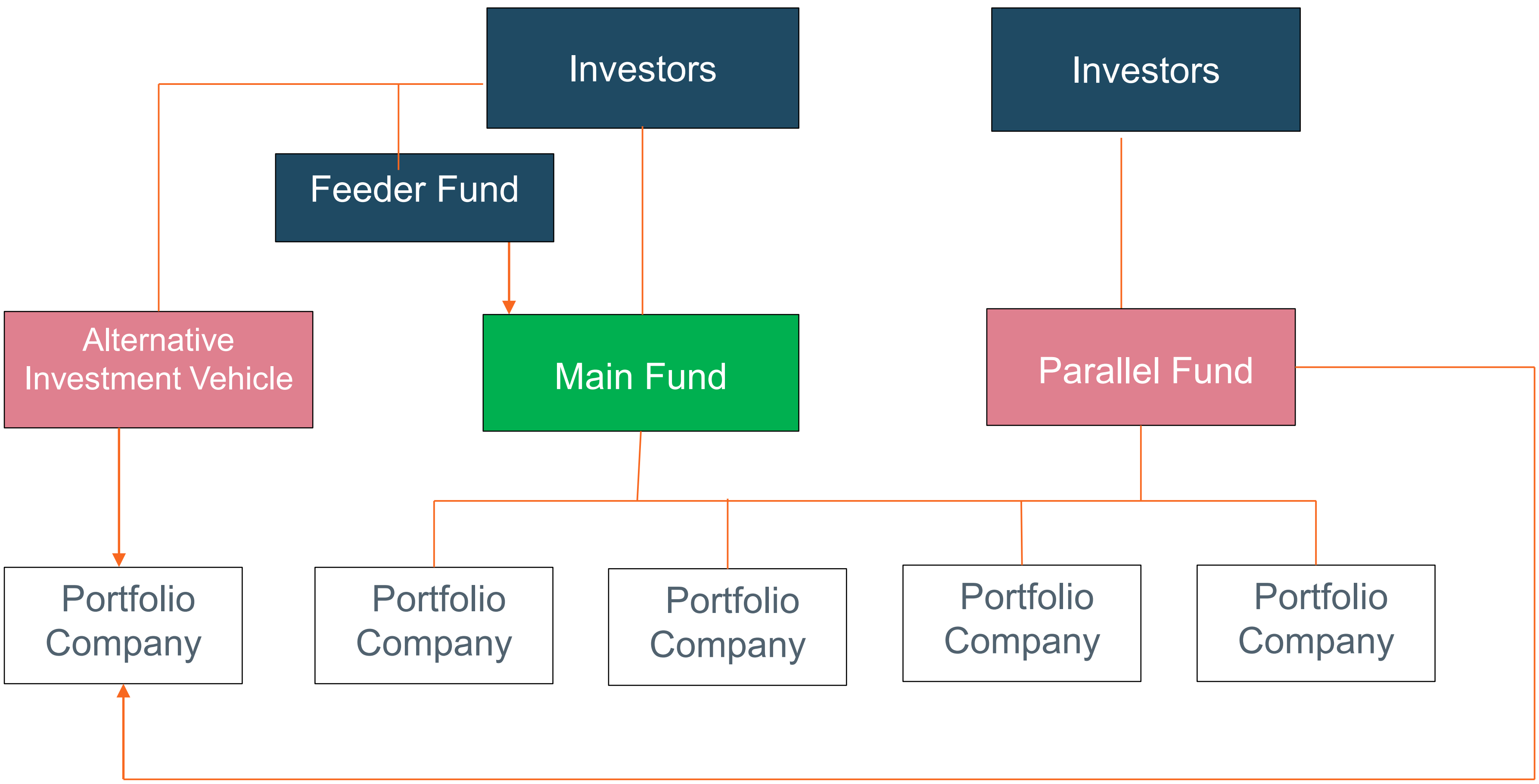
- Classic/historic formulation: indemnification of GP and its partners, members, officers, affiliates, agents (including legal counsel and other service providers) for all actions or inactions relating to the fund's activities unless indemnified party has engaged in fraud, gross negligence, willful misconduct, material breach of the agreement, material violation of securities laws
  - Final ruling?
  - Trend – reject that formulation
  - LPs try to limit use of "materiality"
- Trend: carefully limit categories of acceptable scenario. Institutional LPs requesting exceptions for legal costs relating to: (i) regulatory investigations of GP/IM; (ii) disputes between principals; for exclusions from indemnification and (iii) defending allegations of breach of side letters
- Express provisions setting forth GP's standard of care
  - No fiduciary obligation = red flag to LPs

Indemnities/General Partner Standard of Care

- "Gross negligence, fraud, and willful misconduct" by the GP should be **excluded** from the protection of indemnification / exculpation clauses, even if the governing law would permit it
- LPs should not acquiesce to lessen fiduciary duties owing to LPs
- LPs should reject:
  - provisions allowing GP to reduce all fiduciary duties to the fullest extent; or
  - waivers of broad categories of conflict of interest
- Only award GP discretion where LP has sufficient comfort that the interests of LPs and the fund as a whole will not be adversely affected
- GP should not undertake action that constitutes or could potentially constitute a conflict of interest between the fund and the GP without prior written approval from the LPAC

A sign on the home of a front lawn in Grand Isle, Louisiana on the Gulf Coast. Photo credit: Shutterstock

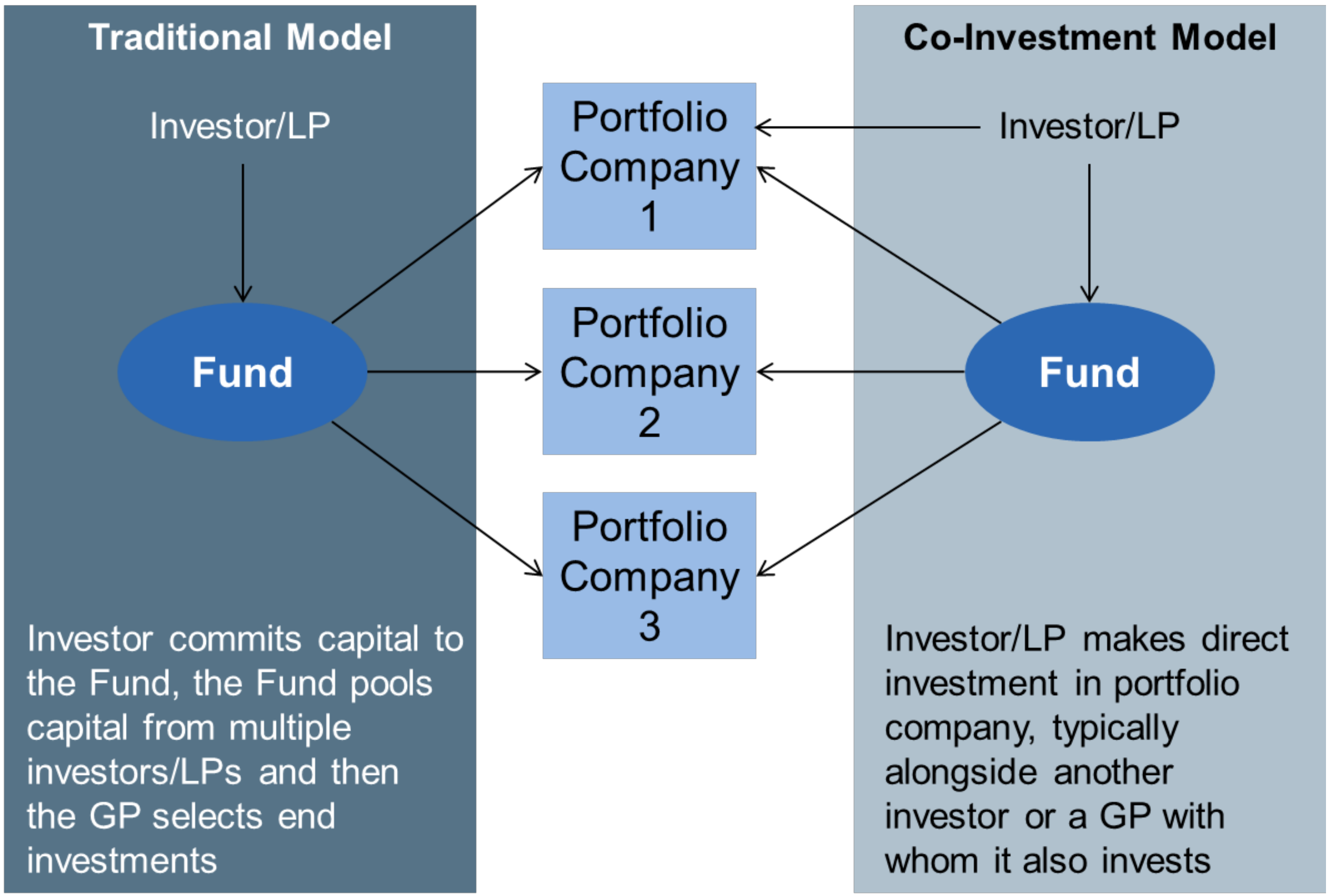
Vehicles Investing Alongside the Fund



Vehicles investing alongside fund

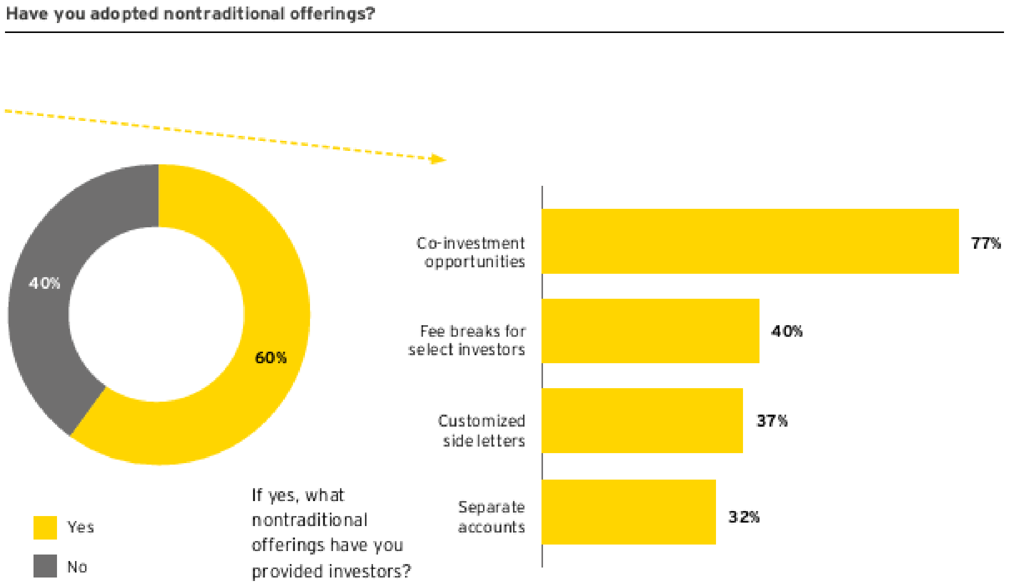
- Parallel Vehicles and AIVs - managed by GP or its affiliate
- Governed by substantially same terms and provisions as the original fund
- Additional economic benefits received by GP must be **proportionate** to the additional economic benefits received by LPs
- Investment fee income and expenses should be shared between the fund and the vehicles **in proportion to capital committed**
- The fund and the vehicles should sell their interests in the portfolio company at the same time and terms as the investment by the fund
- Both investment results of the fund and the vehicles will be aggregated for the purpose of determining distributions

Basic co-investment model



Co-Investments Market Data

Almost 80% of firms offer co-investment opportunities, while 40% provide fee breaks and 37% provide other custom offerings to their key investors. Source: *Source: 2018 Global Private Equity Survey – Ernst & Young*



Co-Investments / Capacity Rights:

Surprising Driver of Marketing and Negotiations

- Historically, fees and expenses would be the most important and heavily negotiated economic issue
- Perhaps this is still true on its face; but only based on participants' and attorneys' time and effort in negotiations of such matters
- But we believe that deal flow is now perhaps the true driving force:
  - determines who gets funded
  - determines negotiating position

"If the Company has excess investment capacity with respect to a Portfolio Investment, the Company shall, to the extent permitted by applicable law, offer co-investment rights to the Preferred Members on terms to be mutually agreed by the Company and the Preferred Members."

Co-Investments/Capacity Rights:

Surprising Driver of Marketing and Negotiations

- Larger PE fund managers often manage a variety of funds focused on different strategies and sectors which overlap in certain instances; it is not uncommon for these funds to co-invest together in the same deal where there is strategy overlap
- Co-investments as a **fundraising tool**
  - Sometimes a new PE fund manager will offer co-investments to certain investors as part of an arrangement to seed a new PE fund and/or to incentivize such investors to participate as anchor investors in the first closing of the new fund
  - In addition, established PE fund managers sometimes offer co-investments to prospective investors as a way of "test driving" the manager's investment program before making a commitment to the manager's fund. "Pledge fund" is a good example

Co-Investments/Capacity Rights: “Hot-button” Issues and Positions

- Request for co-investment rights, including “early bird” or “big bird” incentives (preferential terms for early commitments or large commitments (*e.g.*, priority co-investment rights))
- According to one survey, 38% of GPs have offered co-investment opportunities
- According to one survey, 53% would consider offering such opportunities
- Preqin survey of 80 fund managers found 76% offer co-investment rights to build stronger relationships with LPs, and 51% of GP’s view co-investments as a valuable method for gaining access to additional capital for deals, allowing for investment into a larger transactions
- More likely to be used by mid to large size managers
- Fees on such investments are usually ½ to ¼ the regular fee (for example, 1/10 or 0.50)

Co-Investments / Capacity Rights:

Fiduciary Considerations in Co-Investments

Regulatory Backdrop: Regulators' focus on PE Industry, fairness among management vs. investors, and among investors

- Will LPs be treated *pari passu* and offered deals at the same time as the fund?
- Investment should be on same terms (some exceptions exist)
- Will the opportunity come at the expense of a fund? Need to consider whether the fund has capacity at the time of the co-investments
- Best to work from allocation guidelines among the fund, LPs and third parties
- Disclosure to LPs in advance (whatever the policy is)
  - At the same time, note that giving out more info to co-investors could be problematic
- Do all LPs need to be given the same opportunities?

Co-Investments / Capacity Rights: Other Potential Conflicts to Watch Out For

- Offering to new investors for relationship/marketing at expense of existing investors
- The selection of co-investors
- The allocation of a co-investment opportunity among co-investors
- Investments made at different levels of capital structure
- Different in the timing, terms or rights of co-investors
- "adverse selection" See "Co-Investments: Avoiding Adverse Selection and Generating Outperformance" at https://www.adamsstreetpartners.com/insights/co-investments-outperformance/

Other investment management considerations

- Time diversification, industry diversification and avoid over-concentration by setting pacing limits
- Accommodate a LP's exclusion policy while taking into account any increased concentration effects on remaining LPs
- Provide full transparency around the process and policies for honoring LP's exclusion requests in the event of a non-ratable allocation
- The GP should commit to directing all appropriate investment opportunities to the fund during the investment period
- Investment allocation policy for multi-product firms where GP should fairly allocate opportunities between the fund and other investment vehicles (provide to LPs)

Cross-fund investments

- GP should seek to **limit** the number of **overlapping investments between funds** – set a threshold in the LPA (either by number of deals or by investment size) or enter into a contribution agreement between the partnerships
- Treatment of carried interest and application of fee offsets should be consistent
- Annual notes to the financials should disclose information about all overlapping instruments:
  - name of investment
  - investment size by each fund
  - expected termination date
  - number of extensions
  - remaining dry powder of each fund
- Fees received by the GP from any overlapping positions should be disclosed to LPs
- Avoid transfer of assets between funds (otherwise requires LPAC approval)

GP-led Secondary Transactions

Structure of the Process

- Fair and transparent
- LPs should have sufficient time to evaluate the transaction
- Transaction fees and expenses should be allocated according to existing fund documents and/or in relation to which parties benefit from the transaction
- LPs electing to roll their interests can elect to participate in new structure on a “status quo” basis
- Any process should conform with the LPA (e.g., disclosure, notice periods, conflicts, expense)

Advisors to the Transaction

- GPs should engage an experienced advisor to solicit bids at the cost of the GP
- LPAC should review the GP’s selection of the advisor (role, scope of services, fee)
- LPAC should have the right to hire its own advisor to offer counsel on the process, separate from the GP-selected advisor

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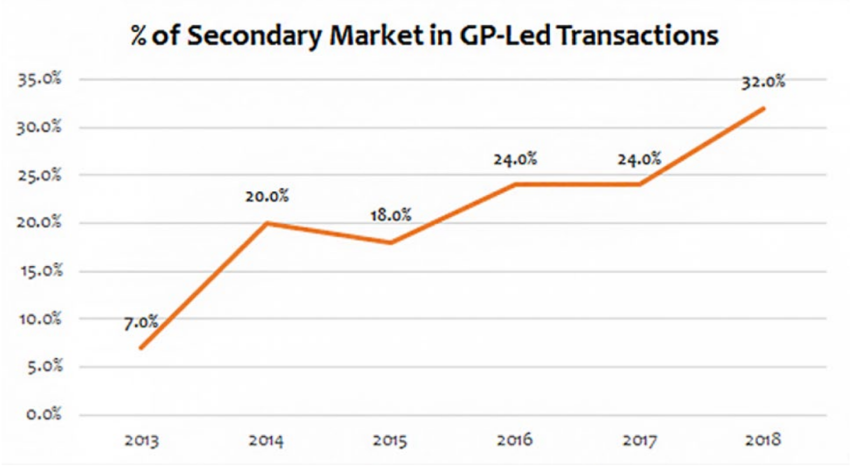
GP-led Secondary Transactions

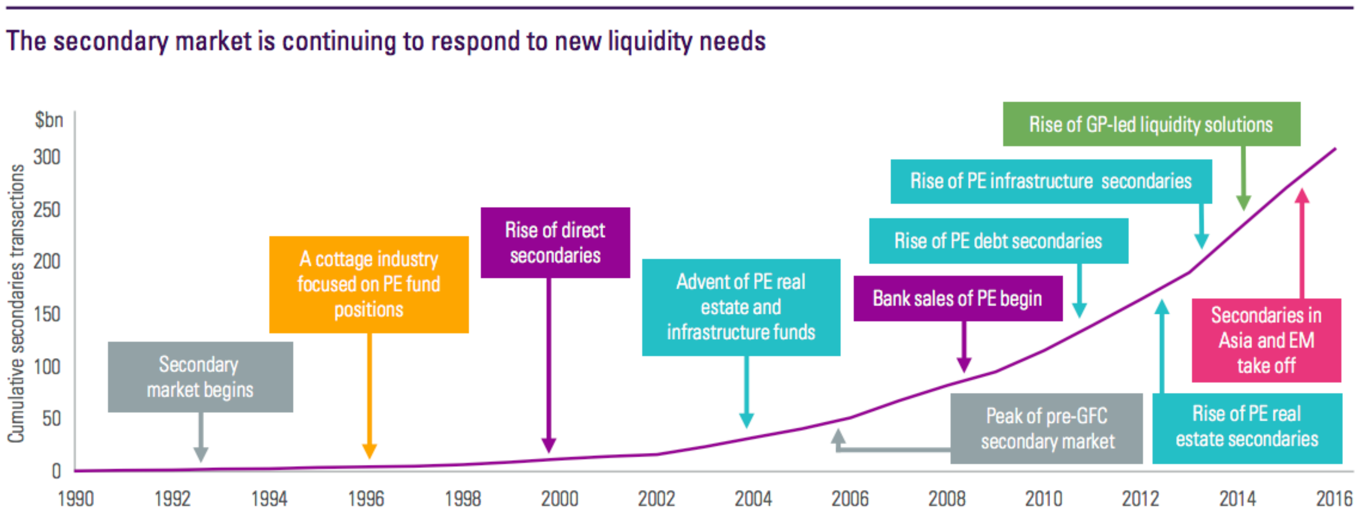
- GP should disclose to the LPAC, and to electing LPs upon request:
  - number, range, and content of bids received
  - LPAC member participation as acquirers, if any
  - management fee and carried interest amount for LPs in the continuation fund
  - management fee and carried interest for LPs allocating primary capital
  - any other changes in the terms versus the original fund



GP-led Secondary Transactions

LP Engagement and Role of the LPAC

- GP should engage the LPAC at the earliest opportunity
- GP should provide information on: (1) process and terms of the deal, (2) the quality and outlook for the remaining investments, (3) the amount of new capital required, (4) the projected time to realization, (5) the reasoning for a GP-led transaction with the addition of capital rather than a fund term extension or other alternative
- Any conflicts related to the transaction should be disclosed, mitigated (if possible), and approved by the LPAC



Changes to the Fund

Recommended Threshold for Key Changes to the Fund under ILPA 3.0

LPA Amendments / Change of Investment Strategy	Super Majority (i.e., two-thirds) together with GP consent
Without Cause - Dissolving the Fund, GP Removal	Super Majority (Simple Majority for appointment of liquidator)
Without Cause – Suspension/ Termination of investment period	Simple Majority (Super Majority under ILPA 2.0)
For Cause – Dissolving the Fund, GP Removal	Simple Majority
For Cause – Suspension/ Termination of investment period (e.g. Key Person Trigger; fraud etc. ***A key person or cause event should result in an automatic suspension of investment period, to become permanent within 180 days, unless and until a super majority of LPs in interest affirmatively vote to reinstate***	• Simple Majority (if affirmative vote is required) • Super Majority <u>to reinstate</u> (if automatic suspension at the first place)

Changes to the Fund

LPA Amendments

- Any amendment should be disclosed to the LPs – all LPs should acknowledge receipt of final documents prior to closing
- Model LPA:
  - Certain Amendments Not Requiring Consent of LPs
  - Certain Amendments Requiring Specified Consent
- Amendments that negatively impact the economics of a single LP should require that LP’s consent

ESG in the world of Private Equity and VC

https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/Private-Equity-Makes-ESG-Promises-But-Their-Impact-Is-Often-Superficial

Illustration by Jeremy Leung/II

- Institutional Investor: "The vast majority of private equity ESG efforts remain nascent and superficial."
- Of the 431 PE firms that directly invest and commit to PRI's six principles, Institutional Investor found that fewer than one in eight publicly disclose that they receive ESG reports from their portfolio companies, and only 16 share whether ESG issues impact financial performance.
- PE + ESG: Intention vs. Action. Why the gap?
  - **Hold period.** The median hold period for a PE-owned portfolio company is 4.5 years
  - Mismatch of hold period vs ESG outperformance causes under-investment in ESG. **Perverse Incentives**.
  - **Quantification**. An investment in ESG is often hard to quantify
  - **Causation vs correlation**. Debate continues over whether "high sustainability" companies outperform because of a focus on ESG, or do they deliver great financial results because ESG is a by-product of a well-run company?
  - **Company type**. Almost all PE—owned companies have never been public.

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Insight: Governing Your Governance (see here: Insight: Governing Your Governance
see here: https://www.linkedin.com/pulse/governing-your-governance-scott-peterman/

Insight: How to Crossover a Hybrid Fund (Part 1)
see here: https://www.linkedin.com/pulse/how-crossover-hybrid-fund-part-1-scott-peterman/

Insight: How to Crossover a Hybrid Fund (Part 2)
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