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Private Equity Managers: Considerations for Managers in the Middle Market

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Private equity funds have experienced strong popularity in recent years, and there is no sign that this is slowing. While the size of private equity firms runs the spectrum from startups with less than $100 million to large managers with tens of billions under management, many in the industry fall in between—what is known as the middle market for private equity managers. This article focuses on certain of the key considerations and issues that middle-market managers may face in an increasingly crowded and competitive marketplace.

What is the middle market? While there is no set definition in the private equity world, the category encompasses managers with a few hundred million under management to those with several billion. Some other typical characteristics of middle-market managers include a relatively small and efficient staff, from five to seven individuals at smaller managers to perhaps 50 to 75 at the largest. Often the private equity firm will have one main office and sometimes a few smaller offices elsewhere in the country or, if the strategy or investor base warrants, in other countries. Senior managers at middle-market private equity firms often wear more than one hat—for instance, the chief financial officer may double as the chief operating officer and chief compliance officer or both. Oftentimes middle-market managers will not have an in-house legal function, and if they do, it is most often a single person serving as the general counsel and sometimes wearing the dual hat of chief compliance officer.

The various fund and operational considerations that are particular to middle-market private equity managers could easily fill a short treatise. In this article, we focus on a few specific areas in the negotiation of private equity fund terms and in the operations of a private equity firm.

Middle-Market Considerations for Certain Fund Terms

There are special considerations with respect to certain terms of the private equity funds that middle-market managers manage. The importance of management fee and carried interest terms for private equity middle-market managers is self-evident and does not require extensive discussion here. Managers of this size rely on management fees for the operation of the management company, and so the level of management fees charged to the fund, as well as management fee breaks that a manager may need to give to large investors, takes on heightened importance. Similarly, the opportunity to earn carried interest or a similar type of performance fee is a key driver for a private equity manager's ability to earn a significant profit, rather than just run the business. Participation by employees in the general partner's carried interest potential is an important component of a private equity manager's ability to attract and retain senior management and investment professional talent.

There are a number of other private equity fund terms that have a less obvious but important impact on the operations and finances of a middle-market private equity firm. Private equity terms, such as key person provisions, indemnification terms, and others, take on added significance for these types of managers. Terms such as these go to the heart of the financial condition and well-being of the manager. While these terms are also important to larger private equity fund managers, those managers have deeper financial resources, greater access to capital, more diverse lines of business, and a far larger number of senior managers and decisionmakers.

Key-Person and Devotion-of-Time Terms

Private equity fund terms typically include a key-person provision that addresses the consequences for the management of the fund in the event that one or more individuals who are considered critical to the execution of the fund's strategy can no longer perform his or her functions. A related provision sometimes found in fund governing documents addresses the amount of time that the key people must devote to the management of the fund's activities. These provisions are intertwined in that a failure to devote the requisite amount of time to the management of the fund will trigger the key-person provision.

The key-person provision is typically triggered when the key persons either fail to devote the requisite amount of time to the fund during the investment period or are engaged in what is often referred to as "disabling conduct," which is certain specified acts of wrongful conduct or crimes. While consequences can vary, generally if the key-person provision is triggered by one of these events, the investment period is suspended for a period of time, and if the event is not cured, the limited partners can vote to terminate the investment period and wind down the fund.

Devotion-of-time and key-person provisions are two of the more highly negotiated terms for middle-market funds. As noted above, middle-market managers are likely to have smaller infrastructures and concentration in terms of their personnel. A smaller middle-market manager may have one founder, and be supported by a team of two to five additional employees, depending on the size of the fund. Larger managers may be able to have five to six key persons, which decreases the likelihood of a key person event occurring that could lead to the termination of the fund.

Founders of middle-market fund managers may want to keep the designation of non-founder investment professional key persons to a minimum for a variety of reasons. From the manager's perspective, the circle of key senior investment professionals is typically limited to between one and perhaps three or four individuals, and accordingly the manager is faced with the reality that each of these individuals is a candidate for inclusion in the provision. Factors that impact this decision include the overall structure of the firm, the senior employees' specific roles, and the demands of prospective investors in the fund. Designation as a key person obviously imparts a level of importance to those individuals who are named. The founders need to have a level of confidence that non-founders designated as key persons will be long-term members of the private equity firm, and certainly for the investment period of the fund for which they are designated as key persons.

Employment dynamics among founders and non-founders of middle-market private equity firms can also be impacted by the key-person question. Compensation packages and equity participation vary widely at middle-market private equity firms, and the smaller size of these firms often creates the atmosphere for a significant level of negotiation of terms. Designation as a key person can create the impression that there may be increased bargaining power, since a departure by a key person can trigger the key-person provision or increase the likelihood of a trigger. Naming an employee as a key person can convey a sense of heightened importance and may lead to compensation discussions that the manager may not otherwise have had. For instance, this may prompt a discussion regarding increased compensation and the grant of the carried interest or performance fee payable to the general partner that might not have occurred. Some private equity managers may seek to keep the number of investment professionals designated as key persons to a minimum for this reason.

At the same time, investors in a middle-market fund have an interest in the key-person provision that can create pressure in the opposite direction. Investing in a middle-market fund means investing based on not only the strategy but also on the investing acumen of the management team, and sometimes one individual in particular. While the key-person provision serves as a protection for limited partners that the management team with which they made their commitment will be substantially the same team that executes the strategy, triggering of the provision is a significant disrupting event in the investment objective of the fund. Accordingly, limited partners will have an interest in having a broad enough key-person group to balance these competing considerations. In particular, where there is not a single dominant founder—as is sometimes the case—investors will have an interest in having several of the investment professionals be designated as key persons. In those circumstances, the key-person provision will be triggered if a certain number of key persons are no longer involved with the fund. Reaching the right result can be a challenging negotiation where the manager's beliefs about who should or should not be a key person diverge from those of the most significant limited partners.

Devotion-of-time provisions also are often a focus of negotiation for middle-market private equity managers, in particular those that are launching their second or third fund. Sometimes this provision is part of the key-person provision, and sometimes it is a standalone provision in the fund limited partnership agreement. When devotion of time is addressed separately, it is often because the manager and/or the fund's investors seek to differentiate between the standard for individuals that are deemed important to the fund's investing strategy and a smaller number of key persons whose importance rises to the level of requiring a potential suspension or termination of the investment period in the event that they are no longer able to perform their responsibilities.

Larger private equity managers have deep investment professional resources. Limited partners recognize this, and accordingly the designated key persons typically are required to spend only that amount of time that the general partner deems is sufficient for the management of the fund. Some larger middle-market managers have the ability to demand and obtain this flexibility as well. With smaller middle-market managers, the size of the firm and the number of investment professionals means that the manager must conduct more of its investing business with fewer individuals than a large private equity manager. In addition, some private equity managers may have other related business lines, such as a differentiated separate account strategy or an affiliated broker-dealer, where the founders and/or some of the senior investment professionals may seek to devote some of their time.

In these circumstances, the specific scope of the devotion-of-time provision can become a focus in negotiations between a middle-market fund manager and its larger and more significant potential investors. The fund manager will attempt to balance the amount of time required to be devoted to the fund versus other business pursuits by advocating for a devotion-of-time provision that will require that the key persons spend a "majority" of their business time on the fund during the fund's investment period. In some instances, the manager may have more bargaining power as a result of the success of prior funds, its track record, or because the particular strategy is in demand. In those instances, a middle-market manager may successfully negotiate a devotion-of-time threshold that requires that the key persons spend only that amount of time that the general partner deems necessary to execute on the fund's investment strategy. Regardless, there typically are time carve-outs for civic and charitable activities, outside directorships, and personal investing activities.

With less established or newer managers, however, limited partners that are making a large commitment to the fund may require that the key persons devote "substantially all of their business time" to the fund's activities. The balance in these circumstances may be struck by designating one or more of the most important individuals as key persons for purposes of the key-person provision, with a "majority-of-time" standard, and those key-person individuals, along with a larger group of persons as "principals," who under the devotion-of-time provision will spend the time that is "reasonably required" for the fund's activities.

Indemnification and Exculpation Provisions

The indemnification and exculpation provisions of a private equity fund partnership agreement also take on added significance for middle-market managers. While the expectation of everyone at the launch of a fund is of course for success, the reality is that things can and do wrong. Middle-market managers need to plan for the best but be prepared for the worst. Whether or not a lawsuit has merit, the need to defend a suit or proceeding can have significant financial consequences for both the fund and the manager.

The governing agreement of a private equity fund will include provisions that limit the liability of the general partner, the management company, their respective employees, and a broad range of affiliates for most types of conduct undertaken in connection with the fund. Similarly, the governing agreement will provide these entities and individuals with wide indemnification coverage for costs and losses that may be incurred in connection with lawsuits and other types of proceedings arising out of activities performed for the fund.

Each of these provisions, however, includes a carve-out that precludes exculpation and indemnification when the parties seeking to trigger these provisions have engaged in certain types of wrongful conduct, often termed "disabling conduct." While the specific terminology and scope varies, one common point of negotiation between a private equity manager and potential investors involves whether the disabling conduct carve-out will be limited to intentional conduct, such as fraud and criminal acts, or whether it will sweep broader to include acts of gross negligence or material breaches of the governing agreements (while sometimes requested by potential investors, rarely will the carve-out include any conduct lower than gross negligence or a material breach of the governing agreements).

The standard for determining whether disabling conduct has occurred for purposes of triggering the indemnification and exculpation provision also can become a subject of negotiation, with three broad possibilities. At one end of the spectrum, some governing agreements provide that disabling conduct precludes indemnification or exculpation only when there has been a final court determination and an exhaustion of all appeals. At the other end of the spectrum, disabling conduct can preclude these protections simply when the parties seeking the protection have "engaged in" the disabling conduct, allowing for the carve-out to apply when there has been no court determination at all and leaving open the potential for debate or disagreement over whether such conduct has occurred. Provisions in the middle generally will provide that disabling conduct precludes exculpation and indemnification when there has been a court determination, sometimes with varying degrees of specificity as to the type of determination required.

The disabling-conduct standard also plays a role in key-person provisions and in provisions that allow limited partners to remove the general partner and the management company. As noted above, disabling conduct is a trigger for the key-person provision. This concept is also used in provisions that permit limited partners to exercise a for-cause right to remove the general partner and management company, subject to a specific negotiated percentage vote by limited partners. Sometimes the disabling-conduct standard used in these provisions is the same as that used for indemnification and exculpation, but there may be variation depending upon specific circumstances.

Private equity managers will of course seek to negotiate toward the protective end of the spectrum with respect to both the type of conduct that constitutes disabling conduct and the standard by which such disabling conduct is judged. While private equity managers do not expect to be engaged in lawsuits or troubling conduct that might trigger a disabling-conduct provision, the significance of the consequences require that these provisions be thoughtfully negotiated. For middle market managers, a single lawsuit, even if covered by errors and omissions insurance, can become a significant drain of resources. Experienced institutional investors that deal with managers of this size will recognize these realities and should not want to see an otherwise successful manager financially hampered and distracted from its efforts to successfully manage the fund investments. Accordingly, the balance for disabling conduct is often struck in the middle of the spectrum.

A related issue is the ability of a manager to call back distributions made to partners in order to fund indemnification and sometimes other obligations. While limited partnership agreements often grant the general partner this right, these provisions vary in terms of the scope of the fund obligations covered (for instance, whether they are limited to indemnification obligations, or include expense obligations and other liabilities of the fund), the length of the time period after the distributions have been made, and the amount of distributions that may be recalled from the partners. This provision can be particularly relevant for a middle-market manager overseeing a fund that is nearing the end of its term, when it is more likely that indemnification obligations may arise. Given that a general partner has liability for the debts of the limited partnership, managers should pay attention to this provision to ensure that the limited partnership is sufficiently protected.

Compliance and Regulatory Considerations

Private equity managers in the middle market may have anywhere from five to about 50 employees, but even the larger middle-market managers are leanly staffed when it comes key senior positions. Most private equity managers in the middle market rely primarily on management fee income to run the business and accordingly seek to achieve cost savings and efficiencies wherever possible, including in the staffing of senior functions, such as chief operating officer, chief financial officer, general counsel, and chief compliance officer. It is not unusual for a private equity manager to look to consolidate these functions by combining certain of them with one individual.

Private equity managers with more than $150 million in private funds under management are required to register with the Securities and Exchange Commission (SEC) and therefore are required to have a chief compliance officer. At the same time, the actual day-to-day responsibilities and job requirements of a middle-market chief compliance officer often will not require the full-time attention of one individual. Accordingly, this function is often consolidated with either the chief financial officer or the general counsel function.

While a common practice, combining these functions presents challenges and potential conflicts of interest. The chief compliance officer is responsible for overseeing and administering the private equity firm's compliance program and ensuring that policies and procedures are maintained and that the firm and its employees understand what is required to comply with the program and with applicable regulations. The chief compliance officer's mandate is necessarily firmwide and of course includes areas that fall within the chief financial officer and general counsel functions.

With respect to the chief financial officer function, combining that role with that of the chief compliance officer is in some respects complementary. The chief financial officer's role with respect to the financial information of the firm and the fund includes an oversight role with respect to the integrity and the use of that information. The chief financial officer is also responsible for overseeing the audit of the private equity funds and for working with the auditors in that regard. The responsibilities of a chief financial officer also include the firm's and the private equity fund's administrative and accounting functions, whether performed in-house or outsourced. Often, the chief financial officer works with the investment professionals on matters relating to valuation of the private equity fund's portfolio investments.

These operational areas are of high importance to private equity fund investors, as they relate to the financial integrity of the fund, the flow of information to fund investors, and the value of the fund's investments. Sharp focus is placed on these areas by the SEC, and a private equity firm's compliance program needs to address the private equity firm's handling of these areas and provide guidance to firm employees. In this respect, combining the role of chief financial officer with that of the chief compliance officer can be a benefit for the firm, as it allows the manager to assess the firm's compliance efforts in these areas first-hand with full information and a deep understanding of finance, administration, valuation, and other areas.

At the same time, the benefit of combining these functions comes with a potential conflict of interest. Because these financial and operational areas are highly important to a private equity fund and its investors, there is a significant interest in independent compliance oversight. When the chief financial officer also serves as chief compliance officer, obviously that independent oversight is not present to the same extent.

Combining the roles of general counsel and chief compliance officer creates similar synergies and challenges. The chief compliance officer position is not in and of itself a legal one and does not require legal training. At the same time, a significant part of the chief compliance officer's duties includes the review and understanding of the rules, guidance, enforcement actions, and other written authorities of the SEC and potentially other regulatory agencies. When the chief compliance officer is also a lawyer, he or she can apply that legal training and judgment to understanding the rules of the regulatory road and to the provision of guidance to the private equity firm. In addition, the general counsel is often a part of senior management discussions about commercial matters of importance to the private equity manager. When the general counsel is also the chief compliance officer, the latter function is by necessity elevated to the boardroom level, thereby enhancing the role within the organization.

However, as with the chief financial officer position, combining the chief compliance officer function with the general counsel role can present a conflict of interest in certain circumstances. While both the general counsel and the chief compliance officer seek to provide guidance to the private equity manager on compliance matters, the general counsel's role is that of an advocate who is charged with protecting the firm's interests within the boundaries of the law, protected by the attorney-client relationship. By contrast, the chief compliance officer's responsibilities are to administer the compliance program and detect and prevent violations, not to provide advice on them, and are not as a matter of course protected by the privilege accorded to counsel and client. Where there is no clear answer as to whether a particular practice creates regulatory risk or constitutes a compliance violation, the general counsel's response as an advocate may not be the same as the chief compliance officer's response as the overseer of the firm's compliance program.

There are a number of ways for middle-market firms that choose to combine functions such as these to address the potential conflicts. One is through the use of outside advisors. When there may be a conflict of interest created by the competing roles of chief compliance officer and either chief financial officer or general counsel, outside counsel or a compliance consultant can provide guidance as to how to navigate the particular issue. Another mechanism that has been adopted by some private equity firms is the creation of a compliance committee made up of the chief compliance officer and other senior investment professionals of the firm. Compliance issues that may present a conflict for the individual wearing two hats are presented to the compliance committee for open discussion and recommendation. Another similar route taken by some private equity firms is the presentation of compliance questions to the private equity firm's board of directors or managers. While many middle-market private equity firms do not have a separate board of directors, this type of governing body is becoming increasingly of interest to firms, in particular to non-US private equity managers that are accustomed to having governing boards and to growing middle market managers that see the need for more formalized corporate governance. A board of directors can effectively play the same role as a compliance committee in addressing a potential conflict created where one individual is filling a dual role as chief compliance officer and either chief financial officer or general counsel.

The middle market private equity fund industry is made up of a robust and diverse range of firms in terms of size, scope, and strategies. While there has been consolidation in other areas of the asset management industry, mid-size private equity firms remain a strong and growing segment of the overall private equity business. An understanding as to how the size and character of these firms should inform the terms of the private equity funds that they manage and how private equity managers approach compliance and regulatory matters is key to the continued success of this segment of the industry.

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