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# 'Til death do us part: Issues to consider when a new GP joins the firm

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This article addresses the issues founders face when they move beyond their initial partnership and take steps to institutionalize the private equity firm they founded by admitting new general partners. Consider the following hypothetical construct:

- For the first five years, it had just been the two of you (the “Founder GPs”). Principals and associates had joined the firm, of course, but at the GP level it was a true partnership of equals – share and share alike, with consensus required for all major decisions. You already have two funds under your belt – Fund I, which is fully invested and managing out its portfolio, and Fund II, which is 60% committed and looking to source three to five additional deals. You plan to launch Fund III into the market some time next year when Fund II is fully committed under its partnership agreement.
- Then, you met him (or her) (the “New GP”). Compatible investment focus and philosophy. Great track record. A Rolodex full of potential investors. He convincingly made the case that he had no room to grow at his current firm. In your head, you’ve already drafted the press release: “PE Veteran to Take Firm to Next Level.”

A business partnership is very much like any other type of romance. Before you say “I do,” there are a myriad of details to work out. When the romantic fog is at its thickest, some of the issues may seem an annoyance, or even an unpleasant damper on the ardor of the romance. However, the time to address them is now – not some time in the future when unresolved differences in expectations threaten to fracture the relationship.

This article will explore the financial and governance issues to consider when adding a new GP to a private equity firm, specifically: (i) structuring the compensation package (including shares of the carried interest, management company net profits and management company enterprise value); (ii) ongoing decision making (both at the fund and firm level); (iii) planning for a possible parting of the ways some time in the future; and (iv) messaging to the firm’s investors.

## Sharing the wealth: Dividing up firm profits

The New GP will expect compensation in the form of carried interest generated by the funds and a share in

management company profits. So far, the Founder GPs have split carried interest and net profits equally. The new GP may equal the Founder GPs in terms of talent, deal flow potential and investor contacts. However, he cannot claim equal status with the Founder GPs in terms of sweat equity invested in the business to date. Moreover, his track record – though impressive – is not a reliable indicator of how well he will perform in a new environment. The initial question for the Founder GPs is whether the New GP will “share and share alike” in management company profits and carried interest from the outset, or does he start with some lesser share that builds over time?

Carried interest The extent to which the New GP shares in the carried interest of each fund probably turns on where the fund is in its life cycle. The New GP will play a key role in raising Fund III and contribute his pro rata share of deal flow once the fund is formed. As a result, he probably expects to share Fund III’s carried interest equally with the Founder GPs. But in contrast, Fund II has already been raised, so the New GP will contribute no new investors. However, the New GP may well source deals for Fund II and so will probably share in the carried interest to some degree. Accordingly, his share is likely to be less than the shares of the Founder GPs who have sourced all of the investors and all of the deals to date.

Fund I is now past its investment period, and the Founder GPs are solely focused on generating liquidity for the remaining portfolio. The New GP will contribute neither prospective investors nor deal flow. Accordingly, the New GP may not share in the Fund I carried interest at all. However, if the New GP will take over existing board seats or contribute additional expertise to the existing portfolio companies, then the correct answer becomes less clear. If the New GP generates significant value for the Fund I portfolio, he may feel entitled to some share of the carried interest.

The threshold question of how much carried interest to allocate to the New GP also depends on whether carried interest is allocated on a deal-by-deal basis or across all deals done by the fund. If the New GP’s participation in either prior fund is only selective, you could consider sharing only carried interest generated by the deals in which he participates. However, this is easier to say on paper than to actually put into practice. Carried interest is typically calculated on the

performance of the entire portfolio, and trying to tease out one deal's contribution to the whole is basically guesswork, at least until you get to the end of the fund's life and can total up the results from each investment.

There is another alternative to a direct carried interest grant with respect to Funds I and II in the case of situations where it may be difficult for the Founder GPs to determine how the New GP can be allocated carried interest fairly, given his lack of historical connection to both funds. This is to provide the New GP with "phantom" carry that tracks the return on the fund's investments, but that is capped at a pre-set amount by the Founder GPs. This phantom carry – which takes the form of a cash payment from the management company and is treated as ordinary income – essentially functions as a bonus incentive for the New GP with respect to funds to which the New GP contributes, but avoids the dilution and political concerns that the Founder GPs face when allocating direct carried interest. There are vesting and deferred compensation issues (Section 409A) that need to be addressed with counsel when structuring these phantom carry plans, since they are essentially deferred compensation arrangements, but the approach may provide a middle ground for allowing the New GP to participate in the profits arising from historical funds.

Once you determine the desired carried interest split, determining the vesting schedules is a logical next step. For Fund III, the New GP probably would expect to vest on the same schedule as the Founder GPs, with that schedule driven by marketplace expectations. However, as the New GP is an unproven commodity, you may consider delaying vesting somewhat while the relationship proves itself. While the Founder GPs vest from day one, for example, the New GP could have a one-year cliff on his initial vesting tranche, with subsequent vesting over time before becoming 100% vested.

Vesting with respect to existing funds presents a dilemma. The Founder GPs may be halfway through their Fund II vesting schedules and almost fully vested in Fund I. If the New GP goes on an equivalent Fund I and Fund II vesting schedule, with credit for "time served" by the Founder GPs, then he could be substantially vested from day one without having added any value to the fund. On the other hand, giving no credit for time served creates a mismatch between the New GP's vesting schedule and the fund's investment cycle. Some compromise, with partial credit for time served by the Founder GPs or adding an initial cliff to the vesting schedule, may be the right answer.

**Capital contributions** The extent of the New GP's share in carried interest is often directly tied to his contributions to fund capital. Both investors and the Founder GPs alike will want the New GP to invest a meaningful portion of his net worth to evidence his commitment. By tradition, general partners have contributed 1% of total fund capital. However, this percentage is creeping up, driven by investors' desire to

see more "skin in the game" and deemed contribution mechanisms that defer management fees into capital and permit larger contributions without the pain of having to write large checks for capital calls.

Some firms allocate the general partner's contribution amount among the individual GPs in lockstep with carried interest. In other words, if the New GP gets one-third of the carried interest, he makes one-third of the general partner's required capital contribution to the fund. Other firms do not take a strict lockstep approach. They may require each GP to invest a minimum amount as "carried interest contributions," but permit the GPs to put additional capital to work on a discretionary basis.

Now, consider a complication: The New GP was seriously under-compensated at his former firm – a big reason why he wants to jump to your firm now. As a result, the New GP lacks the financial resources to make substantial capital contributions in cash. To make matters worse, Fund II is currently 40% called. Upon his admission to the Fund II general partner, the New GP is expected to contribute an equal percentage of his commitment – a significant lump-sum payment. You could solve the problem by giving the New GP a low-interest, full-recourse loan from the management company to cover all or some portion of his capital calls. Such loans are typically paid off with fund distributions, and any balance is due either at liquidation or termination of employment. Extending credit to a new employee involves risk, of course, and these types of notes generally accelerate if the New GP's employment is terminated for any reason. If the relationship ends in termination before the note is paid, you either have to write off the balance in severance negotiations or try to collect on the balance. To the extent that the New GP lacked the financial resources to make cash contributions to begin with, he may still lack financial resources when required to pay off the loan.

Some fund agreements permit the fund itself to extend recourse notes to the general partner (and, by extension, to the New GP) to make capital calls. As above, the notes are paid out of distributions, with any balance due at the termination of the fund. However, these notes effectively make the limited partners creditors of the general partner. They are generally disliked by limited partners and have largely fallen out of favor.

Another potential solution lies within the funds' deemed contribution mechanisms. With a deemed contribution mechanism, the general partner makes a substantial portion of its capital calls by waiving equivalent amounts of management fees. In addition to easing the pain of writing large checks, deemed contribution mechanisms potentially convert management fee taxed as ordinary income to long-term capital gains. However, deemed contributions also reduce management company net profits: Every dollar of waived fees comes off the management company's bottom line. To the extent that the New GP participates in a deemed contribution mechanism, consider how his salary, bonus or

## Hiring checklist

Adding senior talent from the outside with skills that enhance and complement those of the existing team can be an effective means to move your firm to the next level in terms of growth and depth of expertise. But just as with any other marriage, clearly setting the expectations of the parties at the outset can help ensure a smooth long-term relationship, as well as protect the firm in case the relationship does not work out. Below is a quick checklist of the issues discussed in this article for future reference.

### I. Structuring compensation

#### A. Carried interest

- (i) In which funds – new vs. existing
- (ii) Participation in the carried interest pool as a whole or just deal-by-deal
- (iii) Use of “phantom” carried interest vs. direct interest in carried interest
- (iv) Vesting schedule – new vs. existing funds, in which Founder GPs may be substantially vested

#### B. Capital commitments

- (i) In which funds – new vs. existing
- (ii) How much – in lockstep with share of carried interest or open to negotiation
- (iii) Contributions made by recourse notes
- (iv) Participation in deemed contribution mechanism

#### C. Management company

- (i) Participate immediately in net profits vs. a waiting period
- (ii) Equivalent net profits share with Founder GPs vs. reduced share to ramp up over time
- (iii) Profit participation restricted to certain pools
- (iv) Share of capital proceeds if management company is sold

### II. Decision making

#### A. General partner level (fund decisions)

- (i) With respect to which funds
- (ii) “One man, one vote” vs. voting by percentages (weighted to senior GPs)
- (iii) Majority needed to be make routine decisions, investments/divestments and other key decisions (can be different)

#### B. Management company

- (i) Immediate participation, or only after a grace period elapses
- (ii) “One man, one vote” vs. voting by percentages (weighted to senior GPs)
- (iii) Majority needed to make routine decisions vs. “mission-critical” decisions (can be different)
- (iv) Are some decisions reserved solely for senior GPs (such as sale of the business)?

### III. Planning for possible future separation

#### A. Termination mechanics

- (i) Ensure the New GP can be terminated at any time without cause
- (ii) What is requisite GP majority needed to terminate?

#### B. Decision making – Typically immediate cessation of decision making authority upon termination

#### C. Types of terminations (which can effect termination economics)

- (i) The New GP’s voluntary resignation
- (ii) Termination by the firm with cause (usually some form of willful misconduct or gross negligence)
- (iii) Termination by the firm without cause
- (iv) Death or disability

- (v) Staged termination (GP remains on existing boards for some time, is paid some consulting fee by the firm and may continue to vest)

#### D. Future participation in carried interest

- (i) Keeps vested portion of carried interest (at least if terminated by the firm without cause)
- (ii) Consider complete forfeiture of carried interest if terminated for cause
- (iii) Possible vesting penalty for voluntary resignation
- (iv) Possible acceleration if terminated without cause or in case of death or disability
- (v) Adjust future allocations/distributions to “true up” prior carried interest distributions vs. required repayment of excess distributions
- (vi) Ability to escrow future carried interest distributions to support possible general partner clawback

#### E. Capital commitments to general partners

- (i) Remaining commitment remains the same, is reduced by some fraction or is reduced to zero
- (ii) All future contributions made in cash (no further participation in deemed contribution mechanism)

#### F. Economic interest in management company

- (i) Interest in current income typically reduced to zero
- (ii) Will GP retain any declining share in capital proceeds if management company is sold?
- (iii) Capital account balance paid out (preferably over time)

#### G. Nonsolicitation and noncompetition provisions

- (i) Typically in force for one-two years
- (ii) Restrict GP’s ability to solicit employees to leave the firm or portfolio companies
- (iii) Restrict GP’s ability to solicit current or prospective limited partners to invest in a competing fund
- (iv) Restrict GP from working for a competing fund – how broad are restrictions?
- (v) Tie breach to loss of economic benefits (any severance, management company capital account payout and vested share of carried interest)
- (vi) Consider a “garden leave” clause, which requires 90–180-day notice of any resignation, during which the GP remains obligated to facilitate the transition
- (vii) Is GP a California resident? If so, noncompetition and nonsolicitation of customers potentially unenforceable. Discuss with California labor counsel.

#### H. Confidentiality provisions

- (i) Require GP to keep firm and portfolio company info in confidence and use only for firm’s benefit
- (ii) Perpetual – No time limit on enforceability
- (iii) Include return or destroy obligation upon termination
- (iv) Make sure confidentiality obligation covers track record
- (v) Tie breach of covenant to loss of economic benefits (any severance, management company capital account payout and vested share of carried interest)

#### I. Investor messaging

- (i) Ensure the New GP’s economic/governance rights are in line with the message
- (ii) Impact on key-man provisions

distribution of net profit should be reduced to take into account the value of the deemed contribution made on his behalf. Also, you should consider what steps should be taken to recover any deemed contribution amounts from the New GP if his subsequent performance proves disappointing and he is terminated.

Management company net profits The New GP probably will be offered an immediate share in the carried interest generated by one or more of the funds. Immediate participation in management company profits is less certain. Private equity firms routinely offer investment professionals at the GP, principal and even senior associate levels some participation in carried interest. But participation in management company profits is often reserved for a select few. As additional funds generate management fees, costs typically do not keep pace with rising revenue. As a result, management company profits can become a steady and lucrative income source for those given access to it. The Founder GPs may well want the New GP to serve some trial period with the firm before sharing in management company profits. However, the management company may implement a substantial discretionary or even a guaranteed minimum bonus to the New GP during this period to make the compensation package sufficiently attractive. In addition, this bonus arrangement may use deferral features to put in place “handcuffs” to help ensure that the New GP has the proper incentive to stay with the new firm.

When it is time for the New GP to participate in management company profits, the question then turns on how large a share he receives and in what types of profits. To date, the Founder GPs have shared profits equally – “share and share alike.” The New GP could be inducted into the management company as an equal, with net profits now split in equal thirds. Or, because the Founder GPs have been with the firm from day one and built the value of the business over time, the Founder GPs may argue for a proportionately larger share of profits, at least at the beginning. Shares of net profit need not be static, and the New GP’s share could increase over time as he builds seniority. The Founder GPs added the New GP to enable the firm to raise larger funds that generate more fees. As firm profits increase, the Founder GPs can give the New GP a larger share of the enlarged pie without sacrificing their own incomes.

You also could divide management company profits into separate pools. Fees generated from each of Fund I, Fund II and Fund III are assigned to individual pools. Management company expenses are then allocated across the pools until only net profit remains. The New GP might have an equal third of the Fund III pool, where he will be fully involved in fund formation and deal sourcing, but have a lesser share in the Fund II pool and maybe no share of the Fund I pool. This idea may appear attractive on paper, but conflicts of interest can arise regarding expense allocation. Do you allocate expenses across the pools based on revenues generated by the funds, or do you allocate expenses

based on the relative amount of company resources devoted to each fund? The methodology tied to resources used would overweight expenses to the Fund III pool, as the most active fund is likely to require the most firm resources. The methodology tied to revenues also may favor the new fund, since the older funds in wind down may no longer be generating management fees, particularly if transaction fees and other offsets reduced management fees.

The Founder GPs also may seek to preserve a long-term “tail” or interest in the management company profits even as they wind down their commitment and turn over the reins to the New GP and the next generation of management. The length and size of these “tail” arrangements vary, but they do involve a balancing between the Founder GPs’ claim to some royalty for having created a franchise and the concern of the next generation that they not be weighed down by the heavy “tax” of former partners no longer involved in the business.

To this point, we have only addressed the current income component of management compared profits. We still need to consider how to allocate capital profits if the management company is ever sold. You could allocate capital profits using the same formula used to allocate current income. However, capital profits are even more closely tied to long-term value creation than is current income. By virtue of their tenure, the Founder GPs have done far more to generate long-term value than the New GP. Accordingly, although the New GP may have a significant, even equal, share of current income, he could have a far smaller share of any capital profits, and Founder GPs may retain ongoing “tail” arrangements that allow them to participate in the proceeds from the sale of the management company even after a Founder GP may have sold his interest back to the company. Over time, the New GP will increasingly contribute to firm value, and eventually the value he’s created may be indistinguishable from that created by the Founder GPs. At that point, shares of capital profits probably should be closer to equivalent.

### A seat at the table: Participation in decision making

Like firm profits, firm decision making typically occurs at two levels: the fund level (within the individual fund general partners) and the enterprise level (within the management company). Firm personnel with decision-making authority may not be the same across these entities, and the requisite majorities may differ for various types of decisions. In practice, everyone may participate in major decisions and the firm operates by consensus. However, as the group expands and a clear consensus may not always be achieved, formal decision-making distinctions can become critical and thus deserve careful advance thought. The Founder GPs have a long history of working together, and the consensus model has worked well to date. Now that the New GP is entering the mix, accurately predicting how



the decision-making chemistry may change is, at best, problematic.

Fund decisions Decisions regarding each individual fund, including investment decisions, are technically made by each fund's general partner. General partners for U.S. funds are typically structured as either limited partnerships or limited liability companies. If structured as a limited partnership, the general partner will have its own general partner (typically a limited liability company), where all fund decisions are actually made. If the general partner is structured as a limited liability company, some but not all of the members may be designated as "Class A Members" or "Managing Members," who will make the decisions on behalf of the general partner and, by extension, the fund.

The New GP probably will be a managing member and part of the decision-making process for Fund III. However, this may not be the case for Fund II and Fund I. As the New GP may source some deals for Fund II, he may be admitted as a managing member of Fund II as well. His status as a managing member of Fund I is less likely. In this case, the Founder GPs sourced the deals, sit on the boards and know the portfolio. Certainly the New GP would participate in Fund I decisions as a practical matter. But the Founder GPs may keep the formal decision-making authority to themselves.

The next question is how to weight the decision-making process. The simplest formula is "one man, one vote" – each GP has an equal voice in fund decisions. Alternatively, firms can adopt weighted voting based on "percentage interests" (perhaps equivalent to relative shares of the carried interest). In this model, the Founder GPs may have higher percentage interests, and thus greater voting strength, than would the New GP. Firms that choose a weighted voting approach can engage in complex analysis to set the "right" percentages. For example, the two founding partners of a fund-of-funds opened up formal participation in fund decision making to the other partners, principles, the CFO and in-house counsel. However, the founders were loathe to let democracy pose too great an actual risk to their ultimate control. Accordingly, they set voting percentages so that if the two founders agreed on an issue, they could not be outvoted. Similarly, if the founders split on an issue, near unanimity among the other members was required to take action over the dissenting founder's objection.

When you had just the two Founder GPs, all decisions had to be unanimous. Now that the New GP has joined the mix, the question is, do you still require consensus? If you do, then any one GP can block an action. The New GP could effectively hold the Founder GPs hostage, with no easy way to break the deadlock except the "nuclear option" of terminating the New GP. If you decide to require only a two-thirds vote, you eliminate potential hostage situations. But then, each Founder GP has to face the possibility that he could be outvoted, where before his concurrence was required for any major decision.

Note that the requisite majority need not be the same for each type of decision. More mission-critical decisions may require higher majorities than routine decisions. For example, removing a GP as a managing member often requires unanimous consent of the other GPs, while removing a principle as a non-managing member would only require a simple majority.

Management company As was the case with the New GP's participation in management company profits, the New GP's participation in management company decision making may be delayed while the GPs get to know and trust each other. The Founder GPs undoubtedly welcome the New GP's expertise at the fund level, where investment decisions are technically made. Also, prospective investors enthused by the New GP's arrival will want him to participate fully in fund decision making. However, decisions made at the management company level can go to the heart of the firm's long-term strategy and vision. Accordingly, the Founder GPs may want to delay admitting the New GP into the inner sanctum, at least during some trial period.

Once the Founder GPs decide to admit the New GP to the management company, the potential decision-making alternatives are the same as discussed above: either "one man, one vote" or some weighted voting methodology that concentrates voting strength in the Founder GPs. Also, you can require different majorities for different categories of firm decisions. The Founder GPs could decide to reserve a subset of extremely sensitive decisions solely to themselves, at least for a while. The decision to sell the company or admit an additional GP to the management company, for example, could be reserved for the Founder GPs.

### "It felt so right. How did it turn out so wrong?"

We are all familiar with the sobering statistics on marriage – close to half of all marriages end in divorce. The odds of business partnerships lasting "until death (or retirement) do us part" are probably not much better. As a result, some of the most important issues to consider when a new GP joins the firm are what will happen if it doesn't work out. Broadly speaking, there are four potential types of GP terminations, and your planning should anticipate each as a distinct possibility: (1) voluntary resignation; (2) termination without cause; (3) termination with cause; and (4) phased withdrawal. GP terminations are almost always heavily negotiated. Your goal should be to have maximum leverage in these negotiations should you ever need it.

"That's it. We're through!" The first issue is a relatively straightforward one: Make sure you can terminate the New GP, if you want to, as a "no-fault divorce." The New GP should be unambiguously terminable with or without cause under the governing agreements of the management company and each general partner.

A few years ago, we advised a new client to revise their governing documents to provide that any GP could be

terminated without cause by the unanimous action of the other GPs. The client rebuked us that this was against the consensual philosophy of the partnership. Termination for cause was OK, but otherwise no GP should be forced out of the partnership against his or her will. Some time later, the client wanted to terminate a GP who was guilty of lackluster performance, but nothing that rose to the level of cause. Hopefully, this GP would agree to go quietly, having lost the confidence of his partners. He didn't, and the firm was left with no contractual means to force a termination. The situation ultimately ended in litigation. After it was finally settled, the client instructed us to revise all their governing agreements to permit termination of any GP with – or without – cause.

Even the provisions governing a termination for cause need to be dealt with properly. This involves having a broad and acceptable definition of cause that will pick up material violations of firm policy and activity that could have a material adverse impact on the firm's standing or reputation, in addition to the more traditional "bad acts" such as conviction of a crime, willful misconduct and others. Also, the provisions should allow for the firm to retain the right to determine if conditions existed for cause after the New GP has been terminated (referred to as "after-acquired evidence"). This would cover situations where the New GP leaves with vested carried interest and the firm later discovers that he had engaged in bad acts and should have been terminated for cause, had such acts been known at the time of departure.

Once the New GP is terminated, his decision-making authority at the management company and the fund level ceases immediately. What becomes of his economic interests, however, can be the subject of intense negotiations and requires careful planning.

Economic interests in the general partners The New GP's interest in each of the general partners will be subject to vesting schedules, as discussed above. Upon termination, vesting typically stops, and any unvested carried interest is forfeited and reallocated among the remaining partners. However, the type of departure may determine how the vesting formula is applied.

If termination is for cause, many firms will reduce vested carried interest to zero and force the New GP to sell back his remaining interest to the firm at a heavily discounted price. Since "cause" generally applies to identifiable "bad acts," the New GP's actions probably have damaged the firm, or at least caused considerable embarrassment. Thus, it is hard to argue that a harsh penalty for conduct constituting cause is somehow unfair. Similarly, some firms impose a vesting penalty if the New GP voluntarily resigns to take on a new position. Although the New GP has not engaged in "cause" behavior that affirmatively damaged the firm, he has bailed out on his partners, imperiled investor relations, perhaps triggered a key-man provision and, in general, left the firm in the lurch. In this case, it also is probably reasonable to apply some economic penalty.

On the flip side, the New GP may try and negotiate some acceleration of vesting in case of a termination without cause. The New GP may be as wary of his new partners as the Founder GPs are of him. He may want some downside protection in case the Founder GPs simply have a change of heart and don't want him around any more. In addition, some firms may accelerate vesting in cases of death or permanent disability. Ultimately, it is a question of firm culture as to whether the remaining GPs want to provide such a benefit to the family that the departed GP leaves behind or is no longer able to support.

When a terminated GP's share of the carried interest is reduced, you should consider what to do if carried interest has already been paid before the termination date. Firms typically pay out carried interest as though a GP were fully vested (although some firms will deposit unvested carried interest in an escrow account). Suppose the New GP has a 20% share of the carried interest and is terminated when 50% vested. Going forward, his interest in the carried interest is reduced to 10%. But if carried interest had already been paid out at the 20% rate, the New GP would receive, in aggregate, more than 10% of the carried interest at the end of the day. The firm may decide to simply accept this possibility as a sunk cost. However, it also can reduce subsequent allocations and distributions of carried interest to "true up" the prior distribution that was made at the 20% rate – if the general partner agreement includes such a provision. This approach is not a perfect fix if the fund lacks sufficient future profits to complete the true up. For additional protection, you can provide for mandatory repayment of excess carried interest at the time of termination. This alternative is less common, but can increase leverage in termination negotiations if the New GP not only faces loss of income on a going-forward basis, but also a repayment obligation.

Finally, consider adding the contractual ability to retain the New GP's carried interest distributions in an escrow account after termination. The fund may be subject to a general partner clawback at liquidation if the general partner has received excess carried interest from the fund. Once the New GP has severed ties with the firm, it may be difficult to collect his share of the clawback from him, even if he is contractually obligated to pay it. As a result, the Founder GPs may need to cover the New GP's share of the clawback out of their own pockets, either because they agreed to joint and several liability for any clawback or to protect the firm's reputation.

Although the New GP's share of the carried interest may receive the most focus, you also should consider what happens to the New GP's capital commitment if he is terminated. There are basically three options: The New GP's remaining capital commitment stays the same; the New GP's remaining capital commitment is partially reduced by some pre-determined formula; and the New GP's remaining capital commitment is simply reduced to zero. If the New GP retains some or all of his remaining commitment, he typically will lose the

ability to make future deemed contributions. All future contributions would be made in cash.

Requiring that the New GP fund the full balance of his commitment in cash probably gives the firm maximum leverage in termination negotiations. The New GP may want the commitment reduced, either because he lacks the cash flow to fund it or because he simply wants to sever ties with the firm and move on. His only alternative to a negotiated reduction would be to default on a capital call, in which case you typically could extinguish his entire general partner interest as a default penalty.

On the other hand, if the fund looks like a winner, the Founder GPs may want to take over the New GP's remaining commitment to put more of their own capital to work. To get the best of both worlds, consider providing that a terminated GP's commitment is not reduced and must be paid in cash – unless the remaining GPs, in their sole discretion, decide to reduce it.

Economic interest in the management company Upon termination, the New GP's interest in management company net profits probably would be reduced to zero, and whatever remaining balance in his capital account is paid out. With respect to the capital account balance, you probably want to provide that the balance would be paid out over an extended period to avoid a large lump-sum payment obligation. Also, consider providing for some discount (or even complete forfeiture) of the capital account balance if the termination was for cause or a voluntary resignation to work for a competitor.

The New GP's share of enterprise value after termination could be an open negotiation point. Suppose the New GP were terminated without cause, and the management company were sold immediately thereafter. As a result you may see some residual value clause built into the management company agreement providing that, upon termination without cause, the former GP retains some share of sale proceeds that would then ramp down over time.

Nonsolicitation and noncompetition provisions During the New GP's tenure, he will build relationships with firm and portfolio company employees and with firm investors. The contacts and acumen that attracted you to him in the first place could make him a formidable competitor for deal flow and investor commitments if he jumped to another firm. In summary, the boost the New GP gave the firm during his tenure may be quickly offset by the damage he can do after he leaves. Accordingly, private equity firms increasingly require GPs to sign strict investor and employee nonsolicitation and noncompetition covenants, which restrict the former GP's activities following termination for typically one to two years. These provisions also are buttressed with broad confidentiality provisions that prevent a departing GP from using track record and other financial and investment data to solicit new investors and/or compete against his old firm.

Nonsolicitation provisions protect relationships with employees and investors The New GP would be prohibited from soliciting any employee of the firm or portfolio company to leave his or her employment, and many times the clauses go further to prohibit the hiring of the protected class, even if there is no solicitation by the New GP. Similarly, the New GP would be prohibited from soliciting the firm's limited partners (current or prospective) to invest in any other private equity fund. Noncompetition provisions go further, and are somewhat less common. Under a noncompetition provision, the New GP cannot work for another private equity firm or other business his former employer would consider a competitor.

The actual scope of these provisions can be heavily negotiated when they are put in place. Similarly, their application can be heavily negotiated at termination. The terminated GP probably does not want to be kept out of the market for one to two years, and to the extent you have put tough nonsolicitation and noncompetition provisions in place you can significantly increase your leverage. If these provisions are breached, the firm typically can (i) seek injunctive relief to stop the alleged solicitation or competition, and (ii) impose economic penalties, such as terminating severance payments or participation in carried interest.

However, you need to tread carefully when putting these provisions in place to ensure they will be enforceable when you need them. Nonsolicitation and noncompetition provisions are governed by state law, which can vary widely from state to state. In general, these provisions may not be enforceable (or may be enforced for shorter periods of time and/or with narrower provisions) if viewed by a court as overly broad restraints of trade that go beyond what is necessary to protect against the disclosure of trade secrets or the goodwill that the firm has developed with its investors and instead unreasonably preclude the New GP from earning a living in his chosen field.

In some states post-termination restrictions are not enforceable, or enforceable only to a limited degree. Consider the situation that would arise if the New GP is assigned to open the firm's new California office. Section 16600 of the California Business and Professional Code provides that "[e]xcept as provided in this chapter, every contract by which anyone is restricted from engaging in a lawful profession, trade, or business of any kind is void." As a result, a California court will not enforce a noncompetition provision against an employee working and living in California, either with injunctive relief or money damages, even if the resident signed a noncompetition agreement and even if the restrictions are narrowly tailored. Just recently California's highest court rejected efforts to limit competition that stopped short of blanket noncompetition agreements and held it illegal under California law to prohibit the solicitation of investors.

There is a narrow exception under California law, however, if the New GP has agreed, in connection with



becoming a member or partner in the general partner and/or management company, to be subject to a noncompetition provision in connection with his withdrawal from the firm in return for the buyout of his economic interests. This exception requires careful drafting of the underlying firm documents.

California courts probably are more likely to enforce a “no raid” provision protecting against the hiring of employees, and will protect against the misappropriation of trade secrets and confidential information, including track records.

You can still structure the economic arrangements with the New GP to have a deterrent effect on a terminated GP, even in light of Section 16600. If the original grant of carried interest provided that it would be forfeited upon post-termination competition, a California court probably would enforce the provision.

Garden leave/Notice provisions Even if noncompetition provisions are difficult to enforce, another technique can protect the firm from the New GP hastily departing. The terms of the offer letter with the New GP, or the membership provisions of the underlying operative documents, could provide that the New GP give the firm advance notice (e.g. 90 to 180 days) prior to departing. During this “garden leave”/notice period, the New GP would be expected to continue with his responsibilities, as such responsibilities are set forth in the operating agreements, and assist the firm in transitioning matters.

Confidentiality provisions During his tenure, the New GP also has learned the inner workings of your business and many of the portfolio companies and the firm’s “track record” associated with fund investments. Much of this information is a closely guarded trade secret, which could damage the firm or its portfolio companies if it were made public. As a result, private equity firms increasingly require GPs to sign confidentiality agreements that require the GP to keep nonpublic information in strict confidence and to use such information solely for the firm’s benefit. Typically, you would also include a requirement that the terminated GP return or destroy any confidential information in his or her possession at termination. Confidentiality provisions also can increase firm leverage to the extent they prohibit a terminated GP from disclosing his investment track record.

The typical remedies for a breach of a confidentiality agreement are the same as for a breach of the nonsolicitation and noncompetition agreement provisions discussed above: an injunction to halt the disclosure and imposition of economic penalties.

### “I now pronounce you ... GP and GP.”

The diligence calls have been made, the agreements negotiated and the champagne corks popped. Now, you can get back to drafting that press release you were thinking about in the first paragraph. Good news

is always the easiest news to communicate to your investors, but in a skeptical market you can expect investors to peer beneath the cover of the press release.

First, investors probably will ask about the economic arrangements between the Founder GPs and the New GP. Although you can argue that these are confidential, the tight fund-raising market makes it virtually untenable to duck transparency with your investors. Make sure the economic and control arrangements with the New GP harmonize with your message: If you market the New GP as the rock star who will bring the team to the next level, investors will probably expect to see some equivalence with the Founder GPs in terms of compensation and decision-making authority. If there is a disconnect and the New GP is not perceived as being treated as an equal, investors may question whether he is being inadequately compensated (in which case he could leave) or whether he is really as impressive as you say he is. If he’s really a rock star, he could hold out for better terms.

Second, how do you position the dynamics of the new team to your maximum advantage? In Fund I and Fund II, it was just the two Founder GPs. These funds may well have tight key-man provisions that are triggered if either of the Founder GPs leaves. Any key-man provision that requires the continued health and loyalty of just one person is risky for the firm. Now you have added to the bench strength and may be in a position to negotiate a more favorable key man for Fund III, which might require two of three of the GPs to depart as a trigger. However, key-man provisions today are hotly contested between investors and the sponsors. Convincing investors that one or both of the Founder GPs are not still the key rainmakers that investors have bet on may be a hard sell.

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