

# At the negotiating table: Ts & Cs that require attention

What are the focal points during private fund negotiations today?

**Proskauer** lawyers **Michael Suppappola**, **Edward Lee**, **Lewis Phillips** and **Andrew Shore** dissect key private equity terms receiving careful scrutiny



**The fine print:** fees and fund extensions are key talking points

Throughout the years, private equity fund limited partners have sought to align interests with general partners through the good faith negotiation of private equity fund limited partnership agreements and other governing documents. The relationship between LPs and GPs has continually shifted as market conditions and the private equity industry have evolved.

During the global financial crisis of 2007-2009 and subsequent recession, severe economic headwinds resulted in a very difficult fundraising environment for many GPs. During this time and for a number of years thereafter,

the “pendulum” of negotiating leverage shifted sharply in the direction of LPs, culminating in the publication of the first version of the “ILPA Private Equity Principles” in September of 2009. Although a number of oversubscribed GPs with distinguished track records were able to push through this period relatively unscathed, many other GPs were no longer in a position to dictate terms.

However, in the more robust post-recessionary fundraising environment, the fundraising pendulum has begun shifting back to a wider group of general partners that have exhibited a consistent ability to procure strong returns.

Regardless of the state of the market, there are several economic and governance terms that remain a continual focal point for LPs when reviewing and negotiating fund agreements. Here are our top nine:

## Management fees

A private equity fund’s management fee is generally utilized to support the fund manager’s overhead and operating costs, such as salaries, employee compensation, benefits, rent and office equipment. Most private equity funds calculate management fees during the fund’s “commitment period” based on a percentage of the fund’s committed capital, with post-commitment period fees calculated by reference to the acquisition cost of unrealized investments. The fee percentages are driven largely by fund size, the breadth of a GP’s back-office operations and, to a certain extent, strategy. Top-performing GPs have generally been able to resist recent LP pressure to reduce management fee levels.

However, in light of the growing number of funds that remain in existence long past their stated terms, LPs have increasingly focused their attention on management fee payments following a fund’s initial term (typically 10 years) in an effort to ensure that GP/LP interests remain aligned in the later years of a fund’s life. Accordingly, LPs have increasingly requested that GPs place limitations on how long the GP can extend the term of a fund (typically by requesting that LPs or LP advisory board representatives approve term extensions beyond a certain time horizon) and the amount of management fee that is subsequently payable during a fund’s liquidation period.

Although many GPs have successfully resisted LP pressure to reduce management fee levels, a continued focus on the amount of transaction fees and

other portfolio company remuneration received by the GP and its affiliates that will offset the management fee has recently seen a shift in favor of the LPs, with many funds moving to a 100 percent offset. Additionally, recent regulatory scrutiny regarding the collection and retention of such fees by the certain consultants, advisors and operating partners has resulted in increased disclosure and transparency around such arrangements.

Finally, many GPs desiring to expedite fundraising efforts in recent years have successfully implemented “early closer” management fee discounts, which provide investors with an incentive to commit capital at or near the fund’s initial closing. Volume discounts, whereby an investor pays a reduced percentage of management fee when committing above a certain tier of capital, have also become increasingly popular for GPs wishing to incentivize LPs to make additional commitments.

### The waterfall

While “2 and 20” remains the general guidepost for private equity management fee and carried interest, there has been an increasing amount of bifurcation in the industry with respect to the structure of distribution waterfalls. Some GPs have been required to give up their historic “deal-by-deal” carried interest structure (whereby carried interest is generally collected based on the performance of individual realized investments) for a more LP-favorable “whole fund” model (whereby carried interest is generally collected only after a return of all capital contributions plus a preferred return). With respect to GPs who have retained deal-by-deal waterfalls, LPs have increasingly demanded additional interim clawback calculations and/or escrow mechanisms to address investor concerns regarding over-distribution of

carried interest to the GP prior to the fund’s liquidation period.

At the other end of the market, top-tier GPs have not only retained their deal-by-deal carried interest but have also introduced “premium carry” waterfalls, whereby the GP receives a higher carried interest percentage (e.g., 25 percent to 30 percent) if the fund meets certain IRR, NAV or other performance objectives. The increasingly wide disparity in waterfall structures is largely the result of a maturing marketplace.

The balance of power in negotiating these key economics is largely determined by the supply and demand for allocations to a particular fund. As a result, GPs who have outperformed their peers and have not sought to substantially increase their fund size in recent

years often have stronger negotiating positions than others.

### Fund size & GP commitment

An increase in a private equity fund’s size also tends to lead to an increase in the size of the GP’s team, and LPs continue to focus on ensuring a strong GP/LP alignment with respect to the GP’s capital commitment to a fund. In recent years, the market has witnessed a general increase of the percentage that the GP’s commitment represents of third party commitments to the fund. When assessing fund size and the GP’s commitment, LPs may also focus on additional key factors such as whether the fund has a “hard cap” on the amount it may raise, use of leverage, the size of the team, team succession matters, and increased internal regulatory costs.





### Key person clauses

Key person clauses are one of the most highly negotiated provisions in a fund agreement. The actual key person event trigger (i.e., the number and nature of the key persons who must abide by the requisite time devotion standard) will depend on the structure of the particular GP's team and business. The time devotion required of the key persons should accurately and fairly reflect those persons' responsibilities to the GP's general business and other investment products. It is increasingly common for individual key persons to be subject to different time and attention requirements.

When triggered, key person provisions typically result in the suspension of the investment period. LPs will often look for the suspension to be automatic

rather than requiring an advisory committee or investor vote, but this may depend on the circumstances of the trigger. There may also be some discussion regarding the GP's permitted activities during a suspension. Although a suspension period will typically result in a prohibition on investments in new portfolio companies, some investors will push for additional limitations (such as limitations relating to follow-on investment activity) and/or advisory board oversight functions.

When reviewing general investor protection provisions on a holistic basis, an LP's comfort level with the key person standard will typically impact negotiations around other protections, from seeking potential "no fault" suspension of the investment period with an investor vote to potential "no fault"

**Fund negotiations:** Successor funds a point of interest

and "for cause" removal and/or dissolution votes.

### GP removal rights

Provisions giving investors the power to remove the GP are increasingly common. Negotiations surrounding potential removal rights will often focus on (i) whether the GP may be removed "for cause" and/or on a "no fault" basis; (ii) the types of bad acts and other events that may trigger a "for cause" removal; (iii) the voting threshold to trigger the removal; and (iv) the result of removal on the GP's capital commitment and carried interest. In some situations, the fund agreement may require the newly appointed replacement GP to purchase the removed GP's interest at a certain appraised value, and often at a discount in the event the GP is removed "for cause."

Focal points for negotiations between the GP and LPs over what amounts to "cause" will include the relevant persons whose conduct will be considered (e.g. the manager, GP, key persons, etc.), certain materiality standards, and the type of court decision required to trigger removal.

As an alternative or supplement to GP removal rights, LPs may also consider requesting the right to commence an early dissolution of the fund, either on a "no fault" or "for cause" basis.

### Term and extensions

The traditional model for a private equity fund provides for a fixed term of approximately 10 years, plus up to 2-3 extensions of one year each. There are often variations to this model depending on the fund's strategy and the types of assets that the fund is acquiring. For

example, debt funds may feature shorter terms and infrastructure funds typically have longer lifespans.

Following the financial crisis, many private equity funds found it increasingly difficult to sell certain assets that were purchased during the early part of the decade. These difficulties have resulted in a large number of funds that are out of term extensions but still retain a handful of remaining assets that cannot be sold at a desirable value. In light of these issues, some LPs are taking a pragmatic view on negotiating the basis on which a fund's term may be extended, preferring sales at an appropriate time over a premature forced liquidation. As noted above, LPs are increasingly focused on the level of management fees paid during any extension and during liquidation.

Some GPs are now contemplating longer terms for newer funds in an effort to mitigate these issues on a go-forward basis. Moreover, the inability of GPs to efficiently liquidate existing funds combined with increased LP pressure regarding liquidity has recently led to the increased prevalence of complex secondary restructurings of end-of-life funds.

### Successor funds

LPs will want to ensure that each GP they invest with spends an appropriate period of time investing their capital and not end the search for new investments prematurely. The key persons are typically permitted to dedicate time to a successor fund within their time commitment obligations, and therefore a restriction on when a successor fund can be raised is important. GPs will typically want to ensure that any restriction on raising a successor fund is only tied to products with a substantially similar strategy, particularly larger GPs that may manage

multiple funds with a large disparity in investment strategies and/or investment teams.

Successor fund restrictions are often based on when a certain percentage of total commitments have been made by the fund (i.e., a successor fund is typically permitted when a substantial amount of the fund's capital is invested and/or reserved for follow-on investments or expenses). LPs will also typically request that a fund's management fee "ramp down" to the post-investment period formulation when a successor fund is raised.

### Conflicts & allocations

A GP may manage multiple funds making new investments at the same time, such as successor funds and managed accounts. To the extent that multiple funds or accounts have an overlapping

“The fundraising pendulum has begun shifting back to a wider group of GPs that have exhibited a consistent ability to procure strong returns”

investment strategy, the GP may be faced with allocation conflicts. For example, should a new investment be allocated to the prior fund, the successor fund, or proportionally to both funds? Should follow-on investment opportunities be solely allocated to the fund(s) that previously invested in the related portfolio company? Even if a prior fund is no longer making new investments and/or no longer has capital to make a

follow-on investment, fund agreements may permit a successor fund sharing the same investment strategy to make "cross-over" investments in a portfolio company of the prior fund.

The typical forum for resolving such conflicts is the fund's LP advisory board. LPs have sought increasing transparency regarding conflicts in recent years, and many LPs will request that the GP have a stated allocation policy when investing on behalf of multiple accounts with similar strategies.

### Side letters and most-favored nation

Side letters have become a burdensome but necessary aspect of the fundraising process for GPs in recent years. LPs with considerable capital commitments may seek protection against the general partner agreeing to preferential terms with other investors through receipt of a "most-favored nation" provision, which would require the GP to provide (and, in some cases, offer) to the LP certain side letter provisions the GP has agreed to with other investors. The MFN may be included in the LPA, although is more typically negotiated with individual investors. MFN rights will also typically be subject to certain carve-outs, so that terms relating to, for example, advisory board seats or an investor's specific regulatory or tax status are not available to all investors. In addition, GPs will often seek to limit the MFN so that investors may only obtain the benefit of provisions given to investors with the same or smaller commitments. Oversubscribed GPs may seek to eliminate side letters altogether. ■

*Michael Suppappola is a Boston-based partner in Proskauer's Private Investment Funds Group, while Proskauer associates Edward Lee, Lewis Phillips and Andrew Shore are based in the same practice in London.*