ILPA Private Equity Principles

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While the pace of private equity capital-raising has slowed dramatically over the last year, there has been an enhanced focus on fund terms by private equity fund investors ("Limited Partners"). In September 2009, the Institutional Limited Partners Association (the "ILPA")\(^1\), a private equity industry association, published a set of principles, the “ILPA Private Equity Principles,” that is intended to restore and strengthen the alignment of interest between Limited Partners and their private equity fund sponsors ("General Partners"). The concepts proposed by the ILPA are suggested best practices and are intended to serve as a basis for discussion between General Partners and the Limited Partners. In addition, Appendix A to the ILPA Private Equity Principles sets forth certain private equity preferred terms, and Appendix B sets forth certain recommended practices and duties of Limited Partner advisory committees. General Partners are not bound by these concepts but we expect that the Limited Partners will use (and in fact are using) them as a benchmark during any negotiation they will have with the General Partners. The principles were developed through the collaborative efforts of many institutional private equity investors and their senior investment officers, the ILPA, and the Private Equity Principles and Best Practices Committee of the Board of Directors of the ILPA.

The ILPA Private Equity Principles focus on three principal objectives: (i) alignment of interests between General Partners and Limited Partners, (ii) General Partner governance, and (iii) transparency to Limited Partners. Set forth below is a summary of the ILPA Private Equity Principles, together with a selection of preferred private equity terms from Appendix A and recommended practices from Appendix B to the ILPA Private Equity Principles which support the relevant principles.

Alignment of Interests

1. Limited Partners should obtain tighter distribution provisions in limited partnership agreements to avoid "carried interest" clawbacks. Specifically, in order to align the interest of a General Partner and the Limited Partners, portfolio-wide distribution waterfalls (i.e., all contributions plus preferred return should be returned first before the General Partner receives any carried interest), instead of a deal-by-deal distribution model, and/or escrows of all or part of the carried interest should be used to avoid clawbacks.

2. To the extent that a deal-by-deal distribution model is used and a clawback is required, the limited partnership agreement should provide that the clawback amount should be paid fully and promptly by those who receive carried interest payments. Preferred private equity terms to support this principle include the following concepts:

   • The portion of the cost for investments that have been partially impaired or written off and all fees and expenses (instead of a pro rata portion of fees and expenses for exited deals)
should be returned to Limited Partners prior to the General Partner receiving any carried interest.

- For purposes of the distribution waterfall, all unrealized investments should be valued at lower of cost or fair value.
- All or part of the carried interest earned by the General Partner should be placed in an escrow account with significant reserves (i.e., 30% of carry distributions or more).
- Carried interest should be calculated on net profits and on an after-tax basis and should not accrue on current income.
- A General Partner should determine the amount of its clawback and disclose to the Limited Partners such amount as of the end of every quarter with a plan to resolve the clawback. Furthermore, all clawback liabilities should be gross of taxes paid by the recipients of the carried interest. All clawback liabilities should be paid back to the fund by the recipients of the carried interest within two years after the recognition of such liabilities. Carried interest recipients should be liable for all clawbacks on a joint and several basis.

3. General Partners should have a substantial equity interest in the fund and such interest should be funded primarily with cash rather than an offset of management fees. Furthermore, principals of a General Partner should be restricted from transferring their interest in the General Partner in order to ensure alignment with the Limited Partners. Additional provisions to align the interests of partners include:

- Key personnel should devote almost all of their business time to the fund. The General Partner and its principals should not be allowed to close another fund with substantially similar investment objectives and strategies until after the fund’s investment period has ended or after a significant portion of the fund’s capital has been called.
- The General Partner should be prohibited from investing in opportunities that are appropriate for the fund through other vehicles unless such investment is made on a pro-rata basis under co-investment arrangements established and disclosed to the Limited Partners prior to the close of the fund.

4. Management fees charged by a General Partner should be limited to an amount that is required to cover normal overhead expenses of the General Partner. The recommended terms to support this principle include the following:

- A fee model for the fund should be provided to potential investors.
- Management fees should be based on all reasonable operating expenses of the General Partner, which should include overhead, staff compensation, travel, and other general administrative items as well as interactions with the Limited Partners.
- There should be a step down for management fees upon the formation of a successor fund and at the end of the investment period.
- An advisory board consisting of representatives of the Limited Partners (an "Advisory Board") should review fund expenses annually.
- The General Partner should be responsible for placement agent fees and insurance of the General Partner.
5. All transaction and monitoring fees charged by the General Partner should accrue to the benefit of the fund. A related preferred term is the offsetting of all of such fees against management fees and partnership expenses over the life of the fund.

6. All fees and carried interest earned by a General Partner should be directed predominantly to the personnel working on the fund.

7. The Limited Partners should not bear any tax expense associated with any new tax law that personally affects principals and employees of the General Partner.

**Governance**

8. The limited partnership agreement of a fund should reinforce the General Partner’s duty of care. Provisions that reduce a General Partner’s fiduciary duties, allow a broad waiver of conflict of interests, permit the General Partner to exercise its sole discretion to the detriment of the Limited Partners, or permit the General Partner to weigh its own self-interest against those of the Limited Partners should be avoided. The “gross negligence, fraud, and willful misconduct” indemnification and exculpation standard should be the minimum standard. The relevant preferred terms include the following:

- The Limited Partners should be able to remove the General Partner for bad acts upon preliminary determination, not by a final non-appealable court decision. The termination of the employee responsible for such actions should not be a cure of such bad acts.
- A General Partner should not be exculpated or indemnified for liabilities arising from its material breach of the limited partnership agreement and other governing documents of the fund, breach of fiduciary duties, or other “cause” events.
- Indemnification of a General Partner and its affiliates should be capped as a percentage of the size of the fund.
- The Limited Partners should require the disclosure of events affecting the ability of a principal of the General Partner to meet his or her obligation to the fund and a discussion of such events with the Advisory Board.
- The consent of a supermajority in interest of the Limited Partners should be required for any amendment to the limited partnership agreement of the fund.

9. A supermajority in interest of the Limited Partners should have the right to dissolve the fund or remove the General Partner without cause, and a majority in interest of the Limited Partners should have the ability to terminate or suspend the investment period without cause.

10. Advisory Board meeting processes and procedures should be standardized. The limited partnership agreement should provide for the following:

- The General Partner should present all known conflicts to the Advisory Board and seek prior approval for any material conflicts or affiliated transactions, including cross-fund investments.
- Formation of an Advisory Board:
Concurrently with each closing, the General Partner should distribute a list of the members of the Advisory Board (including their contact information) to all of the Limited Partners, with any subsequent update as necessary.

The Advisory Board should generally comprise seven to eight representatives of the Limited Partners (up to 12 members for larger funds), representing a diversified group of investors. The General Partner should also offer non-voting observer seats to certain Limited Partners.

Any change to the composition of the Advisory Board should be made only by mutual consent of the Advisory Board and the General Partner, with timely notification to all of the Limited Partners.

The General Partner should establish voting thresholds and protocols, including a quorum of 50% of Advisory Board members when votes are required.

Members of the Advisory Board should not receive any compensation from the General Partner or the fund, but should be reimbursed by the fund for their reasonable expenses relating to Advisory Board matters.

Meeting procedure of an Advisory Board:

Advisory Board meetings should be held in person at least twice annually.

Any two members of the Advisory Board should have the right to call for a meeting.

The General Partner should send to each member of the Advisory Board at least 10 days prior to a meeting a summary of any matter that requires the consent of the Advisory Board. The Advisory Board should have the right to request the General Partner to send such matter to all of the Limited Partners for consent even if the limited partnership agreement allows the Advisory Committee to make the decision.

The General Partner should provide notice regarding decisions made by the Advisory Board to all of the Limited Partners within a reasonable time after the decision has been made.

The Advisory Board should be able to access the independent auditors, advisors, and legal counsel of the fund at the expense of the fund or the General Partner.

Members of the Advisory Board should be indemnified by the fund.

The General Partner should promptly make available voting records of the Advisory Board upon request of a member of the Advisory Board.

11. The General Partner should incorporate time and industry diversification in its investment strategy (unless it is an industry-focused fund).

12. Investments made by the fund should be consistent with the investment strategy described by the General Partner to the Limited Partners during fund raising. Specifically, the limited partnership agreement should contain the following terms:

- The purpose section of the limited partnership agreement of the fund should narrowly describe the investment strategy of the fund.
• The General Partner should disclose any change to the investment strategy of the fund to the Limited Partners, and such change should require the approval of a supermajority of the Limited Partners.

13. The investment period of the fund should be suspended automatically upon the occurrence of a “key-person” or “for cause” event. An affirmative vote of at least a majority in interest of the Limited Partners should be required to reinstate the investment period.

14. The auditor of a fund should be independent and should act in the best interests of the fund and not the General Partner. The ILPA recommends the following terms:

- A fund’s external auditor should not perform other services for the General Partner and/or its affiliates if practicable.
- A change in the independent external auditor of a fund should require the consent of its Limited Partners.
- The income allocations and distributions of a fund, the balance of capital accounts, and the amount of expenses (including management fee) and carried interest should all be reviewed and certified by an external auditor as being consistent with the limited partnership agreement.

Transparency

15. Management fee and carried interest calculations should be subject to the Limited Partner and independent auditor review and certification. In particular, all fees, including transaction, financing, monitoring, management, and redemption fees, earned by a General Partner should be disclosed in each audited financial report and with each capital call and distribution notice.

16. Detailed valuation and financial reporting with respect to portfolio companies should be made available to the Limited Partners on a quarterly basis. The limited partnership agreement of a fund should provide for the following:

- The General Partner should provide an annual report to the Limited Partners within 75 days of the fiscal year end, which includes audited financial statements, internal rate of return calculations, the aggregate amount carried interest received, breakdown of fees received by the General Partner, and fund expenses.
- The General Partner should provide a quarterly report to the Limited Partners within 45 days of the end of a quarter, which includes unaudited quarterly profit and loss statements, schedules showing changes from the previous quarter, and information on material changes in investments and expenses.
- The General Partner should provide a quarterly report on each portfolio company, which includes the amount of original investment (including loans and guarantees), the amount of follow-on investments, a discussion by the General Partner of recent key developments regarding such portfolio company, and certain financial information such as valuation, revenue, amount of debt, EBITDA, amount of profit and loss, and cash position and burn rate.

17. There should be enhanced disclosure regarding a General Partner. In particular, a General Partner should fully disclose the following:
• To prospective investors – the economic arrangement among the General Partner, its principals and any other third-party investors in the General Partner, the organizational structure of the General Partner and its affiliates, the economic arrangement between the General Partner and any placement agent for the fund, and any inquiries by the Securities and Exchange Commission or any other regulatory bodies.

• To its Limited Partners – any material activities of its affiliated entities, including formation of publicly listed vehicles, sale of ownership of the management company, public offering of shares in the management company, and formation of other funds dedicated to alternative strategies.

18. The fund and its partners should protect proprietary information from public disclosure.

19. In addition, the ILPA recommends that a General Partner should include the following information in the fund’s marketing materials:

• Valuation for each unrealized portfolio company in previous funds sponsored by the General Partner.

• A justification by the General Partner of values that are different from those in the audited statements.

• A summary of any pending or threatened litigation.

• Performance information for other funds sponsored by the General Partner using both IRR calculation and multiple of invested capital model (including net of fee performance).

• Whether the General Partner provides any performance information for any standard private equity benchmark calculation.

• Any political contribution made by placement agents, the manager, or any associated individuals to trustees or elected officials on investor boards.

The ILPA does not intend to set the market norm for fund terms with the principles summarized in this client alert. It merely intends for these principles to serve as a basis for discussion between General Partners and Limited Partners. It is contemplated that investors and their legal counsel will advocate that these principles are best practices and that these preferred terms support such best practices and will advocate their use during negotiations. Many of these best practices and preferred terms are in practice (at least in some combination) in many private equity funds today. However, Limited Partners should anticipate that General Partners may not be amenable to implementing some of these principles and preferred terms, including using a portfolio-wide distribution waterfall instead of a deal-by-deal distribution waterfall, having joint and several clawback obligations of the carried interest recipients, and allowing no fault removal of the General Partner, particularly where the General Partner has a successful track record and has not historically adopted such terms.
If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 The ILPA has more than 200 institutional participants, that collectively manage approximately $1 trillion of private equity assets, and has an executive committee comprised of senior professionals from institutional investors from the United States and Canada.