

ILPA Private Equity Principles 2.0

BY THE INVESTMENT MANAGEMENT & PRIVATE INVESTMENT FUNDS PRACTICES

In January 2011, the Institutional Limited Partners Association, a private equity industry association ("ILPA"), released an updated version of its Private Equity Principles, setting forth its recommendations for private equity fund best practices and principles (the "Updated Principles"). ILPA initially released its Private Equity Principles in September 2009 (the "Original Principles") to encourage discussions between limited partners and general partners of private equity funds regarding key principles of such funds. During 2010, ILPA solicited feedback from general partners and limited partners in order to refine the Original Principles. With the Updated Principles, ILPA has sought to clarify and expand on certain concepts in the Original Principles. This Client Alert summarizes some of the substantive revisions that ILPA made in the Updated Principles to the Original Principles.

The Updated Principles continue to focus on the three principal objectives that were introduced in the Original Principles, namely, (i) alignment of interests between general partners and limited partners, (ii) governance, and (iii) transparency to limited partners. However, ILPA has now revised some of its recommendations in the Original Principles. The Updated Principles include three appendices which provide detail on specific topics of broad relevance or great complexity and which are intended to be subordinate to the more general principles set forth in the Updated Principles. Appendix A of the Updated Principles contains a discussion on certain recommended practices and duties of a limited partner advisory committee (the "LPAC"), and is a redrafted version of the original Appendix A attached to the Original Principles. Appendix B is new, and it covers best practices with respect to general partner clawbacks. Appendix C discusses best practices with respect to financial reporting.

I. Alignment of Interest

A. Carried Interest Clawbacks

One of the most substantive changes in the Updated Principles relates to carried interest clawbacks. While ILPA has retained its preference for the portfolio-wide distribution waterfall model to minimize excess carried interest distributions to general partners, the Updated Principles expand on ILPA's guidelines with respect to the deal-by-deal distribution waterfall model to include (i) a NAV coverage test of at least 125%, and (ii) interim clawbacks periodically and upon specific events (e.g., a key person event or insufficient NAV coverage).

The Updated Principles also recommend that general partner clawbacks be net of income taxes¹. In addition, the Updated Principles recommend that clawback contributions by general partners should be made "fully and timely" rather than within two years after the recognition of the liability as provided in the Original Principles, and that general partner clawback obligations should extend beyond the term of the fund to cover any provision for limited partner giveback of distributions.

Further, the ILPA principles continue to recommend that clawback liabilities extend to the members of a general partner on a joint and several basis. If joint and several liability is not provided, the Updated Principles recommend that certain covenants and conditions be included in the fund partnership agreement to fortify the clawback obligation, including (i) a guarantee from a creditworthy parent company, a general partner member or multiple general partner members, and (ii) an escrow established to hold at least 30% of the carried interest distribution. The Updated Principles also recommend robust enforcement powers for limited partners, including the right to directly enforce clawback guaranties against individual members of the general partner. Under the Updated Principles, actual and potential clawback liabilities should be disclosed to all limited partners in the fund's annual financial statements with a plan by the general partner to address such liabilities.

As noted above, the Updated Principles propose that the general partner clawback be net of income taxes, and the Updated Principles contain provisions for the calculations of taxes to be so netted. These reductions include taking into account (i) the actual tax rate of the members of the general partner for tax distributions instead of a hypothetical tax rate, which is usually based on the highest marginal tax rate in a given jurisdiction, (ii) loss carryforwards and carrybacks, (iii) the character of partnership income and deductions attributable to state tax payments, (iv) deductions or losses resulting from the clawback contribution of the general partner members, and (v) any change in taxation between the date of the fund partnership agreement and the dates of the clawback contributions by the general partner members.

B. Management Fee

In addition to the recommendation in the Original Principles for a reduced management fee post-investment period and upon the formation of a successor fund, the Updated Principles now provide that management fees should be further reduced during any period that the term of a fund has been extended.

C. Expenses

The Updated Principles provide that deal sourcing expenses should be covered by management fees and are now silent on insurance expenses of the general partners. The Original Principles were silent on deal sourcing expenses and suggested that insurance expenses should be borne by general partners.

D. Term of the Fund

The Updated Principles recommend that any extension of the term of a fund should be approved by a majority of the members of the LPAC or the limited partners, and if the LPAC or the limited partners do not consent to such extension, the general partner should be required to fully liquidate the fund within one year after the end of the term of the fund.

E. General Partner Capital Commitment

The Updated Principles recommend that the general partner's capital commitment to a fund should be contributed entirely in cash instead of through the use of a management fee waiver. The Original Principles had recommended that a high percentage of the general partner's capital commitment be contributed in cash with the remainder as a management fee waiver.

F. General Partner Conflicts of Interest

The Updated Principles contain two new recommendations regarding conflicts of interest situations. First, the Updated Principles recommend that the general partner should not be allowed to co-invest in fund investments selectively, but should be required to invest entirely through the fund. Second, the Updated Principles recommend that fees generated by any affiliate of the general partner, such as advisory and in-house consulting fees, whether charged to the fund or a portfolio company, should be reviewed and approved by a majority of the members of the LPAC.

II. Governance

A. Key Person, Removal and Termination Remedies

The Original Principles had recommended that, without cause, (i) a majority in interest of the limited partners of a fund should be able to elect to suspend or terminate the investment period of the fund, and (ii) two-thirds in interest of the limited partners should be able to elect to remove the general partner or dissolve the fund. In the Updated Principles, ILPA has changed its previous recommendation and recommends that, without cause, (i) two-thirds in interest of the limited partners be required to suspend or terminate the investment period of the fund, and (ii) three-quarters in interest of the limited partners be required to remove the general partner or dissolve the fund.

B. Investment Strategy

The Updated Principles recommend that general partners should accommodate a limited partner's policy with respect to limitations imposed on such limited partner's ability to invest in certain sectors and/or jurisdictions. If the accommodation of such policy causes a limited partner to be excused from any investment, the general partner should take into account the concentration effects on the other limited partners and the transparency of process and policies in the event such excused investment results in a non-ratable allocation of investments among the limited partners.

C. Indemnification

With respect to indemnification expenses of the partnership, the Updated Principles recommend that any requirement imposed on the limited partners in a fund to return distributions to the fund for the purpose of covering the fund's indemnification obligations should be capped at an amount equal to a reasonable percentage of committed capital (no more than 25%) and should be limited to two years following the date of distribution (as opposed to a period of time following the termination of the fund). The Original Principles did not suggest a specific cap on the re-contribution obligation for indemnification expenses or a time limitation.

D. Amendments

The Original Principles recommended that any amendment to a fund partnership agreement should require the approval of a super-majority in interest of the limited partners. In the Updated Principles, ILPA has changed its recommendation to the following requirements: (i) the approval of a majority in interest of the limited partners for general amendments, (ii) a super-majority in interest of the limited partners for certain amendments,² and (iii) the consent of each limited partner whose economic interest would be negatively affected by the proposed amendment.

E. LPAC

The Original Principles recommended that the LPAC be permitted to engage independent counsel at the fund's expense. In the Updated Principles, ILPA has modified this recommendation to provide that independent counsel should be provided to the LPAC only if the LPAC is considering important fund governance matters or if the general partner's interests are not aligned with those of the limited partners.

The Updated Principles provide that a minority of three or more members of the LPAC may, using reasonable judgment and discretion and after consulting with the general partner, call LPAC meetings. The Original Principles recommended that two or more members of the LPAC may call LPAC meetings. The Updated Principles also recommend that each member of the LPAC, prior to voting on fund matters, should consider whether he or she has any potential conflicts of interest and should disclose any actual conflict to other members of the LPAC.

The Original Principles provided that the LPAC should have the right to request the general partner to send any matter requiring the consent of the LPAC to all of the limited partners for consent even if the fund partnership agreement allows the LPAC to make the decision. The Updated Principles are silent with respect to this recommendation.

III. Transparency

The Updated Principles recommend that notices for capital calls and distributions should provide information consistent with the ILPA Standardized Reporting Format, which is provided on ILPA's website and which was not part of the Original Principles. In addition, the Updated Principles now recommend that general partners be required to deliver annual reports to investors within 90 days after the end of the fiscal year, instead of 75 days as recommended in the Original Principles.

The Updated Principles also contain two new reporting recommendations which were not included in the Original Principles: (i) funds should provide quarterly and annual information with respect to portfolio company debt, along with a description of the terms and maturity of such debt, and (ii) the general partner should disclose any breach of the fund partnership agreement or other fund documents by the general partner.

Notably, while the Original Principles recommended that a general partner should be required to disclose the splits of profits among the principals of the general partner and the capital commitment amount of each principal of the general partner, the Updated Principles do not include this requirement.

IV. Conclusion

As with the Original Principles, ILPA has indicated that it does not intend for general partners and limited partners to use the Updated Principles as a checklist or to commit to any specific terms described above. ILPA has expressed a recognition that each fund should be considered separately and holistically and that "a single set of terms cannot provide for the broad flexibility of market circumstance." ILPA intends that the Updated Principles will, however, provide a guide for negotiations between a general partner and limited partners on key fund principles.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Christian Parker
44.20.3023.5161
christianparker@paulhastings.com

Jonathan Shenkman
44.20.3023.5131
jonathanshenkman@paulhastings.com

Los Angeles

Siobhan M. Burke
1.213.683.6282
siobhanburke@paulhastings.com

Rob R. Carlson
1.213.683.6220
robcarlson@paulhastings.com

Stanley Liu
1.213.683.6101
stanleyliu@paulhastings.com

New York

Lawrence J. Hass
1.212.318.6401
larryhass@paulhastings.com

Thomas M. Rao
1.212.318.6838
thomasrao@paulhastings.com

Joshua H. Sternoff
1.212.318.6011
joshsternoff@paulhastings.com

Palo Alto

Thomas S. Wisialowski
1.650.320.1820
thomaswisialowski@paulhastings.com

¹ The ILPA previously recommended that general partner clawbacks should be gross of income taxes. After extensive discussions with general partners, ILPA determined that it would be impractical to ask general partners to bear the cost of the taxes paid on the carried interest received (but returned) by general partners.

² The Updated Principles do not include examples of such amendments.