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# Private Equity Alert

## ILPA Private Equity Principles – The Sequel

*By Andrew Chizzik and Brett Bush*

In September 2009, the Institutional Limited Partners Association ("ILPA") released a set of Private Equity Principles (the "Original Principles") to serve as a guideline for best practices in private equity investing from the perspective of institutional limited partners. The Original Principles were intended to provide a framework for negotiations and relationships between private equity sponsors and their investors. In January 2011, ILPA published an updated version of the Original Principles (the "Current ILPA Principles") to reflect feedback from the investment community and to provide additional clarity and context to the Original Principles. The Current ILPA Principles can be viewed at http://ilpa.org/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-2.0.pdf.

The material concepts contained in the Original Principles remain largely unchanged in the Current ILPA Principles, with the focus continuing to be on alignment of interest, governance and transparency. Key tenets of the Original Principles remain in place, including a full return of capital waterfall (*i.e.*, a "European style" waterfall) being characterized as "best practice". However, the Current ILPA Principles do contain a number of significant changes, including certain new concepts and details, a number of which are concessions by ILPA to the realities and market terms of private equity funds. The significant changes contained in the Current ILPA Principles are highlighted below.

### Clawback

The most significant modification is in the area of the General Partner clawback. In the Original Principles, the clawback was addressed very briefly, focusing primarily on (i) the establishment of a carry escrow account of 30%, (ii) the clear disclosure of clawback liabilities at the end of each reporting period, (iii) the clawback being gross of taxes and (iv) the existence of joint and several liability. The Current ILPA Principles, on the other hand, devote an entire appendix exclusively to clawback considerations. The clawback appendix explicitly recommends interim clawbacks (the concept was more vague in the Original Principles) that are triggered at defined intervals as well as upon specific events (e.g., failure of a Net Asset Value coverage test, generally of at least 125%). In addition, more details are provided on the issue of joint and several liability. The Current ILPA Principles recommend joint and several liability of the individual members of the General Partner, but, in a possible nod to current market terms, they also provide for potential alternatives to joint and several liability (e.g., a full guarantee of the clawback by a substantial parent company or a subset of the members of the General Partner). In each case, the Current ILPA Principles provide that limited partners should be able to directly enforce the clawback against the members of the General Partner. Another new clawback recommendation in the Current ILPA Principles is that the clawback period should extend beyond the term of the fund to account for liquidation and any limited partner giveback of distributions after the end of the term. Finally, in what appears to be another concession to private equity sponsors, the Current ILPA Principles concede that a clawback fully gross of taxes would be impractical. Instead, they propose that any tax advantage or excess tax advances recognized or received by the members of the General Partner (after taking into account actual, not hypothetical, tax rates, and any benefits of loss carryforwards, carrybacks, deductions, changes in tax law, etc.) be returned to the fund for the benefit of its limited partners.

## Transaction Fees

The Original Principles were explicit that all transaction (and similar) fees should "accrue 100% to the benefit of the fund". The Current ILPA Principles state instead that such fees should "accrue to the benefit of the fund". Whether the change was meant to signal that an offset percentage lower than 100% was acceptable or, on the other hand, that the 100% offset should be sufficiently ingrained in the private equity marketplace to deem the explicit inclusion superfluous is ambiguous, and limited partners and general partners may well draw different conclusions.

## Other Significant Modifications

In addition to the significant changes discussed above, other meaningful modifications contained in the Current ILPA Principles include:

**Alignment of Interest:**

- Extensions to a fund's term should require the approval of a majority of limited partners or the limited partner advisory committee (the "LPAC") (the Original Principles were silent on the approval process);
- Management fees should step down upon the extension of a fund's term (the Original Principles were silent on this point);
- The General Partner must fully liquidate the fund within one year following the expiration of the fund's term except with limited partner consent (the Original Principles were silent on this point);
- All of the General Partner's commitment should be contributed in cash and not through a management fee waiver (as opposed to a "high percentage" in the Original Principles);
- The General Partner should not be permitted to co-invest in select portfolio companies (*i.e.*, no "cherry-picking") (the Original Principles were silent on this point); and
- The recommendation in the Original Principles that the General Partner should bear its own insurance expenses has been removed, but "deal sourcing" has been added to the list of expenses that should be borne by the sponsor. As

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with a number of other terms and concepts contained in the Original Principles and the Current ILPA Principles, "deal sourcing" is not defined and therefore, ILPA's intent regarding what should be included in "deal sourcing" is unclear.

**Governance:**

- The Current ILPA Principles contain a stronger fiduciary duty recommendation (*i.e.*, any provisions that allow the General Partner to reduce or escape its fiduciary duties in any way must be avoided);
- While the Original Principles did not provide specific numerical recommendations, the Current ILPA Principles provide that limited partner givebacks should be limited to 25% of commitments and a reasonable period, such as two years from the date of the applicable distribution;
- "No-fault" suspension and termination of commitment period should be permitted with a two-thirds vote (a majority was recommended in the Original Principles) and "no-fault" removal of the General Partner and dissolution of the fund should require a three-quarters vote (two-thirds was recommended in the Original Principles);
- The Original Principles recommended an automatic suspension of the investment period following a "key-man" or "cause" event, which would become permanent unless there was a two-thirds vote to reinstate. The Current ILPA Principles contemplate a "defined super-majority" instead of two-thirds, suggesting that higher thresholds are anticipated;
- A majority of limited partners must be able to remove the General Partner or terminate the fund for "cause" (the Original Principles did not contemplate a "for cause" termination or a specific vote threshold);
- Amendments generally should require a majority vote of limited partners, although certain amendments should require a super-majority vote and amendments that negatively affect the economics of a particular limited partner should require such limited partner's consent (the Original Principles solely contemplated a super-majority vote for all amendments);
- Amendments to key-man provisions should be approved by a majority of limited partners or the LPAC, a lower threshold than the super-majority contained in the Original Principles;
- There is no longer a materiality qualifier for conflicts to be brought to the LPAC for approval and there is a new recommendation that fees generated by an affiliate of the sponsor, whether charged to a fund or any of its portfolio companies, should be approved by the LPAC; and
- There is a new recommendation in the Current ILPA Principles that the General Partner should accommodate limited partners' excuse policies; a corresponding caution regarding the concentration effects of excuse provisions is also included in the Current ILPA Principles.

**Transparency:**

- A "risk management" section has been added, recommending that annual reports to limited partners include portfolio company and fund information regarding material risks and how they are managed (e.g., concentration, foreign exchange, leverage and other risks);
- The time period for distributing annual reports was extended from 75 to 90 days;
- The recommendation contained in the Original Principles regarding the detailed information to be provided in fund marketing materials, including profit sharing splits and individual commitment amounts, has been removed; and
- A standardized reporting template for capital calls and distributions has been prepared by ILPA and posted on its website. The template calls for extensive detail (e.g., management fee calculations, itemized fees and corresponding offsets, waterfall calculations, potential clawback totals, references to applicable sections of the fund agreement, deal parameters and portfolio company information, etc.) with a focus on presenting the information from an accounting perspective in a manner consistent with the ultimate accounting of the transaction in the fund's records. The template itself

can be accessed from http://ilpa.org/principles-version-2-0/ and an instruction guide to the template, with an example, can be viewed at http://ilpa.org/wp-content/uploads/2011/01/ILPA-Reporting-Guidelines1.pdf. Additional templates for annual and quarterly reporting, as well as "portfolio metrics", are currently in development.

## Conclusion

While ILPA's Private Equity Principles will continue to serve as an important backdrop to the negotiations and relationships between private equity sponsors and their investors with many of the changes summarized herein likely being part of the dialogue, it is expected that specific negotiations will continue to operate on an independent and case-by-case basis, based upon myriad factors and influences that are particular to the applicable sponsor and its investors.

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