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■ The growing importance of fund governance – ILPA principles and beyond

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A crisis is too good an opportunity to waste. Not only is this the motto of Rahm Emanuel, Obama's chief of staff, it is also on the minds of many limited partners investing in private equity and other alternative investment funds.

The global financial crisis is testing many established structures in the business world, including the common limited partnership model of private equity investing. Although the private equity world is shaken by the crisis, the good news is that its governing model, which is common in the US, UK, Germany and many other jurisdictions, is proving to be robust. The reason is that existing fund agreements in many ways already aim at aligning the interests of fund managers and investors. Fund managers, for instance, always participate with their own money in their funds. Thus, the current debate on excessive management compensation is less of an issue in the funds arena.

In fund formation, the future has already begun so the current trend allows some predictions to be made. There will be fine-tuning on the economics side. The main market shift, however, will be on fund governance issues, as limited partners want to gain more control and demand better downside protection of their investments.

Fund governance is increasingly coming into the spotlight. But when current fund market trends are reported, the focus is still on developments on the economic side. Cases are getting attention where, due to the harsh financial conditions, carried interest percentages are marked down (from 25 percent to the standard 20 percent as happened in certain US VC funds), management fees are capped or fund sizes reduced.

This was highlighted in September 2009, when the Institutional Limited Partners Association (ILPA) published its

'Private Equity Principles'. The ILPA is an influential non-profit association consisting of around 220 institutional investors in private equity funds that collectively manage around \$1 trillion. Members include all major investor groups in this asset class (except fund-of-funds).

The ILPA publication is the first major set of guidelines and 'best practices' prepared by limited partners in private equity funds. Not surprisingly, the proposals are generally investor-friendly and deviate, on certain points, from current market terms (some of which still date back before the financial crisis).

The ILPA principles are designed to enhance fund governance, strengthen the alignment of interests between fund managers and investors, and provide greater transparency to investors. The ILPA's proposals cover a number of (but not all) important fund terms and contain detailed guidelines for investor advisory committees.

On the economic side, the ILPA principles cover issues such as carried interest and management fees. Regarding carried interest, the ILPA expresses a preference for the European whole-of-fund carried interest structures over typical US deal-by-deal carry schemes to avoid clawback situations. Also, the ILPA demands large reserves (30 percent or more) in case of clawback obligations as well as joint and several guarantees in respect of clawback obligations to ensure clawback repayment. The ILPA insists on calculating the clawback on a gross of taxes paid basis, and finally proposes clear disclosure and fixed timeframes for clawback payments.

Concerning management fees, the ILPA stresses that fees should be limited to cover reasonable operating costs and not be excessive. Management fees should be reduced significantly at the end of the investment period and in case of formation

of a follow-on fund. The ILPA proposes a 100 percent offset of fees (transaction, monitoring, break-up fees, etc.) so that the fund fully benefits from fees charged by the general partner or affiliates. Placement fees should be paid by the general partner, not the fund. Limited partners should have the power to review partnership expenses annually.

To ensure the correct alignment of interest, the ILPA suggests that fund managers subscribe for a 'substantial' equity interest in the fund: 'put your money where your mouth is'. Contributions should consist of cash rather than 'cashless' contributions by waiver of management fee. The ILPA demands that the fund managers should be restricted from transferring their interests in the general partner (or other entity receiving the carried interest) to ensure an alignment of interest with investors. The fees and carried interest payments should be predominantly directed to the professional staff of the fund manager.

On the transparency side, the ILPA pushes for increased disclosure starting with the marketing phase (organisational structure of the general partner, profit sharing splits among principals and vesting schedules, individual commitment amounts by principals, as well as other more standard information in fund marketing materials). Ongoing reporting should provide greater details in capital call and distributions notices (calculating carry and offset of management fees), periodical financial reports (audited annual and unaudited quarterly reports, detailed portfolio company reports on a quarterly basis), ad-hoc notices of unforeseen events (regulatory inquiries, triggering of key-men provisions). This shall include early disclosure of changes in the management company (public listed vehicles, selling stakes of ownership, formation of other funds).

In our view, the real achievement of the ILPA lies in emphasising the importance of fund governance. The starting point for the ILPA is the need to reinforce the duty of care and other fiduciary duties by the general partner towards investors. Some private equity funds have made use of the possibility in certain jurisdictions to substantially reduce certain fiduciary duties of the general partner to the limited partners. The ILPA emphasises that general partners should act in the best interest of the fund and the investors rather than acting in their self-interest.

The ILPA wants to strengthen investor rights. Investors should be able to remove the general partner or dissolve the fund without cause with a supermajority of two-thirds in limited partner interests. A simple majority of investors should be able to suspend or early terminate the investment period without cause. Up to now, some funds do not provide such 'no fault' rights or require a large supermajority (up to 90 percent of interests).

In the case of 'for cause events' or key-person events, the investment period should be suspended automatically with the option of reinstating it by an affirmative vote of two-thirds in interests (not the other way around, as often seen today). Regarding 'for cause events', the ILPA considers a preliminary determination by a court to be sufficient, rather than a final, non-appealable decision which in practice could take many years.

In pursuing the investment strategy, the fund management should be consistent and avoid style drifts – or get a supermajority approval as in the case of other amendments to the partnership agreement. The ILPA stresses that the fund managers should recognise the importance of time diversification of investments (including potential limitations on sums that can be drawn down each year) and suggests that partnership agreements should contain explicit limitations on investment and industry concentrations.

According to the ILPA, the investor advisory committee is the main body to enforce fund governance, particularly regarding affiliated transactions and other conflicts of interests and portfolio company valuations, audited by an independent auditor. The ILPA lays down detailed rules regarding the size, formation, meeting protocol, role, rights, and responsibilities of the advisory committee. Among the proposals are the right of 'in camera' meetings of limited partners only (without management representatives), and the quite revolutionary idea of an independent fund counsel.

Although only time will tell if fund sponsors will endorse the ILPA principles, investors have been more active in recent months in defending themselves against practices that they consider are deviations from good fund governance. In current fundraisings, investors already request a more detailed legal due diligence (term review) which leads to tougher negotiations on economic and fund governance terms. Other examples include cases of conflict of interests in making new portfolio investments (e.g., among different fund vehicles of the same sponsor), alleged misrepresentations in the fund marketing process, unfavourable terms in restructuring of existing funds (including fund size reductions) and raising annex funds.

Investors have reacted by making use of all rights available to them. Some of the more classical investor protection rights (the above mentioned 'no fault' and 'for cause' rights) may, however, not have been included in fund agreements, may require a high supermajority (e.g., 80 percent) of commitments, or may have additional requirements (e.g., no general partner removal in the first two years of the investment period).

Thus, investors have been forced to become more creative in protecting their interests. These include calling for advisory board meetings, initiating special limited partner meetings and coordinating among investors to build a (super-)majority, 'strategic defaults' (as opposed to defaults due to liquidity issues), and entering into negotiated settlements of disputes with general partners. These aspects are not covered by the ILPA principles. For better investor coordination, it is essential that investors receive a list of limited partners with contact information and list of advisory committee members (another ILPA demand).

In cases of funds with very GP-friendly governance, limited partner activism may ultimately succeed in unorthodox ways, including investor letters or contacting regulatory authorities and the press. However, if a conflict escalates outside the fund governance structure, it may become a threat to the reputation and standing of the fund management. In consequence, fund

managers should have an interest in channelling and addressing legitimate investor concerns within the fund structure.

Thus, a more balanced fund framework is also in the interest of the fund management and can even be used as a marketing tool in the current tough fundraising environment. It may mitigate future conflicts and allows fund managers to focus on

investing funds and adding value to portfolio companies. At second glance, the financial crisis indeed seems to be too good an opportunity to waste – even from a fund management perspective.

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