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ILPA Guidelines: Version 2.0 Offers Greater Flexibility for LPs and GPs

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The Institutional Limited Partners Association ("**ILPA**") released Version 2.0 of its Private Equity Principles (the "**Revised Principles**"), offering a revised version of ILPA's take on the best practices in establishing private equity partnerships between limited partners ("**LPs**") and fund managers.[1] This Client Alert summarizes the principal changes from the prior ILPA guidelines.

OVERVIEW

Like the prior version of the ILPA Principles issued in September 2009 (the "**2009 Principles**")[2], the Revised Principles continue to focus on three guiding principles for developing effective partnership agreements - Alignment of Interest Between GPs and LPs, Fund Governance and Transparency to Investors – while revising some of ILPA's prior recommendations within each category. The Revised Principles also include an updated Appendix A describing the role and best practices of the LP Advisory Committee ("LPAC"), and two new appendices that cover terms and best practices relating to clawbacks and financial reporting. Finally, the Revised Principles also feature a sample reporting template for capital call and distribution notices, which is one of five standardized templates that ILPA is developing in consultation with fund general partners ("**GPs**").[3]

In preparing the Revised Principles, it appears that ILPA sought to incorporate a level of perspective and market reality that some observers thought was lacking in the 2009 Principles. In the introduction to the Revised Principles, ILPA notes that the some of the changes arose from feedback from GPs and LPs in response to the 2009 Principles, and that the revisions represent an effort to increase the Principles' "focus, clarity and practicality." Moreover, ILPA notes that the Revised Principles "should not be applied as a checklist, as each partnership should be considered separately and holistically."

ALIGNMENT OF INTEREST

Waterfall/Carry Clawbacks

ILPA maintains its preference for the "European style" waterfall[4] (to reduce the likelihood of a clawback), but the Revised Principles also provide a list of ways to improve the deal-by-deal waterfall[5], including (i) carry escrows of 30% or more, (ii) a 125% NAV test, and (iii) interim clawbacks tested at intervals and upon specific events (e.g., a key person event or insufficient NAV coverage).

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[1] The ILPA Private Equity Principles Version 2.0 are available at http://ilpa.org/.
[2] The original version of the ILPA Private Equity Principles, are also available at http://ilpa.org/.
[3] Standardized templates are also being developed for annual and quarterly reporting and supporting financial schedules.
[4] A European style waterfall returns all capital contributed to date, plus a preferred return, before the GP receives carry distributions.
[5] Generally, a deal-by-deal waterfall returns the cost of realized investments (and writedowns) to date, plus fees and expenses attributable to such realized investments, before the GP receives carry distributions. In an "early winner, late loser" scenario, this model can increase the likelihood of a GP clawback.

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ILPA has now conceded that GP clawbacks should be net of taxes (thus, reversing course on its prior recommendation that GP clawbacks should be gross of tax). According to the Revised Principles, after extensive discussions with GPs, ILPA determined that it would be impractical to ask GPs to bear the cost of the tax that was previously paid on the carry received (but returned) by the GP (which has historically been absorbed by the LPs). However, the Revised Principles recommend a number of ways to reduce the tax burden, including (i) eliminating the hypothetical tax rate (usually based on the highest marginal tax rate in a given jurisdiction), (ii) imposing a rate based on the actual tax situation of the individual GP member, (iii) taking into account loss carryforwards and carrybacks, (iv) considering the character of the income and deductions attributable to state tax payments, deductions or losses resulting from the clawback contribution, and (v) taking into account any change in taxation between the date of the LPA and the clawback.

The Revised Principles provide that clawback obligations should be "fully and timely repaid" (rather than repayment within two years as suggested in the 2009 Principles), and should extend beyond the term of the fund (including liquidation and the "tail period" for any LP giveback of distributions).

ILPA continues to favor joint and several liability of individual GP members for the clawback, but unlike the 2009 Principles, the Revised Principles offer potential alternatives if only several liability is provided, including (i) a backstop guarantee from a creditworthy parent company, individual GP member or subset of members, and (ii) carry escrows.

The Revised Principles also recommend that LPs have robust enforcement powers, including the right to directly enforce the GP clawback guaranty against individual GPs.

Management Fee and Expenses

The Revised Principles continue to advocate for a lower fee at the end of the investment period and the formation of a successor fund, and now also suggest that fees should be reduced if a fund's term is extended.

With respect to expenses, the Revised Principles recommend that deal sourcing fees should be borne by the GP, but are now silent on insurance expenses (which the 2009 Principles said should be borne entirely by the GP).

The 2009 Principles recommended a cap on indemnification expenses based on a percentage of the total fund size, however, the Revised Principles provide that LP givebacks should be limited to no more than 25% of the committed capital and should be further limited to two years following the date of distribution.

ILPA expanded its recommendation regarding offset fees by also covering transaction fees and any other consideration charged by the GP. Notably, however, the Revised Principles do not include a recommended percentage of the fees that should offset the management fee (unlike the 2009 Principles, which recommended a 100% offset in favor of the LPs).

Term of the Fund

As in the 2009 Principles, the Revised Principles state that fund extensions should only be permitted in one-year increments. The Revised Principles also add that any such extensions should be approved by a majority of the LPAC or the LPs.

The Revised Principles further recommend that if the LPAC (or LPs) do not consent to an extension of the fund's term, then the GP should be required to fully liquidate the fund within one year of the end of the fund's term.

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GP Commitment/Conflicts

ILPA clarifies in the Revised Principles that the GP's entire commitment should be contributed in cash rather than through a management fee waiver. (The 2009 Principles recommended that a high percentage be contributed in cash).

The Revised Principles include a statement that the GP should not be allowed to cherry-pick underlying deals in which to co-invest with the fund. Instead, the GP's entire interest should be through the fund.

In addition, the Revised Principles also provide that fees generated by an affiliate of the GP (e.g., advisory or in-house consulting fees), whether charged to the fund or a portfolio company, should be reviewed and approved by a majority of the LPAC.

GOVERNANCE

Key Person, Removal and Termination Remedies

Consistent with the 2009 Principles, the Revised Principles call for a majority vote of the LPs to remove the GP or terminate the fund for "cause". ILPA does not define the term "cause".

ILPA revised its prior recommendation for no fault rights in favor of GPs. The Revised Principles now recommend (i) a vote of two-thirds in interest of the LPs to exercise a no fault right to suspend or terminate the commitment period (rather than a majority in interest vote in the 2009 Principles), and (ii) a three-quarters in interest vote to exercise a no fault right to remove the GP or dissolve the fund (rather than the previous two-thirds in interest vote).

Investment Strategy

The Revised Principles provide that GPs should accommodate LP investment policies and provide applicable excuse rights, provided that consideration should be given to the impact such excuse may have on the concentration effects on the other LPs. This provision also calls for transparency of process and policies in the event an excuse results in a non-ratable allocation.

Amendments

ILPA refined its prior stance on amendments to the LPA (which suggested approval of a super-majority in interest of the LPs). The Revised Principles suggest the approval of:

- a majority in interest for general amendments;
- a super-majority in interest for "certain amendments" (which are not described in the guidelines, but presumably would include any specially negotiated or investor-specific provisions (including tax or regulatory provisions), provisions affecting the fund's investment strategy (as suggested in the 2009 Principles), and provisions related to fund economics or limited liability); and
- unanimous consent from any LPs whose economics would be negatively affected by an amendment.

The Revised Principles suggest approval by a majority of the LPAC or LPs for changes to the key person provisions. (This is more GP-friendly than the 2009 Principles, which suggested a two-thirds in interest vote for all amendments).

Independent Auditor/Fund Counsel

ILPA's 2009 recommendation that the LPAC be permitted to engage independent counsel at the fund's expense was pared back in the Revised Principles to provide that counsel should only be used if the LPAC is considering important

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fund governance matters or where the GP's interests may not be aligned with those of the LPs. The Revised Principles also provide that the use of independent counsel should be reserved for use by a "reasonable minority of the LPAC."

TRANSPARENCY

The Revised Principles recommend that capital calls and distributions should provide information consistent with the ILPA Standardized Reporting Format, and should include estimates of quarterly projection on capital calls and distributions. The new standardized report features (i) information presented from an accounting perspective, (ii) management fee and waterfall details, (iii) with each distribution, the amount of carry and build up to carry calculation, (iv) reporting of the LP share of the fund, and itemized details of all GP fees, and (v) clear references to the LPA sections.

The Revised Principles recommend that GPs be required to deliver annual reports to investors within 90 days of year-end (rather than 75 days in the 2009 Principles).

The Revised Principles add that a fund should provide information (quarterly and annually) regarding a portfolio company's debt, describing the terms and maturity.

Unlike the 2009 Principles, the Revised Principles do not specify the types of information the GP should provide as part of its due diligence or marketing materials.

The Revised Principles eliminate ILPA's prior recommendation that the GP be required to disclose the profit sharing splits among the principals' (including vesting schedules), or the individual commitment amounts of each principal that makes up the GP commitment.

ILPA now recommends in the Revised Principles that the GP be required to disclose any breach of the LPA or other fund documents.

Please contact a member of Morrison & Foerster LLP's Private Equity Fund Group with any questions.

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