It Is Time for LPs To Be Accountable…

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"Blaming others for your problems is like blaming donuts for being fat.
It wasn't the donut, it was the choice."
- Jeffrey Gitomer

We have been investing in private equity for decades and have always favored general partners (GPs) who view their limited partners (LPs) more as "partners" and less as "limited." Recently, however, we have seen more and more **GPs propose limited partnership agreements (LPAs) that are increasingly GP-friendly.** Law firms are willing co-collaborators since by and large they service the GP community. **The time has come to call out these practices and demand change**.

What puzzles us the most is that by and large **LPs are not pushing back**. Even worse, **where are the large fiduciaries on this issue?** The big state pension funds and other large allocators have the negotiating power, so why are they signing up for these terms? LP groups such as the Institutional Limited Partners Association (ILPA) have been telling the SEC about certain abuses in the industry, and the SEC continues to focus on this. However, at the end of the day, **it is the LPs who sign these LPAs and, to quote Nancy Reagan, sometimes LPs need to Just Say No!**

We wanted to highlight a few things that particularly illustrate how private equity GPs are skewing things in their favor:

The Issue	**The Problem**	**Some Solutions**
Transparency and Notice Provisions	GPs commit to a bare minimum LP reporting and disclosure, and many GPs refuse to commit to notifying LPs of events that LPs should be aware of. GPs do not typically commit to disclosing fund expenditures in detail.	**GPs should be obligated to disclose material events promptly** (e.g., within 10 days): - Changes of auditor, valuation methodology, law firm, or regulatory registration - Criminal convictions - Regulatory charges, investigations, subpoenas, etc. beyond a normal exam - Securities-related litigation - Sale of an interest in the GP - Commencement of a new fund or strategy **GPs should commit to providing a detailed annual financial report**, breaking down all fund expenditures and revenue items.
GP Contributions Through Reduction in Management Fee	Many GPs make a portion or even all of their commitment through a reduction in management fee.	Unless the manager is a raising a first-time fund, **GPs should be "invested" alongside their partners** at the outset and not use an accounting device to build up a capital account. **Capital, not a revenue stream, should be at risk.**
Organizational Expenses	There has been a steady rise of organizational expense caps. Many LPs do not appreciate that all LPs share in the cost of negotiating side letters, even if they do not receive any benefit or if one particular side letter negotiation far exceeds any other. Some LPAs even carve out the cost of side letters from the organizational cap.	A big reason for the spiraling cost of fund formation is the use of law firms to do administrative work and the extensive negotiation of side letters with institutional LPs. **Organizational expenses should be capped at reasonable levels** to mitigate this risk. GPs can lessen the burden of all LPs bearing this cost by **capping the cost of legal fees for any single side letter negotiation** (above such cap it is the GP or the prospective LP's cost). At a bare minimum, if side letter negotiations are a fund expense, the cost must accrue against the cap.
Partnership Expenses	Things we have seen designated a fund expense include: - Allocations of in-house employees - Firm compliance (ADV, etc.) - CRM systems - Industry association membership fees - Facilities expenses - Private air travel Some of these expenses (IT, software, etc.) provide benefits to both the GP and the fund, yet the fund typically bears the entire cost.	**The management fee should cover firm-related expenses**, including: - Salaries of all employees (regardless if they are providing services, such as legal or accounting, to the portfolio companies) - Costs of running its business, such as compliance or CRM systems If private aircraft travel is to be a covered fund expense, the covered cost of it should be capped at the equivalent of first-class travel. When the fund pays for IT, software, or other expenses that provide benefits to both the fund and the GP, the expense provision should require the GP to do an allocation of the expense between the GP and fund depending on the reasonable value of the benefits received.
Management Fee Offsets	Compensation paid directly to the GP as a result of its portfolio company investments (director fees, advisory fees, etc.) belongs to the fund but sometimes some or all of it goes to the GP.	**100% of the fees received by the GP should reduce the management fees**. If the compensation exceeds a management fee payment, the excess must be carried over to the next payment and fully credited to the LPs.

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Management Fee After Investment Period	Some LPAs provide that the management fee calculation after the investment period is based on the cost of any investments less any "permanent write-offs" or based on commitments minus the cost of any write-offs.	**After the investment period, GPs should be paid only on the lower of the value or cost of the portfolio companies**. The best formulation, to avoid the risk of any inflated fees, is to base management fee on the lesser of fair market value (NAV) or cost of any investment. Some GPs go further and provide a step down in the management fee percentage.
Early Termination of Investment Period	Most LPAs have "no fault" termination provisions that allow LPs to terminate the Investment Period with an adequate majority of the LPs. However, many GPs set the consent level so high (>80%) that termination is unlikely. Not all LPAs include "for cause" termination provisions, and in those events (violations of securities law etc.), sometimes the LPA requires consent (>80%) to terminate.	**A reasonable super-majority (66%) should be able to terminate the Investment Period** if circumstances warrant it. Votes such as these should not include the GP or any partners affiliated with the GP (most LPAs do not carve out accounts of LPs affiliated with the GP. "For cause" terminations should be automatic, and reinstating the investment period should require supermajority LP consent (75%+ etc.).
Key Person Provisions	LPAs often have convoluted provisions to measure what triggers a key person event. Often the key person must be uninvolved for a period of time (e.g., 90 days) before a key event happens. In addition, some LPAs provide that the GP has as much as twelve months after the Key Person Event to propose a plan.	**GPs should commit that they will spend substantially all of their business time on the fund**. In particular, a Key Person should not be able to return to work for one day to avoid triggering a continuous absence. **GPs should commit to promptly offer a plan to resolve the Key Person event**, in a reasonable time (e.g., 60 days) after it happens or otherwise the Investment Period should terminate immediately.
Capital Calls After the Investment Period	GP can often call capital after the Investment Period for transactions that were "in process" as of the end of the last day of the Investment Period.	**New investments should not be made after the Investment Period** unless they are subject to a written LOI prior to the end of the investment period or with approval of the limited partners' advisory committee (LPAC).
Preferred Returns	A preferred return means the GP does not get its incentive fee compensation (carry) until it has delivered a minimal level of return to LPs. In the absence of such provision, LPs are at risk of paying a performance fee for a return that does not compensate them for the illiquid and long-term nature of private equity.	**All buyout funds should have some preferred return, and 8% is a reasonable threshold** – we hope GPs can sign up for that. At a minimum, we think a 6% pref should not be controversial. If the GP does not think it can exceed that return, then it should be upfront about that with LPs.
Distributions of Publicly Traded Securities	LP distributions can be in the form of publicly traded securities, and the GP's carry is calculated based on the value at the time of distribution. However, LPs can try to sell the securities simultaneously, pushing the price down after they've been distributed.	LPAs should include a provision for valuing distributions of publicly traded securities for purposes of calculating the carry, to be based on the average last traded price over a 10-day period (5 days before distribution and 5 days after), and then an adjustment in the event that the GP has received more/less than it should have at the time of the distribution.
Carry Clawbacks – Catch-ups, Interim Clawbacks, and Escrows	A fund can be "in the carry" at an early stage of its life, and the GP can be paid carry, even though later the GP is no longer entitled to those payments because the fund did not achieve its preferred return.	**Carry payment provisions should have some controls**, such as: - A "catch-up" provision that is less than 100% - An interim clawback some time between the end of the investment period and the end of the fund - An escrow provision that requires carry payments (or a portion) to be held in escrow. - A timeframe for when the GP must make its clawback payment (e.g., 60 days after determination).

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Carry Clawbacks – After Tax	For purposes of calculating the amount of the clawback, LPAs typically provide that the tax calculation is at the highest assumed tax rates, ignoring the actual tax situation of the effected GP member and such things as the deductibility of U.S. state and local taxes.	**<u>After-tax amounts clawed back should be based on the individual GP member's actual tax situation</u>** and should take into account – - Loss carryforwards and carrybacks - Character of the fund income - Deductions for state/local taxes - Losses relating to the clawback contribution - Any change in taxation between date of LPA and the clawback.
Indemnification/Exculpation	LPAs typically indemnify and exculpate a GP for anything that does not constitute gross negligence, violation of law, or willful malfeasance. LPAs also will only disallow indemnification if there is a final, non-appealable judgement of wrongdoing by the GP.	**<u>LPAs should require a level of conduct that all investment fiduciaries adhere to</u>**, and if the GP violates its fiduciary duty to LPs, there should be no exculpation or indemnification. Likewise, if the GP violates the LPA or the investment management agreement, or if the GP commits fraud, there should be no indemnification. Given the long litigation cycle through all levels of appeal, **<u>LPAs should also not require LPs to exhaust all legal remedies before voiding an indemnification right</u>**; there should be no indemnification if any court finds that the GP violated its fiduciary duty to its partners. LPAs should also require the indemnified parties first to seek reimbursement from third parties or insurance before being reimbursed by the fund.
Partner Voting	LPAs require limited partner approval for a wide variety of things in which the GP has an interest. Most will remove the GP from the denominator for approval thresholds (majority, 66% etc.). Rarely however do the GP affiliated LP accounts get excluded as well.	**<u>All matters requiring partner approval should not include any GP-affiliated accounts</u>**.
Most Favored Nations (MFN) Provisions	Many MFNs provide that LPs above a certain commitment level automatically get the benefits of any side letter with an LP of the same or smaller size.	We discourage side letters since by their nature they create unequal rights among partners. Any concession should be in the LPA for the benefit of all partners. However, if they are used, and the GP uses commitment size to offer better terms to larger partners, **<u>commitments to prior funds should be included in the MFN calculation</u>**.
Extensions of the Partnership Term	GPs typically can extend the life of the fund beyond the original 10-year period, often for one or two years in its discretion and/or one or two years with LPAC approval. Fees in the extension period generally do not change.	To ensure an adequate disincentive to extend the life of the fund and to align all partners' interest, **<u>there should be no management fees during the extension period or at least a substantial step down</u>**.
Time Period Calculations and the Definition of "Business Day"	All LPAs have periods of time when the LPs or GPs must act (e.g., fund a capital call, GPs provide notice of something, etc.). Where the notice is short, LPAs often refer to numbers of business days, which are usually defined as when banks are open. However, some say business days include "**such other day as the General Partner may from time to time determine**." This essentially gives the GP the ability to use weekends and holidays to truncate the time for LPs to act or consider decisions.	**The definition of "business days" should be tied to an objective standard** (e.g., when banks are open) and not subject to the discretion of GPs.

There is obviously no perfect LPA, and the best agreements align the incentives and the risk/rewards for all parties. For example, managers should not be incentivized solely to invest the capital, regardless of the quality of deals they can find.

At the end of the day, LPs need to answer a simple question: Is the expected NET return acceptable and will it outweigh any terms that are GP-friendly? Top managers can charge top fees and negotiate onerous terms (as long as they deliver), but they should not be paid for just showing up. In our experience, **GPs who provide transparency, are reasonable on fees/expenses, and treat their LPs as true partners usually are the ones who generate the best long-term returns.**

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Readers of our letters know that **we are always looking for ways to improve and identify best ideas**. In that regard, we hope these suggestions will prompt a broader discussion among private equity investors and GPs that will make private equity investing more rewarding for everyone. Please email and share any feedback with us at PE@AIM13.com. Thank you!