Key Contractual Considerations in Private Equity Fund Placements

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Introduction

This paper examines the economic intuition that underpins key legal terms commonly found in private equity fund partnership agreements. As a primer, it attempts to encapsulate, in non-legal language, the rationale behind economic points of negotiation, investigate the scope for trade-offs and offer practitioner insights.

Private Equity Partnerships

The prevalent legal structure used by private equity sponsors is the Limited Partnership. This partnership is structured as an investment vehicle with a finite life, usually 10 to 15 years. A Limited Partnership must have a "General Partner" ("GP"), which is typically an entity owned by the sponsor of the private equity fund. The fund has one or more capital contributors known as "Limited Partners" ("LP"s).

The GP is the legal entity with unlimited liability; it serves as the intermediary between external contributors of capital and businesses who seek capital. Uses of the capital for corporate finance activities include, among others, investment for growth, acquisition, refinancing, restructuring, and management or leveraged buyouts. The "Management Company," a legal entity setup to serve as the investment advisor to the fund, receives an annual management fee. It manages the partnership using policies articulated in the partnership agreement. The agreement covers economic and contractual terms, specifies fees, governance mechanisms and stipulates provisions that define the agreements between the GP and LPs.

Private equity funds are structured as limited partnerships and are governed by terms defined in the limited partnership agreement

LPs, as the name suggests, have limited liability and are not involved with the fund's day-to-day operations. They are passive contributors of capital and receive income and capital gains on their investment in the partnership. Their liability is usually limited to their paid and unpaid capital contributions and any distributions that they may be required to make to the GP. In ordinary circumstances, LPs do not have the right to withdraw or to reduce their capital contributions to the partnership without GP consent. LPs are also not allowed to undertake any transactions with respect to the fund or control the affairs of the partnership.

The primary objective of such a partnership is to generate significant returns, mainly through long-term capital appreciation, by making, holding and disposing of privately negotiated equity and related investments. The sponsor typically designates senior members of its organization, usually known as the "Principals," to comprise the GP. These designees actively manage the partnership, act as agents of the fund and direct its affairs. It is not uncommon to require that such designees devote substantially all of their business time to the affairs and activities of the fund, except when they manage other pre-existing funds, or are in the process of raising a successor fund. With a view to provide stability and resilience to the partnership, internal GP agreements normally stipulate that no principal may transfer, sell, or otherwise dispose of their interest in the partnership without the consent of all the principals that make up the GP.

Fund Economics

There are several components that define overall fund economics. They include:

Management Fees

"Management fees" are intended to defray normal operating expenses of the management company during the course of business. These expenses are broadly in the form of salaries and employee benefits, office expenses, travel, business entertainment, equipment rental, bookkeeping, conducting due diligence and fund administration. There are no fixed rules that determine management fees; the norm has been 1% to 2.5% of total commitments during the fund's investment period and at a reduced rate thereafter. The reduced amount is consistent with the lowered workload once the fund is fully invested. Sometimes management fee reduction is implemented as a smaller percentage charged to the entire fund. In other instances, while the percentage rate remains the same, it is applied to a smaller capital base—often to the cost of unrealized investments held by the partnership.

Formulaic applications of a fixed percentage of capital commitments may, at times, result in management fee accrual to the partnership that exceeds the actual expense needs of the partnership, serving as an additional revenue source for the sponsor. In such cases, management fees may become a primary profit center for the management company, which LPs usually frown upon.

It is important to assess overall fund economics—fees and management expenses along with treatment of carried interest

The long-term incentives for all participants are perhaps best aligned when management fees are used to offset ongoing expenses while the majority of the sponsor's compensation, and those of its principals designated to the GP, derives from fund profits through their share of "Carried Interest" (defined later on). Contractual provisions that foster this outcome may include allowing for a sliding, declining scale on management fee as committed capital increases, imposing constraints on the concurrent management of multiple funds and allowing successor funds to be raised only after the existing fund is deemed to be "Fully Invested." Restricting the receipt of the management fee from successor funds until the successor fund investment activity actually begins is yet another provision employed.

Expenses

Setting and monitoring annual predefined budgeted operating expenses may help bring better accountability, expense discipline and interest alignment. It may, however, reduce GP flexibility, be administratively cumbersome and unrealistic. Budgeted expenses have not been accepted in the industry despite occasional efforts to introduce them by some LPs. In order to preclude perverse incentives to perpetuate a fund's life by keeping impaired investments alive for the explicit purpose of realizing management fee, agreements often explicitly specify the conditions under which materially impaired investments may continue to be carried on the fund's books.

In addition to management fee specification, the fund reimburses the management company for initial organization expenses, typically with a stipulated upper limit and excess thereof to be borne by the GP. Also, occasionally, employees of the sponsor or individual principals may receive compensation in the form of options or other securities from their portfolio companies in return for services provided in the course of performing tasks on behalf of the fund. In such cases, LPs have been known to suggest a proportional reduction—from a conflict of interest perspective—in the management fee by the amount of the net vested proceeds of such compensation.

Carried interest is a call option given to the GP on the Fund's profits

Ancillary Fees

"Ancillary Fees"—more typical for large buyout funds than for venture funds—are revenues that the management company receives from investment banking transaction fees, portfolio company monitoring fees and director compensation. These fees may be credited to the management company or to the fund, or in some proportion to both. Provisions that specify the manner by which these fees are split have a bearing on fund economics. Investors occasionally propose management fee offsets by a percentage of the amount of any director fee, consulting, monitoring, investment banking, transaction or break-up fees or other remuneration received by the fund's principals. The sharing, or otherwise disposition, of ancillary fees is usually a negotiation item between investors and the GP.

Carried Interest

Carried interest is profit sharing that accrues to the GP. It is typically payable following contributed capital return to LPs and the GP, reimbursements of management fees charged to investors and, in some cases, after meeting a pre-set "Hurdle Rate" (defined later on) of return. Carried interest is the principal part of the GP compensation that aligns the LP/GP economic interest and reduces agency cost. The GP, in turn, disburses the carried interest to principals and other individuals who constitute the partnership. The typical split is 80/20 with 80% going to the LP and 20% to the GP. However, it is not entirely uncommon to see funds with a weaker negotiating position—such as a first time fund—to agree to less than 20% in order to encourage LPs to invest. Likewise, there have been cases when GPs of sought after funds have asked for and have received more than 20% carried interest.

In the earlier days of the private equity industry, distributions to the GP were made on a deal-by-deal basis rather than on an aggregate of portfolio value basis. GPs preferred the former. The method rewarded the partnership for selective good deals without being fined for loss-making unprofitable deals. The practice of deal-by-deal profit sharing has largely been done away with, though there have been occasional cases where GPs have offered to take a lower carried interest if they could have it on a deal-by-deal basis, rather than on a portfolio aggregate basis. Exceptions to the aggregating of portfolio value method may however be permissible as in the case of one-off investments or for pledge funds that tend to charge carried interest without netting.

From an economic point of view, it is reasonable to view carried interest in conjunction with management fees rather than view either in isolation, for they both act to reduce net returns to investors. Investors benefit from modeling, simulating and optimizing tradeoffs between higher carried interest and lower management fees or vice versa. Smaller funds generate lower levels of absolute management fees, for fees are calculated as a percentage of fund size. Timing matters in such cases. Carried interest generated early on through successful deals may be very important for initial GP compensation and motivation. It may also go a long way to attract and retain good talent to the sponsor.

Typically, a GP will contribute somewhere between 1% and 2% of the fund's capital. This permits carried interest distributions to the GP to be treated as capital gains rather than fee income

Investors in private equity funds tend to emphasize an evaluation of team composition, individual and collective track record, team synergy, team resilience and team economics before they decide to invest. Sometimes, such as for first time lesser known funds, LPs prefer that the fund documents specify the manner in which the carried interest is divided internally amongst team members. Often this information is hard to come by. Knowing the split of carried interest becomes relevant during those very rare claw-back situations when the fund's principals are severally liable. Whether this ought to be specifically incorporated contractually or not remains debatable.

GP Commitment

The GP receives no preferential terms as compared to an LP with respect to its interest in the partnership. This applies to its subscription commitments, capital contribution and distributions. Typically, a GP will contribute somewhere between 1% and 2% of the fund's capital. This permits carried interest distributions to the GP to be treated as capital gains rather than fee income. Investors view the GP capital contribution in excess of a de minimis amount as an indication of further alignment of the LP/GP interest.

In the case of lesser known sponsors, LPs may also take added comfort when the GP contribution is a sizeable portion relative to a principal's net worth. However, estimates and disclosures of a principal's net worth are exceedingly hard to come by. A question sometimes arises: should every partner personally make a capital contribution or should the GP entity make the contribution on behalf of all the partners? From the LP's perspective, the GP is composed of principals who ought to be individually as well as collectively vested in the success of the fund. Accordingly, some LPs much prefer that every individual team member put a significant portion of their net worth at stake in the fund, preferably in proportion to their share of the partnership. This may not always be practical when junior partners may not have the financial ability to do so, or in those cases when the fund size is very large.

Distribution of a fund's profits usually includes a "catch-up" clause and also a "claw back" clause

Distribution Issues

The surplus income and capital gains that a fund generates after deducting expenses, subtracting the cost of investments and making provision for liabilities are the fund's profits. These are distributed to LPs and the GP in accordance with the terms set in the agreement. Many agreements that provide for a hurdle rate also have a "Catch Up" provision that specifies the manner of GP participation rate. For example, assume that the preferred or hurdle rate is 8% and the profit split is 80/20 for the LP and GP, respectively, with a "100% catch-up." In this case, all distributions after the return of contributed capital to all capital contributors, and an 8% preferred rate on the LP's capital, goes to the GP until it receives its proportionate share of the profits the LP has received.[1] In other words, the GP "catches up" with the LP. Sometimes the catch-up amount is on a 50/50 basis or "50% catch-up," which has the natural effect of slowing down disbursements of carried interest to the GP[2]—distributions during this phase are now shared on an equal 50/50 basis between investors and the GP. There could be another agreed percentage catch-up rate too.

Sometimes the GP share flows into an escrow account to build "Claw Back" reserves (defined later on) and any surplus then flows to the GP. As mentioned earlier, there is no hard and fast rule and practices vary depending on the specifics of the fund situation.

In many cases, the GP retains rights on how they choose to distribute realized fund proceeds back to investors in the form of combinations of cash, freely tradable securities or restricted/illiquid securities. While this provides flexibility to the partnership, most investors prefer to receive distributions in freely tradable securities or in cash. Cash has the advantage of being fungible and less volatile as opposed to a complex in-kind security distribution with the attendant valuation and/or liquidation risk. On the other hand, cash distributions are taxable immediately while the tax incidence on in-kind security distributions is generally deferred until realization.

Hurdle Rate

The hurdle rate is a minimum threshold rate of return that LPs must receive prior to any distributions to the GP. Its intent is to provide downside protection to investors. The sponsor and investors may sometimes negotiate on hurdle rate provisions. For instance, on issues such as whether once the hurdle rate is achieved, the GP ought to receive carried interest on each dollar of profit up to the hurdle rate (as is the common practice in the U.S.) or on profit in excess of it (as in Europe). Variants exist on how this is addressed as there is no hard and fast rule.

Hurdle rates being a "contingent barrier" in the option parlance may evoke behavior incongruent with the interests of investors. Envisage a scenario where a fund has had a series of successful portfolio exits in the early stages of its investment cycle. In such a case, the hurdle rate will be easily met and will no longer serve as an incentive for the GP to outperform. The combination of the hurdle rate and the stage of fund life may give rise to perverse incentives. If a fund is very close to the end of its investment period and performance has been far below the hurdle rate, the GP has a perverse incentive to do any risky deal—the proverbial "swing for the fences"—that may potentially generate returns to exceed the hurdle rate. A deal, any deal during these circumstances, is a call option on the fund essentially; GPs have an all-or-nothing decision to make, while the effect on the LPs is more or less incremental. Alternatively, GPs who know that they can raise a new fund, may simply let the fund's investment period run out when performance is significantly below the hurdle rate due to the marginal upside optionality to them.

The treatment for one-off, short-term (holding periods of less than a year), opportunistic investments made by employing temporary bridge financings is slightly different; in these cases, distributions typically do not flow through the traditional hurdle rate/waterfall[3] calculations but are returned to investors on a pro rata basis.

1 The GP receives 100% of subsequent fund profits until it receives 20% of the 8% (hurdle rate) that the LP has received.

2 In this situation, the GP receives 50% of subsequent fund profits until it receives 20% of the 8% (hurdle rate) that the LP has received and the LP receives the remaining 50% thereby slowing down the GP "catch up."

3 Waterfall is the predefined mechanism for allocation of fund profits and capital distribution cash flows between LPs and the GP.

Contractual clauses that align long-term LP and GP interests foster better outcomes

Return of GP Capital Contribution

Whether GP contributions should be returned before, or concurrently with, or after LP capital contributions have been returned has been debated extensively. The prevailing practice is that the GP, being no different from the LP, in that it too is a concurrent provider of equity capital to the fund, receive distributions simultaneously with other investors. Variations abound, however. Venture funds have tended to return contributed capital to GPs before any carried interest, while buyout funds often return both contributed capital and carried interest after every deal. This is because the size of individual deals in buyouts tend to be much larger than those in venture capital investments.

In certain cases, once the hurdle rate is reached, the fund may tactically make LP distributions before they distribute GP carried interest. This seemingly innocuous practice increases the fund's internal rate of return ("IRR") because distributed cash flows to LPs come in earlier; it is a common practice for investors to look at IRR as the single most important measure of investment performance. Discerning investors, however, know that at the end of the day what also matters is real cash-on-cash returns and not just the interim IRR.

Claw Back

The claw back clause is meant to ensure that the GP shares in the fund's profits only after the LP receives back its contributed capital, fees and expenses are paid, and after the fund has achieved the performance hurdle rate. Should, for any reason, the GP receive carried interest in excess of the predefined share over the life of the fund, the fund can claw back this excess amount from the GP and distribute it to LPs.

Negotiations with the GP often focus on the intricacies of its implementation; in some cases, with lesser known funds, the practice has been to set up an escrow account, which holds a part of the GP carried interest. In these cases, LPs and the GP often differ on the escrow amount and its duration. The GP position often is that if the fund has far exceeded the hurdle rate, the escrow account should be released to the GP. Investors, often are reluctant to acquiesce for they worry that the GP could receive more than it is entitled to if it liquidates good deals in the portfolio initially and retains non-performing investments for later liquidation.

The LP position gravitates towards the argument that since they receive the bulk of their returns towards the end of the fund's life, so should the GP. They may contend that carried interest should not be paid until the end of the fund's life because the GP's stated intent is to generate high returns and, accordingly, should be rewarded for doing so only after accomplishing it. Additionally, non-performing portfolio companies should not be kept alive merely to extend the life of the fund to avoid the claw back. Proposals to introduce interim period claw back based on interim fund valuations are exceedingly cumbersome to implement and are rare.

Vesting Schedule

Often investors do not know how carried interest is being shared between the principals who make up the GP entity or when that interest is actually disbursed. Investors prefer to know the sharing and vesting schedules. While it is in the principal's interest to have their portion of carried interest vest as soon as possible, the industry practice has been for it to do so over a longer period (in some cases five years). Obviously, LPs would rather see the individual principal's shares vest over the longer life of the fund than earlier.

Winding Down

As funds approach the end of their lives, GP motivation to continue to perform the fund's activities may also decline. This is the period after the fund has exited its investments, fulfilled its obligations to portfolio companies, distributed remaining harvested capital back to fund sponsors, repaid debts, released escrows and prepares to terminate. Contractual clauses that specify orderly liquidation of fund assets, with commensurate incentives and penalties to ensure orderly fund close down within a stipulated time period, are often incorporated.

Good governance structures balance the GP's management freedom and flexibility with preserving LP's rights

Issues of Fund Governance

These are the rules and principles that the fund abides by; they help specify the decision process followed by the GP and the management company in dispensing their duties to the investors.

Oversubscription

A fund may be over-subscribed due to strong investor demand. Following established practice in capital markets, the fund may allocate oversubscriptions based on long-standing historical relationships, at other times on a first come first served basis or on a pro-rata basis. To provide clarity to the process and to avoid appearing arbitrary, sponsors often pre-specify the allocation methodology in such situations.

At the same time, to ensure that the GP does not raise more capital than it can effectively deploy without compromising the fund's investment thesis, upper bounds on the fund size are quite frequent. Conversely, the LP/GP agreement or the fund memorandum may specify the minimum size at which the fund may close.

Investments Prior to Initial Closing Date

Prior to the initial fund closing date, an existing fund or an entity affiliated with the GP may make certain investments on a temporary basis for the benefit of the successor fund. These are also known as "Warehoused" investments. This often happens when fund closings get delayed and the principals see an excellent opportunity that they would rather not pass on. It may be to investor's advantage to have these investments transferred to the partnership when the fund subsequently closes. This is best done when the underlying interest is valued at cost and an interest equivalent amount is charged to the GP that is calculated from the date such investments are made through to the date of transfer to the partnership.

Subsequent Closing

A fund may have more than one closing date; a series of two or more "soft" closes wherein it continues to accept additional allocations from existing investors only, followed by a final "hard" close after which it does not accept new allocations from any investor. In order to ensure that all investors are treated fairly, it is sometimes seen as desirable to articulate investor allocation acceptance methodology during soft-close times along the lines of investor oversubscription discussed above.

Capital Drawdown

Investors in a private equity fund commit to providing a pre-agreed sum of capital to the fund over a specified period of time. This is called the LP "Capital Commitment." However, the entire funding may not be needed immediately. The GP draws down or calls the capital over a period of time when investment opportunities arise. Drawdown usually occurs over a four to five year investment period, though this can be sooner as seen in some recent vintages. The flexibility to call capital on an as needed basis, with a few weeks notice, reduces cash drag on overall fund returns. Some investors monitor for timing issues between drawdown and deployment when they qualitatively evaluate performance.

Side Letters

The GP may negotiate or offer preferential terms for certain LPs for a variety of reasons. "Side Letters" have the effect of establishing new rights, prioritizing rights, altering existing rights and supplementing the terms of the standard LP subscription agreement. Disclosing the existence of side letters to all LPs promotes transparency and enhances LP confidence. However, there may be some leeway as to disclosing the exact content of the side letters. Large LPs, with negotiating power, protect themselves by insisting on likewise "favored clauses" popularly termed as "Most Favored Nation" clause (following trade agreements between countries) that make available the same privileges to them too.[4]

Indemnification Clauses

GPs favor inserting indemnification clauses in the fund documents to protect themselves from liability arising from claims, demands, controversy, disputes, costs and losses. Indemnification clauses also extend to LPs who serve on the partnership advisory board. Indemnification may reduce accountability for GP actions. Negotiations on the difference between what construes "gross negligence" versus "simple negligence" remain commonplace.

Valuation

There are no globally accepted standards for arriving at private investment valuations. The general idea is that valuations be prudent, reflecting the fair value of underlying holdings. Industry bodies such as the Institutional Limited Partners Association, National Venture Capital Association ("NVCA"), European Venture Capital Association ("EVCA"), Private Equity Investment Guideline Group and Association for Investment Management Research have proposed valuation guidelines, which are often followed. This is easier said than done; issues often arise as to whether investments ought to be carried at cost, or at cost with adjustment for subsequent financing events—and if so, whether financing needs to be material or not, or valuations be marked to market using available public comparables.

While exchange-traded, freely tradable securities are at the easy end of the valuation spectrum, non-tradable ones form the long tail at the other end. For example, freely tradable but volatile securities may be valued as the arithmetic average of the closing prices for a pre-specified number of days preceding valuation date. For non-freely tradable securities, the fair market value is sometimes appraised by an independent party.[5] Since this is a crucial element in establishing carried interest computations, it would be helpful to investors if valuation methods are articulated in the LP/GP agreement.

Investment Mandate

The GP has a lot of freedom to invest within the broad terms of the fund's mandate. LP advisory committee oversight of the investment activities, an appropriate level of disclosure and quarterly reports help ensure GP conformance to the investment mandate guidelines.

All else being equal clear articulation of the valuation methodology, co-investment rights and key person clause makes for better agreements...

Co-investment Rights

"Co-investment Rights" give the LP an option to invest directly in an operating company or an underlying asset alongside the fund. Sometimes co-investment terms exempt the LP from paying a management fee to the management company. This provides extra inducement for investors to invest in a fund.

Some funds permit co-investor LPs and the GP to invest in an underlying investment on the same terms as the fund. These may be in ongoing opportunities or may sometimes arise from previous investments made by the GP. Care needs to be taken to avoid conflicts of interest where select LPs and the GP participate in cherry picked deals

4 *Lately, regulators have been questioning the fairness of some side letters. It is not entirely uncommon to see such side letters initially intended for a select few LPs now be broadly offered to other investors particularly so in hedge fund contexts.*

5 *FASB 157 for Level I, Level II and Level III asset classification is becoming increasingly relevant.*

...as do clauses that increase transparency and facilitate conflict resolution

that are expected to outperform other deals held by the fund. LPs also favor fund provisions, which ensure that co-investments do not provide bailout funding for past underperforming investments. These provisions usually specify the fund's total maximum investment in such deals and also specify conditions under which the fund is allowed to purchase securities.

Key Person Event

In some partnerships, LPs may view certain individual principals, from the others that make up the GP entity, as being critical to the success of the fund. In such instances, their special ability to deliver and execute on a fund's investment thesis is often a prime consideration for LPs to invest in the first place. They prefer that these individuals, also known as "Key Person," actively manage the fund. When one or more of these individuals no longer contribute to the functioning of the fund, LPs protect their interest by choosing to cease further capital disbursements or, in extreme cases, vote for partnership termination. In these cases, some agreements do specify what constitutes a key person event, partner replacement provisions and the LP recourse.

Successor Funds

Investors expect the GP to focus entirely on deploying and harvesting the fund in which they have invested. The sponsor, on the other hand, is also interested in its franchise building, partnership continuity, as well as selectively diversifying their LP base to develop sustained sources of future capital.

LPs accordingly ask for provisions that curtail successive fund raising until the existing fund has been deemed to be entirely invested. The practice is to treat a fund as "Deemed Fully Invested" when 70% to 80% of the fund's capital has been invested or is reserved. GPs sometimes elect to keep reserve capital aside for future follow-on financings. Agreements often pre-specify this reserve amount and cap it at 10% to 15% of committed capital to meet definitions of deemed fully invested.

Successor funds may sometimes have a different set of LPs although there is often a large "re-up" (where investors in previous funds elect to invest again in successor funds) in well performing funds. New investors may have concerns about conflicts of interest if the GP has complete discretion, albeit limited by fiduciary duty under applicable law, in cherry picking opportunities and allocating them between existing and successor funds. Investors therefore insist that a previous fund be deemed fully invested before a GP begins making investments to a successor fund.

Parallel, Feeder and Affiliate Funds

To address different tax or regulatory issues for a diverse LP base, the GP may sometimes form one or more parallel funds. In such cases, all investments in and divestments of the partnership, as well as distributions, are best made on the same terms as the main fund.

Structurally a "Master-Feeder" fund structure is commonly used to accumulate funds raised from taxable, tax-exempt and foreign investors into one central investment vehicle. The central vehicle is known as the master fund. The master-feeder structure creates separate feeder vehicles for each investor group. Investors subscribe for partnership interests in the appropriate feeder fund that caters to their particular tax and domicile status. Feeder funds invest their proceeds in the master vehicle. It is at the master level that the actual portfolio investments are made. Profits and losses are apportioned pro-rata to the Net Asset Value of each feeder fund.

It is important to note that feeder funds are not tied to the master fund. They are legal entities that can invest in any number of master funds. Likewise, a master fund is not tied to a feeder either and can accept investments from any number of feeders. The U.S. taxable investor feeder is usually a domestic limited partnership. The non-U.S. investor feeder, which sometimes also caters to U.S. tax-exempt investors seeking to avoid unrelated business taxable income "UBTI" (described later on), is sometimes set up as an offshore corporation. U.S. taxable investors can subscribe directly into the offshore master fund.

Sometimes, the GP may form a fund for affiliates called an "Affiliates Fund." This fund is meant for select individuals, industry leaders, partners and employees who are committed to adding value to the partnership. An affiliate fund may have preferential economic terms such as by way of reduced management fee or sharing of carried interest. In such cases, it is prudent to specify a maximum size, usually a very small percentage of the overall fund, for the affiliate fund as well as enact provisions so that the affiliate fund co-invests on a pro rata basis and on similar terms as the partnership.

Partnership Term

The life of a fund is a function of its investment thesis and the business cycle of underlying portfolio investments. The norm has been 10 years (though this is getting longer for large LBO funds) with the first five usually being the investing period and the latter five as the development, maturation and harvesting period. Additionally, agreements often provide for extending the fund by one or two years with a view to enable orderly liquidation and/or value maximization.

No Fault Divorce

In the extremely rare case when LPs lose confidence in the GP, brought on by gross negligence or egregious abrogation of GP responsibility, the "No Fault Divorce" clause provides an exit to LPs by terminating the partnership or electing to end further capital contribution. However, this clause may be ineffective if the GP has already drawn down and invested the majority of fund capital. In such cases, LPs are better served by having recourse to other means to cure the event than simple partnership termination. The no fault divorce clause is quite rare and, even when present, is very seldom exercised.

Partnership termination and exit provision clauses help avert expensive legal procedures

Removal of GP

A GP may elect to choose to leave the partnership during the fund's life or may be asked to leave for cause. Cause may include events such as violation of Federal or state securities laws, felony, acts of fraud, misappropriation, embezzlement, intentional misconduct, and dereliction of duty or other material breaches of obligations. Removal for cause requires a majority LP vote. Some agreements, especially so for lesser known funds, specify procedures for GP removal and responsibility transition to provide LPs such protection. This, like the no fault divorce clause, is quite rare too.

Removal of LP

LPs, given their role as passive providers of capital are seldom, if ever, removed from a fund partnership except if they default on their fund commitments. Failure to furnish the capital in full on the drawdown date following capital call notices may invoke a penalty rate of interest. If the LP fails to make the contribution by the default date, the LP is deemed to have defaulted on its commitment. Such defaults may be detrimental to the remaining LPs and the GP as it may impair the course of the fund's future investing strategy.

The GP has wide ranging powers in these cases. They include giving the LP a chance to cure the default by accepting a late contribution, imposing a default charge, penalties or withholding distributions. Depending on the nature of LP default, the GP may assist the defaulting LP in selling its interest in the partnership or may purchase it from the LP themselves. Alternately, they may offer the defaulting LP's entire existing and future interest in the partnership to the other partners for purchase, usually in proportion to pro rata subscription interests. In extreme cases, the GP may file a lawsuit to collect the unpaid capital contribution, interest and costs, and reimbursement with interest at the default rate.

It is not always straightforward to transfer LP economic interest to others within or outside the partnership. In most cases, it requires the consent of the GP, for such transfers may have federal income tax consequences for the GP. Moreover, partnership interests are not registered under the Securities Act of 1933 and, therefore, cannot be sold or transferred unless they are registered or an exemption from such registration is available.

Fund documents tend to give the GP wide latitude and their actions have important ramifications for the remaining investors. For instance, when a GP borrows money to provide financing to temporarily tide over LP defaults, its actions may trigger UBTI for remaining LPs. In another case, if it assumes the defaulting LP's interest, investor voting rights may get reassigned, which may have governance ramifications.

UBTI

Pension plans, qualified plans and other tax-exempt investors are generally exempted from paying income tax as long as they are passive investors and hold securities for the explicit purpose of realizing income and capital appreciation.

Sometimes the nature of an investment triggers a tax liability for investors when those investments generate Unrelated Business Taxable Income ("UBTI"). Qualified plan LPs negotiate provisions that inhibit the GP from making investments that generate UBTI. This often conflicts with the needs of other non-tax-exempt LPs and the GP themselves who are indifferent to UBTI and are concerned with making profitable investments on an after tax basis. LPs, when they evaluate investing in a fund, often explore the constituent LP base to determine whether the fund would be indifferent to UBTI or will take active steps to avoid it.[6]

Grasp of the economic intuition underlying LP/GP agreements is conducive to better long-term outcomes for both the GP and the LP

Conclusion

The private equity industry is evolving at a fast pace, as have the terms of engagement between LPs and GPs. The agreements and clauses that define the relationship between LPs and GPs are nonstandard and privately negotiated. This article examined some of the key economic and governance issues that impact the LP/GP relationship. Issues that may lead to conflict of interests were identified and methods suggested to best align investor and GP interests. Negotiating LP/GP contracts involves a balance between preserving LP rights without materially curtailing GP flexibility to provide attractive returns—the primary reason for entering into these contracts in the first place. Awareness of subtle issues and their degree of economic sensitivity to all parties will, hopefully, help make transactions more efficient, reduce contractual friction and benefit the industry as a whole.

6 *IRS circular 203 disclosure: Citigroup, Inc., its affiliates, and its employees are not in the business of providing tax or legal advice to any taxpayer outside of Citigroup, Inc. and its affiliates. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon by any such taxpayer for the purpose of avoiding tax penalties. Tax-related statements, if any, may have been written in connection with the "promotion or marketing" of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.*

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