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Key man by law

Certain rules not widely known under the Advisers Act will need to be considered during succession planning.

Does your partnership agreement include a keyman clause? Most do. But even if it doesn't, many private equity firms are learning that registration with the US Securities & Exchange Commission (SEC) means investors are provided a key man clause sort of by default.

Section 205 of the Advisers Act includes a provision that says registered investment advisors cannot "enter into, extend, or renew any investment advisory contract…if such contract fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party by the contract."

Unfortunately the SEC hasn't exactly given crystal-clear guidance on what that provision means in the private equity context. But industry lawyers interpreting the language say "contract" means the limited partnership agreement, "assignment of such contract" means new firm management and "without the consent of the other party" means without approval from LPs. That, in spirit, is a key man clause.

In more plain English, lawyers say the provision means managing partners with significant control over the firm – either through ownership shares or representation on a management committee for instance – should gain LP consent before transferring a significant amount of control over to a colleague, third-party firm or investor. A good rule of thumb is a 25 percent control test, says Robert Sutton, a private funds partner at law firm Kirkland & Ellis. "Any time you anticipate someone at the firm gaining more than 25 percent voting control, or dipping below it, it's worth considering whether to seek approval from LPs before executing the transfer of shares or rights."

Sutton says the approval may not be required in every instance – for example, where no change in actual control ultimately occurs, perhaps because someone else has historically held and will continue to hold a majority voting stake. "However, it's still an appropriate time to at least stop and ask yourself (and perhaps your counsel) the question."

The rule should be a point of consideration during succession planning. Before speaking with their lawyers, most GPs are already alive to the fact that key man provisions will need to be reviewed when a senior partner is ready to retire for instance. Before that keyman partner can cash out his or her ownership shares – and make way for the next generation of leadership – investors may need to be consulted (perhaps via an LP advisory board) before he or she can enter retirement. Less obvious to GPs is that the SEC will want to see documentation of that consent should the partner's retirement result in a change in control under the Advisers Act. Another scenario is an aging founder who begins dividing power amongst a consortium of senior partners. If those partners acquire significant influence and control, then Section 205 may be triggered.

Moreover, partnership agreements that do not explicitly address the Section 205 rule should operate as if they do, the SEC warned private equity firms under its purview last year. In a worst case scenario, violating the section could nullify the entire LPA. Again, there are no hard and fast rules around what constitutes "assignment" under the provision in a private equity context, and not every transfer will be an "assignment," but it's a rule worth highlighting as a growing number of private equity firms begin to think (and rethink) their succession plans. And as those succession plans are implemented, it's worth mentioning there may be certain approvals needed before power is transferred.

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