

KIRKLAND BRIEF

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ILPA — Private Equity Principles

The Institutional Limited Partners Association recently published its “Private Equity Principles”, highlighting a laundry list of issues on which LPs think that GPs have pushed the boundaries in recent years.

As if private equity fund raising was not tough enough in the current economic climate, general partners (GPs) had a collective sharp intake of breath when the largest trade association for private equity investors, the Institutional Limited Partners Association (ILPA) published its “Private Equity Principles” in September. Although there is little data on which to base any view as to current trends in private equity fund terms, there is naturally a sense that the pendulum of negotiating strength has swung from GPs to investors/limited partners (LPs). Nonetheless, even though fund agreements have traditionally been fully negotiated contracts, GPs have always negotiated with limited partners individually rather than collectively. It is against this background that ILPA has issued a “wish list” for private equity fund terms.

However, it may not be as alarming for GPs as it sounds as, whilst the Principles deal with some core economic provisions, many fund agreements already reflect a large number of ILPA’s recommended terms.

What is ILPA?

ILPA has existed as the trade association for institutional private equity investors since the early 1990s. It started as an informal networking club between a dozen or so investors to share views and information and as a forum for training and education. It has grown over the years, like the wider industry itself, and now boasts more than 200 members globally, including public and corporate pension plans, endowments, foundations, family offices and insurance companies, and claims its membership represents more than U.S. \$1 trillion in private equity assets under management. Its doors are not open to GPs or intermediaries and traditionally it has kept a rather low profile. It is therefore somewhat surprising that some of the Principles it has proposed are fairly bold.

The Principles

To a large extent the Principles mirror those adopted by the Oregon State Investment Council earlier this year. Whilst the Principles do represent something of a laundry list of issues on which LPs think some GPs have pushed the boundaries over recent years, they are often quite general in their approach. Nevertheless it is likely that, in light of the current fund raising environment, GPs will find themselves benchmarked against the Principles.

The three areas that the Principles seek to address are alignment of interest, governance standards and transparency. In themselves, these are clearly unobjectionable. When one drills down into some of the detail, however, it can be easily seen where a significant number of current fund agreements do not comply.

Alignment of Interest

The major themes of the alignment of interest principles include:

- A whole fund carried interest distribution model (i.e., that all LPs’ drawn capital should be returned, plus hurdle, prior to any payment of carried interest). ILPA does accept the alternative deal-by-deal model, subject to LPs recovering historic losses and write downs, but with the suggestion that at least 30% of any carried interest distributions ought to be placed in escrow as security for potential future clawback obligations and, as an additional disincentive, that clawback obligations should be joint and several among executives with no credit for personal tax liabilities.
- Restrictions on management fees and transaction fees. The Principles not only suggest that management fees should be sufficient to cover “normal operating costs” only, but also that all transaction and other fees charged should be for the benefit of the fund rather than, as commonly is the case, split between the fund and the GP.

There are very few funds whose management fees are based directly on GP budgets. This was a feature in some funds raised following the dot-com bubble but mainly related to venture/technology funds, which tend to be smaller in any event.

The Principles also state that carried interest should be calculated by reference to returns net of all fees and tax, resulting in carried interest entitlements being lower whenever there are portfolio company level withholding taxes irrespective as to whether LPs are in fact able to reclaim (or otherwise benefit from) such taxes.

Governance

In terms of governance, ILPA is keen to avoid any erosion or contracting out of fiduciary and other duties owed by the GP in a private equity fund. They also provide for more frequent and involved disclosure to and consultation with investor advisory committees and require that fund investment strategies be more tightly defined to avoid so-called “style drift”. Similarly, ILPA sees termination and GP removal rights as important in achieving balanced governance.

Transparency

As regards transparency, ILPA sees a larger role for the fund’s auditor (who should be independent of both the GP and the fund’s other activities), and looks for frequent and detailed reporting and communication with LPs generally. In particular, the Principles require detailed disclosure of fees, carried interest payments and clawback, and the calculation methods used. In fact, most GPs will find that their quarterly reports already satisfy the vast majority of ILPA’s information reporting requirements.

Comply or Explain?

Although it is too early to tell whether the ILPA Principles will gain sufficient investor support to require GPs to comply or explain on an habitual basis, many GPs will be pleasantly surprised on a review of their existing or proposed terms to find that, in fact, there are few areas in which they deviate materially from ILPA’s Principles. Some of the industry’s larger investors have stated that the Principles mark the beginning of a new chapter in the private equity industry, but it is likely to continue to be the case that terms are negotiated on an investor by investor basis and, whilst terms and conditions may not be elevated to the ‘number one’ issue for investors when deciding whether to invest, their importance may be increased as a result of the Principles being published.

Should you have any questions about the matters addressed in this *Kirkland Brief*, please contact the following Kirkland author or your regular Kirkland contact.

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