

## Version 2.0 of ILPA Private Equity Principles Reflects Change in Approach

### PENpoints

*Version 2.0 of ILPA's Private Equity Principles purports to reflect feedback from both LPs and GPs and expands upon the same themes as the earlier principles: alignment of interest, governance and transparency.*

On January 11, 2011, the Institutional Limited Partners Association (“ILPA”) released Version 2.0 of its Private Equity Principles (“Version 2.0”), updating the original principles issued in September of 2009 (discussed in our earlier [KirklandPEN](#)). Version 2.0 represents evolution rather than revolution, preserving the thematic structure of the earlier document and leaving much of the original language intact. However, unlike the original principles, which ILPA said were based on input from institutional private equity limited partners (“LPs”) and their senior investment officers, Version 2.0 purports to reflect feedback from both LPs and general partners (“GPs”).

Version 2.0 expands upon the same three themes as the earlier principles—Alignment of Interest, Governance and Transparency, and adds three related appendices—a list of Carry Clawback Best Practice Considerations, a set of proposed best practices for an LP advisory committee (“LPAC”) and a table of Financial Reporting proposals.<sup>1</sup> The following highlights some of the significant provisions and noteworthy changes in Version 2.0.

#### Alignment of Interest

*Waterfall.* Version 2.0 continues to recommend a “European-style” waterfall (full return of all contributions plus hurdle prior to payment of any carried interest). Recognizing that not all funds will adopt this structure, Version 2.0 proposes several recommendations for deal-by-deal waterfall structures, most of which remain unchanged from the earlier principles. These include:

- Investment proceeds from a given investment should be first used to return all capital invested in such investment, as well as any partial impairments or write-offs of other investments.
- Carried interest distributions should be delayed

until all capital contributed for fees and expenses to date (as opposed to the portion attributed to realized deals) has been returned.

- No distributions of carried interest from current income or recapitalization proceeds should be made until all the capital invested in the applicable investment has been returned.
- Carry escrow accounts with significant reserves (30% of carry distributions or more) should be imposed.
- NAV coverage tests (generally at least 125% of unreturned invested capital) are recommended to ensure sufficient “margin of error” on valuations.

*Clawbacks.* The new clawback discussion proposes several new LP-protective features and modifications to provisions in the prior principles criticized as impractical. For example:

- Rather than demanding that all clawback amounts be returned gross of taxes, as in the prior principles, Version 2.0 suggests a nuanced approach intended to result in a GP member returning an amount equal to the lesser of (a) the excess carry paid and (b) the total amount of carry paid less the amount of tax actually paid by the GP member, taking into account, e.g., his or her actual tax rate, loss carryforwards and carrybacks, the character of the fund income, and deductions for state tax payments.
- In lieu of joint and several liability among all GP members for clawback obligations, Version 2.0 would permit a several obligation together with a

### INSIDE KIRKLANDPEN

<i>PENbriefs</i> . . . . .	3
<i>PENnotes</i> . . . . .	4

creditworthy guarantee from a substantial parent company, an individual GP member or some subset of GP members.

- Version 2.0 now recommends interim clawbacks at the end of the commitment period and upon the occurrence of certain triggering events (e.g., key-man departure or insufficient NAV coverage).

*Fees and Expenses.* Version 2.0 generally follows the earlier version's positions on management fees, fund expenses and fee income offsets,<sup>2</sup> but often uses a milder tone. For instance, where the previous version provided that the management fee "should step down significantly" at the end of the commitment period or commencement of a successor fund, Version 2.0 suggests that upon such events the fee "should take into account the lower levels of expenses" that follow.

### **Governance**

Version 2.0's governance prescriptions remain similar to the earlier version, emphasizing investment team stability, consistent strategy and fiduciary duties. However, several provisions in Version 2.0 appear to take into account the GPs' interests as well as the differing interests among the LPs themselves. For example, Version 2.0 provides the following:

- A majority in interest of the LPs should be permitted to remove the GP for cause, but not simply "upon preliminary determination" of bad acts (as in the original principles); rather, a provision for GP removal for cause should employ mechanisms "constructed so that the LPs can act before there is irreparable damage to their interests."
- A 2/3 in interest LP vote, rather than the simple majority vote prescribed by the earlier version, should be required to suspend or terminate the commitment period without cause.
- A 3/4 in interest LP vote, rather than the 2/3 in interest vote prescribed by the earlier version, should be required to remove the GP or dissolve the fund without cause.
- An all-partner giveback is contemplated, but apparently only for GP indemnification requirements, subject to an aggregate cap equal to 25% of commitments and a time limit of two years after the applicable distribution. The previous version did not contemplate an all-partner giveback and proposed that all indemnification obligations be

capped at a percentage of total commitments.

- Only a simple majority in interest of LPs should be required for most amendments to the partnership agreement, with supermajorities (or individual consents) for special cases, rather than a supermajority vote on any amendment (as in the earlier version).

### **Transparency**

In addition to many of the same information and disclosure obligations contemplated in the original principles, Version 2.0 suggests the use of ILPA's Standardized Reporting Templates (the Capital Call and Distribution Template is the only one currently available (at <http://ilpa.org>)). Version 2.0 also calls for enhanced risk management disclosure in annual reports regarding, among other things, concentration risk, foreign exchange risk, leverage risk and reputational risk.

### **Limited Partner Advisory Committee**

Version 2.0 strikes a more flexible tone from the original principles regarding LPACs. Where the previous version urged standardization of LPAC practices in order to rectify the "inconsistency" and "lack of uniformity" among private equity funds, Version 2.0's LPAC proposals are intended "to provide a model" recognizing "the differing constituencies of individual partnerships" and acknowledging "that one standard might not fit every situation."

For example, while Version 2.0, like its predecessor, lists a variety of specific instances where the LPAC should be consulted, it also casts the committee's functions and duties in broader and more flexible terms, calling for "an open forum for discussion of matters of interest and concern to the partnership" while allowing that the functions "may evolve" and that "the focus should clearly be on substance rather than form."

Additionally, Version 2.0 appears to recognize that the interests of a fund may not be perfectly aligned with the interests of its LPAC, cautioning about conflicts within the LPAC: it "should operate as a committee, not as a collection of individual members" and each member should "consider whether they have any potential conflict of interest" and disclose actual conflicts to other LPAC members.

**Conclusion**

Version 2.0 of the ILPA Private Equity Principles represents an incremental shift toward a more flexible, practical and bilateral approach to private equity fund

terms and procedures. As a result, while the ILPA principles likely will remain more of a measuring stick used by LPs in evaluating funds than a strict set of requirements, Version 2.0 is likely to play a continuing role in fund formation negotiations.

- 
- 1 These include a Capital Call and Distribution Template, the first of several recommended Standardized Reporting Templates that ILPA has under development.
  - 2 Version 2.0 provides that management fees should be based upon reasonable operating expenses and salaries, and should not create GP wealth; all transaction, monitoring and similar fees should benefit the fund; and the GP should (at a minimum) bear the cost of overhead, staff compensation, travel, deal sourcing, interactions with LPs and other general administrative expenses.
- 

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

**Bruce I. Ettelson, P.C.**

<http://www.kirkland.com/bettelson>

+1 312-862-2326

**Chris P. Kallos, P.C.**

<http://www.kirkland.com/ckallos>

+1 312-862-2146

**William C. Brashares**

<http://www.kirkland.com/bbrashares>

+1 212-446-4826

**PEN**briefs

## Airgas Poison Pill Upheld as the Delaware Chancery Court Endorses the “Just Not Now” Defense

In a recent decision, the Delaware Chancery Court upheld Airgas, Inc.’s continued use of a poison pill defense to prevent a hostile tender offer by Air Products and Chemicals, Inc. This was a landmark decision, as it addressed for the first time whether a target board can keep a poison pill in place even in the face of a premium-priced, all cash, non-coercive tender offer for all shares even after the board has had enough time to pursue strategic alternatives and all relevant information about the deal has been made public. To learn more, see our recent [M&A Update](#).

## PENnotes

**Hedge Fund Breakfast Seminar: Market and Regulatory Trends**  
**Minneapolis, Minnesota**  
**February 24, 2011**

Kirkland & Ellis and the University of Minnesota Law School will host a networking breakfast and seminar on February 24, 2011, at the University of Minnesota Law School. The seminar will cover current market and regulatory developments affecting hedge funds and other private fund managers. Panelists will include Kirkland partners Scott A. Moehrke, P.C., Nabil Sabki, Charles J. Clark, John F. Hartmann, P.C. and William R. Welke, P.C. For more information, or to register for this event, please visit: <http://communications.kirkland.com/vf/7531j9298V7965Izm1>.

**The 17th Annual Columbia Business School Private Equity and Venture Capital Conference: “Navigating New Opportunities And Challenges”**  
**New York, New York**  
**February 25, 2011**

The Columbia Business School Private Equity and Venture Capital Conference, sponsored by Kirkland & Ellis, will focus on recent opportunities and challenges that have emerged in the private equity and venture capital industries. Kirkland partner Kirk A. Radke will speak on a private equity panel titled “The Leveraged Buyout in 2011.” For more information, please visit: [www.cbspevcconference.com/index.html](http://www.cbspevcconference.com/index.html).

**The University of Chicago’s Booth School of Business 10th Annual Private Equity Conference**  
**Chicago, Illinois**  
**February 25, 2011**

The 2011 Booth School of Business Private Equity Conference will focus on strategies for differentiating one’s fund and achieving industry leading performance in today’s investment environment. Kirkland partner Stephen L. Ritchie, P.C., will moderate a panel on “Recent Developments in Private Equity Transactional Markets.” For more information, or to register, please visit: <http://student.chicagobooth.edu/group/pe/conference/index.htm>.

**The 17th Annual Harvard Venture Capital & Private Equity Conference**  
**Boston, Massachusetts**  
**February 26, 2011**

The 2011 Harvard Venture Capital & Private Equity Conference, sponsored by Kirkland & Ellis, will address issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. Kirkland partner Kirk A. Radke will participate in a panel discussing large buyouts, partner Armand A. Della Monica will participate in a panel discussing distressed investments and partner Abrar Hussain will moderate a panel on private equity in Asia. For more information, or to register, please visit: [www.hbsvcpeconference.com/index.php](http://www.hbsvcpeconference.com/index.php).

**The 6th Annual NYU Stern Private Equity Conference**  
**New York, New York**  
**March 4, 2011**

The 6th Annual NYU Stern Private Equity Conference, sponsored by Kirkland & Ellis, will be held on March 4, 2011, in NYU’s Kimmel Center. The conference will feature leading panelists discussing, among other topics: emerging markets, leveraged buyouts, distressed investing, growth capital and venture capital. Kirkland partner Markus P. Bolsinger will participate in a panel on “Leveraged Buyouts” and partner Jonathan S. Henes will participate in a panel on “The Distressed Paradox: Where are all the Deals?” For more information, or to register for this event, please visit: [http://people.stern.nyu.edu/spec/eve\\_conference\\_2011.htm](http://people.stern.nyu.edu/spec/eve_conference_2011.htm).

**The 2011 ACG Chicago Awards Gala**  
**Chicago, Illinois**  
**March 10, 2011**

The Chicago chapter of the Association for Corporate Growth will hold its annual awards gala on Thursday, March 10, 2011, in Chicago. Kirkland partner Jack S. Levin, P.C., will be honored with the Lifetime Achievement Award, Walgreens will receive the Corporate Growth Award and KeHE Distributors will receive the Emerging Growth Award. For more information, or to register for this event, please visit: [www.acgchicago.com/events](http://www.acgchicago.com/events).

**Chicago**

Kirkland & Ellis LLP  
300 North LaSalle  
Chicago, IL 60654  
+1 (312) 862-2000  
+1 (312) 862-2200 fax

**Hong Kong**

Kirkland & Ellis LLP  
26th Floor  
Gloucester Tower  
The Landmark  
15 Queen's Road Central  
Hong Kong  
+852-3761-3300  
+852-3761-3301 fax

**London**

Kirkland & Ellis  
International LLP  
30 St Mary Axe  
London, EC3A 8AF  
United Kingdom  
+44 20 7469 2000  
+44 20 7469 2001 fax

**Los Angeles**

Kirkland & Ellis LLP  
333 South Hope Street  
29th Floor  
Los Angeles, CA 90071  
+1 (213) 680-8400  
+1 (213) 680-8500 fax

**Munich**

Kirkland & Ellis  
International LLP  
Maximilianstrasse 11  
80539 Munich  
Germany  
+49 89 2030 6000  
+49 89 2030 6100 fax

**New York**

Kirkland & Ellis LLP  
601 Lexington Avenue  
New York, NY 10022  
+1 (212) 446-4800  
+1 (212) 446-4900 fax

**Palo Alto**

Kirkland & Ellis LLP  
950 Page Mill Road  
Palo Alto, CA 94304  
+1 (650) 859-7000  
+1 (650) 859-7500 fax

**San Francisco**

Kirkland & Ellis LLP  
555 California Street  
San Francisco, CA 94104  
+1 (415) 439-1400  
+1 (415) 439-1500 fax

**Shanghai**

11th Floor, HSBC Building  
Shanghai IFC  
8 Century Avenue  
Pudong New District  
Shanghai 200120  
P.R. China  
+8621 3857 6300  
+8621 3857 6301 fax

**Washington, D.C.**

Kirkland & Ellis LLP  
655 Fifteenth Street, N.W.  
Washington, D.C. 20005  
+1 (202) 879-5000  
+1 (202) 879-5200 fax

## Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was recognized as "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

*The Lawyer* magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

# KIRKLANDPEN

# KIRKLAND & ELLIS LLP

## EDITORS

**Jack S. Levin, P.C.**

**Margaret A. Gibson, P.C.**

**Norbert B. Knapke II**

## SUBSCRIPTIONS

To subscribe to *KirklandPEN*, please e-mail

[kirklandpen@kirkland.com](mailto:kirklandpen@kirkland.com)

+1 (312) 862-2894

This publication is distributed with the understanding that the author, publisher and distributor of this publication and/or any linked publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, portions of this publication may constitute Attorney Advertising.