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ILPA Private Equity Principles – The Third Installment

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In late June 2019, the Institutional Limited Partners Association ("ILPA") released its third iteration of a set of Private Equity Principles (the "Current ILPA Principles"), updating their previously released set of principles (the "Prior Principles") which ILPA published in January 2011 (summarized here). ILPA has issued each of the Current Principles and Prior Principles, as well as the original set of principles released in September 2009 (the "Original Principles"), for purposes of serving as a guideline for industry best practices in private equity investing from the perspective of sophisticated institutional limited partners. The Current ILPA Principles are intended to expand on the Original Principles and Prior Principles, based on feedback received from a variety of sources throughout the investment community, as well as to reflect the evolution of industry standards from the perspective of ILPA and its constituencies. The Current ILPA Principles can be viewed here.

The Current ILPA Principles continue to emphasize the importance of alignment of interest, governance and transparency and provide recommendations on a significantly expanded set of topics (which is not surprising given the eight years that have passed since the release of the Prior Principles), as well as additional detail on a number of topics previously covered in the Prior Principles. The Current ILPA Principles include a number of proposals which are likely to be perceived by sponsors as being primarily for the benefit of investors. There are other proposals, particularly as they relate to issues of governance and transparency, which ILPA would likely view as being beneficial to both investors and sponsors, but which sponsors may find to be overly burdensome. There are also, however, a small number of proposals which, if implemented, would likely be well received by sponsors. These and other items of note are summarized below.

Waterfall

As with the Prior Principles, ILPA maintains that a full return of capital waterfall (*i.e.* a "European style" waterfall) is "best practice" but recognizes that a deal-by-deal waterfall is a common alternative.

The Current ILPA Principles place a significantly increased emphasis on private equity fund sponsors' calculation of preferred return and carried interest, including certain recommendations that depart from common market practice, for example, that carried interest should be calculated based solely on the portion of profits that exceed a limited partner's preferred return.

Fees

In addition to reiterating much of the Prior Principles' guidance regarding the calculation of and use for the management fee, the Current ILPA Principles contain a new section providing specific recommendations as to the base that sponsors should use in calculating management fees, including the suggestion that general partners and investors consider the merits of a bifurcated fee during the investment period, reflecting a blended percentage of committed and invested capital (an approach that would be quite unusual for a traditional private equity fund). In addition, while the Prior Principals recommended that management fees should step down during any extension of a fund's term, the Current ILPA Principles go a step further to suggest that no fees should be charged during any such extension unless limited partners have otherwise agreed based on applicable facts and circumstances.

Also included is an expanded discussion of the calculation, assessment and reporting of other non-management fee income, stating unequivocally that all portfolio company fees should be 100% offset against the management fee including those attributable to coinvestors and emphasizing adequate disclosure surrounding such fees and any offsets thereto, including that any fees not fully offset should be disclosed to limited partners.

Expenses

The section focusing on expenses is one of the most significantly expanded sections of the release, clearly indicating that this is a strong point of focus for ILPA. While this is not surprising, particularly given the focus of the U.S. Securities and Exchange Commission on expense allocation and disclosure, the particular areas of focus for ILPA are helpful insofar as it may give sponsors a better sense of what investor comments to anticipate during fundraising. ILPA's overarching advice with respect to expenses is that the allocation of agreed expenses should be subject to regular review by both limited partners and an independent auditor.

Notably, ILPA also instructs that (A) organizational expense caps should take into account not only the size of the fund but also "specific cost factors" such as compliance with new regulatory regimes and (B) in an effort to reduce the cost associated with negotiating complex side letter requests, investors should attempt to limit side letter requests to only those required pursuant to statutory or other "institution-specific" needs – a welcome suggestion for many sponsors.

Expenses are broken down into two categories: (1) those that should be borne solely by the fund, which includes (A) expenses related to LPAC meetings, but expressly excluding the costs of entertainment, (B) costs of a third party administrator to the extent such administrator has been approved by limited partners, (C) travel expenses incurred in respect of a deal, but only following the completion of an initial term sheet in respect thereof, and (D) broken deal expenses, which ILPA notes should not include expenses incurred in connection with preliminary due diligence and sourcing; and (2) those that should be borne by the management company (through a management fee offset or otherwise), which includes (A) consultants' fees, such as due diligence consulting costs (noting, however, that the cost of any "specialized" consultant hired at the explicit request of a limited partner should be paid by such requesting partner), (B) ESG-related expenses, (C) placement agent fees (as opposed to placement agent expenses, which ILPA notes should be borne by the fund but subject to approval by the LPAC), (D) costs associated with operating partners (an expense which is frequently borne by the fund, assuming proper disclosure is provided), (E) overhead costs and expenses of the manager, (F) expenses related to the investment activities of the manager on behalf of the fund, including attendance at industry conferences, expenses in connection with maintenance of books and records, the costs of complying with regulatory requirements such as registration fees, and expenses in connection with corrective actions required pursuant to a regulatory examination and (G) expenses relating to technological upgrades and cyber security. ILPA also notes that expenses specific to individual limited partners should be allocated to such limited partners rather than shared across the fund as a whole, though many limited partners might object to such special allocation and sponsors may find the process of tracking such expenses and administering such allocation to be onerous.

The Current ILPA Principles also acknowledge the possibility of unforeseen expenses which may arise throughout the life of a fund that have not been explicitly addressed in the fund's governing documents. In the case of such unforeseen expenses, ILPA recommends that general partners should involve the limited partners and the LPAC in conversations surrounding any adjustments they feel are necessary to expense allocation policies or the interpretation thereof, suggesting the LPAC should be "supportive" of such changes.

Fund Term and Structure

The recommendations contained in the Current ILPA Principles as to limitations on the life of a fund reflect a more conservative approach than those included in the Prior Principles, reiterating the instruction of the Prior Principles that fund term extensions should be allowed only in one year increments and additionally advising that there should be no more than two such one-year extensions and that such extensions should be approved first by the LPAC and then by approval of a super majority in interest of limited partners.

Additionally, there is a new focus on transparency with limited partners as to ownership and structure at the GP and management company levels, proposing that a sponsor (a) disclose the ownership of the management company and (b) notify limited partners of any intent to transfer any amount of general partner interests to a third party, including in such notification a clear explanation of the reason for such transaction, any effect on cash flows and the impact on carried interest allocation among the other members of the general partner.

A new section has been included containing advice as to the use of parallel or alternative investment vehicles in a fund structure, including a recommendation that general partners should provide limited partners participating in any alternative vehicle with the governing documents of such vehicle at least ten business days in advance of signing, which many sponsors may find operationally challenging.

Key Person

The Current ILPA Principles expand significantly on the recommendations set forth in the Prior Principles with respect to Key Person provisions. ILPA emphasizes the importance of (a) selecting the appropriate key persons (who should be individuals who have the most impact on the performance of a fund, regardless of title), (b) advanced planning for the potential departure and replacement of key persons and disclosure surrounding such departures and (c) a narrowly drafted key person provision whereby the departure of anyone who limited partners may "reasonably believe" to be key persons would trigger such provision. Such advice leaves open some room for interpretation as to how such a provision would be drafted.

Whereas the Prior Principles provided that amendments to the key person provisions must be approved by either the LPAC or a majority in interest of limited partners, the Current ILPA Principles do away with the possibility of an LPAC approval and suggest that sponsors must obtain a majority in interest of limited partners.

In addition, the Current ILPA Principles note the importance of key person obligations following the end of the investment period for purposes of maximizing returns on investments as they approach disposition, although they do not provide a specific recommendation.

Fund Governance

The Current ILPA Principles include an expanded section addressing general partner removal and replacement, specifying that in the case of a for-cause removal, termination of an individual responsible for such cause event is not in and of itself sufficient as a cure and further, that any such person should be stripped of any economic entitlements, including carried interest payments, in respect of the fund. While the recommended threshold for for-cause removal of the general partner remains the same as the Prior Principles (a majority in interest vote), the Current ILPA Principles propose a lower threshold for no-fault removal of the general partner, which would require a “Super Majority” (*i.e.*, two-thirds) in interest (rather than the three-quarters in interest recommended in the Prior Principles).

In addition, there is an expanded discussion of a general partner’s fiduciary duties to limited partners, underscoring the importance of avoiding the contractual diminution of any such duties, and making certain specific recommendations that may not align with most sponsors’ current practices, namely that indemnification expenses should be capped as a percentage of total fund size.

In addition to the voting thresholds for general partner removal set forth above, the Current ILPA Principles also include the following voting thresholds for certain fundamental changes to a fund:

- LPA amendments should require a “Super Majority” in interest, which reflects a higher threshold than the Prior Principles, which recommended a default threshold of a majority in interest, with only certain amendments requiring a super majority.
- No-fault dissolution of the fund should require a “Super Majority” in interest, which reflects a lower threshold than the Prior Principles, which recommended three-quarters in interest.
- Suspension of the investment period should require a majority in interest, which reflects a lower threshold than the Prior Principles, which recommended two-thirds in interest.

New sections not present in the Prior Principles have been added to address GP-led secondary transactions (reflecting a consolidated version of their previous release on this topic, which can be found here, and which is summarized here), cross-fund investments (recommending that general partners should avoid multiple funds investing in the same investment and any such cross-fund investments should be subject to express limitations and disclosure requirements) and co-investment allocations (which should be subject to written policies and disclosed to limited partners in detail, particularly in cases where there may be a conflict of interest).

LPAC Best Practices

The Current ILPA Principles include a discussion of LPAC best practices that is similar in spirit, yet considerably more fulsome than the corresponding section included in the Prior Principles. The Current ILPA Principles stress the importance of selecting a modest number of limited partners that are diverse in their size, type, tax status and quality of relationship with the general partner to comprise the LPAC. The Current ILPA Principles include an extensive list of items that should be subject to LPAC review and/or approval, including those relating to key persons and departures of key staff, clawbacks and true-ups, costs of operational advisors, and material ESG incidents or other risks to the investments. The Current ILPA Principles also set forth a number of specific recommendations as to the timing, mechanics and substance of LPAC meetings, including a robust sample meeting agenda.

Auditor Independence and Scope of Fund Audit

The Current ILPA Principles include a new section regarding the role of an auditor of a private equity fund, specifying that the scope of the fund’s audit should include examination of capital account statements, fees and expenses, and waterfall calculations and emphasizing the importance of disclosure to the LPAC as to both the scope work performed and details of the auditor’s findings. In addition, ILPA suggests that the general partner should form an audit committee comprised of a representative of all limited partners in the fund (rather than solely the LPAC members) which may be tasked with approval of auditor selection, duties and scope of engagement. While common in the public company arena, such audit committees are unusual in the private funds world.

Financial Disclosures

The Current ILPA Principles go into greater detail as to the recommended content and process for disclosure of such financial information, which largely follows the disclosures included in the ILPA Reporting Template for Fees, Expenses and Carried Interest, which can be found here. Specific proposals include that quarterly financials should include sufficient detail to enable investors to verify the general partner's calculation of management fees, expenses, offsets, carried interest, and other information presented therein and that capital calls and distribution notices should include estimates of quarterly projections. In addition, it is recommended that general partners should include in their annual reports information on the compensation of their members, including the capital commitment and carry allocation for each member in both current and previous funds as well as information on each such member's ownership interest in the management company. While the Fee Reporting Template and Capital Call and Distribution Notice Templates have garnered significant traction in the marketplace, the ILPA quarterly reporting template has not been as widely adopted (even prior to the recommendations included in the Current ILPA Principles).

Subscription Lines of Credit

While the instruction of the Prior Principles that quarterly and annual reporting should include a schedule of fund-level leverage is reiterated, a number of additional recommendations have been added, including (a) the impact of capital call credit facilities should be included in the disclosure of performance information (i.e., IRR, TVPI and MOIC), which should be presented on both a levered and unlevered basis in a fund's annual report, (b) the terms for any credit facility should be provided to limited partners upon request and (c) such facilities should be outstanding for no more than 180 days and limited to a maximum percentage of fund commitments, with a 20% limitation provided as an example. ILPA previously issued a release on subscription lines of credit in June 2017 which can be found here, and which is summarized here.

Fund Marketing Materials

A section has been added specifying what should be included in a fund's marketing materials, including descriptions of pending or threatened litigation, political contributions of the manager or associated persons to trustees or elected officials on investor boards, and a policy for subscription line usage.

Policy Disclosures

A comprehensive discussion of disclosures relating to manager policies and events impacting the fund has been newly added. While focusing largely on the parameters of an appropriate and fulsome ESG policy (including the recommendation that such policy should specify verifiable, documented procedures rather than more general statements as to promised behavior), throughout the release, ILPA also suggests that general partners should maintain additional policies such as those relating to travel, allocations, subscription line usage, harassment and discrimination, risk management and an organizational code of conduct, all of which should be made available to limited partners.

A fulsome list of events upon which notice should be provided to limited partners is also introduced, which includes, the occurrence of any legal or regulatory inquiry or examination in connection with the fund (with no exclusion for routine exams), changes in general partner ownership (both in respect of governance and beneficial economic ownership), any material liability arising during the term of the fund and any potential breach of the general partner's organizational code of conduct.

Conclusion

Given that the Current ILPA Principles have significantly expanded upon the Prior Principles in a number of ways—several of which may conflict with the practical realities faced by private equity sponsors in the efficient management of their business—it is unlikely that a significant portion of limited partners will insist on all of these recommendations during the course of negotiations. Sponsors should, however, be prepared to at least dialogue with limited partners on the topics summarized in this release, some of which may not have been the subject of any significant discussion prior to the release of the Current ILPA Principles.

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