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Negotiating Private Equity Fund Terms: Key Provisions for PE Sponsors and LP Investors and the New ILPA Model Limited Partnership Agreement

Waterfall Provisions, GP Removal Rights, Standard of Care, Carried Interest, Management Fees, MFN Rights

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Today's faculty features:

John J. McDonald, Managing Partner, **Tremont Street Partners**, Greenwich, CT

Michael D. Saarinen, Partner, **Alston & Bird**, New York, NY

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Negotiating Private Equity Fund Terms:

Key Provisions for PE Sponsors and LP Investors and the New ILPA Model Limited Partnership Agreement

John McDonald
Managing Partner
Tremont Street Partners, LLC
John.McDonald@TremontStreetPartners.com

Michael D. Saarinen
Partner
Alston & Bird LLP
Michael.Saarinen@Alston.com

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SCOPE OF PRESENTATION

- This webinar will examine current trends and hot issues in private equity (PE) fund terms and considerations involving structuring and negotiating fund document terms for PE sponsors and limited partner investors (LPs) in PE funds
  - We will discuss some of the ways in which key issues are addressed in the Institutional Limited Partners Association's (ILPA) Model Limited Partnership Agreement (LPA) relative to how they are addressed elsewhere in the marketplace
  - We will outline certain terms that are relevant to US private equity funds engaged in leveraged buyout acquisitions of operating companies
  - In order to get into meaningful depth, while working within our time constraints for this webinar, we will necessarily not discuss the terms of other types of private funds, such as hedge funds or real estate funds, or the structuring aspects of buyout funds, such as use of offshore feeder and parallel funds.

PE FUND TERMS

- PE fund core documents
  - Operating agreement
  - Subscription agreement
  - Side letters between the fund sponsor and individual LPs

- Influences on PE fund terms
  - Longstanding practices of a particular PE fund sponsor
  - Market environment
  - Relative negotiating leverage of the parties
  - Regulatory developments
  - Other factors

- In this webinar, we will discuss how certain terms are addressed in ILPA's Model LPA and in the market more generally.

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BACKGROUND ON ILPA

- ILPA is a trade group for institutional LPs such as:
  - Pension funds
  - Endowments
  - Foundations
  - Insurance companies
  - Family offices
  - Sovereign wealth funds
- Institutional LPs have a range of priorities, regulatory obligations and stakeholders

BACKGROUND ON ILPA MODEL LPA

- The 2019 ILPA Model LPA was developed by a group of internal and external counsel that represent the PE sponsor and LP communities in the fund formation process
  - A consultation draft was released to ILPA members for comment in fall 2018
  - Comments were incorporated in fall 2019
  - Publicly released in October 2019
  - Available for download on ILPA's website: https://ilpa.org/wp-content/uploads/2019/10/ILPA-Model-Limited-Partnership-Agreement-October-2019.pdf

GOALS OF ILPA MODEL LPA

- Stated goals of ILPA Model LPA:
  - Promote alignment of interests between PE sponsors and LPs
  - Implement the concepts in the most recent version of the ILPA Principles (version 3.0), which are a set of model deal terms and principles for PE fund investments
- Like the ILPA Principles on which it was based, the ILPA Model LPA generally tends to be LP favorable

WATERFALLS: INTRODUCTION

- The "waterfall" provisions constitute the central economic deal of a PE fund – the allocation of profits
- Waterfalls typically provide that LPs receive their contributed capital, plus a preferred return at a stated IRR (the "hurdle"), before the PE sponsor shares in profits on investments made by the PE fund through "carried interest" payments (subject to a "GP catch-up")
  - ➢The carried interest share of PE fund profits is the "20%" component of "2 & 20" compensation traditionally paid to PE sponsors (the "2%" component is the management fee)

WATERFALLS:
"WHOLE FUND" VS. "DEAL-BY-DEAL"

- European "whole fund" waterfalls
  - PE sponsor does not receive carried interest until all of an LP's capital contributions – including contributions towards unrealized investments – have been recovered and the preferred return threshold has been met
- American "Deal-by-deal" waterfalls
  - PE sponsor may receive carried interest from individual investments in the PE fund before the LPs have been fully compensated for their contributions

WATERFALLS:
"WHOLE FUND" VS. "DEAL-BY-DEAL" (cont.)

- ILPA Model LPA uses a European-style "whole fund" waterfall
  - ➢ILPA is expected to release an alternative model LPA featuring a "deal-by-deal" waterfall

WATERFALLS:
PREFERRED RETURN

- Preferred return IRR calculation is time-sensitive
  - IRR decreases if there is a longer duration between when capital is called from LPs to make a portfolio company investment and when it is ultimately returned to LPs upon sale of the portfolio company
- Relationship between credit facilities and PE fund IRR
  - Credit facilities cause LP capital to be deployed for shorter period of time than otherwise would be the case
  - Preferred return IRR increases as the duration of LP capital deployment is shortened, unless the IRR formula is modified to take into account the use of credit facilities

WATERFALLS: PREFERRED RETURN (cont.)

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- ILPA Model LPA features a modified preferred return formula that addresses the impact of credit facilities on IRR
  - ➢ In contrast to a traditional PE fund waterfall, its preferred return runs from the date of draw on the credit facility or the date of LP capital call (if no credit facility is used)

WATERFALLS:
CARRIED INTEREST CLAWBACKS
&
OTHER LP ECONOMIC PROTECTIONS

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- Form and function of clawbacks
- Types of clawbacks
  - “End of fund life” clawbacks
  - Interim clawbacks
- Other types of LP protections
  - Escrow accounts

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WATERFALLS:
CARRIED INTEREST CLAWBACKS
&
OTHER LP ECONOMIC PROTECTIONS (cont.)

- ILPA Model LPA requires that a portion of each carried interest distribution made to the GP must be deposited in an escrow account available to satisfy any clawback obligations of the GP
- A clawback calculation is made on the first anniversary of the end of the commitment period, upon the removal of the GP, at the time of the fund's final liquidating distribution, and when any distributions are required to be returned by the LPs
- ILPA Model LPA approach is arguably "belt and suspenders"
  - "Whole fund" waterfall
  - Escrow of carry
  - Interim clawbacks

TERMINATION RIGHTS: OVERVIEW

- Private equity funds are long-term investment vehicles
  - PE fund's investment thesis is based on acquiring, improving and selling portfolio companies, which takes a substantial amount of time
- LPs may have the ability to end the relationship with a PE sponsor early in limited circumstances
- Potential consequences of early termination
  - Cessation of the fund's investment period
  - Removal and replacement of fund's general partner
  - Termination and liquidation of the fund

TERMINATION RIGHTS: “FOR CAUSE” AND “NO FAULT DIVORCE”

- Termination can occur either with or without “cause”
  - Traditionally, “for cause” termination was the norm
- “For cause” termination rights
  - “Cause” is triggered upon an LP vote after occurrence of certain PE sponsor “bad acts” listed in the LPA
  - LP vote threshold tends to be a majority in interest or greater
- “Bad acts” triggers may include:
  - breach of fiduciary duty
  - commission of a felony or a misdemeanor relating to theft or dishonesty or violation of securities laws
  - material breaches of fund documents resulting in material adverse effect

TERMINATION RIGHTS:
"FOR CAUSE" AND "NO FAULT DIVORCE" (contd.)

- In addition to "for cause" termination, PE funds may permit "no fault divorce" provisions enabling LPs to terminate the relationship with the fund sponsor early without being required to show "cause"
- Unlike "for cause" termination, which may require only a simple majority in interest of the LPs, the voting threshold for "no fault divorce" typically requires a supermajority
- "No fault divorce" may be utilized where no "bad act" has occurred but LPs are dissatisfied due to driven extremely poor fund investment performance or serious issues with the fund sponsor
- PE sponsors sometimes have a "honeymoon period" after the final closing before LPs can seek "no fault divorce" termination
- In practice, "no fault divorces" are extremely rare

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TERMINATION RIGHTS: “FOR CAUSE” AND “NO FAULT DIVORCE” (contd.)

- ILPA Model LPA permits “for cause" and “no fault divorce” termination
- Termination “for cause”
  - Simple majority LP threshold (rather than a higher percentage)
  - No requirement that there be a court determination (much less a “final judgment not subject to further appeal”) that the cause event has occurred
  - Broad definition of cause event
- “Cause” includes:
  - fraud, bad faith or willful misconduct of the GP, the investment manager, any of the key persons and any of their respective affiliates
  - gross negligence or reckless disregard of any such person in relation to activities of the fund
  - breach by of the fiduciary duty standard of care included in ILPA Form LPA
  - material breach of any other term of the LPA or of any other fund document
  - misdemeanor criminal conduct by a key person
- “No fault divorce” termination upon vote of 75% in interest of LP investors

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CONSEQUENCES OF TERMINATION

- "For cause" terminations typically (but not always) result in the PE sponsor's carried interest in the fund either being substantially or totally forfeited, sometimes (but not often) with retroactive effect to require repayment of previously-made carried interest payments by the PE sponsor.
- For "no fault divorce" terminations, the treatment of carried interest can vary substantially
  - ➢ Fair market value buyout by the successor fund manager
  - ➢ Conversion of carried interest into a limited partnership interest in the fund, sometimes with some degree of "haircut"

CONSEQUENCES OF TERMINATION (cont.)

- ILPA Model LPA gives LPs a range of options for termination of the relationship
  - ➢ Removal of PE sponsor
  - ➢ Early termination of investment period
  - ➢ Termination and liquidation of PE fund

- Economics of "for cause" termination
  - ➢ Forfeiture of rights to receive further distributions of carried interest and any amounts retained in the clawback
  - ➢ Return of escrow account to the PE fund for distribution to LPs, effectively providing for retroactive forfeiture of carried interest

- ILPA's notes accompanying the model LPA suggest that small or emerging managers could benefit from a 1-2 year "honeymoon period" after final closing of the fund before "no-fault divorce" termination applies, and that management fees should continue for 6-18 months after any such termination

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STANDARD OF CARE

- ILPA Model LPA includes express language requiring the fund sponsor (both the GP and the investment manager) to "act reasonably and in good faith" and "use the standard of care that an ordinarily prudent person in a like position would exercise under similar circumstances."
- This contractual standard of care supplements, and doesn't replace, any fiduciary duties applicable to the PE sponsor under applicable law (e.g., the Investment Advisers Act of 1940).
- It applies to all investment decisions, delegations of authority, exercises of discretion (including instances in which the fund sponsor can act "in its sole discretion" under the LPA), and other acts or omissions of the fund sponsor, not only under the LPA, but also under other fund documents such as the investment management agreement, side letters and subscription agreements, as well as "any other agreements or understandings relating to or otherwise affecting the fund".
- ILPA's approach to standard of care is more LP-investor friendly than is typically seen in the fund documents of seasoned PE sponsors.

STANDARD OF CARE (cont.)

- ILPA Model LPA standard of care is driven by concern among some LPs that fund sponsors have been able to "contract out" of fiduciary duties by including language expressly disclaiming fiduciary duties in their fund documents
  - ➢ Court decisions have upheld contractual fiduciary duty waivers for fund managers, although they are more common in real estate funds in which the manager is exempt from registration under the Investment Advisers Act of 1940 than in US buyout funds in which the PE sponsor is a RIA
  - ➢ Rather than simply referencing "fiduciary duties," the ILPA Model LPA language goes further and actively imposes a contractual standard of care that is in addition to what might otherwise apply under applicable law, such as under the Investment Advisers Act of 1940
  - ➢ This approach is not customary for PE funds, although it is not unusual for termination rights to include breach of "fiduciary duties", which is typically left undefined in the LPA and interpreted to consist of fiduciary duties under the Investment Advisers Act of 1940

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EXCULPATION AND INDEMNIFICATION

- The potential liability of fund sponsors to the fund or LPs is typically limited in "exculpation" provisions contained in the LPA to instances in which they commit the same types of "bad acts" that also trigger the LPs' right to terminate the fund discussed above (e.g., bad faith, fraud, willful misconduct and gross negligence relating to their duties to the fund)
- These "bad acts" also typically act as exceptions to the general right of fund sponsors to be indemnified out of fund assets for any lawsuits and other liabilities to which they are subjected in their capacity as managers of the fund, which then limits fund sponsors right to advancement of expenses
- Although the lists of "bad acts" for exculpation and indemnification purposes tend to closely track each other, in part because they are both derived from statutory provisions contained in Delaware law, the list of "bad acts" is often broader in the fund termination context.

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EXCULPATION AND INDEMNIFICATION (cont.)

- As is the case in the fund termination context, both the scope of "bad acts" (e.g., negligence vs. gross negligence, "intentional" fraud vs. fraud) and the standard to which they need to be proven (e.g., by a court in a final judgment not subject to further appeal, or not) may be negotiated issues for PE sponsors and LPs in fund documents

- LPs typically seek a broader definition of bad acts and a lower threshold of proof and PE sponsors typically seek the opposite.

  - ➢ Although, for many years, the market standard of proof for these purposes was a "final court judgment not subject to further appeal," LPs have increasingly been seeking to eliminate this requirement
  - ➢ This is the case because there is often a years-long litigation process before any such judgment will be rendered and a real possibility that no such determination may actually ever be made by a court, even in instances in which "bad acts" have clearly occurred, due to settlement of litigation or factors

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EXCULPATION AND INDEMNIFICATION (cont.)

- ILPA Model LPA has pro-LP broad “bad act” carve-outs from the exculpation provisions limiting the liability of fund sponsor affiliates, which cover:
  - ➢ commission of fraud, bad faith or willful misconduct, gross negligence or reckless disregard;
  - ➢ a breach of the LPA (including the “standard of care” provisions discussed above) or any other fund document (including side letters); and
  - ➢ violation of any law or regulation.
- Indemnification is subject to the same broad “bad act” carve-outs as the exculpation provisions discussed above, except there are additional carve-outs from indemnification for actions relating to bankruptcy proceedings involving the fund sponsor affiliates and for “internal disputes” among PE sponsor entities

EXPENSE ALLOCATION PRACTICES

- SEC Office of Compliance, Inspections and Examinations (OCIE) Director Andrew Bowden's "*Sunshine Speech*" and SEC Asset Management Division Enforcement Co-Chief Julie Riewe's "*Conflicts, Conflicts, Everywhere*" speech, followed by a steady series of SEC enforcement actions against PE sponsors have made clear that proper disclosure of expenses, including "broken deal" expenses, among PE sponsor management companies, co-invest vehicles and other affiliates, on the one hand, and PE funds (and therefore LPs), on the other hand, is extremely important to the SEC.
- In addition to the SEC, LPs are increasingly focusing on disclosure of expense allocation provisions in PE fund documents, as well on the underlying practices in their due diligence processes concerning PE funds in which they invest.

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CONFLICTS OF INTEREST

- Expense allocation is just one part of the broader issue of conflicts of interest in PE fund operations
  - Offset of acquisition fees, financing fees, directors' fees, monitoring fees and other transaction fees collected by PE sponsor affiliates from portfolio companies against management fees collected by the PE sponsor from the fund
  - approval rights concerning affiliated party transactions
  - allocation of investment opportunities among the fund and other investment vehicles managed by PE sponsor affiliates
- Practices with respect to affiliated party transactions vary among different PE sponsors, with limited partner advisory committee (LPAC) approval sometimes only required to the extent that an affiliated party transaction is not on arms' length terms, while other fund documents require LPAC approval for all affiliated party transactions, regardless of whether or not they are on arms' length terms

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CONFLICTS OF INTEREST (cont.)

- Some PE sponsors seek to obtain effective "pre-approval" for a broad range of potential affiliated party transactions through disclosure in the fund documents, while explicit LPAC approval of affiliated party transaction is required in other instances
- Provisions concerning allocation of investment opportunities are similarly varied
  - ➢ Some PE funds strictly require the PE sponsor to allocate to the fund all investment opportunities within the fund's investment objective of which the PE sponsor becomes aware until the earlier of investment of 75% (or a similarly high percentage) of the fund's committed capital or the end of its investment period
  - ➢ Other PE funds have allocation policies granting the PE sponsor broad leeway in allocating investment opportunities among the fund, on the one hand, and separate accounts, co-investment vehicles and other funds being managed by the PE sponsor, on the other hand.

CONFLICTS OF INTEREST (cont.)

- ILPA Model LPA expands the traditional role of the LPAC to address many conflict of interest situations, among other things. Approval or consent of the LPAC is required for:
  - Appointment of the fund's auditor
  - Extension of the investment period or the term of the fund
  - Various types of investments and transactions
  - Establishment of reserves for fund expenses during the fund's winding up
- The PE sponsor is required to disclose to the LPAC:
  - Actual and material potential conflicts of interest (whether or not disclosed in the PPM)
  - Valuations of fund investments
  - Transaction fee income received by PE sponsor affiliates
  - Calculation of management fees, carried interest and fund expenses
  - Legal proceedings, changes of control of PE sponsor entities, claims of indemnification, and co-investment opportunities

CONFLICTS OF INTEREST (cont.)

- ILPA Model LPA-mandated disclosures are not unusual in side letters proposed by sophisticated LPs making substantial investments in large private equity funds, but this level of LPAC consent rights and reporting for all investors is unusual
- ILPA Model LPA specifically provides that disclosure of actual or potential conflicts to LPs in fund documents does not waive those conflicts of interest or otherwise reduce or eliminate the requirement for the LPAC to consent to a conflict of interest, negating some PE sponsor's "pre-approval" approach
- With respect to allocation of investment opportunities, the ILPA Model LPA limits a fund sponsor's activities with respect to other funds and vehicles that it manages (or intends to manage)
  - ➢ For instance, the term "successor fund" is broadly defined, limiting a PE sponsor's ability to launch similar funds and investment vehicles (including separately managed accounts and co-investment vehicles) without LP consent
- ILPA Model LPA does not include any language concerning investment allocation policies and practices of the type often seen in fund documents of larger PE sponsors

CO-INVESTMENT RIGHTS

- PE sponsors often come across investment opportunities that they are unable to pursue, whether due to insufficient remaining available capital commitments in the fund, the transaction being so large that it would exceed concentration limitations in the fund documents, or otherwise. In these situations, the PE sponsor may offer LPs the ability to "co-invest" in the opportunity alongside the fund.
- Co-investments are typically made on a reduced or no-fee basis since the LP is arguably doing the PE sponsor a favor by enabling it to do a transaction that it would not otherwise be able to do. In addition, the PE sponsor is typically already collecting management fees and carried interest on the portion of the portfolio company investment made by the fund.
- Co-investments are sometimes made directly into the portfolio company, but are more often made into a special purpose vehicle established by the PE sponsor for that purpose. Sometimes, senior personnel of the PE sponsor will personally invest their capital into the co-investment vehicle.

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CO-INVESTMENT RIGHTS (cont.)

- Co-investment opportunities have become increasingly sought-after by LPs for several reasons.
  - First, because co-investments are typically done on a reduced or no-fee (i.e., carried interest and management fees) basis, co-investments enable LPs to effectively "average down" their fee percentage on investments made with the fund sponsor, improving their net returns. Also, for public pension funds like CALPERS that invest in PE funds, the fees that they pay to PE sponsors have become a politically sensitive topic
  - Second, in a world in which there are large amounts of capital chasing few deals, co-investments offer LPs (particularly large institutional ones) the ability to deploy capital in scale, which can be very attractive.
  - Third, some institutional LPs use co-investments to help build-out their organizations with an eye toward eventually making direct investments in portfolio companies without fund sponsor involvement, and therefore becoming something of a competitor to the PE sponsor

CO-INVESTMENT RIGHTS (cont.)

- The strong demand has made allocation of co-investment opportunities by a PE sponsor among the LPs in the fund creates complex issues
- PE sponsors often allocate co-investment opportunities to LPs to further relationship-building for future fundraising processes, based on the LP's ability to move quickly and in scale, and the LP bringing strategic benefits to the transaction (due to, for example, a pension fund LP's relationships with local regulators in the jurisdiction in which the portfolio company investment will be made)
- PE sponsors typically seek to preserve flexibility in making co-investment allocation decisions (obligating themselves only to acknowledge their interest in co-investment opportunities), rather than tying themselves into pro rata allocation processes
- The terms of co-investment arrangements are typically negotiated on a case-by-case basis depending on factors such as the type and identity of the investor, asset type or portfolio company business, the intended use of the capital, and key tax considerations

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CO-INVESTMENT RIGHTS (cont.)

- ILPA Model LPA requires the PE sponsor to provide notice to each LP of all co-investment opportunities offered and made by the GP. However, as noted above, PE sponsors typically want to preserve flexibility when making co-investment allocation decisions and this type of notice requirement would be inconsistent with their preferred way of doing things
- As noted above, allocation of expenses among the fund and co-investment vehicles managed by PE sponsors has been a subject of scrutiny by the SEC, as well as some LPs
- The ILPA Model LPA requires that each co-investor bear its *pro rata* share (based on capital committed to a co-investment) of any fees, expenses and liabilities relating to portfolio company investment, in order to ensure fairness to all other LPs in the fund

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LIMITED PARTNER ADVISORY COMMITTEE

- ILPA Model LPA includes detailed provisions concerning the rights and practices of the Limited Partner Advisory Committee (LPAC)
  - Any LPAC member can call a meeting of the LPAC
  - LPAC members can meet *in camera* without the PE sponsor being present
  - The LPAC can appoint advisors (e.g., attorneys, accountants and valuation experts), whose reasonable expenses are borne by the fund
  - LPAC members are covered by D&O insurance policies, which the fund is required to maintain to address potential claims against LPAC members (such as for breach of trust or negligence)
  - The PE sponsor is required to take minutes of LPAC meetings and report such minutes to all LPs
  - LPAC approval is required for all affiliate transactions entered into by the fund.

MANAGEMENT FEES

- ILPA Model LPA provides that no management fees are payable:
  - During the fund’s liquidation period
  - During any extensions to the fund's term, even if those extensions are approved by the LPAC
  - During any “key person” suspension period, which could prove problematic because a lack of management fee income could hamper a PE sponsor’s ability to hire an appropriate replacement key person
- The ILPA Model LPA includes a 100% management fee offset without any exception for amounts paid to operating partners (i.e., employees of the general partner who have a dedicated role at portfolio companies) and without the possibility of allocating offsets to non-management fee-paying partners

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MOST FAVORED NATIONS

- ILPA Model LPA includes a broad most favored nations (MFN) provision:
  - Not size-based
  - While there are some carve outs to the MFN (such as LPAC seats), a number of traditional carve-outs are absent
  - No election process and MFN rights automatically apply to all LPs

SIDE LETTERS

- ILPA Model LPA-mandated MFN may limit ability to offer large or strategically important LPs better or more bespoke terms.
  - Reduced fees for “early bird” LPs participating in a fund’s initial closing can be important for fundraising
  - Tailored side letter provisions may be necessary for LPs that are subject to internal or external legal requirements that dictate certain reporting to the LP from the fund or limit an LP’s ability to participate in certain types of portfolio company investments made by the fund.
- The ILPA Model LPA limits the PE sponsor’s authority to enter into side letters to its “reasonable discretion”

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REPORTING AND LP COMMUNICATIONS

- ILPA Model LPA requirements regarding scope and detail of reporting to be made by the PE sponsor to all LPs
- Automatically providing such information to all LPs under the LPA, even if they haven't asked for it in their side letters, could have confidentiality implications for PE sponsors and paradoxically result in less detailed reporting to LPs
- Under the ILPA Model LPA, LPs are explicitly permitted to communicate with each other regarding fund-related issues, and PE sponsors are required to regularly provide the LPs with a list of all other LPs in the fund to ensure that the partners are familiar with their peers and are able to exercise their governance rights, if necessary. Some LPs, particularly sovereign wealth funds, are very sensitive about confidentiality and may object to being identified as an investor in a fund. More generally, these types of provisions are not typically included in the fund documents of seasoned PE sponsors

THANK YOU! - QUESTIONS?

John McDonald
Managing Partner
Tremont Street Partners, LLC
John.McDonald@TremontStreetPartners.com
(203) 708-7255

Michael Saarinen
Partner
Alston & Bird LLP
Michael.Saarinen@Alston.com
(212) 210-9441