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FUNDRAISING STRATEGY

Open dialogue

Creating a partnership between LPs and GPs can be an intricate and complex process, but it can be made easier if clear guidelines are followed, write Pepper Hamilton's Julia Corelli and Edward Dartley

Corelli: *LPs want regular contact with GP partners*

Dartley: *balance transparency with business objectives*

In crafting current fund investments, investors have negotiated with fund managers for greater transparency, more efficiency and more egalitarianism. Navigating these issues necessarily becomes the priority for any GP's list – veteran or emerging. While GPs may seek to start with what is "market" to justify their position as well as to be as palatable as possible to the broadest array of LPs, what is "market" varies dramatically depending upon the manager, the strategy, and, yes, the expected LP constituents. In designing fund terms for the most successful fundraising, GPs and LPs who adhere to these three principles – transparency, efficiency and equality – position themselves best for a healthy GP/LP relationship throughout the fund's life. The paragraphs below present some of the more common issues that arise in the fundraising process and how these three principles affect them.

BALANCING TRANSPARENCY WITH BUSINESS OBJECTIVES

The past three years have seen greater interest in increased transparency. The GP's challenge is to balance transparency to LPs with protecting the fund's portfolio company investments and the GP's legitimate business objectives. But how, exactly, does a GP increase transparency while satisfying its fiduciary obligations and its obligations to increase value through portfolio company growth? The following are several issues GPs consider in structuring their GP/LP relationships that implicate the transparency issue:

- **Clarity in Economics:** Both GPs and LPs recognise that a large commitment may warrant reduced management fees or carry. This can be achieved through the use of side letters and "most-favoured nation" ("MFN") provisions to ensure same treatment for other like-sized investors, some GPs choose to bake these rights directly into the fund agreement, thereby making it clear to all what commitment level warrants the favorable economics and automatically providing them to anyone meeting the same size test. This avoids the slippery slope negotiation that can occur when a LP who is close, but not quite at the same size, does not think the small difference in commitment size should deny them the favourable economics. Building the right to favorable economics into the LPA, which can then only be changed by amendment, can spare the GP from making decisions that are both politically challenging (vis-à-vis other LPs) and economically challenging (vis-à-vis the GP and its stakeholders and employees).

- **Reporting regularly on portfolio company developments:** GPs that provide regular communications to LPs, at least quarterly and when there are material developments, of both good and bad information, are viewed more favourably by LPs. At the same time, non-disclosure obligations and the need to preserve the confidentiality of portfolio company information will legitimately temper the flow of information. In such circumstances, the GP's duties shift to one of non-disclosure in order to protect the fund and all its stakeholders and act in their best interests. Lastly, certain categories of LPs, such as public pension funds subject to FOIA or sunshine obligations, or LPs that may hold interests in competitive businesses, warrant special arrangements, such as limiting sensitive information or granting access only to third-party advisors.

- **Specially Allocated Expenses:** When expenses are specially allocated, GPs should make clear in the fund LPA what mechanics are to be used to ensure the proper economic impact of the special allocation. Commonly, this is addressed with a carve-out to the unreturned capital contribution balance returned in the fund's distribution waterfall. But often the mechanics are left for the accountants to work into the mix of K-1 expense attributions. Without clarity in the LPA, LPs have little means to oversee that they are not bearing an improper share of expenses benefitting other LPs.

- **Clawback determinations:** Internally, GPs pay close and regular attention to the clawback scenario. Reporting on clawback position is neither expensive nor difficult, and allows for mutual understanding of the GP's carry calculation on a real time basis. Limiting the ability to make carry distributions when remaining unrealized values are such that a clawback could be tripped requires a close look at the valuation oversight authority of the LP Advisory Committee (LPAC) to strike the right balance of GP and LP competing considerations.

- **Sharing regulatory examination material:** The SEC does not impose any restriction on a firm's ability to share examination deficiency letters with LPs. But should they be shared? Many GPs do not believe it appropriate, and for good reason. The deficiencies cited may be based on findings with which the managers disagree, or which identify matters long-since addressed. In recent years, more LPs have negotiated greater information rights in this area, though this does not translate to immediate or detailed disclosure to all LPs concerning the commencement or findings of an examination. Beyond contractual obligations, the level and timing of voluntary disclosure by GPs regarding such matters continues to fall along a spectrum.

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- **Co-investment opportunities:** Co-investment rights are coveted by many LPs. While the LPs with the largest commitments are not always the right ones to receive a co-investment opportunity, they often have the most negotiating clout. However, the GP's fiduciary duty is always to do what is best for the fund and its investors, i.e. enhancing the value of the fund's portfolio companies and investor returns. During the fundraising period, the LP constituency evolves. The GP needs to be careful about not pre-ordaining how all co-investment opportunities will be offered so that, once the LP base is fully constituted, the GP can fulfill its fiduciary obligation with respect to co-investment rights.

MAXIMISING EFFICIENCIES

This is a broad topic that includes numerous areas: avoiding tax leakage, flexibility in fund and deal structures, allocating fees and expenses, structuring and operating the management firm. No doubt, efficiency is a universal goal, but how do GPs achieve it? Here are some examples:

- **3c1 and 3c7 parallel entities:** 3c1 and 3c7 are the two most commonly employed exemptions under the Investment Company Act of 1940 by which US privately held pooled investment vehicles avoid having to register as investment companies. In oversimplified terms, 3c1 applies if the fund has less than 100 beneficial owners, and 3c7 applies if all of the fund's owners are qualified purchasers. Fund PPMs will frequently state that the fund expects to be exempt under one and allow the sponsor to establish a parallel vehicle under the other if the LP base warrants it. To achieve this often requires a transfer of portfolio securities from one entity to the other, with an appropriate "true-up" payment for the time-use of the transferor's funds. Several inefficiencies can arise and must be avoided. For instance, the transaction documents by which the transferred portfolio securities were acquired need to allow for the transfer without any cost »

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» being imposed on the fund, and all transaction costs and other economic attributes of the investment incurred prior to the transfer should be shared proportionately.

- **Foreign/ERISA Feeders/Parallels:** A special feeder or parallel fund is often used to accommodate foreign or ERISA investors. Other LPs in the fund occasionally take the position that the associated costs should be borne solely by the foreign/ERISA investors, notwithstanding the fact that all LPs benefit by the "greater investment pie". Not only do such special entities lead to potential problems with amendments, but the necessary special expense allocations can lead to difficult questions of expense attribution. In turn, this can give rise to unanticipated stresses in the GP/LP relationship. However, LPs expect GPs to have the flexibility to achieve the structural necessities engendered by ERISA, foreign and tax exempt LPs. Advance consideration of how the associated expenses are to be borne is essential.

- **Blockers and AIVs:** Blocker corporations are used to reduce or eliminate the effects of UBTI and ECI on tax-exempt and foreign, respectively, LPs. Debt-equity hybrid structures are then used to reduce the impact of a blocker on taxable investors. Who bears the cost of the blocker is an evolving issue for taxable LPs. If a blocker is put in place with respect to the entire fund, returns to taxable investors who would accept pass-through treatment are negatively impacted by the "extra" layer of tax. In addition, the costs of forming and operating the blocker, and, more importantly, the potentially dampened exit valuation, impacts them as well. Alternative investment vehicles (AIVs) can be used to ensure the impact of blocker structures is only on those who need them. GPs need to analyze the attributes of their investor base when they are setting up the fund in order to plan for the right ability to move taxable investors, tax-exempts or foreign investors between the fund and AIVs with respect to pass-through investments and where blocker and AIV costs need to land.

- **Series partnerships:** Series partnerships are partnerships which create silos of investment pools designed to insulate one asset pool from the liabilities of the other. To gain the benefits of insulation, each silo needs to be operated as its own partnership, i.e. each series obtains an EIN, maintains separate books and records, issues separate K-1s, and files separate tax returns. The benefit of the series partnership is that it offers uniformity of terms across series, allowing the GP to focus only on the allocation of the investment among LPs in the series and to avoid re-negotiation of terms each time a series is established. It is particularly well suited to when multiple strategies are aggregated in the same partnership and LPs want to invest disproportionately in the different strategies. The efficiencies gained by series partnerships are the same efficiencies gained by predesigning a co-investment vehicle: lessening the need for negotiation each time a new series is opened. While the initial document is more complicated, the efficiencies gained in the long run when there are multiple series over several years, can be substantial.

- **Amendments during Fundraising:** LP comments that affect all limited partners, such as a restriction on foreign investments, belong in the LPA and not in side letters. It is impossible for a GP to anticipate all comments that LPs may raise, and amendments during a fundraising process are inevitable. The GP needs the flexibility to negotiate with LPs to add refinements to the LPA without having to go back for a vote on the amendment. Accordingly, it is customary to include an appropriately-crafted exception to the requirement for LP consent when amendments do not adversely affect LPs. GPs generally provide an amended and restated LPA after the final closing, but LPs expect to be kept informed of changes to their partnership agreement along the way. Many LPs request notice in advance of proposed amendments. This is actually a good thing for the GP because, if no LP objects to the proposed amendment, it clearly established that it was not adverse and never needed LP consent.

EGALITARIANISM

The third category of LPA design features relates to the egalitarian relationship among GPs and LPs, i.e. The balance of power between GPs and LPs, as well as among LPs. This balance has to reflect that the LPs are hiring the GP to do a job and give the LPs rights to keep the GP on mission. No one LP should have more sway than others, though, obviously, those with larger capital commitments will have more voting control than those with smaller commitments. While LPs typically share common interests and often act as a group, certain LPs may serve as bellwethers for LP reaction and GPs should capitalize on the insights they may offer. Following are several LPA terms where GPs can, in designing the fund LPA, put this concept to work:

- **Term:** The fund LPA provides for a fixed term, often ten years, with the GP having the ability to extend the term for two to three successive one-year periods. The LPs typically do not want the extension beyond the ten years unless it is absolutely necessary, and so they impose restrictions on the ability to extend the term or impose economic penalties for doing so. Having some flexibility to extend the term is appropriate for a GP. Giving LPs some controls over it is also appropriate. One method for balancing the need for additional extensions without a cumbersome full LP vote is to give the extension power to the LPAC, which in turn highlights that the LPAC must view itself as acting for all LPs and not just those who appoint it.

- **Indemnification:** Indemnification is another area where there is give-and-take between GP and LP to strike a balance of power. While indemnification continues to be a standard LPA term (with carve-outs for certain forms of misconduct), there are a number of marketplace exceptions that have developed in recent years, including: (1) for disputes between principals or employment related claims from GP employees; (2) if a significant percentage of the LPs bring a claim against the GP; and (3) if the indemnified party is the GP, for certain settlements or compromises reached without LPAC approval.

- **Regular quarterly meetings with LPs:** In-person annual LP meetings are routinely held , but quarterly or semi-annual meetings of all LPs are not, as they would require additional expense for the fund, and time away from the business of investing and growing value in those investments. Personal interaction is a key to a successful GP/LP relationship but holding meetings with only some LPs and not others (other than LPAC meetings) can leave some LPs feeling out of the loop, or worse, disenfranchised. For GPs that have an engaged LP base, a technological alternative – such as webinars or conference calls – on a periodic basis can be a welcome solution.

- **GP removal:** The percentage of LPs who can force a no-fault removal of the GP is often set forth in the initial LPA (or if excluded initially is negotiated in) and then pushed upward during the fundraising process. Given the ramifications of a GP removal, it is appropriate and necessary to have this percentage set extremely high in a no-fault situation (and similarly appropriate to exclude GP affiliates from the vote). For-cause removal rights are usually a lower percentage threshold (also excluding GP affiliates), and include appropriate carve-outs to avoid allowing a single bad actor within the GP to trigger the for-cause removal right. Removal is a rare and drastic circumstance and, while necessary, should be properly tailored to ensure appropriate checks and balances. It should be used only in circumstances where it is clearly warranted. Careful attention needs to be paid to both a no-fault and for-cause removal percentage as the LP investor base develops during the fundraising process to ensure that the intended checks and balances are preserved.

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CONCLUSIONS

The foregoing is a non-exhaustive discussion of ways LPs and GPs seek to achieve a fair and balanced LPA that will govern their partnership. There are many other terms that need to be designed with these principles in mind. Both GP and LPs need to be open to the fact that circumstances change – at both GPs and LPs – during the partnership's term. To make the GP/LP relationship successful, each side has to be prepared to be accommodating. GPs set the foundation for that when they first serve up an LPA. LPs solidify it when they take reasoned and reasonable positions during negotiations. If the fundraising process is successful in this respect, then addressing issues later on is much easier as both sides are much more likely to continue to adhere to the basic principles of transparency, efficiency and fairness. ■