Ringing the changes

Fund agreements between LPs and GPs are under constant scrutiny. Four partners from law firm Schulte Roth & Zabel discuss recent changes and the key terms that are crucial in today's market

Q: Which parts of the LP agreement are investors most concerned about?

Stephanie Breslow: A lot of the issues up for discussion are regulatory driven. More granularity is being demanded in fund disclosure, particularly in expenses which used to be a short section of the LP agreement. Things like classes of air travel, how legal fees are handled and details about what constitutes an offering expense just weren't there. As this expands, some investors worry the GP is trying to pass on new things. In fact, these items were put through before, but the regulators are asking GPs to be more specific so that investors are clear about what they are signing up to.

The text is also tightening in terms of the potential conflicts for a GP. Fund documents used to say that the GP may do X or Y. Now we are adding more detail about special terms that other investors might be getting or how investment opportunities are allocated. There's more granularity about both what might happen in theory and what happens in practice.

Breslow: Investors worry about expenses

Q: What are the implications for Most Favored Nation clauses?

Joseph Smith: We are seeing a lot of pressure over MFN provisions. Historically, the big investors used to negotiate discounts or other favorable terms, on the basis of their greater commitments, with large investors tending to get MFN clauses. Other goodies would go to people that needed them for tax or regulatory reasons to allow them to invest.

One change is that pressure for MFN provisions is being driven by gatekeepers, or intermediaries, who don't actually have discretionary control over the group of investors that they represent, but try to get bulk MFN treatment for their clients. This has become a hot topic and raises the question of whether smaller investors, who are not represented by intermediaries, are unfairly disadvantaged as a result.

Similarly, some investors are asking for certain advantages because they have policies that require them, rather than a bona fide legal or tax requirement. For example, if you have a mere policy (rather than legal requirement) that stipulates you can only be sued in your home jurisdiction, that imposes a cost on the fund and the other investors purely for the convenience of one investor. You don't want to create an environment in which LPs get unique advantages.

Smith: MFN clauses can be contentious

Q: How much discussion is there over co-investment rights?

Phyllis Schwartz: The right to co-investment is one of the topics that comes up over and over again when we are helping GPs to raise private equity funds. Historically, a GP might simply include an acknowledgement in the agreement that an investor is interested in co-investment opportunities, but no promises were made. Today, many investors, and particularly the larger ones, are negotiating defined co-investment rights upfront in their side letters, so that any co-investment rights granted to LPs come with a commitment to a pro rata allocation.

Given the regulatory issues, we are careful to ensure that all investors know who is getting the co-investment rights. We focus on describing the co-investment terms, such as whether the co-investors are paying expenses or not, particularly with respect to dead-deal expenses. The regulators are very conscious of expenses as an area of concern. They also raise conflict issues when GPs take a piece of a co-investment. Some of our documents will provide for investor approval of GP co-investments upfront.

Q: How do co-investment deals differ?

PS: A big issue is over how co-investors are approached because GPs like to work with investors who can decide quickly on whether to participate. Not all investors have the resources to do this, so GPs need to be able to discuss how opportunities will be allocated. There may be a difference between opportunities for syndicating existing deals, and the chance to come in prior to the acquisition closing, so there may have to be different procedures. The basic problem is that for reasons of commercial expediency, fund documents have historically given GPs a lot of discretion on these issues, but the new regulatory environment means GPs need to be much more explicit about their processes and procedures.

Q: What about the terms relating to the GPs themselves?

SB: Investors want more details of the upper-tier documentation that sets out the arrangements between owners and employees of the sponsor to find out who is doing what and how the governance works. We discourage our fund sponsor clients from disclosing the full document as it contains sensitive information about economics and governance, but there are questions about the allocation of carry and other basic terms. There has also been a big increase in demand for information on the regulatory history of the key principals, especially litigation involving them or any indemnity claims.

Omoz Osayimwese: Investors are keen to understand the carried interest share and vesting arrangements of GPs. A key concern is to ensure that the investment team is adequately and appropriately incentivized to work on the fund. In some instances, GPs have requested longer vesting periods. In other cases, the principals have been asked to broaden the group receiving carried interest to include more junior team members. Investors also want details of succession planning and what would happen if a key person dies or ceases to work on the fund.

Schwartz: Co-investment terms differ

Osayimwese: Incentives are a key concern

Q: It sounds like much of the pressure on terms is driven by regulators rather than investors, forcing GPs to give a lot of ground. Is that your view?

JS: In part, yes. But if you're a portfolio manager for an institutional limited partner, and you read the headlines about regulatory scrutiny, you have to be asking more aggressive questions. So, it's not just the regulators, it's the environment, and the net result is that GPs feel they have to cover their bases more, as do investors.

But while the GPs are giving ground, we are not seeing lower carry or reduced management fees. The basic economic terms are proving to be cycle-durable, and so not much has changed. The documentation is becoming much lengthier because GPs are demanding more protection against regulatory attack and LPs do not want to be associated with GPs who have regulatory problems. Also, we are seeing longer offering periods – sometimes as much as 18 months – as people work through these complexities. That certainly wasn't so pronounced in prior cycles. And the thrust of what has changed in the LP agreement has definitely been driven by the regulatory environment. ■

Stephanie Breslow is co-head of the Investment Management Group. Her role covers investment management, partnerships and securities, including regulatory advice and the formation of liquid securities and private equity funds.

Omoz Osayimwese represents sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds.

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