Seizing the moment

For managers about to launch a new vehicle, now is a perfect time to review their Limited Partnership Agreement, says *Joseph Smith* of Schulte Roth & Zabel

With fundraising climbing up to peak pre-crisis levels, Joseph Smith, partner at law firm Schulte Roth & Zabel, believes managers launching new vehicles are well-placed to review their Limited Partnership Agreement. He explains why.

Q Why shouldn't a manager simply use its previous LPA as the model for the next one?

JS: Of course, in all likelihood, it should be the basis of the new LPA. However, there are several important reasons to re-examine it. The most important is that laws change. The second is that sponsor platforms and their businesses evolve over time. An obvious example is that key persons eventually approach retirement. Also, restrictions on, or authorizations for, particular types of investments may no longer be appropriate. Perhaps the manager now sponsors separate funds for different types of deals. Moreover, it is not always the case, but any number of GPs have very technical provisions in their fund documents that they just wish were different. Processes for approving interested transactions may be inadequate or too cumbersome. The mechanics of clawbacks, recycling and follow-on investments are often suboptimal.

Q When is it a good time to undertake a review?

JS: Every time GPs plan a new fundraise, they should carefully reconsider their fund documents, not necessarily to completely redraft them but to maintain an inventory of things they must change vs. things they wish they could change.

Smith: there are important reasons for re-examining your LPA

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Some things must be changed due to changes in law. For example, new partnership audit rules in the US are effective from tax year 2018. A failure to revise an LPA in response to changes of this nature can have a meaningful and inequitable economic impact.

Q Are there more new laws or regulations GPs should prepare for?

JS: While laws always change, this is a reasonably settled regulatory environment. The US and European governments are unlikely to expand the scope of regulation, but I don't think they are going to retract regulations, either. Given that this continues to be a robust fundraising environment — stronger than many people had expected it to be at this point — and that laws are relatively settled after recent changes, this is a great time to take a step forward in perfecting your LPA.

Q What else might GPs want to change in their next LPA?

JS: In the context of the SEC Presence Exam Initiative, there has been enormous scrutiny on disclosure and the permissibility of certain fund expenses, including broken deal expenses relating to co-investments. Some fund managers have changed relevant language of their documentation but did so in a quick-draw fashion, without time to reflect. The critical thing is to look at what the GP actually does administratively regarding expense allocation and to make sure that policy, practice, disclosure and LPA mechanics actually true-up.

Q GPs like to be able to say to LPs that their latest LPA is unchanged. Why?

JS: Integral to any LP's fiduciary decision to invest is the proper review of terms and conditions. To the extent to which a manager can say to an LP 'the terms are unchanged, you have agreed to this before,' they are implicitly saying that they have already passed that diligence hurdle. LPs have a diligence budget, and they will often ask their counsel to undertake a simple black-line review of what's new, rather than review the entire document. All of this creates momentum on both sides to change documents as little as possible.

That said, a GP can fall into a trap where, in the context of actually operating the fund, it wishes that changes had been made.

Q How does a GP strike the balance?

JS: Informed experience. One has to understand how each provision relates to the others, the varieties of different asset classes and the history of the industry. For instance, a GP might like to change the 8 percent preferred return that has long been standard. That it persists is unusually favorable to LPs in a low inflation, low interest rate environment. For GPs in certain asset classes that are really fixed-income alternatives, or those with exceedingly strong returns, it may well be appropriate to reduce the preferred return, or otherwise tweak fee structures or waterfalls. However, for many asset managers, this might lead to very challenging negotiations with LPs.

Q Do some GPs want to make changes to the LPA but feel they can't?

JS: Absolutely. As suggested above, GPs come in two flavours. There's the GP that wants an easy fundraise and to minimize revisions. On the other hand, there are managers who want to clean up the entire LPA. Then, counsel is in the position of advising that they be judicious about it, because the more black-lining there is, the more LP scrutiny will result.

Q Credit structures are increasingly common in LPAs and increasingly scrutinized. Why do GPs include them?

JS: GPs like to include provisions that don't just authorize the use of the credit facilities but also run to the benefit of the lenders themselves so that the GPs don't have to chase down investor letters in order to implement a subscription facility. That streamlines things enormously.

Of course, in keeping with the recent concerns of ILPA and the regulators, various aspects of these facilities should be well-disclosed.

Q Where else have you seen significant changes to LPA terms?

JS: Of course, in the aftermath of the financial crisis and some impaired track records, there was a general movement toward the so-called European (or fund-as-a-whole) waterfall. In the aftermath of greater regulatory scrutiny, there has been an expansion of disclosure and mechanical detail relating to fund expenses. Today, US GPs increasingly ask co-investing LPs to agree that they will pick up a pro-rata share of expenses relating to negotiations and diligence if the transaction dies. For GPs not doing this, it is critically important that their documentation explicitly states that those costs will be absorbed by the main fund. Another response we've seen to increased scrutiny of co-investment programs is GPs setting up sidecar or oversubscription funds that charge fees on invested, not committed, capital.

Finally, many US fund sponsors seeking to raise money in the European Union but not desiring to incur the administrative burden or expense of setting up their own alternative investment fund manager (AIFM), now use a third party, unaffiliated AIFM to establish an EU fund to co-invest alongside the sponsor's non-EU fund. Because the AIFM may not be an affiliate of the sponsor, this may require some technical tweaking to traditionally drafted parallel fund provisions.

Q Side letters can make documentation lengthy. Should they be included in the LPA?

JS: If a provision is ubiquitous in side letters and it's something that the GP must or desires to live with forever, certainly it's fine to put it in the LPA. However, there are several things to remember. First, an LP that proposes a particular side letter provision may not re-up for the successor fund. Second, many side letter provisions are responsive to changes in law that may not affect every limited partner or may change over time. They sometimes reflect immediate responses to changes in law that may not be relevant next time. The important thing is to draft side letter provisions as consistently as possible and to maintain a compendium that cross-references the LPA, so that the GP is not at risk of a foot fault.

Q The theme of disclosure relates closely to media coverage. Why is it important for funds to be aware of how they are presented in the media?

JS: Regulatory initiatives, and perhaps more importantly, enforcement initiatives, have attracted press attention. Private equity professionals on the LP side often report to people who are reading about the industry in the newspapers but who are not private equity professionals themselves. Decisions to change the LPA, as well as changes to standards, practices and disclosure, ought to be made with an eye to how the industry is perceived. That's just good investor relations. ■