

Investor Remedies: The Importance Of Key-Person Provisions

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In a typical private equity fund, investors are making capital commitments to a limited partnership that will be drawn down over a number of years at the direction of the general partner of the limited partnership. Drawn-down capital commitments will be used to make private equity investments as well as to pay fund expenses. In addition to the classic case of a private equity fund making investments in private companies, the private equity fund format is also used for private investment funds following other illiquid and quasi-liquid investment strategies, including making investments in real estate, asset-backed securities, distressed debt, venture capital, loans and structured finance securities, among others.

The success of investment strategies predicated on making private equity investments and other illiquid or quasi-liquid investments often requires the fund to hold and manage such investments over several years. Investments made by private equity funds are also generally difficult, if not impossible, to mark to market. Unlike more liquid securities, such as publicly traded stocks and bonds, currencies or commodities, there is no market on which investors can get frequent periodic valuations of the fund's investments. The certainty as to valuation that frequent periodic valuation (e.g., daily price quotes) provides is what allows hedge funds and mutual funds to be continuously open to investors. Investors in such open-ended funds can easily exit from their investments in such funds as the funds can easily liquidate investments to cash out investors. Private equity funds by contrast offer extremely limited liquidity to their investors since the underlying fund investments are difficult to value for purposes of allowing investors to buy into, or exit, the fund.

Determining performance-based compensation absent a sale of fund investments to be paid to the fund's general partner is also difficult if there is uncertainty regarding the valuation of such investments. The nature of a typical private equity fund's investment program is often predicated on the fund holding and managing its investments in portfolio companies for an extended period of time. Selling a portion of such investments or prematurely selling a fund's entire investment in a portfolio company in order to cash out an investor is not at all practical and is frequently impossible.

As a result of this lack of liquidity, investors typically only invest in a fund during a short fundraising period that is generally no longer than a year. Fund investors will typically not see any return of capital invested in a fund until after the fund's investment period is over. This could be as long as five or six years from the beginning of the fund's term. In addition, many private equity funds have terms in the eight to 10 years range, often with the possibility of up to two one-year extensions. Further, the end of a fund's term does not necessarily mean the end of the fund but instead the commencement of liquidation of a fund's assets that could take an additional few years. All of this means that an investor making an investment in a private equity fund has to have a very long horizon.

The Need for Remedies

The structure of the typical private equity fund and, in particular, the fact that investors have no liquidity once they make their investments in a fund means that investors are often concerned about what happens if things go wrong with the fund. How do investors deal with fund underperformance, potentially self-serving transactions between the fund and the general partner, the death or disability of a “key person,” disputes or disagreements among the fund’s principals or allegations or findings of fraud, gross negligence and willful misconduct by the general partner? Investor concerns relating to these matters often lead to extensive negotiations between investors and the general partner before investors invest in a fund. In trying to address these concerns, investors often ask for rights that would allow them to: replace a general partner or fund manager, cause the general partner to commence liquidation of the fund’s investments, stop the fund from continuing to invest, or approve certain fund transactions that could result in actual or potential conflicts of interest between the fund and general partner. Investors also want to know that they will receive sufficient information from the general partner regarding the general partner’s activities and the fund’s investments in order to be able to exercise any remedies they might have negotiated for under the fund’s limited partnership agreement.

Key-Person Provisions

Investment in a private equity fund is very much a bet that the general partner, and specifically the fund’s principals and other members of the investment team, will be able to successfully execute the fund’s investment program. One key concern of investors is therefore what happens if a key person dies, is permanently disabled or otherwise ceases to be involved in managing the fund. Investors will often have a firm idea of who they want the key person or key persons to be.

Under a standard key-person provision in a private equity fund limited partnership agreement, when a key-person event occurs, the general partner is required to promptly notify the fund’s investors of the occurrence of the key-person event. In addition, during some specified period of time following the key-person event, the fund’s investment period will be reinstated if the fund’s limited partner advisory committee (LPAC) approves a qualified replacement of the departing key person that has been proposed to the LPAC by the general partner.

From the investors’ perspective, the key person or key persons will be the individual or individuals who the investors believe are critical to sourcing, making, managing and exiting from investments. General partners, and particularly the senior or founding principals of a fund, may disagree with fund investors as to whether the key persons should be a broader or narrower group of the investment team members. There will therefore often be extensive negotiation between the general partner and investors regarding who is considered to be a key person of the fund. A typical formulation of a key-person provision would be a requirement that if the named key person, or, if there is more than one key person, a certain number of designated key persons (e.g., two out of three designated key persons), were to cease to spend substantially all of their business time in the fund, then the fund’s investment period would be automatically suspended. Following any such suspension, there is then a time period during which investors may vote to reinstate the fund’s investment period.

Generally, if a supermajority in interest (e.g., two-thirds in interest) of investors do not vote to affirmatively reinstate the fund’s investment period, the investment period will be permanently terminated. There are many variations to the basic formulation described above. Suspension of the investment period may be triggered by a number of different events, some of which are not necessarily

mutually exclusive. For example, the disability of the specified key person for at least a certain time period (e.g., 90 consecutive days) could be a key-person event, as could the departure of a specified key person from the fund manager.

Investors are also concerned about circumstances where there is a lot of employee turnover at a general partner even though the principals (who are often key persons) remain with the general partner. Investors will often try to address this by asking for a multitier key-person provision where there might be a senior group subject to a particular key-person standard and one or two additional groups of individuals who may be subject to a less restrictive key-person standard. A common formulation might be a first tier that is triggered by one of two (or two out of three) principals ceasing to spend substantially all of their business time on the fund and a second tier that is triggered by the cessation of employment of four out of eight other members of the investment team.

In circumstances where investors successfully negotiate for a broadening of the key-person provision to cover members of the investment team besides the founding or senior principals, there may be an unintended internal political effect on the general partner. This is because making someone (e.g., junior partner or less senior investment team member) a key person can result in giving that individual leverage to negotiate for a bigger piece of fund economics. A junior partner who is a key person could threaten to resign if the founding or senior principal does not give him or her a larger piece of carried interest. So, senior or founding principals will often need to balance the loss of internal political leverage with acceding to investors' requests for broader group of key persons.

One advantage of multitiered key-person provisions from a general partner's perspective is that it can assist on a private equity firm's succession planning by introducing the next generation of the firm's investment talent to the fund's investors. This next generation would be members of the investment team who are anticipated to play a larger role in the future managing funds sponsored by the private equity firm. The next generation could also be the people who are actually doing most of the work on existing funds even though their names are not on the door. The transition of a private equity firm's leadership and senior investment personnel (who are often the key persons of funds managed by such firm) to the next generation is often a long drawn-out process that involves passing on more responsibility and authority to junior partners and communicating such increases in responsibility and authority to investors. This transition often nears its culmination when members of the next generation become the key persons in the funds sponsored by the private equity firm.

Conclusion

The various remedies that investors typically negotiate for in a private equity fund are an important governance mechanism for fund investors. Investors may not necessarily be able to negotiate for the full myriad of removal, termination, informational or LPAC rights; however, obtaining a key-person provision goes a long way toward allowing investors to address situations where there are issues with the conduct of the general partner.

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