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FUND AGREEMENTS

LPAs: finding the right balance

When raising a successor fund, an equilibrium needs to be struck between cloning the previous Limited Partnership Agreement and making wholesale revisions, write Joseph Smith, Jason Behrens and David Miller of law firm Schulte Roth & Zabel

Sponsors indulge in two very different fantasies when forming a successor fund. The first is to clone their predecessor Limited Partnership Agreement, change the date and the Roman numeral and be done with it. The second is to revise every longstanding, suboptimal provision and finally be governed under documents that say what they wished. Neither approach is practical, so it behooves general partners and fund counsel to think carefully about which changes to make and when to make them.

The first of these fantasies is compelling because it is presumed to minimise legal costs and streamline negotiations. Indeed, counsel to limited partners who are instructed to do a mere "blackline review" have light work under this scenario. But even for GPs who like their current terms and trust the integrity of their existing documents, this can be foolhardy. Changes to the regulatory environment, the evolving range of LP comments and the vicissitudes of the market compel that predecessor fund documents be reconsidered. A foresightful approach to this exercise is proven to deliver superior results.

Nonetheless, it is important to recognise that the second fantasy – an extensive rewrite in the pursuit of perfection – can also be perilous. Certainly, a sponsor with an excellent track record that is fundraising when LPs are awash in capital will have an easier time making changes, but even a successful sponsor can overplay its hand. Not only is a full-blown rewrite expensive, it is particularly so in an environment where LP commentary is likely to be extensive. Moreover, presenting a heavy blackline can raise questions about past compliance and weaken the argument that the terms have already been agreed.

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These considerations beg the question of how to find the right balance. Experienced fund counsel can be invaluable in anticipating the repercussions of proposed revisions. Given today's robust fundraising environment and – importantly – a changed but reasonably settled regulatory landscape, now is a good time to carefully take stock of an LPA.

A comprehensive study of potential revisions and best practices could fill a treatise, but we can address six points that every GP should discuss with its fund counsel today. Keep in mind that once a provision must be changed due to tax, regulatory or market dynamics, it may be easier to implement other desired changes because they are addressed in the same or closely related provisions.

1 CHANGES TO LAWS REQUIRE CHANGES TO DOCUMENTS

The most necessary and uncontroversial changes are those made in light of changes to black-letter law. For example, GPs should currently modify their LPAs due to the new partnership audit rules applying to tax returns filed for tax year 2018 onward. Under the new rules, if fund items of income or loss are adjusted in an IRS audit, the IRS will impose a tax on the fund. The fund can then either pay the tax (subject to adjustment based on the fund's investor profile) or make an election under Code Section 6226 to push the audit adjustment out to investors who would then be directly liable for the tax.

In light of this change, a GP should ensure, among other things, that an LPA enables it to make a Section 6226 election. In addition, the LPA should deem any such

***Smith**: GPs have two different LPA 'fantasies'*

***Behrens**: partnership audit rules are changing*

***Miller**: use of credit facilities are a concern*

tax paid by the fund as distributed to the investor to which it relates. This deemed distribution will permit the investors for which the fund obtained the reduction in tax to get the benefit of the reduction. Moreover, it will enable the GP to receive its carried interest unreduced by other investors' tax. Finally, the LPA should oblige the relevant investors to cover their share of the tax if the amounts distributable to them are insufficient to do so.

Another current example of a law necessitating document changes is the new Department of Labor fiduciary regulation, effective as of 9 June 2018, expanding the definition of who is a fiduciary in the context of marketing funds to Individual Retirement Accounts and ERISA-covered pension plans. GPs should be updating their subscription agreements in light of this new regulation.

2 PRESSURE POINTS

In addition to changes of law, it is important to remember other areas of increased regulatory and investor scrutiny. Indeed, it is critical for fund counsel to be abreast not just of SEC pronouncements and enforcement actions but their press coverage, because this inevitably informs investor concerns.

3 FUND EXPENSES AND BROKEN DEALS

By now, you have undoubtedly read about how GPs are expanding the definition of "fund expenses". Given the regulatory climate, it is important to consider not only the completeness of the list but also the manner in which cost allocation policies are implemented. For example, many LPAs now expressly provide that a potential co-investor's allocable portion of broken-deal expenses "may" or "will" be absorbed by the lead fund.

4 CREDIT FACILITIES

The use of subscription credit facilities is another hot topic, particularly as it relates to reported IRRs. As regulators and investors increasingly focus on their use as structural leverage, the Institutional Limited Partners Association recently released guidance on their risks and parameters of use. Among other recommendations, ILPA advocates greater disclosure regarding contemplated size, duration and potential impact on reported IRRs.

This heightened scrutiny presents both a requirement and an opportunity for GPs to revisit the LPA. For example, while updating the credit facility provisions, it may be an opportunity to modernise the approach to LP estoppel letters – so called "investor acknowledgement letters". To mitigate the effort involved, many GPs have been successful in eliminating these letters altogether while satisfying their lenders by including investor representations directly in the LPA.

5 EUROPEAN CONSIDERATIONS

Many mid-market GPs without foreign offices but seeking to raise capital in the European Union wisely consider using a "third-party ManCo" to act as an AIFM (Alternative Investment Fund Manager) for a parallel vehicle to be organised in the EU. If this is a possibility, care should be taken to draft the parallel investment vehicle provision in such a way as to facilitate allocating a proportionate share of each deal to an EU AIF (Alternative Investment Fund), even if technical portfolio management discretion will rest with a non-affiliated GP that acts as the AIFM.

6 BEST PRACTICES FOR SIDE LETTERS

Some GPs ask whether the litany of side letter provisions should be incorporated into the next fund's LPA. As well intentioned as this may be, it is often misguided. The limited upside of having "everything in one place" does not justify the potential downside, including getting stuck with a provision when the LP who requested it does not re-up for the next fund, and the difficulty of seeking a waiver of the provision from a majority (or super-majority) of LPs rather than from particular side letter recipients. ■