ILPA Releases Deal-By-Deal Model LPA

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Earlier this year the Institutional Limited Partners Association (ILPA) released a Delaware-law based Model Limited Partnership Agreement (Model II LPA) for use by private equity fund sponsors wishing to implement a "deal-by-deal" distribution waterfall of the type more common in the United States. The Model II LPA is a variation on the European style "whole-of-fund" model limited partnership agreement ILPA published in October 2019. Like the earlier "whole-of-fund" model, the Model II LPA builds upon the concepts set forth in the third edition of the ILPA Principles (Principles 3.0), which seek to promote the alignment of interests between general partners (GPs) and limited partners (LPs) through better fund governance, the adoption of a higher standard of care, and increased transparency and enhanced disclosure. For more information regarding the "whole-of-fund" model LPA and ILPA's Principles 3.0, please see our Investment Management Advisories "ILPA Publishes Model Limited Partnership Agreement Applying Principles 3.0" and "ILPA Principles 3.0: Focusing on Enhancing Transparency in Private Equity Funds and Alternative Investments."

By providing model language for the limited partnership agreement of a fund using a deal-by-deal distribution waterfall, ILPA expects that the Model II LPA will provide several benefits to the industry, including (1) minimizing the complexity, time and cost of negotiations between GPs and LPs and reducing the length of side letter agreements; (2) providing GPs with greater fundraising certainty; (3) lowering fund formation costs; and (4) providing LPs more balanced and transparent terms that clearly explain their rights and obligations. Nevertheless, realizing these benefits may prove difficult in practice. This is because, although the Model II LPA was drafted with input from lawyers in the industry representing both GPs and LPs, ILPA represents the interests of the investor community and the Model II LPA is in many respects a LP friendly agreement.

The full text of the Model II LPA is available here.

Notable Provisions of the Model II LPA

The Distribution Waterfall. What distinguishes the Model II LPA from the earlier whole-of-fund model limited partnership agreement is, of course, how net gains realized from the sale or other disposition of all or a portion of a portfolio investment are distributed among the partners. In the whole-of-fund model, the GP does not start to receive its carried interest distributions until LPs have received cumulative distributions equal to their aggregate capital contributions to the fund plus their preferred return (or hurdle).

In contrast, a standard deal-by-deal distribution waterfall generally allows the GP to receive carried interest distributions as soon as the LPs have received cumulative distributions equal to the sum of their capital contributions used to fund each realized portfolio investment and to pay expenses plus the preferred return on such capital contributions. Many such deal-by-deal waterfalls also require that LPs recoup their capital contributions used to fund portfolio investments (and related expenses) that have been written off or that have otherwise suffered a material impairment and been permanently written down before the GP receives any carried interest distributions.

The Model II LPA adds a few decidedly LP-friendly variations to this more standard model which may very well lead to more rather than less negotiation between GPs and LPs. Under the Model II LPA, before the GP starts to receive its carry, not only must each LP have received cumulative distributions equal to the sum of their capital contributions used to fund each realized portfolio investment and pay fund expenses, but also an amount equal to their pro rata portion of the fund's "unrealized losses" (i.e., the portion of the capital contributions made by the LPs to fund unrealized portfolio investments that exceeds the value of those unrealized portfolio investments on the date of determination), plus the preferred return on all such capital contributions.

Requiring LPs to receive distributable proceeds equal to the aggregate ordinary unrealized losses on portfolio investments that have not been written off or "Permanently Written Down"[1] by the fund is not a market term and one a well advised general partner would likely not accept, particularly when combined with the interim clawback mechanism discussed below. Together, those two provisions amount to duplicative protection against the risk of an over distribution of carried interest to the GP.

In addition, under the Model II LPA, the calculation of the preferred return takes into account not only the capital contributions used to fund realized investments and pay expenses, but also the portion of capital contributions used to fund still unrealized portfolio investments that exceeds the value of those unrealized investments on the date of determination. This feature also is not currently a market standard term.

Final and Interim Clawback. When the final liquidating distribution is to be made to the partners, the Model II LPA, like the earlier whole-of-fund limited partnership agreement, requires the GP to determine if it has received cumulative distributions of carried interest over the life of the fund that exceed what it should have received, taking into account in the aggregate all capital contributions and all distributions during the life of the fund. Any such excess is to be returned to the fund for distribution to the LPs.

Because the deal-by-deal distribution waterfall allows carried interest distributions to be made to the GP before the LPs have been returned their aggregate capital contributions plus the preferred return, the risk of the GP receiving excess carried interest distributions over the life of the fund is greater because distributed profits from each realized investment may be offset by losses from future dispositions of portfolio investments. The Model II LPA seeks to mitigate this risk by introducing an interim clawback provision.

On various measurement dates beginning on the first anniversary of the end of the commitment period, if the GP has received any distributions of carried interest, the GP must calculate what it would owe the LPs if the fund had made a hypothetical final liquidating distribution of its assets at their value on the date the interim clawback is being calculated. If an interim clawback obligation exists, the GP must provide the LPs with its calculation and contribute the interim clawback amount to the fund (which amount shall not exceed the sum of the cumulative carried interest distributions made to the GP reduced by any taxes paid or payable by the GP with respect thereto). The interim clawback amount is distributed to the LPs and is treated as an "advance" that will be offset against any future distributions owed to the LPs.

To allay further LP concerns about the payment of carried interest to a GP before the final position of a fund is known, the Model II LPA also requires the GP to deposit 30 percent of all distributions of carried interest into an escrow account to secure its potential clawback obligation.

Management Fee. During the Commitment Period, the management fee is a percentage of the Capital Commitments. Thereafter, it is a percentage of the Capital Contributions used to fund the acquisition cost of portfolio investments (other than temporary investments) less the acquisition cost of portfolio investments that have been realized, written off or Permanently Written Down.

[1] Under the Model II LPA, a portfolio investment is "Permanently Written Down" when it has been written down to below 50 percent of its original acquisition cost.

Governance, Standard of Care, Exculpation and Indemnity. The Model II LPA incorporates the provisions included in the whole-of-fund model limited partnership agreement, which was updated earlier this year, relating to fund governance, the GP's standard of care and fiduciary duty, the exculpation and indemnity of the GP and its affiliates and their respective partners, members, employees, directors, officers and key persons, fund termination and GP removal. Please see our Investment Management Advisory, "ILPA Publishes Model Limited Partnership Agreement Applying Principles 3.0," for a discussion of those provisions.

Conclusion

The Model II LPA is the latest component of ILPA's broader LPA Simplification Initiative. ILPA recognizes that the Model II LPA may not be appropriate for every fund, and as we have indicated above, its LP friendly terms are likely not going to be acceptable to most GPs and are not yet market standard. That said, as noted above, certain aspects of the Model II LPA are consistent with and reflect the increased bargaining power of LPs. Furthermore, similar to the earlier whole-of-fund model limited partnership agreement, the Model II LPA provides a practical application of Principles 3.0 and can serve as a starting point for focusing negotiations between GPs and LPs, which may reduce legal costs and organizational expenses.

We will continue to monitor developments in this area and provide further updates in due course.

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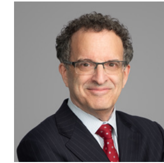

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