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ILPA Principles 3.0: Back to the Future?

Key Takeaways for Private Equity Fund Sponsors and Investors

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In June 2019, the Institutional Limited Partners Association (ILPA) published a third version of principles that set out ILPA's view of industry best practices (ILPA 3.0). ILPA 3.0 contains several recommendations regarding the ways in which fund sponsors should structure their funds to ensure a greater alignment of interests between funds and their investors. Some of these recommendations represent a departure from current market standards.

Fund sponsors that are expecting to raise a fund in 2019 and beyond should become familiar with ILPA 3.0 and the ways in which their fund terms may represent a departure from ILPA 3.0. Conversely, institutional investors may also want to familiarize themselves with ILPA 3.0 to consider whether they wish to adopt any of the recommendations of ILPA 3.0 as standard requests when they are investing in private equity funds.

It remains to be seen whether and to what extent the industry will adopt ILPA's best practice recommendations and what impact the industry's response may have on LPs and GPs, particularly in respect of recommendations that affect fund economics.

What You Need to Know About ILPA 3.0: Key Changes

The Buck Stops Here: Key Economic Terms

While many of ILPA's recommendations are relatively uncontroversial, other recommendations may be more troubling for fund sponsors, specifically those that would affect the economics of a fund:

- **Calculation of Preferred Return.** ILPA recommends that to "mitigate investor risks, the carried interest calculation should ideally utilize a 'hard hurdle' whereby the GP's carried interest is based only on the portion of profits that exceed the LPs' preferred return."[1] One of the stated rationales for this recommendation is to improve alignment of interests between GPs and LPs; however, this approach would eliminate the "catch-up" provision of the distribution waterfall. A catch-up provision ensures that the GP receives carried interest on all net profits, including those in respect of the preferred return. The effect of this recommendation is that the GP will, in fact, not receive the stated carried interest percentage.

  Consistent with guidance it issued in 2017, ILPA also recommends that the preferred return be calculated from the date on which the investors' capital is at risk (to address a scenario in which the GP draws on its subscription line in lieu of making a capital call to fund investments).[2] This approach may be less troubling from a GP's perspective than the proposal to remove the catch-up, but it has not yet gained traction in the market. However, given the increasing concerns of institutional investors regarding the use of subscription lines, fund sponsors should be prepared to justify the permitted uses of those subscription lines in the fund's partnership agreement or consider adopting the ILPA's 2017 guidance.

- **Clawback.** ILPA has reverted to its 2009 position regarding the calculation of clawback obligations: any clawback obligation should be determined gross of taxes paid by carried interest recipients. This approach would have the effect of individual carry recipients being out of pocket for taxes paid on the carried interest, which may not be recoverable following a clawback payment.

- **Fee Offsets.** ILPA 3.0 states, "Any portfolio company fees that are charged should be 100% offset against the management fee and subject to standard disclosure."[3] ILPA's prior view was simply that fee offsets should accrue to the benefit of the fund. While a 100% fee offset is quite typical, the devil is always in the details. For example, an issue that may arise relates to LPs such as the sponsor who do not pay management fees. Because those LPs do not pay management fees, they would not get the benefit of a fee offset if it is structured as a simple 100% offset. An alternative approach is to notionally allocate a pro rata portion of fee offsets to all LPs, including those that do not pay management fees, to avoid skewing the economics among the LPs as a result of the offset.
- **Partnership Expenses.** ILPA 3.0 has increased the focus on the type of expenses that would be appropriate to charge to a fund. For example, an ILPA 3.0 compliant fund would be permitted to charge the costs of a third-party administrator to the fund only if the LPs have approved the use of a third-party administrator. In addition, travel expenses related to sourcing a deal, networking and "preliminary" due diligence should be borne by the fund manager rather than the fund itself. Under ILPA 3.0, travel related to a potential investment may be treated as a transaction cost borne by the fund only after the potential investment advances past the initial term sheet. ILPA also states that expenses for due diligence related to environmental, social and governance (ESG) issues and to management and reporting should be borne by the manager.
- **Cap on Indemnification.** ILPA 3.0 recommends that indemnification expenses be "capped as a percentage of total fund size."[4] If this approach is adopted by fund sponsors, the GP of the fund could be required to bear the costs of significant claims, such as indemnification claims brought by third parties against the GP following the sale of a business or claims brought against the principals of the fund. Although representation and warranty insurance can mitigate this risk to some extent in the M&A context, representation and warranty insurance policies customarily include significant carve-outs for items such as environmental claims and any claims that are known at the time the agreement is entered into.

Focus on Transparency and Good Governance

In addition to the recommendations relating to economic terms, ILPA 3.0 sets out the following recommendations, each of which appears to be focussed on transparency and good governance:

- GPs should consider establishing and maintaining an ESG policy with verifiable procedures and protocols.
- Any and all changes in ownership of the fund manager, however small, should be reported to LPs in advance.
- All potential conflicts of interest, including those specifically contemplated in a fund's governing agreements, should be cleared by the LP Advisory Committee. ILPA has identified cross-fund investments and GP-led secondary transactions as of particular concern in this regard, and ILPA 3.0 includes detailed recommendations regarding the manner in which GPs should mitigate conflicts in the context of GP-led secondary transactions.
- Carve-outs to indemnification clauses such as fraud, gross negligence and wilful misconduct should not be qualified by material adverse effect, which ILPA regards as having the effect of inappropriately lessening the fiduciary duty owed to LPs.
- Fund sponsors should seek to "avoid over-concentration in short time periods";[5] we note, however, that ILPA has not recommended including pacing requirements in the partnership agreement. It remains to be seen whether the investor community will embrace the concept of pacing requirements and begin to request them more frequently.

How Will ILPA 3.0 Change Your Life, or Will It?

It would be easy to conclude that ILPA 3.0 will change the landscape of fund term negotiations in a significant way, given the extent of its recommendations. But to borrow a phrase from *Back to the Future Part III*, "your future hasn't been written yet."[6] Market practice varies from ILPA's past recommendations, and it is likely to continue to do so in the future. In our view, the best response to ILPA 3.0 would be reasoned, contextual and market-driven. After all, ILPA itself acknowledges that the principles should not "be applied as a checklist, as each partnership should be considered separately and holistically. A single set of preferred terms and practices cannot provide for the broad variability of products, strategies and investor preferences across the market at any given time, nor account for every individual circumstance."[7]

Private equity fund sponsors would be well advised to become familiar with ILPA 3.0, which contains a number of additional recommendations not summarized here. Sponsors should come to the negotiating table prepared to discuss why they have proposed certain fund terms that diverge from ILPA 3.0. Investors, meanwhile, should consider ILPA 3.0 in the context of each fund they are evaluating, the parties' relative bargaining powers and their own priorities. ILPA 3.0 has not relieved fund sponsors and their investors of the obligation to pick their battles, but it has given them more things to think about when they do.

[1] ILPA 3.0 at 10.

[2] "Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners," online: https://ilpa.org/subscription-line-of-credit.

[3] ILPA 3.0 at 13.

[4] ILPA 3.0 at 21.

[5] ILPA 3.0 at 22.

[6] https://www.imdb.com/title/tt0099088/characters/nm0000502.

[7] ILPA 3.0 at 6.

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