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Legal Update

Analysis of the ILPA Model Fund Agreement

On October 30, 2019, the Institutional Limited Partners Association ("ILPA") publicly released a model Limited Partnership Agreement for private equity buyout funds.[1] ILPA is the world's largest industry association for institutional LPs in the private equity asset class, and its prior announcements of proposed principles have historically affected sponsor-investor negotiations.

The Model LPA is intended to represent the ILPA Principles 3.0,[2] which offer a series of benchmark provisions intended by ILPA to promote a closer alignment of interests among sponsors and investors. ILPA describes the purpose of the Model LPA as follows:

> The hundreds of LPAs developed each year are the product of bespoke efforts and one-off negotiations that come with excessive cost to both GPs and LPs. We encourage all industry stakeholders to review the [Model LPA] and use it as a basis for a more effective process, with the confidence that the provisions therein are supported by the LP community.[3]

In light of ILPA's stature and the influence of earlier versions of the Principles on the private fund industry, we expect that some of the Model LPA terms will be raised in the course of negotiations, particularly those involving first-time fund sponsors. As highlighted by the following summary, the Model LPA generally reflects negotiated positions that are more favorable to investors than to sponsors. Our analysis is intended to help facilitate review of ILPA's proposed benchmarks for all parties as we move into a more competitive fundraising environment.

I. Fund Economics.

The Model LPA's economic provisions principally relate to distributions (including GP clawbacks, LP givebacks, and escrows), Management Fees, and the allocation of expenses between the Fund and the sponsor.

A. Distributions.

The waterfall requires a return to the LPs of all capital contributions, plus the agreed Preferred Return, before any Carried Interest is paid to the GP. After that, the GP is entitled to a catch-up (the bracketed percentage to the GP is 80%), with the GP receiving 20% of any further distributions. Notably, a footnote to the definition of Preferred Return provides that the Preferred

Return should begin to accrue when the corresponding draw under any subscription line of credit was made.

Tax distributions, if any, are to be made to all LPs as well as the GP, on a pro rata basis based on their Commitments. The inclusion of LPs in tax distributions may result in a substantial reduction in the amount of cash available for the GP's owners to pay the tax due on any income recognized in respect of the Carried Interest. In any case, basing the partners' rights to distributions on relative Commitments does not take into account that the GP typically could be subject to income taxation with respect to its carried interest (i.e., not related to any Commitment) in a year prior to the year it is otherwise entitled to receive carried interest payments. Note further that the Model LPA's provisions on tax distributions appear to contradict themselves; the amount of a partner's tax distributions depends on the amount of actual tax payable by the partner (with no reference to its owners or any deemed tax concept) *and* without regard to whether the partner is taxable (*see* definition of *Tax Amount*). The use of actual tax amounts for calculating tax distributions and the GP Clawback obligation may be challenging to implement in practice for both LPs and the GP.

B. GP Clawback.

A GP clawback happens upon: (i) the first anniversary of the end of the Commitment Period, (ii) a GP removal, (iii) Fund liquidation, and (iv) any time there is an LP giveback. The amount of the GP clawback (before any "after-tax" reduction described in the next sentence) equals the greater of (i) the excess of Carried Interest distributions to the GP over what the cumulative carry distributions would be based upon actual performance to date, and (ii) the amount necessary to provide the LPs a return of their capital contributions plus the Preferred Return. The GP clawback is limited to the aggregate amount of carry distributions reduced by Carried Interest taxes actually paid (not deemed paid) by the GP and its owners, net of tax benefits that would be realized in the year of such clawback payment. The GP is required to provide evidence of tax obligations to the LPs. To the extent all or a portion of the Carried Interest is allocable to individuals (or to pass-through entities held by individuals), the obligation to disclose personal tax information may raise privacy concerns. We also note that the expense of calculating actual taxes paid by individuals subject to the clawback (net of any respective benefits in respect of amounts clawed back) may not in fact generate much savings to the Fund as compared to a conventional hypothetical calculation.

C. Escrow Account.

The GP is required to place in escrow for each LP a to-be-agreed percentage of carry distributions (other than tax distributions), to be released when the LP has received distributions equal to its Commitment (i.e., not Capital Contributions) plus any Preferred Return.

D. Management Fees.

The Management Fee begins on the First Investment Date (although the Model LPA indicates that the Initial Closing Date may be appropriate for some Funds) and ends on the last day of the initial Term (i.e., without regard to any extensions). The fee is based on a percentage of Commitments until the earlier of the end of the Commitment Period and the date a management fee begins to accrue on a Successor Fund. After the Commitment Period (or during any Key Person suspension period), the fee is based upon a percentage of capital contributed to fund the Acquisition Cost of investments that have not been realized or permanently written down.

E. LP Giveback.

See II.D below for a description of the limits on the GP's right to recall distributions to LPs.

F. Fund Expenses and GP Expenses.

Although the Principles articulate an objective that Fund Expenses be clearly described, the Model LPA's relevant provisions (Sections 2.5 and 2.6) in significant respects create uncertainty regarding the dividing line between Fund Expenses and General Partner Expenses. The Model LPA requires that Fund Expenses be "reasonable and properly incurred," and further requires the General Partner to pay "all normal operating expenses attributable to the Fund's investment activities." The reasonableness requirement for Fund Expenses may lead to additional scrutiny of whether certain expenses are reasonable, even though the GP may have met its standard of care or if factors outside of its reasonable control may have triggered the expenses.

The Model LPA's requirement that the GP pay all normal operating expenses attributable to investment activities also creates uncertainty because of the many potential interpretations of the provision's scope. Similar interpretive challenges arise from the requirement that the GP pay the expenses of investment consultants other than those providing specialized services not "ordinarily provided" by the GP. To the extent that the Model LPA's expense provisions are used as a starting point, both sponsors and investors will want to carefully adapt them to their particular circumstances in order to avoid unnecessary ambiguity in interpretation.

It is also notable that the Model LPA treats as General Partner Expenses costs of Form PF filings, fees for maintaining the Fund's and the GP's registered office in its state of formation, and the costs of all internal personnel of the sponsor, including accounting and legal personnel. Furthermore, the costs of computer software and communications generally, including the cost of any web portals, are included as General Partner Expenses.

Overall, the economic provisions in the Model LPA, particularly regarding the treatment of credit facilities in the waterfall, tax distributions and expenses, if adopted going forward, would represent a significant movement in favor of LPs.

II. Standard of Care, Exculpation and Indemnification.

ILPA's Model LPA advances a number of related provisions intended to heighten the standard of care employed by the Fund sponsor in the course of managing the Fund. The enhanced standards proposed by ILPA are generally reflected in (A) the standard of care, (B) the incorporation of state common law fiduciary concepts, (C) the inclusion of an affirmative duty to pre-clear all conflicts of interest, (D) the proposed exculpatory and indemnity standards, and (E) related mechanical provisions, such as the LP giveback.

A. Standard of Care.

In formulating contractual fiduciary standards for the fund industry, historical practice evolved to ensure that the agreed standard of care did not create an untenable warranty of performance that in practice invalidated the limitations on the sponsor's liability as reflected in the exculpatory and indemnity provisions of the Fund agreement. This approach was historically agreed because the contours of the many sources of fiduciary requirements often overlap or conflict. For example, separate fiduciary duties of fair disclosure may exist under the Advisers Act,[4] under the laws imposed by the Fund entity's domicile (e.g., in Delaware, under the Delaware Revised Uniform Limited Partnership Act ("DRULPA"), as supplemented by the case law developed by the Delaware courts), or as agreed contractually in the Fund partnership agreement or via ancillary agreements such as side letters.

The Model LPA takes a different approach and offers the following standard of care provisions at Section 20.5 (collectively, the "Standard of Care"):

> The General Partner and the Fund Manager each shall manage and control the Fund and its business and affairs reasonably and in good faith and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. The foregoing duties apply to all investment decisions, delegations of authority, and all other acts or omissions of the General Partner or the Fund Manager under this Agreement or any other Fund Document. This Section . . . supplements, and does not replace, the fiduciary duties applicable to the General Partner or the Fund Manager, as the case may be, pursuant to [DRULPA] or any other applicable law. In the event of any inconsistency between this Section . . . and any other provision of this Agreement or of any other Fund Document, this Section . . . shall govern. For the avoidance of doubt, the General Partner and the Fund Manager each shall exercise its "good faith," "discretion," "sole discretion," . . . or other subjective standard of care set forth in this Agreement in a manner consistent with this Section . . . .

The Model LPA's proposed Standard of Care is notable for advancing an "ordinarily prudent person" standard that applies without exception. The Standard of Care thus potentially conflicts with other provisions of the agreement, such as the exculpatory and indemnity provisions, which typically employ a "gross negligence" standard. The Model LPA foresees this potential conflict and provides that, not only does Standard of Care expressly override all other provisions of the Model LPA, it also overrides other conflicting provisions of the "Fund Documents", which are defined to include side letters and other documents relating to the Fund.

The proposed Standard of Care is also at the vanguard for introducing the Fund Manager as a party to the Model LPA, subject to the same fiduciary standards as the GP. All delegations of authority under the Model LPA are subject to the Standard of Care.

B. Incorporation of Fiduciary Duties.

Perhaps the most significant proposed change to industry standards is the express incorporation by the Model LPA of the fiduciary duties applicable to the GP and the Fund Manager pursuant to the DRULPA or any other applicable law. As noted above, the Standard of Care would impose state common law fiduciary duties on the GP and the Fund Manager with respect to "[a]ll investment decisions, delegations of authority, and all other acts or omissions of the GP or the Fund Manager under [the Model LPA] or any other Fund Document." The effect is to incorporate the state common law (including case law) applicable to fiduciaries, based on the contractual choice of law. The Model LPA is governed by Delaware law, and our discussion therefore focuses on the DRULPA.

The incorporation of state common law is a default position under most alternative entity organizational statutes in the United States, including those of the State of Delaware, but it is not compelled. For example, the DRULPA provides that any fiduciary duties owed may be limited or eliminated in a partnership agreement, other than the implied contractual covenant of good faith and fair dealing.[5] Given the many overlapping and often conflicting formulations of the fiduciary duties of care, loyalty and disclosure under various legal regimes, the standard industry position for private funds has historically been to eliminate all standards (including fiduciary standards) to the maximum extent permitted by applicable law. Most agreements instead rely on the carefully negotiated provisions of the fund partnership agreement. This position developed over time in consideration of the sponsor's need to ensure that its investment team would be fully protected by the negotiated terms of the fund partnership agreement (except in agreed excluded circumstances, such as an intentional violation or gross negligence) rather than second-guessed in hindsight on the basis of other applicable law.

By opening the door to undefined claims for breach of fiduciary duty, the Model LPA's Standard of Care thus represents a significant departure from the established approach. This possible result is not unintended. The Principles clearly state that "Limited Partnership Agreements should reinforce rather than dilute the fiduciary duties of [GPs] to [Limited Partners]."

Both sponsors and investors should carefully consider the unintended effects of importing state fiduciary law concepts into their agreements. A thorough analysis under the selected governing law should be undertaken to ensure that the application of residual fiduciary concepts such as the duties of care and loyalty, opportunity doctrines, partner oppression, and fair disclosure, etc., do not impose inadvertent additional obligations on the partners.

C. Pre-Clearance of Conflicts of Interest.

In addition to preserving traditional statutory concepts of fiduciary duty, the Model LPA expressly retains at Section 9.5 the LPs' right to withhold consent to a sponsor conflict, even if the conflict was previously disclosed in the Fund's offering documents:

> For the avoidance of doubt, the General Partner and the Fund Manager hereby acknowledge and agree that nothing disclosed (as a "Risk Factor" or otherwise) in the Fund's offering documentation, as the same may be modified from time to time, shall be deemed solely by virtue of such disclosure to be a permissible conflict of interest under this Agreement or to otherwise reduce or eliminate the requirement for Advisory Committee disclosure or prior written consent as set forth in this Section . . . .

This reservation is accompanied by a requirement that the GP and the Fund Manager promptly disclose to the Advisory Committee all actual or material potential conflicts of interest between (i) the Fund, any Portfolio Investment or any Portfolio Company on the one hand, and (ii) any Interested Person[6] on the other hand (including the Fund directly or indirectly entering into a business transaction with any Interested Person, whether or not on arm's-length terms and conditions).

Provisions such as these are in line with the general retention of common law fiduciary duties, such as the duties of loyalty and fair disclosure, which generally prohibit a fiduciary from using its position to obtain a benefit at the expense of its clients or beneficiaries. Even if disclosure of a particular conflict suffices to mitigate a particular conflict for Advisers Act purposes, these types of provisions may, in certain circumstances, empower investors and any other beneficiaries with standing to seek relief if a disclosed conflict results in a loss for the Fund. The Model LPA provisions also potentially increase the settlement value for plaintiffs seeking to impose liability on that basis.

D. Exculpation and Indemnification.

Article 16 of the Model LPA sets out the proposed exculpation and indemnity provisions, which establish the circumstances in which an investor retains the right to seek redress, while demarcating the circumstances in which the assets of the Fund may be used to pay the defense costs of the sponsor if an investor or a third party seeks redress for Damages.

The GP Covered Persons are generally exculpated from all Damages except for an "Exculpation Exclusion Event" and indemnified and held harmless except for an "Indemnification Exclusion Event". The main definition is as follows:

> "Exculpation Exclusion Event" means, with respect to the relevant GP Covered Person, any conduct or lack of conduct in relation to the activities of the Fund that constitutes any of the following:
>
> a) fraud, bad faith or willful misconduct;
>
> b) gross negligence or reckless disregard;
>
> c) a breach of any of the terms of [the] Agreement, including a breach of Section 20.5 (Standard of Care), or any other Fund Document;
>
> d) a violation of any laws, regulations, judgments, orders or other legally enforceable actions, domestic, foreign or multinational, or any other conduct described in clause (iv) or clause (v) of the definition of "Removal Conduct";[7] or
>
> e) any and all matters based upon, arising out of or otherwise with respect to any Proceeding between or among GP Covered Persons or Interested Persons.

The "Indemnification Exclusion Event" definition tracks the above but adds the GP Covered Person's insolvency, dissolution, liquidation, or bankruptcy as a springing basis for exclusion from coverage. Depending on the choice of law, the parties should consider the extent to which applicable common law may incorporate standards of conduct in the event that the undefined concepts of "fraud" or "dissolution" that do not involve intentional acts.

Consistent with the Principles, the Model LPA also introduces exceptions to coverage for any breach of the Model LPA (including the Standard of Care) or any other Fund Document. The Model LPA also eliminates coverage in the context of any violation of applicable law, irrespective of intent or materiality. No quarter is granted in the event the GP Covered Person consults with reputable counsel as to the application of law to the Fund's circumstances. The Model LPA thus eliminates relief for the sponsor in the event of any breach of the Fund's main contract or any ancillary agreement relating to the Fund, whether or not material, and regardless of whether the breach has an effect on the Fund or the Partners.

We also note that the Model LPA proposes strict quantum and temporal limitations on recalling distributions from investors in the event additional assets are needed to satisfy an indemnity. The Model LPA caps a Limited Partner's aggregate giveback liability at the lesser of (i) 30% of all distributions received by such LP from the Fund, and (ii) 25% of such LP's Commitment. The right to recall distributions expires upon the earlier of (x) the second anniversary of the applicable distribution (unless an open claim is notified), and (y) the second anniversary of the termination of the Fund.

E. Related Indemnity Provisions.

Other notable indemnity provisions advanced by the Model LPA would:

- Exculpate the members of the Fund's Advisory Committee, except to the extent a court finds that such member or its affiliates engaged in fraud or bad faith;
- Require a GP Covered Person to use "best efforts" to exhaust all other sources of recovery (e.g., insurance) prior to using the assets of the Fund;
- Eliminate advancement of expenses to a GP Covered Person until the "ultimate" determination by a court if a specified majority of investors (left undetermined by the Model LPA) brings an action for Damages against such GP Covered Person;
- Compel the GP to promptly report to the investors any claim for indemnification, including the material details and developments from time to time; and
- Prohibit amendments of the indemnity provisions without the consent of the applicable beneficiary(ies).

III. Co-Investments.

The Model LPA includes several provisions relating to potential co-investment and joint venture opportunities, as follows:

- The GP may provide co-investment opportunities (either directly or through an intermediate holding vehicle) to LPs, strategic third parties or any other third party.
- Allocation of a co-investment opportunity to any "Interested Person" would require the prior written consent of the Advisory Committee. An "Interested Person" includes any Person who is controlled by, or is under common control with, the GP, and as such could include certain investment vehicles formed by the GP to facilitate the co-investment.[8]
- All co-investments must be made in accordance with the GP's co-investment policy.
- Any co-investment must be made and divested "at substantially the same time and on the same terms (save as required for legal, tax or regulatory purposes)," including the same form of consideration. This provision could affect the timing of any planned co-investment as well as the structure of potential lender or other third-party guarantees and indemnification obligations.
- The co-investor "shall bear" its pro rata share (based on capital committed to the co-investment) of any fees, expenses and liabilities related to the Portfolio Investment. The Model LPA does not provide for any exceptions to this requirement.
- The GP must provide notice to each LP of all co-investments "offered and made" and, in brackets, the identify of all co-investors.

The Model LPAs provisions on co-investments, if adopted, would require additional Advisory Committee approval for the use of sidecars and special purpose co-investment vehicles and limit flexibility on the terms and timing for admitting third-party co-investors.

IV. Governance, Control and Advisory Committee Provisions.

The Model LPA includes a number of investor-favorable provisions relating to the ordinary course of fund governance. A summary of certain noteworthy provisions in that regard is included below (in addition to the heightened standard of care and expansive investor information rights that are discussed elsewhere in this Legal Update).

A. Limited Partners' Rights and Remedies.

The Model LPA grants a full set of no-fault remedies to the LPs, e.g., the right, for any or no reason, to terminate the Fund's investment period, to remove and replace the GP and/or to terminate the Fund, which rights are exercisable with the consent of 75% in interest (based on relative Commitments) of the LPs. A certain percentage (not specified in the Model LPA) in interest of the LPs also has the right to suspend the Fund's investment period.

The consent of a majority in interest of the LPs (or, in certain instances, the Advisory Committee's consent) is required to effect any extension of the Fund's investment period or the Fund's term or to waive Model LPA investment restrictions that are subject to waiver. The consent of a majority in interest of the LPs is also required to allow for the Fund's liquidation process to continue beyond one year after the Fund's dissolution.

In addition, high voting thresholds apply with respect to certain matters on which the Model LPA requires LPs' consent. For example, any transfer of the GP's interest in the Fund and any Change of Control (at the GP or the Fund Manager level) requires the consent of 85% in interest of the LPs. Also, amendments or modifications to the Model LPA generally require the consent of 75% in interest of the LPs. Certain specific provisions (such as those regarding the Fund's maximum size or investment restrictions) can only be amended with the consent of 90% in interest of the LPs, and certain other provisions (such as those regarding distributions, allocations or the Management Fee) can only be amended with the consent of each LP adversely affected thereby. The consent of an LP is also required for the LP to be required to participate in any investment through an alternative investment vehicle (an "AIV"), unless all LPs are participating in such investment through such AIV.

The power of attorney granted by the LPs to the GP under the Model LPA is limited solely to the execution of amendments to the Model LPA duly adopted in accordance therewith.

Finally, the GP's authority to enter into side letters is limited to the GP's reasonable and good faith discretion, and all LPs (regardless of their respective Commitment amounts) are automatically granted the benefit of all more favorable side letter terms, subject to certain narrow exemptions.

B. Advisory Committee Provisions.

Consistent with the Principles, the Model LPA gives the Advisory Committee an expanded role in fund governance. Although some funds take the approach that an Advisory Committee is primarily consultative, the Model LPA vests the Advisory Committee with the authority to provide advice to the GP on matters submitted by the GP as well as matters identified by the Advisory Committee. In addition, the Model LPA prohibits the GP and the Fund Manager from knowingly undertaking any conduct constituting an actual or potential conflict of interest between the Fund or any of its portfolio companies or portfolio investments, on the one hand, and any Interested

Person, on the other hand, without the prior written consent of the Advisory Committee. This prohibition also applies with respect to any business transaction with an Interested Person, whether or not on an arm's-length basis. In a footnote to this provision, ILPA acknowledges that such strict prohibitions on conflict transactions will be impracticable for some fund sponsors.

The Model LPA also requires the Advisory Committee's approval with respect to a number of other matters, such as the replacement of the Fund's named auditor; the decision to disaggregate the Fund's and its AIVs' investment results; all determinations as to actions or waivers with respect to a default by an Affiliated Partner; the allocation of a co-investment opportunity to an Interested Person; the sale of a Defaulting Partner's interest to an Interested Person or the sale to the GP or any of its Affiliates of any securities that a Limited Partner has elected not to receive in kind; and the establishment of any reserves upon conclusion of the Fund's liquidation.

Finally, under the Model LPA, the GP is required to furnish to the Advisory Committee extensive information concerning the Fund and its assets, including, among other matters, annual disclosure of the calculations and a list of the Management Fee, the Carried Interest and other Fund expenses; information about any co-investment opportunity offered by the GP or any of its Affiliates to any person; notice of certain litigation and regulatory and administrative proceedings, including notice of any indemnification claim brought under the Model LPA; and such other pertinent information as the Advisory Committee may request. Importantly, any valuations determined by or on behalf of the GP or the Fund are required to be disclosed to the Advisory Committee on a timely basis, and the Advisory Committee has the right to subject any valuation to confirmation or adjustment by an independent appraisal firm approved by the Advisory Committee.

The Model LPA equips the Advisory Committee with an expanded set of tools and protections in carrying out its functions, including mandatory implementation of the Advisory Committee best practices described in the Principles, the ability at any time to meet *in camera* without any Interested Person present, and the right to appoint professional advisors.

In general, the Model LPA enhances the liability protections for members of the Advisory Committee and the LPs that appoint them. They are fully exculpated, indemnified and insured at the Fund's expense. Further, the Model LPA expressly disclaims for all Advisory Committee members and the LPs who appoint them any fiduciary or other obligation when choosing how to exercise the expanded oversight rights, including when appointing professional advisors at the expense of the Fund.

V. Key Person and Removal Provisions.

The Key Person and removal provisions in the Model LPA are reflective of the Model LPA's overall focus on more extensive involvement of all LPs in Fund governance and exercise of rights and remedies vis-à-vis the Fund sponsor.

A. Key Person.

The Model LPA sets standards for both conduct giving rise to a Key Person Event, as well as consequences and rights of action for LPs upon the occurrence of a Key Person Event.

A Key Person Event is deemed to have occurred if either the designated Key Persons have ceased to devote the required time and attention and attention to the Fund and any prior or successor funds or if there is a Change of Control.

Although a change of control concept is often implicit in Key Person provisions, the Model LPA highlights a Change of Control as a separate Key Person Event trigger. A Change of Control is broadly defined as any action that results in either the Key Persons ceasing to control the GP and the Fund Manager or the Key Persons being entitled to less than a specified percentage of the Carried Interest (with 75% suggested as a potentially appropriate threshold). Included in the Change of Control concept is a requirement that the GP notify the LPs upon any transfer by the Key Persons of their control of the GP or Fund Manager or transfer by any Key Person of his or her entitlement to any amount of Carried Interest.

The Model LPA provides that upon any Key Person Event, the GP must immediately give notice to all LPs, and the Commitment Period will be automatically suspended. It further specifies that the Commitment Period will terminate unless a majority in interest of LPs approve a remediation plan or otherwise waive the suspension within 90 days. The Model LPA includes a step-down in the Management Fee base during any suspension period from being calculated on Commitments to being calculated on acquisition cost of investments held (and not written off or permanently written down) at the applicable time.

The Key Person terms in the Model LPA reflect a greater role for LPs as a whole, rather than reserving the exercise of Key Person-related rights for the Advisory Committee, as is commonly seen in the current market. A majority in interest of LPs are required to approve any replacement Key Persons, as well as to resume investing after suspension of the Commitment Period. The Advisory Committee, however, is granted the right to approve the making of capital calls during a suspension or following termination of the Commitment Period for reasons other than paying expenses or liabilities or completing investments in progress or follow-on investments.

Key Person terms are by definition reflective of the particular individual(s) responsible for, as well as other situations applicable to, a Fund’s investment program. Therefore, while the Model LPA provides guidelines for investors and sponsors to consider with respect to Key Person requirements and rights, the Key Person terms included in a particular Fund’s governing documents are likely to reflect the facts and circumstances of the Fund.

In addition to addressing the impact of Key Person-related events on the suspension and termination of the Commitment Period, the Model LPA (Section 9.2) adopts an overall time and attention standard, which requires that the GP, the Fund Manager, and the Key Persons devote (i) during the Commitment Period, substantially all of such Person’s business time to the affairs of the Fund, the GP, the Investment Manager, any Alternative Vehicles, any Parallel Vehicles, any co-investment, Prior Funds, or other investment vehicles permitted by the terms of the Fund’s governing documents and (ii) thereafter, such portion of their time to the affairs of the Fund as is necessary for the management of the Fund. ILPA has not attempted to mandate specific terms such as a maximum number of Key Persons or a minimum number of Key Persons that must meet the time and attention standards before a Key Person Event will be deemed to have occurred.

B. Removal.

The Model LPA provides for both fault and no fault removal of the GP. Consistent with existing ILPA Principles, the Model LPA permits 75% in interest of LPs to remove the GP for any reason or no reason. Reflecting a pro-investor viewpoint and a significant departure from prior ILPA guidance, under the Model LPA there will be an immediate termination of the Management Fee upon delivery of a Removal Without Cause Notice. The GP remains entitled to a to-be-negotiated percentage of the Carried Interest for investments made prior to removal. The Fund can elect to pay any amounts owed to the GP pursuant to a non-interest bearing promissory note.

With respect to the right of a majority in interest of LPs to remove the GP for cause, the Model LPA includes an expansive list of activities constituting "Removal Conduct." However, the Model LPA includes alternative provisions for negotiation as to whether such Removal Conduct must be adjudicated by a court or other independent arbiter or governing body before giving rise to the removal right. Specifically, Removal Conduct includes the following circumstances:

(a) With respect to the GP, Fund Manager, any of the Key Persons and any of their respective Affiliates, any action or inaction that constitutes any of the following:

  (i) fraud, bad faith or willful misconduct;

  (ii) gross negligence or reckless disregard in relation to activities of the Fund;

  (iii) either (A) a breach of the Standard of Care, or (B) a material breach of any of the other terms of any of the Fund's governing documents;

  (iv) a material violation of securities, commodities, AML/OFAC or corrupt practice laws, rules or regulations in relation to the Fund, provided that in the case of the Key Persons any such violations, even if not related to the Fund, will give rise to a removal right;

  (v) criminal conduct related and material to the duties to and with respect to the GP, the Fund Manager or any Fund Vehicle, and for which the maximum sentence is more than a fine; provided that in the case of the Key Persons, any criminal conduct will give rise to a removal right; or

  (vi) any order, judgment or decree of any court, arbitral tribunal or regulatory authority which prohibits, prevents or materially impairs such Person from carrying on its duties or performing its obligations with respect to the Fund; and

(b) with respect to the GP and the Fund Manager, insolvency, administration, dissolution, liquidation, involuntary reorganization, bankruptcy or suspension of payments (or equivalent under foreign law).

Upon any "Removal For Cause Notice", the Model LPA provides that the Management Fee will immediately terminate and the GP's right to receive any Carried Interest will terminate. With respect to either a fault or no-fault removal, the Model LPA imposes on the GP and Fund Manager an affirmative obligation to transition records to a replacement GP and use best efforts to transfer the control of the Fund and its assets without delay. In the event of their non-compliance, the Fund is entitled to withhold amounts owed to the GP. The Model LPA also extends to a majority in interest of the LPs the right to buy out the limited partnership interests of GP affiliates pursuant to a non-interest bearing promissory note.

The inclusion of certain rights for LPs to remove the GP, particularly in the event of adjudicated "cause," are common market practice. However, certain of the Model LPA's provisions would endow the LPs with punitive removal rights, including in the absence of a neutral third-party's determination of "cause." As sponsors and investors consider Model LPA terms in future negotiations, it remains to be seen whether funds will begin to adopt some of these more progressive removal rights.

VI. LP Information and Communication Access.

The Model LPA reflects recent trends in the private equity industry in favor of greater information transparency and reporting to LPs, but has incorporated this approach for all LPs generally rather than just the largest LPs. Taken as a whole, information of this nature and scope would allow an LP to monitor more closely Fund transactions even if the LP is not an Advisory Committee member, identify and collaborate with other LPs on issues of joint concern and enforce the LP's rights under Fund documents. Finally, if adopted, the use of streamlined and standardized reporting metrics would also enhance an investor's ability to evaluate and compare a Fund relative to its peers but would also impose additional administrative burdens on the GP. However, the Model LPA contemplates that the GP may engage a third-party administrator and contemplates that the costs of a third-party fund administrator would be a Fund expense.

A. Nature of Information.

Under the Model LPA, LPs are guaranteed access to the following information: (i) each other investor's[9] name, contact information and Commitment amount, (ii) materials, including meeting minutes, provided during an Advisory Committee meeting, (iii) books and records of the Fund, and (iv) financial information relating to the Fund, prepared in accordance with the ILPA Reporting Template.[10] This approach appears designed to provide all LPs with information that is comparable, regardless of the LP's relative size in the Fund. In particular, access to Advisory Committee meeting minutes, on a defined and regular basis, would provide non-Advisory Committee members of the Fund greater transparency of matters evaluated by the Advisory Committee.

B. Presentation of Information.

Financial information of the Fund should be presented in accordance with the ILPA Reporting Template. That information generally covers three broad categories:

- Fund level information (e.g., assets, liabilities (including leverage), net profit/net loss, expenses, reserves, management fees, management fee offsets, and Carried Interest including escrowed amounts);
- Portfolio-level information (e.g., valuation of each asset, the use of debt, a description of each portfolio company and its operations and the amount of commitment/remaining commitment for each investment); and
- LP information (e.g., capital account balance and any LP requested information such as environmental, social and governance considerations).

With respect to the use of leverage by the Fund and/or a portfolio company, the Model LPA would require Fund sponsors to disclose whether the debt is recourse or non-recourse and the degree/amount of cross-collateralization. For any credit facilities used by the Fund, the net internal rate of return (with and without the use of the credit facility) should accompany the more typical disclosures covering the amount outstanding, the use of proceeds and the terms of the credit facility.

As part of the delivery of the annual audited financial statements, GPs would also be required under the Model LPA to certify (i) whether the GP is aware of any material breach of the limited partnership agreement or any other agreement to which the Fund is a party, as well as any breach of fiduciary duties and (ii) that all distributions have been made in accordance with the limited partnership agreement.

C. Use of Information.

The Model LPA makes it clear that the information provided to LPs may be used for certain purposes without violating the confidentiality provisions of the limited partnership agreement. In addition to customary provisions that allow an LP to disclose confidential information to its advisers who are bound by duties of confidentiality, the Model LPA also allows for disclosure of otherwise confidential information in connection with any assertion of rights by an LP under any Fund governing document. Moreover, an LP's more common right to disclose information required by law, rule or regulation has been expanded to include the right to disclose information required in any "report, statement or testimony" required by a state, municipal or national regulatory body with jurisdiction over such LP. Similarly, a requirement to disclose information to governmental or regulatory authorities in connection with an audit or examination (including tax) is also excepted. These latter categories may arise in connection with investments from pension plans associated with a local or state governmental body who are subject to increasing governance, as well as heightened scrutiny of their investments in private funds.

VII. Fund Finance.

While the Model LPA contemplates the possibility of Fund-level indebtedness by providing a placeholder for provisions relating thereto (and permitting certain security interests – *see* Section 7.2), it appears that ILPA did not fully address provisions that typically are requested by lenders and commonly incorporated by GPs in connection with a subscription-backed credit facility ("SCF"), or other types of Fund financing arrangements. Due to the flexibility afforded to both LPs and the Fund by virtue of these financing arrangements, specific provisions required by lenders relating to Fund-level indebtedness have become a common feature in limited partnership agreements. Certain provisions currently included in the Model LPA, however, could pose challenges for GPs seeking to obtain Fund-level leverage, or to include LPs in the borrowing base for an SCF. As a result, GPs and investors should be aware that strict adherence to certain Model LPA provisions may conflict with lender expectations in such Fund-level financing arrangements, as noted below.

A. Provisions Relating to Indebtedness and Other "Bankable" Terms.

The section addressing indebtedness under the Model LPA is notable for both what is and is not addressed. While there is language permitting Fund-level leverage in Section 7.2 (Limitation on

Indebtedness), we note that it does not include the detail often required by lenders in the SCF market to make a limited partnership agreement "bankable."[11] Of particular note is the following:

- The limitation on indebtedness extends to all borrowings at the Fund level, as well as guarantees at the Fund level of portfolio company indebtedness. The Model LPA has bracketed a suggested level of leverage at 15% of total Commitments, which is lower than the 25%-35% leverage limitation associated with many Fund strategies.
- Indebtedness is also subject to a 6-month repayment requirement (which was also proposed in ILPA's recent publication "Subscription Lines of Credit and Alignment of Interest: Considerations and Best Practices for Limited and General Partners" (the "ILPA SCF Practices")). We also note that where a Fund may seek to use letters of credit under an SCF, it may be desirable to specify whether the incurrence of the letter of credit (versus a draw thereunder) is similarly subject to any repayment requirement.
- There is a provision permitting pledges to support an SCF, although the language does not include a fulsome description of the collateral typically provided to an SCF lender. For example, Section 7.2 does not specifically authorize a pledge of the Commitments and Capital Contributions (versus the right to issue Drawdown Notices), and does not address a pledge of collateral accounts (or a requirement for LPs to fund only into such pledged collateral account while an SCF is in place). It is also commonplace for limited partnership agreements to acknowledge that an SCF lender is relying on Capital Contributions as the primary source of repayment for credit facility borrowings.
- The Model LPA also does not include a statement that the obligation of LPs to fund Capital Contributions to a lender exercising remedies under an SCF is "unconditional", or otherwise provide for typical waivers relating to setoffs, counterclaims or defenses to funding (including in an insolvency proceeding). This can pose a substantial barrier to an SCF given that most SCF lenders will require such provisions to ensure that the obligation of an LP to make Capital Contributions will remain intact during a bankruptcy of the Fund (and not be categorized as a "financial accommodation"). In the absence of such provisions, a lender may require LPs to execute "Investor Letters" (which among other things provide for an acknowledgment of the obligation to fund Capital Contributions without setoff, counterclaim or defense). The need for Investor Letters can increase the costs and burdens associated with an SCF as LPs often seek to negotiate such letters individually or may decline entering into such letters (in which case their Commitments would not be included in the borrowing base for the SCF).
- Section 20.11 of the Model LPA expressly excludes any creditor of the Fund as a third-party beneficiary of the terms of the agreement. It is currently common to include SCF lenders as third-party beneficiaries due to the express authorization to incur this Fund-level indebtedness and the pledge of Commitments and the obligation of LPs to fund Capital Contributions to repay such borrowings.
- The Model LPA further provides in a footnote to Section 7.2 that LPs should not be required to disclose information to a lender that is not in the public domain without its prior written consent. Due to constraints applicable to certain LPs, such investors may limit the obligation to provide financial information to a lender (other than publicly available financial statements) pursuant to their side letters. It is uncommon, however, to see a general prohibition on such information contained in the limited partnership agreement itself. Given that SCF lenders

require certain information to assess creditworthiness of LPs, a general limitation may limit the ability of the GP and investors to collaborate with lenders to achieve the desired facility size and borrowing base (as the lender may reduce the advance rate against investors without publicly available information or may not be able to include such LPs in the borrowing base at all).

- The Model LPA also does not squarely address the full range of variables associated with increasingly complex Fund structures and the corresponding impact on SCFs (such as the potential need to accommodate "cascading pledges" or cross-collateralize borrowings[12] due to ERISA or tax concerns that arise with other Fund entities such as feeder funds or alternative investment vehicles). This may be attributable to the fact that the Model LPA is a model document which is not intended to address these variables.

B. Additional Indebtedness Related Provisions.

In reviewing the Model LPA both GPs and LPs may also wish to consider the following items impacting an SCF in the form agreement:

- With respect to Section 6.4 of the Model LPA, reinvestment of Distributable Proceeds is limited to making Portfolio Investments (and consequently would not be included as part of the LPs Remaining Commitment otherwise available to support SCF borrowings, which is a common feature in many limited partnership agreements).
- It is also becoming quite common for a limited partnership agreement to specify that a Transfer by a Partner of its Interest may be subject to repayment of the portion of SCF borrowings attributable to such transferring Partner as a condition thereto (Section 17.2 of the Model LPA does not address this point).
- Finally, Section 21.2 of the Model LPA appears to contemplate that disputes arising thereunder may be subject to arbitration in certain circumstances (which if applied to all LPs would conflict with customary expectations regarding enforcement of rights and remedies contemplated by SCF lenders in pricing such facilities).

C. Indebtedness Disclosure Provisions.

As with the ILPA SCF Practices, the Model LPA focuses mainly on disclosure to LPs of the use of indebtedness at the Fund level. As such, we note that they did include many requirements regarding SCFs and other indebtedness in Section 15.2, including the following:

- Disclosure of debt at the Fund and Portfolio Company level;
- Description of the use of proceeds of such Credit Facility indebtedness;
- Internal rate of return calculations net of Credit Facility indebtedness;
- Outstanding uncalled capital;
- The number of days each Credit Facility drawdown is outstanding; and
- Certain terms and conditions of such Credit Facility, including SCF fees.

These features are all consistent with the ILPA SCF Practices, and we understand anecdotally that such information is now more readily available from most GPs (either formally or informally).

D. Fund Expenses/Capital Contributions Post-Commitment Period.

Rather than have separate provisions for the repayment of liabilities relating to an SCF (both prior to and after events that give rise to a termination of the Commitment Period, such as a Key Person Event), many limited partnership agreements include both principal and interest relating to an SCF as "Fund Expenses" which are subject to an obligation to fund Capital Contributions following termination of the Commitment Period. The Model LPA, however, only includes interest expense and fees for an SCF in the concept of Fund Expenses (*see* Section 2.5.1.6; Section 2.5.1.9). As a result, both GPs and lenders must take care that such items are separately addressed where necessary in the limited partnership agreement to provide for repayment of liabilities incurred prior to the end of the Commitment Period, and if needed for the Fund to incur indebtedness post-Commitment Period (for follow-on or follow-up investments, for example), to permit the repayment of such liabilities with Capital Contributions.

We note that in Section 7.4 of the Model LPA, all Drawdowns post termination of the Commitment Period (not just those that relate to new "Investments" as the lead-in suggests) are restricted, and as drafted such provision would prohibit capital calls for liabilities under an SCF except for "Fund Expenses." As noted above, this would not include the repayment of outstanding principal amounts under an SCF. This also appears to be inconsistent with the Key Person Event provisions (*see* Section 11.5), which specify that after a suspension or termination of the Commitment Period, Drawdown Notices may be issued to "repay indebtedness and satisfy liabilities of the Fund, incurred prior to such suspension."

E. Overcall Limitations.[13]

A common component of the analysis undertaken by lenders in determining credit risk associated with an SCF is to consider any limitations under the provisions of the limited partnership agreement requiring LPs to make up the shortfalls created by the failure of other LPs to fund Capital Contributions (commonly referred to as an "overcall" provisions). The Model LPA includes provisions limiting overcalls both in the event an LP defaults in its obligation to make a Capital Contribution, and in the event an LP is excused from making a Capital Contribution. With respect to the former, the Model LPA provides that Non-Defaulting Partners are required to fund additional Drawdowns not to exceed "[50%] of the total Capital Contributions that such Limited Partner was originally required to make before the Drawdown of such additional amounts" (*see* Section 6.6.6). Section 6.7.3.5 includes a similar overcall provision and limitation in the case of an Excused LP. Given the overcall percentage is bracketed, it appears that ILPA understands that this concept is one that LPs and GPs may wish to negotiate. Regardless, while overcall limitations come in different forms, the proposed methodology based upon the "percentage of prior capital call" can present more significant SCF limitations (as compared to a limitation based upon the percentage of the LP's total Commitment).

For example, if an LP with a large Commitment were to default, but the LP roster is comprised of a limited number of LPs with large Commitments and the remainder consisting of LPs with smaller Commitments, the "percentage of prior capital call" methodology is more likely to result in a shortfall to the SCF lender (as the limited overcall amount based upon the smaller LP Capital Contributions may not cover the defaulted Capital Contribution amount from a major LP). Lenders in an SCF may therefore seek to limit borrowing base credit for unfunded Commitments and institute more stringent concentration limits due to such overcall limitation (which may or may not align with the GP's desired usage of the credit facility). Furthermore with respect to excused LPs, the level of overcall based on a "percentage of prior capital call" methodology could also result in a funding gap if there are multiple LPs being excused from an investment (for example due to a change in law or other situation). In either situation the likelihood of a shortfall is diminished if the overcall is instead tied to a similar percentage based upon the remaining Commitments of the LPs.

F. Collateral Accounts and Temporary Investments.

Section 7.3 of the Model LPA reflects a requirement for the Fund to invest cash only in "Temporary Investments." This may potentially conflict with the requirements of an SCF lender to direct Capital Contributions to a collateral account which may not be interest bearing. Nevertheless, the spirit of this provision may still be effectuated in connection with an SCF considering that so long as there is no event of default, potential event of default or mandatory prepayment required, Fund borrowers are generally permitted to withdraw funds from the collateral account and thereafter could deploy such funds in Temporary Investments.

VIII. Conclusion.

In its current form, the Model LPA provides a useful outline that covers in depth a variety of topics that the Principles have previously addressed. As such, it reflects a continuation of efforts by ILPA to advance the interests of institutions that invest in private equity funds and other alternative investment funds. We expect the Model LPA likely will be updated from time to time to reflect evolving market conditions and to refine further the topics it addresses. In order to become a regular starting template for investors and sponsors, the Model LPA should be further refined to take into account more of the practical challenges that sponsors and investors face in organizing, financing and operating private funds.

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Endnotes

[1] ILPA, *The ILPA Model Limited Partnership Agreement, October 2019*, https://ilpa.org/model-lpa/ (Oct. 30, 2019) [hereinafter, *Model LPA*]. This summary is an overview and analysis of certain material provisions of the Model LPA and should not be construed as legal advice. Unless the context otherwise requires, capitalized terms used without definition in this summary shall have the respective meanings ascribed by the Model LPA. The terms "GP" and "LPs" are also used herein to refer to the General Partner and the Limited Partners, respectively.

[2] ILPA, *ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*, https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf (June 2019) [hereinafter, *Principles*].

[3] *See* ILPA, *ILPA Publishes Model Limited Partnership Agreement to Strengthen Alignment in the Private Equity Industry, Governance and Alignment of Interests for General and Limited Partners* (Oct. 30, 2019).

[4] The contractual standards agreed in the governing agreement of a commingled fund should be distinguished from the fiduciary standards owed by a registered investment adviser to its clients under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"). *See generally* Securities and Exchange Commission, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248 (June 5, 2019); *see also* Securities and Exchange Commission, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Release No. 34-86031 (June 5, 2019). For Mayer Brown's brief summary of these releases, please *see Mayer Brown Legal Update: SEC Publishes Final Interpretation of Investment Adviser Standard of Conduct*, https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/06/sec-publishes-final-interpretation-of-investment-adviser-standard-of-conduct_v2.pdf (June 14, 2019), and *Mayer Brown Legal Update: Regulation Best Interest*, https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/06/regulation-best-interestnew.pdf (June 12, 2019).

[5] *See* 6 Del. Code §17-1101(d) (2020).

[6] The Model LPA defines an "Interested Person" as each of the General Partner, the Fund Manager, any Key Person, any member of the General Partner's or Fund Manager's investment committee, any of their respective relatives, employees, directors, officers, members, shareholders and partners and any Affiliate of any of the foregoing.

[7] This provision has the effect of conflating the standards for indemnification with those applicable to removal of the sponsor (which may result in forfeiture of Carried Interest). For a discussion of the GP removal provisions, *see* Section V below.

[8] *See* Note 6 above for the Model LPA's definition of "Interested Person."

[9] The term "investor" covers limited partners of the main fund and any investors in parallel funds.

[10] A copy of the ILPA Reporting Template is available at https://ilpa.org/reporting-template.

[11] For further discussion on LPA provisions for SCFs, *see* Model LPA Provisions for Subscription Credit Facilities, https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/model-lpa-provisions-for-subscription-credit-facilities, in the Mayer Brown Fund Finance Market Review Spring 2019, https://www.mayerbrown.com/en/perspectives-events/publications/2019/03/2019-spring-fund-finance-review.

[12] However, we note that in Section 15.2.2.8 there is mention of disclosure to LPs of cross collateralized debt (which is not otherwise expressly permitted in the indebtedness section (*see* Section 7.2)).

[13] For further discussion on overcall provisions for SCFs, *see* Subscription Facilities: Analyzing Overcall Limitations Linked to Fund Concentration Limits, https://www.mayerbrown.com/en/perspectives-events/publications/2013/07/subscription-facilities-analyzing-overcall-limitat, in the Mayer Brown Fund Finance Market Review Summer 2013, https://www.mayerbrown.com/en/perspectives-events/publications/2013/07/fund-finance-market-review.