

TUCK SCHOOL OF BUSINESS AT DARTMOUTH



CENTER FOR
PRIVATE EQUITY
AND ENTREPRENEURSHIP

Limited Partnership Agreement Conference

July 20-21, 2004

Proceedings



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INTRODUCTION

Creating and negotiating a limited partnership agreement (“LPA”) is a detailed and time-consuming task. There are many recurring issues that arise from both the general partner and limited partner perspectives. An ad hoc committee of industry representatives is in the process of drafting a model agreement that will be published as an “open source” document on the Center’s website in the near future. This report summarizes the comments and opinions of industry practitioners who took the time to meet in a working conference hosted by the Center for Private Equity and Entrepreneurship at the Tuck School at Dartmouth. The participants generally were investors, fund managers, attorneys or service providers with multiple years of experience in negotiating and reviewing LPAs. The participants’ insights and viewpoints on major issues in the LPA will play a crucial role in the crafting of the model LPA and the development of industry best practices.

OVERVIEW

Project Summary

The Center for Private Equity and Entrepreneurship at the Tuck School at Dartmouth College is working with an ad hoc committee of leading private equity practitioners (the “Committee”) to develop a better understanding of LPAs. The term “private equity” in this document refers to the industry as a whole, including the venture capital and leveraged buyout industries. This will include the creation of a model LPA that is intended to offer explanations, suggested text for key sections of LPAs, and discussions of alternative approaches. This will assist both general partners and limited partners in drafting and finalizing their contractual arrangements. The development of common language on key sections of LPAs will benefit the industry by reducing transaction costs and facilitating the development of secondary markets and securitizations. The key goal of the project is to complete a model LPA and associated explanations and annotations by Spring 2005.

History

The Committee was formed on an ad hoc basis in the summer of 2002 to address perceived problems with the diverse structure of LPAs in the private equity industry. In particular, the founding members of the Committee expressed concern that, although LPAs all purported to have similar structures, economics and legal objectives, there were as many different forms of LPAs as there were private equity funds. The Committee believed that this was inefficient for the industry, as the diversity of LPA structures resulted in increased transaction costs when entering into new LPAs, inconsistent industry practices, and an impediment to secondary liquidity of limited partnership interests.

Purpose

The model LPA is not intended to benefit just limited partners or just general partners, but it is intended, by making transacting more efficient, to benefit the industry as a whole. The Committee intends that the model LPA will be a document that will serve as the starting point of negotiations between potential limited partners and general partners. Like the ISDA (International Swap Dealers Association) standard swap agreement, it is hoped that the model LPA will provide best practices and engender drafting consistency for the industry but will not recommend specific negotiable economics (e.g., levels of carried interest and management fees).

To be certain, a model LPA is unlikely to be universally adopted by the private equity industry. Both established general partners and limited partners have an interest in retaining many of their historic practices. Nevertheless, having a common benchmark will assist the industry in moving towards greater transactional efficiency and, perhaps, eventual adoption of a standard form LPA. To assist in this goal, it is the intention of the Committee to make the model LPA an “open source” document, giving access to any party that wishes to use it and by publishing it on the Center’s website. Moreover, the Committee believes that, in order to be relevant, the model LPA has to be a “living” document, with an established method of updating it from time-to-time, with the input of all interested members of the industry.

Role of The Center for Private Equity and Entrepreneurship

The Center for Private Equity and Entrepreneurship at the Tuck School at Dartmouth College is able to bring significant value to this project by giving the project a “home” and by combining its resources and research capability to assist the Committee in producing a model LPA. Moreover, through its expertise, it can act to provide both normative and empirical guidance to the study of LPA terms and conditions— the ultimate foundation for provision of the vast majority of capital to the private equity industry.

The Center for Private Equity and Entrepreneurship will take a leading role in the process of studying terms and conditions and the creation of a model LPA through the following initiatives:

Survey - The Center for Private Equity and Entrepreneurship conducted an industry leading survey that answered key questions about the state of terms and conditions in LPAs in the current market. Moreover, this survey, aimed at both limited partners and general partners, gathered data on the key trends in LPA terms and conditions. Members of the Center published the survey results and presented them at the LPA Conference held at the Tuck School.

Conference - The Center for Private Equity and Entrepreneurship hosted an industry conference on LPA terms and conditions in Hanover, New Hampshire on July 20-21, 2004. Following the precedent of the successful conference on private equity valuations, held in the summer of 2003, this conference was a forum to bring together leading private

equity experts (including limited partners, general partners, lawyers, academics, industry association representatives, and intermediaries) to discuss terms and conditions and to provide input into the model LPA. Moreover, the conference provided a forum for discussion of the above referenced survey and general trends in LPA terms and conditions.

Terms and Conditions Primer - In addition to assisting and advising the Committee on the model LPA, the Center will help to author an educational “primer” that will accompany the model LPA. This document will provide general background to terms and conditions and will discuss the rationale behind the structure of and economic bargain contained within LPAs.

Publication - The Center, through its website and elsewhere, has published the survey results, is publishing this conference report, and, ultimately, will make available the model LPA and associated primer.

Committee Membership

The initial committee was restructured into a Steering Committee with two sub-committees. The group intends to expand its membership in order to ensure a greater representation from the industry.

Steering Committee

The Steering Committee is made up of leading representatives from the private equity community (including general partners, limited partners, advisors, and intermediaries). The role of the Steering Committee is to provide general advice and guidance to the project; however, its day-to-day involvement in the planning of the conference and survey and the drafting of the model LPA is limited. Names with an asterisk listed below are responsible for day-to-day activities of the project. The Steering Committee members are:

Name	Title	Company	Committee Responsibility
Colin Blaydon*	Director	Tuck Center	Co-Chair
Mark Wiseman*	Director	Teachers’ Merchant Bank	Co-Chair
A. Dana Callow	Managing Partner	Boston Millennia Partners	Member
Marte Castanos	Sr. Counsel	CalPERS	Member
Brad Cost*	Partner	Torys LLP	Member
Kevin Delbridge	Managing Director	HarbourVest	Member
Craig Dauchy	Partner	Cooley Godward	Member
Charles Hughes	Partner	Easton Capital	Member
Norman Leben	Managing Partner	Bisys / DML	Member
David Martus	Portfolio Manager	Colorado PERA	Member
Jennifer Morais	Portfolio Manager	OMERS	Member
Michael Moreno	Principal	Atlantic Pacific	Member
Tim O’Gara	Managing Director	Lazard Freres	Member

David Rubenstein	Founding Partner	Carlyle Group	Member
Fred Wainwright*	Executive Director	Tuck Center	Member
Ken Whitney	Senior Managing Director	Blackstone	Member

Conference/Survey Sub-Committee

The role of the Conference/Survey Sub-Committee is to conduct and interpret the LPA terms and conditions survey. The Conference/Survey Sub-Committee worked to develop the agenda and to provide logistical planning for the conference, and it also worked closely with both the Steering Committee and the Agreement Sub-Committee to develop content for the survey, conference materials, and the invitee list for the conference. It will take lead responsibility for the completion of the “primer”, working closely with the Agreement Sub-Committee.

The members of the Conference/Survey Sub-Committee are:

Name	Title	Company	Committee Responsibility
Colin Blaydon	Director	Tuck Center	Co-Chair
Fred Wainwright	Executive Director	Tuck Center	Co-Chair
A. Dana Callow	Managing Partner	Boston Millennia Partners	Member
Kevin Delbridge	Managing Director	HarbourVest	Member
Erick DeOliveira	Research Assistant	Tuck Center	Member

Agreement Sub-Committee

The Agreement Sub-Committee is made up of legal experts and leading members of the private equity industry who have an interest in terms and conditions. The role of the Agreement Sub-Committee is to produce the model annotated LPA. The Agreement Sub-Committee also worked to assist in the preparation of conference materials by developing six modules, which were discussed and debated at the conference. The output of the module discussions and the survey helped to inform the Agreement Sub-Committee as to what should be included in the model LPA. The Agreement Sub-Committee works closely with the Steering Committee, and members of the Steering Committee (or their designates) are encouraged to review the draft output of the Agreement Sub-Committee or to participate on the Agreement Sub-Committee itself.

Torys LLP has taken a leadership role in drafting certain provisions with definitions and commentary for inclusion in the model LPA. In developing and reviewing drafts of additional provisions of the model LPA, Torys’ role will be supplemented by other law firms on the Agreement Sub-Committee, some of whom have produced the conference materials in conjunction with Torys.

The members of the Agreement Sub-Committee are:

Name	Title	Company	Committee Responsibility
Brad Cost	Partner	Torys LLP	Co-Chair
Jay Romagnoli	Partner	Torys LLP	Co-Chair
Marte Castaños	Sr. Counsel	CalPERS	Member
Nicholas Dietrich	Partner	Gowling Lafleur Henderson LLP	Member
Erick DeOliveira	Research Assistant	Tuck Center	Member
John Harris	CFO	Carlyle Group	Member
Charles Hughes	Partner	Easton Capital	Member
Amy Johnson- Spina	Associate	Torys LLP	Member
Stephanie Leaist	Manager	Canada Pension Plan	Member
Raj Marphatia	Partner	Ropes & Gray LLP	Member
David Martus	Portfolio Manager	Colorado PERA	Member
Justin McCormack	Associate	Ropes & Gray LLP	Member
Michael Padfield	Legal Counsel	Ontario Teachers' Pension Plan	Member
Steve Resta	Counsel	PA State Employees' Retirement System	Member
Louis Singer	Partner	Orrick, Herrington & Sutcliffe LLP	Member
Phyllis Taylor	General Counsel	The City of New York Board	Member
Jim Treanor	Portfolio Manager	Florida State Board of Administration	Member

Key Goals and Timeline

Previous work by the Committee has produced a draft Table of Contents as well as drafts of provisions relating to the distribution, valuation and clawback sections of the LPA.

The remaining goals of the Committee are as follows:

- Develop drafts of a model LPA
- Finalize the model LPA by Spring 2005
- Make the model LPA available via website
- Present final results in industry conferences

SESSIONS

Summary

The following sections describe the key takeaways from each of the breakout sessions from the conference. The topics covered were:

- Distributions
- GP Clawback
- Structural Governance
- Fees and Expenses
- Powers of LP Advisory Committee and Approval Rights of LPs

Two sessions (with different participants) were held for each subject area. The groups were given preparatory material along with a set of questions to help guide discussions. Members of the committees and other practitioners led the discussions and kept annotations of key points that emerged in the conversations. The discussions generally followed the guide questions; however, at times the groups deviated. The deviations in the discussion topics often moved to cover topics discussed in the other modules, highlighting the difficulty in discussing any particular topic in isolation. For example, it is difficult to assess the fairness of the treatment of fees and expenses in an LPA without taking into account the structure of the carried interest. Similarly, it is difficult to discuss the treatment of the carried interest without looking at the clawback provision. While the breakout groups attempted to stay on topic, each individual module necessarily includes discussion of the linkages to other modules. As such, the groups often did not come to only one conclusion on a particular topic, but rather took an “it depends” approach, exploring the various structures seen in the market today and the different issues they raise. As currently contemplated, the model LPA will be dynamic and will not provide a single boilerplate structure, but rather it will highlight the different ways in which these documents can be structured with current market examples. It will also include explanations of how each individual section can affect, or be affected by, the other parts of the agreement.

One of the recurring themes in almost all of the sessions was the balance between the simplicity and effectiveness of the document. As stated above, the vision is not to create an inflexible document; however, the desire exists for a streamlining of the documentation process, and this can be achieved only through a certain simplicity in the model LPA. An example of this arose in the discussion of ancillary fees received by the GP. While the group did not necessarily support one definition of ancillary fees or one singular treatment of fees in the document, the challenge of trying to create a document that encompasses every possible fee that could be considered as ancillary and defining a specific offset for each of these fees could quickly put a stranglehold on the effectiveness of a model LPA.

Most in the group, LPs and GPs alike, felt that the thrust of the model LPA should be educational. This document is not meant to police the actions of the GP, but rather it is focused on easing the difficulty and complexity that is so prevalent in the documentation process today. The group agreed that the overwhelming majority of GPs are honest in their dealings with LPs, and that part of the mission of the model LPA project is to educate and protect against the small minority of cases in which the GPs' honesty can be called into question. Again, the challenge here is to create a document that protects against this minority but does not become so cumbersome that it cannot be used in dealing with the majority. Leaving some flexibility in the document is also in the interest of the LP community, since micromanagement and over-regulation will likely serve to quash the industry as a whole.

The final theme that arose throughout the sessions was the desire for increased transparency. This theme was prevalent in the Center's conference on valuation and reporting that took place in 2003. During that conference, many LPs and other industry participants were vocal in their dissatisfaction with the transparency that was missing in the valuation process. Many were less concerned with developing a rigid standard for valuation than they were with simply knowing and understanding the methodology used to derive any particular valuation. The feeling was that there had been a fundamental breakdown of trust in the GP/LP relationship, and increasing the transparency in the valuation process would help serve to mend the gap. Similarly, this year's conference saw a desire for more transparency in the documentation process. This appeared to be significantly more important than any desire for a standard or singular document. Just as the LPs wanted to give the GP flexibility in determining the valuation of a particular investment, there was a desire to give both parties the flexibility to make their own business deal. The group simply wanted more visibility in the process and clarity on how each aspect of the document can affect each party in a given situation. In this respect, the model LPA will take a position and then discuss alternatives, serving as a tool for each side to understand its rights and outcomes under a variety of different sample scenarios.

Distributions Module

Concerning the structure (deal-by-deal or aggregate) of the waterfall, the LP representation did not seem to be concerned with the methodology used to distribute the carried interest to the GP, as long as the carry agreed to in the LPA is what the GP receives at the end of fund. Clearly the GP would prefer distributions to be made on a deal-by-deal basis; however, the drawback to this method is the need for clawback provisions and the issues that come with enforcing such provisions (to be addressed in the following section). In fact some GPs have offered to take a lower carry if they can have it on a deal-by-deal basis versus an aggregating methodology. One alternative that received support in the clawback discussion was that in order to minimize the potential for a clawback, an LPA could include valuation protections like the 125% net asset value (NAV) test with respect to all remaining portfolio investments.

Another important issue discussed was the writedown / writeup of investments and whether it should be done on the portfolio or on a deal-by-deal basis. The group agreed that whether applying revaluation on the portfolio or on individual investments, the terms should be written into the LPA, and in particular the valuation formula. The participants noted that utilizing a portfolio approach could encourage GPs to be aggressive on writeups. Although, using the portfolio approach and revaluing on a deal-by-deal basis could minimize clawback issues because of the 125% NAV test netted against the write downs of other investments.

On the subject of returning GP capital contributions (i.e., whether they should occur in advance of, after, or concurrently with, any return of the LP capital contributions), most participants agreed that if the LPs are getting capital returned, the GPs should also receive distributions. This is typically what is seen in the market. The group noted that the general market conditions have a significant number of venture capital firms returning all contributed capital before any carry, while buyout firms tend to return both contributed capital and carry on a deal-by-deal waterfall. Addressing this issue, one participant found that shifting LP distributions to the front end and distributing carry to the GPs later significantly maximizes the LPs IRR. The question that arises, however, is whether this will create an incentive for the LP to chase IRR at the expense of ROI. Another issue that arose was the need to define the frequency and scope of valuations by the GP. The trend that most are seeing in the market is for the GPs to be extremely conservative on valuations to try to head off the clawback issue. This was discussed further in the clawback session.

With regard to fee allocation, the discussion turned to whether or not there was a significant difference to LPs in 1) having their capital contributions with respect to organizational expenses, management fees and Fund expenses returned on a pro rata basis versus on an attributable basis, and 2) the basis on which any attributions of organizational expenses, management fees and Fund expenses should be made. The

group agreed that deal specific expenses should be allocated, while organization expenses and non-specific deal expenses should be allocated on a pro rata basis.

Next, the group discussed the preferred return and related issues, such as the GP catch-up provision. The group agreed that current market terms are for a “soft” hurdle rate (i.e., once the hurdle rate is achieved, the GP receives its carry on each dollar of profit), while the “hard” hurdle rate is more the norm in Europe (i.e., once the hurdle rate is achieved, the GP only receives its carry on profit in excess of the LP’s preferred return). The LPs believe that this practice is fine as long they are not harmed. The market rate seems to be 8%, and there was little disagreement on this. Most LPs are not entirely concerned with the rate, and they felt that a bump to 10% wouldn’t make a huge difference since the actual result in the real world is more like 20% or -20%. The thought here is that the manager is being paid to create alpha and beta, not to achieve the risk free rate. Basically the preferred return is thought of as downside protection only, not as any sort of incentive for the GP. The situation was compared to the re-pricing of options. If a fund has three “home run” investments at the very beginning of its life, then the preferred return no longer matters and no longer serves as an incentive. Conversely, three large losses early on could put the fund so far underwater that the GP has suboptimal incentives – either swing for the fences on every investment or quit the game altogether – and the middle ground that the preferred return was trying to maintain disappears. This issue is highlighted in an equity deal since the implied cost of capital in equity is different than in a debt deal. In funds where there is less volatility such as real estate and mezzanine, the preferred return issue is argued more fervently. It was also noted that, under a deal-by-deal distribution model, LP profits should not be used in the waterfall calculations to satisfy return of capital contributions with respect to other non-realized investments.

There was general agreement that the GPs should be caught up to 100% (not 50/50 or 80/20) once the LPs are provided with their preferred return, although the typical catch-up seen in the market is around 70-80%. It was noted that with small to mid-sized funds in particular, every percentage point in carry early on is important for compensation purposes (to provide incentive for the GP to achieve the highest returns), which would support a varying return structure even though it’s not practical. It was also noted that the preferred return can create a perverse incentive based on fund time period, in that if a GP is approaching the end of the investment period on a fund, there is an incentive to do any deal that will earn more than the preferred return (or if the fund is in the money, any return at all). An LP should be able to preemptively extend the investment period to avoid this incentive; however this is difficult to do in practice. Trying to accomplish this through the LP Advisory Committee was compared to herding cats, and in practice it comes down to the GP’s reputation. It is believed that GPs who know they can raise a new fund can simply let the investment period run out, since little option value exists in the old fund. The issue becomes even more significant when the fund is underwater, as GPs are faced with an all-or-nothing decision while the effect on the LPs is more or less incremental.

At this point the discussion moved to the disposition of temporary investments and bridge financings and whether the related proceeds should flow through the distribution

provisions or be distributed on a pro rata basis. A majority of the group agreed that the current market conditions typically choose to treat temporary investments and bridge financings separately from normal investments for the first year and are typically just returned pro rata. After a year, if these investments remain outstanding, these investments are seen as subject to the preferred return. This raised the question of whether there can be preferred return credit but no carry. There were widely differing views on this topic, with a weak consensus that “cash in and cash out” are subject to the preferred return regardless of whether they are typical, temporary or bridge investments. Furthermore, if it hits the preferred return, it should go through carry waterfall. The LPA should contain, as most currently do, appropriate restrictions to prevent a buyout fund from morphing into a bridge fund.

The next topic addressed was the desired level of detail in a fund’s audited statement and the cost of achieving such a level. The group felt that this issue was not a major issue between LPs and GPs and that the cost incurred by the GP was minimal. There was, however, the recognition that auditors take significant risk by providing an opinion. The LPs believe that displaying the split between LP and GP capital is an important part of the auditor’s statement, as waterfalls can be extremely complicated. Some in the group believed that waterfalls in general had become too complicated, and that simply splitting the difference between the cash in and the cash out on an 80/20 basis would be easier.

The problem is that over the years, so many layers have been added to the equation that often it is extremely difficult for anybody to understand or even model the waterfall. Some newer GPs (who can tend to have fewer financial staff) might not even understand their own waterfall, let alone their LPs. In this case, private equity CFO groups have been helpful. There were a number of participants who did not believe this was really an issue, and there is at least someone in every fund that understands the waterfall. They recognized that waterfall structures can be convoluted but not necessarily overly complicated, and the variety of ways in which these clauses can be drafted gives the appearance of being too complicated. This underscores the usefulness of the model LPA.

The model LPA can also be helpful in developing accepted language for provisions relating to capital accounts. An example of this would be text ensuring that IRS auditing agents will accept that allocations among partners will have a “substantial economic effect”.

Despite the views on the complexity of the waterfall structure, there was consensus in the desire for more transparency. In particular, the example of some LPs wanting their individual accounts to be reviewed by the fund’s auditors arose and is currently under negotiation in many cases. While this trend is on the rise, most felt that it was the result of LP compliance issues and not the desire for more comfort with the audit (in fact most stated that individual account audits would not provide more comfort in the matter). The group also noted that in these cases, the LP whose account is being reviewed should foot the bill for the additional costs, as the review is outside the standard audit. Another target of the push for more transparency is the inclusion on an annual basis of an audited clawback disclosure. GPs present in the session felt that in general most GPs would not

have a problem with providing this disclosure, assuming the methodology was easy and information needed was readily available. The more uncertain issue would be the question of whether an auditor would be comfortable with providing this type of review.

The group also recognized that the audit is not a cure-all, and there are items that will not be picked up in an audit (e.g., money flows within the partnership and transfers of fees between multiple funds within a family). Some LPs can catch large problems or mistakes, but not relatively small ones. The group also noted that most LPs don't question the CFO on a regular basis.

With respect to the GP's duty to disclose the carried interest allocation within the internal structure of the firm, the group felt that this issue is part of the due diligence process rather than a specific document point. GPs are reluctant to disclose their internal carried interest allocation, and they will likely resist efforts to put it into the document because they do not want to be contractually tied to it. If it is disclosed, it is likely shown to a few investors upon request, and the disclosure is often only a rough approximation of the allocation of carried interest rather than the specific percentages. The group thought, however, that this is a very good question for the LP to ask during due diligence and on an ongoing basis. The LP can use this information to better understand GP dynamics including the structure and incentives, team building and succession planning, and changes in key individuals' compensation plans. Additionally, this can be an important issue in a clawback situation, when LPs need to know who has received carried interest and in what amount, and also who may be jointly and severally liable.

General Partner Clawback Module

The main question addressed by the clawback session was that of trying to determine how LPs can be comfortable that at the end of the fund term there will be money to be paid out, and that a logistically simple way to get that money exists. Obviously, LPs would prefer to not reach the point where a clawback becomes necessary. One way to achieve this is to hold onto carried interest payments to the GP until the end of the fund's life. GPs have argued against this, citing the need for current compensation as incentive for the investing professionals, and this structure is not seen currently in the market. In their eyes, the clawback provision is sufficient to protect the LPs from excess distributions over the entire life of the fund, and the clawback is even less critical when there is a preferred return structure in place. An additional argument is that GPs are not guarantors of the future (war, economic turndown), and some even question whether a clawback is necessary if sufficient distributions have been made in the past.

LPs counter that private equity is a long term asset class, and GPs should recognize that they are long term investors and should wait to be compensated as such. Additionally, there is the question of LPs being unable to receive the clawbacks they are owed. One example was that of a 1995 vintage fund maturing presently keeping one company alive in order to extend the life of the fund and avoid paying out the clawback. Others raised the issue of the expense involved with periodic clawbacks – in particular, smaller funds, which as a result of some sort of cost/benefit analysis are light on financial staff, simply don't have the resources to be prepared to implement a clawback immediately.

LPs argue that carry should not be paid until the end of the fund's life because GPs are agreeing to generate high returns and should be rewarded for doing so only after this can be proven. The group noted a movement in the current market for GPs to compromise by stopping carried interest payments on a go-forward basis. In this respect, GPs have found it more palatable to shut off the spout rather than actually taking money out of their pockets. Everyone agreed that it was not in the GP's interest to get to the clawback point, as it makes the relationship with the LP extremely contentious.

The group seemed to agree that the option presented in the current model LPA, including both escrows and interim clawback calculations, is interesting, but it is so far away from the current market (which usually favors one or the other) that it is highly unlikely that it would be included in a negotiated LPA. The group noted that escrow is more common in the buyout world than in the venture world. Many firms put real guarantees in place in 2001, but the group noted that the effectiveness of these guarantees will not be determined until 2010. On the subject of guarantees, the group noted that while guarantees are sometimes "joint and several," "several" is market for stronger firms as a matter of leverage and negotiation. A new, hybrid form of guarantee has shown up with "joint and several" to a cap. However, this never exceeds 100% of the amount the GP

has received (i.e. GP is liable for \$20 but only received \$10, so GP is only on the hook for \$10 in a clawback situation).

The concept of the interim clawback also raised the topic of last year's conference, namely the issue of interim valuations. There is significant debate over whether firms can really be expected to provide interim numbers for carry and returns. It could be particularly difficult for venture firms, especially the small ones. Many in the group pointed to the problems with basing an interim clawback on unrealized valuations, citing the difficulty in tracking the relationship between interim valuations and the end result of the investment. One response was the idea that an interim clawback could be based simply on realized transactions, in which case the carry going into escrow would be paid to the LP instead of the GP. This was seen as a cushioning provision where the GP would not get additional distributions until the clawback is complete. One of the primary issues that LP representation had was the difficulty in getting any sort of valuation / clawback information from certain GPs. It was noted that certain GPs are easy to deal with in this matter, but many are also extremely difficult.

Structural Governance Module

The first topic covered was the allocation of investment opportunities between a fund and a successor fund. The group agreed that the current market format was formulaic, with the two most commonly used options being the following:

- 1) a fifty-fifty split between the Fund and a successor fund; or
- 2) a split based on the relative unfunded commitments of the Fund and a successor fund.

The LPs were not comfortable with the allocation between funds being solely at the GP's discretion and clearly preferred LP Advisory Committee oversight. The group noted, however, that assuming the LPs are in both funds and the economics are the same, the allocation of an investment should not matter to an LP. While this may be true, in many instances these conditions do not hold (some examples are described later in this document in the LP Advisory Committee Module), and the potential for a conflict of interest exists.

On the subject of overlapping investment periods, LPs generally prefer that a Fund be fully invested prior to any investment activity in a successor fund. However, it was also noted that the process of raising a successor fund generally begins prior to the completion of the investment period of a predecessor fund, and preventing the successor fund from investment activity effectively ties up the LPs' committed capital. As such, the LP representation did not want to bar the successor fund from any investment activity, but it believed that reserves for future investments need to be more clearly defined in an LPA.

The group recognized that the successor fund restriction should not bar fundraising, citing the difficulty in defining a finite period of time during which GPs are fundraising, in particular given that most GPs are always in the process of managing their LP relationships. However, the LP representatives agreed that LP agreements do need to more clearly define what constitutes a successor fund in light of changes in the private equity marketplace through the introduction of more complex fund structures (e.g. multinational funds or BDCs, etc.). In particular, the LPs were concerned about the manager receiving two or more streams of fees if there are loose limits on the formation of successor funds. Admittedly, the BDC issue may resolve itself as most of these funds are being pulled from the market.

Another concern centered on the drain on GP time and attention resulting from the fundraising process. The solution from the LPs perspective was again tighter definitions of reserves for future investments to ensure that the current fund is truly nearing completion before fundraising commences. The LPs felt that the reserve should be capped at not more than 5-10% of capital. In particular, the reserve should be approximately 5% for buyout funds and 10% for venture capital firms. The group also noted that smaller buyout firms should be given more leeway and higher reserve

percentages, while larger venture capital funds should be subject to lower reserves due to the pure size of their funds. The participants noted that a range was needed for each of these caps to allow flexibility based on the specific situation. Additionally, LP Advisory Committee review of successor fund raising was seen as an additional and necessary oversight.

The group agreed that the GP should be able to charge management fees and carried interest on co-investment opportunities offered to others (including LPs), but recognized that this is a controversial and heavily negotiated point that differs from agreement to agreement. The LPs believed that without the Fund, there would not be a deal, and therefore at least some percentage, if not one hundred percent, of the management fees and carried interest should be shared with the main fund LPs. The group also agreed that the management fees from the co-investment should be either allocated based on the fund's distribution waterfall or netted 100% against the main fund LPs' management fees. Of particular note was the belief that most LP agreements are currently silent on this issue. The concern with this practice for LPs is that the co-investment may offer a higher management fee and/or carried interest, resulting in a disproportionately high allocation to the other investors at the expense of the main fund LPs. Additionally, there was concern that the ability to earn extra income from co-investments could cause a change in investment strategy, for example pursuing larger deals that the GP could not otherwise execute.

At this point the discussion turned to the key person clause and the specific events that can trigger such a clause. The group agreed that the probability of this type of event occurring is so rare that it is not a significant issue. This could become a more significant issue when dealing with succession planning as senior partners wind down their careers and sell their equity stakes to junior partners. The LPs felt that there should be the following test:

- 1) if the GP is no longer involved with the Fund; or
- 2) if the GP has a change of control.

For example, if two of six GPs defined under the key person clause leave, or if those six GPs no longer control the general partner, the key person clause would be triggered. However, the language of the document would need to take into consideration that junior GPs should not be prevented from replacing Senior GPs as part of natural succession planning.

With regard to the specific coverage of the bad acts clause, the LPs unanimously agreed that they want the right to renegotiate their participation in any fund if any of its principals have committed a securities laws violation, recognizing that even with this right, it is still problematic for an LP to get out of a commitment. Additionally, the LPs want the bad acts clause to cover the conduct of individual principals as well as the GP. In the case of a felony situation, regardless of whether the issue is for business or personal reasons, the LPs likely will not want to be involved with the individual, and they could potentially want to disassociate themselves from the fund entirely. Driving this

sentiment was the potential for bad publicity. The GP representation, on the other hand, expressed significant concern over the ability of their LPs to completely pull their capital commitments.

In discussing the extent to which carried interest should be distributed in the event of removal of a GP under the bad acts clause, all participants agreed that the likelihood of this event is so rare that it is a relatively insignificant or less significant issue. The LPs agreed that they prefer that the removed GP receive no carry from the Fund, but recognized that they normally permit the GP to receive carry for appreciation through the date of removal. This raised the question of what defines the point at which a GP is removed, including indictments, disclosure, appeal, etc.

If a GP is dismissed for cause, the LPs felt that the GP was entitled to the carried interest earned prior to the date of removal. The GP would get his carried interest immediately if the fund was being terminated. On the other hand, if the GP were being removed, then distributions would be made to the GP when the Fund received realized investments from the portfolio. The group agreed that the portfolio needs to be valued by a 3rd party for carried interest calculations because the Fund will most likely bring in a new GP to run the former GP's investments. The LPs acknowledged that the GP is entitled to carried interest prior to the date of removal, or less depending on the value on the date of removal is ultimately realized.

Finally, when the group discussed the default presumption in the event that the key person clause or bad acts clause is triggered, the LPs agreed that they would like the right to 1) terminate the investment period, 2) remove the GP, and 3) terminate the Fund. Ultimately, the LPs want these clauses to provide them with the leverage to force the GP to engage in a meaningful dialog with them. They recognize that they do not want to completely shut down a fund because this is both complicated and costly for both the GPs and the LPs.

Fees and Expenses Module

Discussion opened with the topic of whether a fund's management fee should be based on a reimbursement of expenses model (versus the percentage of committed capital model that is prevalent in today's market) in order to prevent the management fees from becoming excessive. The reimbursement model has appeared in the hedge fund world, but has yet to really take hold in the private equity industry. Increasingly LPs and placement agents are asking what the GPs are doing with all the money they are getting from fees, and the reimbursement model might be a nice checking mechanism, especially when firms are earning fees from multiple funds under management. Most in the group saw the move to a reimbursement model as a means for more transparency, although they recognized that this model is not the only way to achieve the transparency they desire. Most felt that the budget concept might make the most sense economically, but implementation can be mechanically complex, and most favored the percentage model. It was noted that LPs should ask for a budget during the initial negotiations in order to set the fee percentage.

The question was then raised as to how large the percentage should be. There was a concern among the LP group that fees had become excessive, and they do not want GPs viewing management fees as a profit center. They recognized that it takes a lot of money to start a private equity fund. In particular, no one was interested in squeezing the cash flow of a smaller fund to the point at which they need to borrow to cover expenses. Additionally, it is difficult to set a single standardized percentage because of differences in the complexity of the investments being made, the geography of the investments, and the associated staffing needs (i.e. PhDs at venture funds). However, there was concern that a \$1 million annual salary would not provide sufficient incentive for the GP to build the portfolio companies. They would rather have the compensation come through the carry rather than the management fee. Some (albeit few) GPs have also expressed concern over management fee inflation issue, specifically smaller funds have trouble competing for junior talent against their larger counterparts because the percentage based fees at larger funds translate into the ability to offer much better compensation packages. A controversial solution that has been proposed (but not seen much in the market) would be to have the management fee percentage decline as committed capital increases.

The group agreed that a model LPA should include clear and educational language on the structure and mechanism of the management fee calculation. The intent is to avoid any surprises based on the calculations. For example, a fund should not be able to write an investment down to one dollar and still charge a management fee on the full cost just because the investment is not fully written off. The document should have various examples of how to structure and calculate the management fee and all of the issues that commonly arise with each mechanism. This gives the LP a tool to use when analyzing and choosing among different mechanisms.

The group noted that the most common structure seen in the market today is one in which after the 5th year, the management fee starts to decline. Most in the group agreed that the fee structure is dictated by supply and demand in the market, in particular the few “brand name” venture funds being able to write whatever terms they want, while the rest have significantly less leverage and revert to the market terms. The general consensus on the management fee for the successor fund is that it should not start until the investment activity begins.

One of the more heavily contested topics in the session, with a somewhat clear delineation between GP and LP viewpoints, was the issue of the offset for ancillary fees. The LP representation wanted the GPs to be transaction-oriented and felt that having anything less than 100% offset for ancillary fees would lead to GPs acting more like asset managers, looking for current compensation rather than working to maximize transactional gains. Throughout the fee discussion, there was a general trend toward LPs wanting to load as much of the GPs’ compensation into the carry. One issue that arose was the definition of what constitutes an ancillary fee. Three examples that surfaced were monitoring fees, directors’ fees (including options), and transaction fees. Everyone in the group agreed that board fees and any associated options should accrue to the fund. Conversely, there was a weaker consensus on the issue of transaction fees, in particular the large fees that can be associated with a buyout transaction. Most saw this as money that would need to be paid by the company to someone else (i.e. an investment bank) if it did not go to the GP. Because of this, most in the group were forgiving if these fees were not offset against the management fee, although there was caution with respect to giving improper incentives to the GP to maximize transaction fee income.

The greatest disagreement existed within the discussion of monitoring fees, or ongoing fees charged to the company by the GP for his time and management services. The GP perspective is that working with the portfolio company represents a significant drain on time and resources for the GP, and they are providing a real service to the company and should be compensated as such. The LPs countered that the point of the GP’s existence is to build value in the portfolio company, and the GP will see the fruits of his labor when it is time to exit the investment. Again, the LPs were not in favor of the GP charging on a current basis for value creation – in their view, that should be in the carry when the investment is exited. At the very least, the 50/50 offset seemed to be an arbitrary number, and while some in the group thought that these fees should be offset 100%, others saw the logic in an 80/20 split, or one that mimicked the carried interest. The group noted that this is more of an issue with buyout funds, where the portfolio companies are cash generators. Monitoring fees in venture investments are much less common due to the cash-burning nature of the portfolio companies. Such fees could damage a company before the exit opportunity.

The next topic was the valuation of in-kind fees. When valuing options that are counted as fees, the group generally supported using a Black-Scholes valuation at the time of the grant. While this seemed to be the most equitable way to treat in-kind fees, the group understood that this is contradictory to the argument fervently supported by the industry

as a whole against expensing stock options. This contradiction was not reconciled by the end of the discussion.

The final topic of discussion was the issue of the endorsement of the management fee waiver mechanism with respect to the GP commitments. The discussion of this topic centered on the fungible nature of cash and understanding the motivations of the GP in this scenario. LPs generally like to see the GP putting up a significant proportion of his net worth into the fund for incentive purposes. Some saw this as a way for the GP to subsidize his commitment through the management fee and put up less of his own net worth. The counter argument here is that this is a tax-efficient method for the GP to commit to the fund, since capital gains are taxed at a lower rate than fees. It was also noted that the mechanism creates further incentives in that the portfolio has to turn a profit for the GP to collect on his management fee. The consensus after discussion was in favor of a waiver mechanism, but only to the degree that it does not lower the GP's upfront commitment on a tax adjusted basis (i.e. the GP's commitment should be grossed up to take in tax effects of the fee waiver mechanism). One group noted that if the management fee is waived to compensate for clawback, the process gets really complicated.

Powers of LP Advisory Committee and Approval Rights of LPs Module

Discussions included the topic of whether GPs genuinely welcomed the involvement of LPs on an Advisory Committee, or whether they were being “forced into it”. This seemed to stem from a “philosophical attitude” and what is viewed as best practices among two stereotypical GP types: one camp which believes that the GP can learn and benefit from the LPs’ collective broad experience and input, which can be accretive to the success of the fund, and another camp which believes that the LPs should merely write a check and allow the GP to do its job as unencumbered as possible. Nevertheless, both GPs and LPs in the sessions believed that the majority of GPs viewed the Advisory Committee as a good sounding board for a relationship which needed to endure over ten years or more. Additionally, the Advisory Committee is a smaller, more nimble group that can be used as a first line of discussion and communication, and the Advisory Committee support can play an important role in making the GP’s case to the LP group at large. The issue is the degree to which the Advisory Committee’s duties should include approval capabilities, perhaps affecting the fundamental limited liability status of the LPs, versus being consultative. Most favored the latter except on certain issues.

Another theme which arose in both sessions was the notion that it is more important how a GP intends to behave vis-à-vis transparency, access, and other customary LP/Advisory Committee interests versus the written word and contractual rights which might be secured for LPs/Advisory Committee members in the LPA. In other words, a solid “unwritten” relationship and mutual understanding is more important than lists of items for approval or review.

The group expressed that the “issues list” in the LPA for Advisory Committee consideration does not need to be extensive, but should articulate the frequency of meetings and the type of information which would be available for Advisory Committee consideration. In this regard, transparency and openness are viewed as superior to a defined list of matters which the LPs are contractually entitled to be involved with (or to approve as overrides).

In a good number of LPAs, the investment guidelines are not strongly articulated, but where they are, there appears to be a view that an annual certificate attesting to compliance with the guidelines would be a positive development. Additionally, the group suggested that the Advisory Committee be involved in situations where there may be GP conflict of interest or issues of self dealing to ensure that arm’s length transactions occur.

The group appeared to be in strong consensus that the Advisory Committee should not approve valuations, as they are neither experts in valuation nor do they communicate with the CEOs of the portfolio companies on a regular basis. The group did support the

Advisory Committee's right to review the valuation policy, review the actual valuations, and object with third-party arbitration if a dispute arises.

The group did agree that the LPA should provide clear definitions of the responsibilities of each of the parties involved in the GP/Advisory Committee relationship. For example clear definitions of the time frame for sending information to Advisory Committee members in advance of the meetings and certain annual disclosures would be extremely helpful in the process. On the flip side, definitions of meeting frequency, attendance policies, and the preparation of the Advisory Committee members would help facilitate a more productive working relationship between the Advisory Committee and the GP.

As to Advisory Committee membership entitlement, one LP suggested that it might not be wise to base Advisory Committee membership on dollar commitment since the Advisory Committee would then not be able to take advantage of the diversity of interests and points of view in the LP group. The group noted that it is not advantageous to have an Advisory Committee composed of identical LPs, and a possible solution was to have Advisory Committee seats determined in part by the size of the check, with a dedicated number of "at large" seats that can be nominated by the LPs as a whole. The predominant current practice is that Advisory Committee members are selected almost entirely at the GP's discretion, and there is no mechanism for the LPs to select their own representation.

With regard to the alignment of interests between large and small LPs within the same fund, the group agreed that generally such an alignment does exist as a result of the economics involved. The question arose as to whether larger LPs could be "bought" through the promise of co-investment, but no one had seen this occur in practice. One LP did bring up a situation where a conflict could arise and described a situation in which the LP was a large percentage investor in Fund II and on the Advisory Committee but was a much smaller percentage investor in Fund III. When evaluating an investment shared across both funds, the LP may have reason to act in its own interest with regard to Fund II taking into account its entire investment, including its interest in Fund III. This could be in conflict with the interests of smaller Fund II investors, in particular those who are not invested in Fund III, and vice versa.

The general consensus regarding inter-fund and other GP conflicts is that GPs have significant reputation risk in situations like this and in other areas where they can be seen as deviating from LP interests. Most GPs plan to raise subsequent funds, and this acts to some degree as a self policing mechanism. One participant pointed out, however, that LP turnover (both in funds and internal staff) can lead to what he termed as a "short institutional memory," and he cited the significant deviation of certain funds from their investment strategies during the bubble that should have precluded them from raising additional funds but did not.

With respect to the issue of Advisory Committee conflicts of interest where a list of surrogate LP approvals is vested in the Advisory Committee, one of the panels discussed the situation noted above where a possible misalignment (and conflict of interest) may

arise in cases of inter-fund dealings such as joint interests in portfolio companies or transfers between funds, two matters which are often subject to Advisory Committee consent. However, it was believed that such an Advisory Committee member should still be allowed to act in the interests of his nominating LP as opposed to having a broader duty to LPs at large. Perhaps the issue could be resolved by having the customary corporate law declaration of interest and abstention from voting in such a situation.

Some GPs have expressed an interest in excluding Advisory Committee members from LP indemnification in cases beyond fraud, willful misconduct, and absence of good faith. This would include gross negligence, material breach of law, and material breach of contract. The argument against this is that despite their presence on the Advisory Committee, members are still not making the investment decisions (hence their status as limited partners) and should not be excluded from indemnification in these cases. The group did agree, however, that this was not an issue at the forefront of the current market.

An intermediary that acts on behalf of LPs posed the concept of a dual model which would ameliorate both GP and possible LP (in the case of co-investment opportunities and inter-fund membership) conflicts. The Advisory Committee members act as opinion leaders to assist the GP in the formation of a consensus around an issue the GP wishes to take to the LPs, but with a formal approval resting with the LPs as opposed to the Advisory Committee. This offers the best of all worlds, in that the “two classes of LPs” issue raised in the module could be avoided and “democracy” could rule.

Finally, both GPs and LPs appeared to deplore the proliferation of extensive side letters, some of which can include up to 40-50 items, which act as *de facto* amendments to an LPA. There appeared to be reasonable agreement that the source of the evolution of extensive side letters appears rooted in a GP’s (and perhaps its legal advisors’) investment in a model for a predecessor fund which the GP / law firm is disinclined to depart from in a formal way. The reality appears to be that market forces change over different vintage funds and GPs are unlikely to prevail with an earlier vintage model which no longer reflects market realities. Given the prevalence of “most favored nation clauses” in side letters, and the cumbersome administrative process of granting such rights, a better solution must be found. Perhaps, in the end, there is a role for a standardized and annotated terms and conditions document towards which the parties could migrate.

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APPENDICES

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Appendix 2: Survey Results

http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/LPA_survey_summary.pdf