GREAT FUND INSIGHTS

A Great Deal More or a Great Deal Less? ILPA's New Deal-by-Deal Model LPA

Introduction

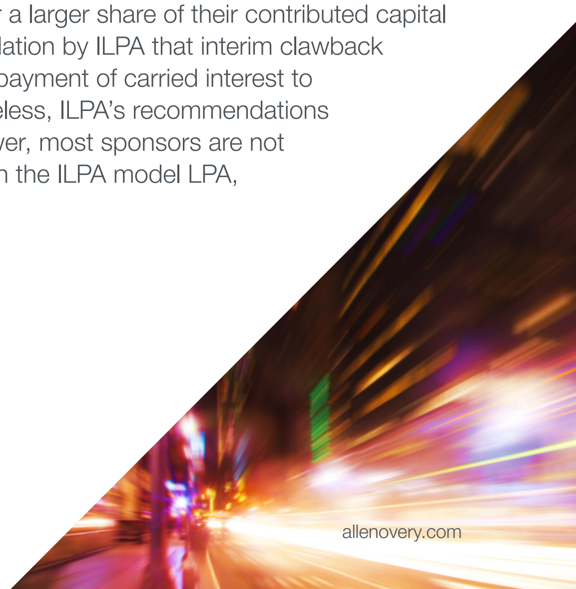
The Institutional Limited Partners Association (**ILPA**) released its "deal-by-deal" model private equity LPA in July 2020, which sits alongside the "whole-of-fund" model private equity LPA released by ILPA previously (the latest version of which is also dated July 2020).[1] Both model LPAs are designed for traditional private equity buyout funds and generally reflect ILPA's Principles 3.0 guidance, which sets out private equity industry best practices. It is worth noting that, other than the waterfall and clawback provisions, the two model LPAs are practically identical. These model LPAs allow investors to benchmark terms that they are negotiating with sponsors against what ILPA deems to be the "market" position for such terms, and the intention is that these model LPAs foster a closer alignment of interests between sponsors and investors.

In its overview for the deal-by-deal model LPA, ILPA acknowledges that deal-by-deal waterfalls tend "*to be more prevalent for emerging managers*". Although whole-of-fund waterfall structures are more common in the European investment fund context, deal-by-deal waterfall structures remain the favoured construct within the U.S. sponsor community. The focus of this article will be on the changes made to the payment waterfall structure in the deal-by-deal model LPA from the whole-of-fund model LPA and the position adopted by ILPA with respect to sponsor clawbacks, including consequential changes to the clawback provision in the deal-by-deal model LPA, which investors should be aware of due to their potential economic impact.

Executive Summary

ILPA's deal-by-deal model LPA encourages the adoption of a "modified" version of a deal-by-deal waterfall whereby sponsors share in any losses incurred by the fund on an ongoing basis and investors recover a larger share of their contributed capital prior to the sponsor participating in carried interest. The consequential recommendation by ILPA that interim clawback obligations are calculated on an annual basis highlights the heightened risk of overpayment of carried interest to sponsors as a result of a fund adopting a deal-by-deal waterfall structure. Nevertheless, ILPA's recommendations need to be looked at in context and unless investors have sufficient bargaining power, most sponsors are not particularly amenable to the argument that their waterfall construct is not in line with the ILPA model LPA, especially if the fund is oversubscribed and/or is one of a series.

[1] https://ilpa.org/model-lpa/



"Whole-of-fund" vs "deal-by-deal"

Funds with whole-of-fund waterfall structures traditionally require investors to receive back all of their contributed capital, as well as a preferred return on that capital, before the sponsor is able to obtain any carried interest. Deal-by-deal waterfall structures generally offer accelerated payments of carry to sponsors and, in most standard deal-by-deal waterfall structures, to the extent that a particular unrealised investment of the fund is not subject to unrealised losses (in short, where the value of the relevant investment is less than its cost), the sponsor does not have to return an investor's contributed capital used to fund the making of such unrealised investment before it is able to participate in carried interest. There are often "hybrid" models between the whole-of-fund and "pure" deal-by-deal structures, and generally a pure deal-by-deal model is unusual, particularly in Europe.

ILPA's "deal-by-deal" payment waterfall

The key change made by ILPA to the distributions clause in the deal-by-deal model LPA is in the first limb of the waterfall, whereby 100% of proceeds arising from a particular investment are distributed to the relevant investor until such investor has received cumulative distributions equal to its contributed capital used to fund the cost of: (i) such investment; (ii) realised investments; (iii) aggregate losses attributable to unrealised losses of unrealised investments; and (iv) fund expenses, including the management fee. This contrasts with a whole-of-fund model pursuant to which proceeds arising from fund investments need to be distributed to investors until they receive cumulative distributions equal to *all* of their capital contributions to the fund. It is significant that ILPA recommends a "modified" or "hybrid" version of a deal-by-deal waterfall whereby the sponsor must: (a) ensure continuous make-up of partial impairments and write-offs; and (b) return all fees and expenses incurred by the fund to date rather than simply returning a portion of all fees and expenses incurred by the fund to date (see the discussion below relating to investment-related fees and expenses and general fees and expenses). This hybrid version ensures that sponsors share in any losses incurred by the fund on an ongoing basis and that investors recover a larger share of their contributed capital prior to any carried interest being paid to the sponsor.

With respect to (i), (ii) and (iii) mentioned above, these components of the first limb of a hybrid deal-by-deal waterfall are common in the market and, in our experience, many sponsors that adopt hybrid deal-by-deal waterfall structures in their funds do accept that proceeds received by a fund from a particular investment be used to offset any unrealised losses stemming from unrealised investments of that fund. Indeed it is very rare to see funds adopt 'pure' deal-by-deal waterfall structures whereby proceeds obtained from a particular investment are not used to return to investors their contributed capital used to fund the cost of other realised investments and unrealised losses of the fund. However, we have seen a mixed picture with respect to (iv) mentioned above and how fees and expenses are dealt with in deal-by-deal waterfalls. Numerous deal-by-deal waterfall structures (particularly those of U.S.-sponsored funds), distinguish between (a) investment-related fees and expenses and (b) general fees and expenses.

While investment-related fees and expenses incurred with respect to a particular investment are typically taken into account in full in the first limb of the waterfall once the fund receives proceeds from such investment (whether as a result of a disposition or otherwise), general fees and expenses can be either included fully or on a pro rata basis by reference to the particular investment in the first limb of the waterfall. A requirement to return only a pro rata share of all general fees and expenses by reference to the particular investment is clearly less investor-friendly and investors should be wary that many sponsors do seek to distinguish between the types of fees and expenses incurred by a fund in order to benefit from a more sponsor-friendly waterfall construct.

Moreover, another observation is that the importance of the valuation of unrealised investments in these deal-by-deal waterfall structures can often result in detailed negotiation around the valuation process, with investors often pushing for enhanced transparency and potentially the right to appoint an independent appraiser.

What is clear is that waterfall arrangements will continue to be complex, nuanced and negotiated on a bespoke basis. There are numerous iterations of deal-by-deal waterfall structures, some more "hybrid" than others, including tiered waterfalls incorporating multiple hurdles and different profit-sharing splits once particular hurdles are met, as well as waterfalls that distinguish between the source of proceeds obtained by the fund (a common distinction being that between "current income" (ie operating income), and "disposition proceeds", with the latter concept capturing gains resulting from the disposition of a particular investment). Unless investors are cornerstone investors or strategic partners for sponsors, most sponsors are not particularly amenable to the argument that their waterfall construct is not in line with ILPA's model LPA, especially if the fund is oversubscribed or is one of a series.

Sponsor clawback obligations and interim clawbacks in the "deal-by-deal" model LPA

If the fund documents include an adequate two-pronged sponsor "clawback" mechanism (ie a mechanism that requires the sponsor to return amounts of carry to the extent of any overpayment) that applies following liquidation of the fund, both whole-of-fund and deal-by-deal waterfall structures should result in the equivalent aggregate sharing of profits between the sponsor and investors over the life of the fund. The key difference is simply that the latter structure allows for the accelerated receipt of carried interest by the sponsor, as previously discussed. Such accelerated receipts of carried interest means that: (a) there is a greater credit risk for investors if large amounts of carried interest have been paid to the sponsor, but ultimately need to be returned to the fund for distribution to the investors (and this may be the case, in particular, if early investments of a fund perform well but subsequent investments do not); and (b) investors may experience lost time value of money if any amounts should have actually been paid to such investors rather than the sponsor as carried interest through the payment waterfall.

Both model LPAs include such a sponsor clawback mechanism and encourage sponsors to deposit at least 30% of accrued carried interest in an escrow account that can be used to cover any potential clawback liabilities. Each model LPA also stipulates that the sponsor ensures that each partner of the sponsor's carry vehicle (including each indirect partner of any such partner) who is entitled to receive any portion of carried interest enters into an undertaking in favour of the fund and for the benefit of investors to pay directly to the fund its pro rata share of any clawback liability of the sponsor to the extent the sponsor has insufficient funds or has otherwise failed to meet its clawback obligation.

To the extent the fund documents include an escrow arrangement (we note that most U.S.-sponsored funds with deal-by-deal waterfall structures do not offer such arrangements, but rather offer sponsor and/or individual guarantees), 30% is a fairly common percentage for investors to push for, although some funds can have as much as 50% in escrow (which is unusual) or as little as 10-20%.

With respect to guarantees and as mentioned above, most U.S.-sponsored funds with deal-by-deal waterfall structures do require the sponsor to obtain some form of guarantee of its clawback obligations. To that end, it is key for investors to consider who is actually providing the guarantee (particularly if the sponsor does not accommodate an escrow arrangement). Guarantees can be given by, for instance, parent companies of the sponsor and/or by underlying recipients of carried interest, with the latter being the position encouraged by ILPA in its model LPAs as mentioned above. Although investors are taking a credit risk on underlying recipients of carried interest, such back-to-back guarantees from such underlying recipients are a key protection for investors in the event that the sponsor cannot meet any clawback liabilities at the end of the life of the fund (or at earlier intervals to the extent there are interim clawbacks).

In addition, the deal-by-deal model LPA encourages annual interim clawbacks – achieved via implementing a hypothetical liquidation of the fund – starting from one year following the end of the fund's investment period. This highlights the heightened risk that a deal-by-deal waterfall structure could result in overpayment of carried interest to the sponsor. To the extent that there is an interim clawback scenario, the deal-by-deal model LPA requires the sponsor to notify investors within ten business days (providing detailed calculations) and contribute to the fund the relevant clawback amount less the sum of any taxes actually paid or payable by the sponsor (or its direct or indirect owners) thereon, as disclosed and evidenced to the investors.

In our experience, sponsors tend to resist obligations to determine interim clawback amounts on an annual basis, but investors should note the key principle that ILPA is stressing here: such hypothetical calculations should be carried out at regular intervals during the life of a fund with a deal-by-deal waterfall structure to reduce the risk of a substantial clawback liability arising at the end of the term or liquidation stage of the fund. As such, investors should note the key tension to be resolved here between, on the one hand, ensuring that sponsors are sufficiently rewarded and incentivised and, on the other hand, ensuring that they have adequate recourse in the event of overpayment of carried interest to sponsors.

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