Case # 5-0019

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# Note on Limited Partnership Agreements

Private equity investment funds have a fixed term that is typically ten years with possible one to two year extensions. Investment fund managers and their sources of capital must develop sophisticated agreements that can stand the test of time. These agreements should ensure that appropriate long-term frameworks, boundaries and alignment of interests are in place.

By far the most common legal structure for private equity funds is the limited partnership. The name refers to the limited liability of the providers of capital, called the “limited partners” or “LPs.” The investment manager is the “general partner” or “GP.” The partnership is governed by a limited partnership agreement (“LPA”) negotiated and signed by the parties involved.

In U.S. private equity funds, each LP must be an “accredited investor,” which is a person or legal entity, such as a company or trust fund, that meets certain net worth and income qualifications and is considered to be sufficiently sophisticated to make investment decisions about complex securities and businesses. Regulation D of the Securities Act of 1933 permits accredited investors to invest in a private partnership without the protections of a registered public offering under the Securities Act. Qualifications for a person are: $1 million net worth or annual income exceeding $200,000 individually or $300,000 with a spouse.

The GP manages the day-to-day activities of the partnership and has unlimited liability for the actions of the partnership. To mitigate this risk, a GP may be formed as another partnership or a limited liability company (“LLC”). An LLC is like a corporation, but with the tax benefit of flow-through of income and losses to

*This case was prepared by Adjunct Assistant Professor Fred Wainwright under the supervision of Professor Colin Blaydon of the Tuck School of Business at Dartmouth College. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.*

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individual owners. In addition, the GP may establish a separate management company (typically a corporation) to provide management services to the fund or a family of funds.

In analyzing private equity limited partnership agreements, several key concepts should be understood.

**Management fee**

This is a fee charged by the GP to the LPs. Management fees in a private equity fund typically range from 1.5% to 2.5% of committed capital, depending on the type and size of fund. This fee structure differs from that of mutual fund managers, which invest in public markets and on average earn less than 1% of assets under management.

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The GP management fee may vary over the life of the fund, generally decreasing over time, as the LPs' original committed capital is paid back from investment returns. The argument for decreasing the fee is that the bulk of the GP's effort is during the first 5 to 6 years of the fund as compared to the monitoring and distribution phase of the fund. Furthermore, GPs are willing to give up management fees in the later years of a fund in anticipation of raising subsequent funds that generate additional streams of management fees.

An alternative to the percentage fee system is a budget-based fee. An annual budget is developed by the GP and LPs with the help of the advisory board to operate the GP on a break-even basis. This preserves the incentive for the GP to seek its primary compensation through its "carried interest" (see below) in the fund's profits, rather than through the management fee.

Before the 1990's, most private equity funds were flat organizations with minimal staffing. An institutionalization trend has developed since the early 1990's that has led to geographical networks of affiliate funds, families of venture capital and buyout funds, joint ventures with mutual funds and other relatively complex structures.

Typically, buyout funds derive significant consulting and advisory fees from portfolio companies, in addition to the management fees from the funds. In some cases, LPs try to limit or share in those portfolio company fees in order to incentivize the GP to generate capital appreciation.

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**Carried interest**

Carried interest is the GP's share in the profits of a private equity fund. Typically, a fund must return the capital given to it by the LPs before the GP can share in the profits of the fund. The GP will then receive a 20% of the net profits as "carried interest," although some successful firms receive 25%-30%. This fee is also known as "carry" or "promote." Many funds must also require repayment of management fees from investment proceeds before the GP can receive any carry.

Some LPAs include a minimum rate of return on the capital invested before the GP can earn any carry. This minimum rate is often called "hurdle rate" or "preferred return." Hurdle rates typically range from 5% to 10%. Other LPAs require that the GP generate sufficient investment profits to repay original capital, management fees, and the preferred return on all capital invested before the GP can earn any carry. Some LPAs allow the GP to earn a carry on a deal-by-deal basis, that is, the GP receives the carried interest on the profits on each deal as it is liquidated without being required to first return all contributed capital.

**Commitment**

Commitment refers to the maximum amount of capital that an individual LP agrees to invest in a fund. The commitment generally includes management fees charged by the GP, as well as other fund expenses.

LPs often insist that GP members individually invest in the partnership. Historically a 1% capital commitment from the GP was required for tax reasons. Although the tax laws have eliminated this requirement, it remains an industry standard and many successful GPs contribute even more. Some GPs may make their capital contribution in the form of promissory notes, although LPs are less tolerant of this practice lately.

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**Takedown**

This term is used in two ways. First, in reference to a schedule of transfer of capital in phases in order to complete a commitment of funds. Second, and more commonly, in reference to a single payment by an LP of a portion of a total commitment of capital. In this sense, takedown is synonymous with "drawdown" and "capital call." Relatively large, early payments from LPs are inefficient because cash waiting to be invested earns minimal interest, which depresses the fund's overall returns. Consequently, just-in-time drawdowns of capital as needed have

become the norm. The partnership agreement generally places a limit on the time period over which funds are invested (the "investment period"), which typically does not exceed 6 years.

**Distribution and "Clawback"**

As investments are monetized via private sales and mergers or public stock offerings, the LPA specifies how profits are allocated. The timing and form of distribution (cash vs. securities) will also be defined. This includes clawback provisions, which give LPs the right to reclaim a portion of carried interest disbursements to a GP for early profitable investments if there are significant losses from later investments in a portfolio. The goal is for disbursements to match the targeted carried interest (for example, an 80/20 split of the cumulative net profit between LPs and the GP). These issues can become very complex in negotiation of the partnership agreement.

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**Termination and No-fault "Divorce"**

LPs can generally terminate their participation in a fund under extreme circumstances, such as the death or withdrawal of key members of the GP group efforts of the partnership. Such "key person" provisions protect them against the departure of key GP members. Usually a clause exists that allows the LPs, acting with a majority or super-majority vote, to terminate the fund if they have lost confidence in the GP. It is likely that any such move will lead to litigation.

Occasionally, an LP will lack sufficient cash to fulfill its commitment or wish to exit a fund for other reasons. GPs will typically help the LP sell its interest in a secondary market (usually at a discount to net asset value). If this cannot be arranged, the GP may impose severe default penalties that may wipe out an LP's entire investment. However, several multibillion dollar funds have been raised in the past few years specifically to purchase LP interests. Despite continued information asymmetry among participants in private equity, there is some liquidity in LP interests.

Many institutional investors require excuse clauses that are triggered if regulatory changes prevent them from continued participation in private equity funds.

**Investments**

According to a typical LPA, a fund has to make most of its investments during the first four to six years of its existence. Although LPs cannot control the actions of the GP (thus risking the loss of liability protection provided by the limited partnership), LPs may require that the GP commit to invest only in specific industry sectors of expertise. Generally, there is wide latitude for GP discretion in investment thesis, since markets shift and new opportunities may develop over time. However, there is always a restriction on the size of any one investment the GP can make in a specific company. This encourages diversification and can prevent “spending good money after bad,” whereby a GP uses cash to attempt to salvage a persistently unprofitable investment.

Private equity funds are typically unleveraged. GPs are restricted in the amount of debt the fund can incur. This does not prevent a fund’s portfolio companies from borrowing. Another important restriction, usually more common in the venture capital industry than in buyouts, applies to cross-fund investing. Each fund is a separate entity. A GP usually cannot use capital from one fund to make investments in companies already funded through an earlier fund managed by the same GP. Individual GPs are often prevented from investing personal capital in startups funded by the partnership. If they convince the LPs to waive this, then the LPs require that the GP individual invest only in the same financing round with the same terms as the fund. Sometimes LPs are allowed to invest additional capital in a portfolio company with the same terms as the fund. In such cases the LPs are considered co-investors in the round.

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**Private placement memorandum (PPM)**

A PPM is a formal document explaining the details of a proposed private equity partnership to potential investors. Typical sections of a PPM include:

- Executive summary
- Investment performance / track record
- Investment thesis
- Investment strategy
- Competitive advantage
- Management biographies
- Board of advisors
- Summary of terms of partnership

- Potential risks
- Applicable regulatory, tax and securities laws
- Accounting and reporting practices

The PPM is often the starting point for meetings, discussions and negotiations among a potential LP and GP, which if successful, ultimately lead to a final LPA.

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## References and Selected Reading


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