

Key Person Language and GP Removal

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People are the key variable in private markets investing, so when issues come up relating to the actions of the GP, it's important to understand what options LP's have. In addition, because the assets are private, there's very little clarity and insight on what's really going on inside the GP. Investors place a lot of trust in the GP, which is why they want to ensure they operate in a manner that is aligned with LP's.

LP's need to ensure that the key principals remain at the fund and focused on the strategy. If this does not occur, or there are issues with the GP, then LP's should understand what options they have, including suspending the investment period or removal of the GP, if necessary.

These are my collected notes over several years of private markets investing. Each LP should think about what is important to their firm and make sure the fund agreements reflect those priorities. These are principles and concepts to think about and discuss, not explicit legal advice.

Key Person Provisions

ILPA Guidance

ILPA (Institutional Limited Partners Association) provides useful guidance on key person language:

Key persons should devote substantially all their business time to the fund, its predecessors and successors within a defined strategy, and its parallel vehicles. Situations impacting a principal's ability to meet the specified "time and attention" standard as delineated within the LPA should be disclosed in a timely manner to all LPs and discussed with, at a minimum, the LPAC.

Key persons for the fund, as identified in the LPA, must not act as a GP for a separate fund managed by the same firm with substantially equivalent investment objectives and policies until after the investment period ends, or the fund is invested, expended, committed or reserved for investments and expenses

Overall Approach

Below are three high-level principles to remember when thinking about key person language:

- Make sure all key principals are identified and included
- Explicitly state the level of activity that is required to the fund and if possible, try to define metrics to measure activity (rarely see this in practice)
- Include language and guidance if one or more covered principals leave

LPA Language

- “Substantially all business time and attention” is the ideal standard
- Don’t Settle for Less-Than-Ideal Language:
 - Ceasing to be an active participant
 - Ceasing to be engaged
 - Ceasing to own or control interests
 - Engaging in improper conduct
- In most LPAs, there’s no language defining “substantial time and attention”
 - Think about the dilution of time and attention spent on existing, successor and predecessor funds
 - Carefully review key person time commitment definitions as they may be broadly drafted to include all the manager’s existing funds
- GP’s claim they want flexibility to pursue opportunities outside of their current strategy – most language allows too much flexibility
 - LP’s should be adamant that they hire the GP for a certain strategy and want to ensure the team remains focused on the fund rather than expanding strategies and AUM
 - You may not be able to change this standard, but at least it shows the GP you are paying attention to where the GP allocates their time
- Negotiate for an automatic suspension of the investment period upon a Key Person Event
- Suspension of investment period:
 - “Terminate the obligations of the Limited Partners to make additional capital contributions to the Partnership” – Obtain language ensuring that the GP also cannot use Fund assets, recycle, or borrow to make new investments or other expenditures, unless expressly permitted under the LPA or with LPAC/LP approval
- Suspension period has costs to the GP organization
 - Sends signal to investment professionals that they should start a job search
 - May send signal to market that portfolio companies’ owner is in distress and “willing to move” assets at a discount
 - Can highlight fissures within LP group and give the GP knowledge and time to exploit those differences
- Understand how SMA accounts with the GP that will compete for investment allocations and/or distract GP focus. Get clarity on how GP will handle allocations and assess ability to manage various accounts

Notice

- Make sure LP’s are notified of key person events

- Negotiate for notice of significant events, departures, “triggers” for time and attention
- Rarely will you ever see defined triggers or have any way to measure time and attention

Covered Persons

- GP’s will stage departures to manage key person risk
- Negotiate protection to avoid “serial replacements”
 - GP will replace one person at a time, thereby never triggering a key person event
- If replacement language exists, make sure the original principals are only included when testing, otherwise the key people may leave and the trigger will never hit
 - Consider avoiding replacement language altogether
- LP wants to protect against one specific individual leaving but GP isn’t willing to allow trigger on that sole individual; GP insists on excessively broad key person triggers
- In large institutional funds, the number of investment professionals designated as ‘key’ may run into the high single digits, or sometimes > 10
- The language may require 3 out of 5, or 5 out of 7, key people to leave to trigger. That’s so broad it’s worthless
- The sheer size of the team, combined with the manager’s ability to replace or add new executives to ‘cure’ a key person breach, can render the key person protection less effective.
- The grace period allowed for a manager to source an adequate replacement for a departing key executive (and cure a suspension of investment powers) varies. Most commonly, it is between six months and a year, but we have encountered periods as short as 90 or 120 days. Sometimes, an LPAC may grant an extension to the suspension period, allowing a manager more time to source a replacement executive

Disclosures

- Ask for disclosure of key person’s time and commitment to the fund
- Ask for key principals to be explicitly named

Role of the LPAC

- The LPAC is a key group that can help guide the fund and existing LPs through a key person event.
- The LPAC can forge consensus and ultimately communicate with a general partner on behalf of LPs as a unified voice. Speaking as a unit, it’s possible to compel a general partner to consider compromise, if not

yield to a set of meaningful changes. Regardless of the financial incentives at play, most fund managers care deeply about their reputations and are apt to listen when their investors speak in unison.

GP Removal

Overall

- GP removal is rarely pursued
 - Removal provisions are a key negotiating tool with GP; rarely do you ever get to GP removal
 - Going to court is not the point; use removal as a negotiation tool
- Removing a fund's GP has its own set of challenges and expenses and is neither an easy nor quick process
 - There may be management fees that will be paid to departing GP's
 - Removal requires high voting thresholds
 - New carry terms will have to be negotiated for new GP
 - Complicated legal issues
 - Relationship and reputational issues
- Removal is used for the absolute worst cases: fraud, willful misconduct, other criminal activity
- Many LP's will not pursue a GP removal, even with clear evidence of misconduct or grounds for removal
- Many LP's don't have the time, desire, nor resources to pursue a lengthy GP removal process
- 3 broad categories for GP Removal
 - Bad Actors
 - For cause, fraud, breach of LPA
 - May need final non appealable adjudication - creating a prolonged process
 - Almost impossible standard to meet - would need to go to Supreme Court
 - Seeing in Europe GP remove this language
 - Governance/Performance Issues
 - Usually need supermajority
 - GP not living up to expectations
 - Shorter process than for-cause removal but more restrictive and capital intensive
 - Tail End
 - Weak performance with illiquid assets and limited exits available

Carried Interest/Fee Issues

- Does the GP retain the full carried interest or is there a haircut (GP may retain 100%, but have seen 25-50% haircuts depending on the reason for removal)
- Do the LP's have to buy-out the GP commitment following a GP removal?

- How much compensation is paid to departing GP (may be 1-2 years of management fees)
 - Confirm when management fee to the removed GP is shut off and starts to be paid to the replacement GP
- Confirm treatment of GP's economics upon removal
 - Potentially different implications if removal is "for cause"
 - Consider re-negotiating management fee/carry for the replacement GP
- Confirm that the removed GP is not in possession of any management fee offsets
- Confirm what happens to carry upon removal
 - Is value of carry frozen as of date of removal? Who values the portfolio for carry purposes?
- Occasionally, the removed manager is also entitled to be cashed-out on removal, with investments being valued at the time of removal at fair value based on a hypothetical realization and any 'pregnant' carried interest being paid out and delivered to the removed manager.
 - This cash-out may also include the manager's stake in the fund as an investor (its 'skin in the game'). These mechanisms undermine the principle that the manager should be treated pari passu with investors and that its wealth creation should not be at the expense of investors. Furthermore, in such circumstances, an independent valuation, and scrutiny of the valuation process by investors, is of paramount importance.

GP Clawback & Other GP Responsibilities

- Does the removed GP remain responsible for any GP clawback?
- Make sure guarantee doesn't go away after a removal
 - Is GP clawback amount determined as of removal date, or does the removed GP remain liable for loss of value after removal date?
- Confirm responsibility for GP commitment –is the replacement GP able to fulfill remaining commitment?
- Require removed GP to participate in follow on investments and expense in which it retains carried interest or investment

LP to LP Communications

- Do you know the other LP's?
 - It's critical to collaborate with other LP's to figure out the best path forward and select a new GP
- Is the GP compelled to share other LP info based on language in the LPA?
- If necessary, make a "books and records" request to GP for name and address of each of the LPs
 - Consider calling a meeting of LPs

- Consider whether GP is entitled to notice of and participate in “all” meetings, or whether LPs can meet without the GP

Complications

- Beware the complexities of removal: poison pills and change of control at portfolio level, fund plumbing (including bank accounts, service providers, independent directors, etc.)
- Does the manager have to resign from the boards of the portfolio companies?
- Make sure GP is not automatically named the liquidator after a successful vote to remove

Replacement GP

- The difficulty in finding an effective GP to take over a fund where the manager has been removed for cause can be significant and should not be underestimated
- Is the GP required to propose replacement key persons? If so, how long does the GP have to propose replacements for LPAC/LP approval?
- Many LPAs provide for GP removal, but are silent on GP replacement
- Ideally the LPAC would be involved in interviewing prospective replacement GPs and making a recommendation to LPs
- Removal/replacement of GP does not terminate the fund, unless the LP’s wait too long to replace then liquidation/dissolution may occur. Check the language to determine how much time LP’s have (90 days is common)
- In order to adequately incentivize a replacement manager, the LPs may find themselves doubling up on costs, as the removed GP may retain significant carried interest entitlement
 - Is there carry available to incentivize the replacement GP?

LP Voting

- LPs should ensure that the GP (and any affiliated parties that hold LP interests in the fund) are excluded from any removal voting
- Make sure percentage is set so that no single LP can block the vote
- Most voting thresholds at 75%, some even at 80%
- Despite all being investors in the fund, LP’s will have different levels of desire to remove:
 - LP’s with significant co-invest or SMA strategies may not want to remove so they don’t ruin the relationship
 - Fund of Funds don’t want to develop a reputation as hard to work with or develop a reputation as being unfriendly to GPs as they risk being excluded from other funds.
 - Some LP’s just don’t care or it’s a small investment and they don’t want to bother
 - Some LP’s avoid conflict at all costs

No-fault removal

No-fault removal is a powerful LP tool. It rarely gets used, but it's a nice option to have if needed

- Most funds have no-fault removal
- No-fault removal may be disallowed during first couple years after fund closing
- Avoids a fight over whether "for-cause" definition is met
- LP's prefer a no-fault removal vs for-cause
- Higher voting threshold than for-cause removal
 - Likely at 75% or 80% for no-fault removal
- Three Types of No-Fault Rights:
 - Suspension/Termination of Investment Period
 - Termination and Replacement of GP
 - Dissolution (and Liquidation) of the Fund

For-cause removal

- For-cause definition is almost impossible to meet
- When standard of care is violated, that should be enough for removal. Shouldn't have to consider damages for removal
- Try to avoid language where a final, non-appealable determination is required. Effectively removes any chance of a for-cause removal since it may take a decade to get to that level
 - What is a "final" determination: trial court? appeal? Supreme Court?
- Most GP's retain 100% of their carry even if removed, so the incentive to behave is diminished
- Don't rely on termination of a bad employee to cure a cause event
- Ideally 50% of carry if forfeited, the market is around 25-33%
 - This would be a source of compensation for replacement GP
 - Fraud, felony, gross negligence
 - Material breach of LPA or willful breach of fiduciary duty
- What is the standard for cause?
 - Determination by certain % of LPs?
 - Determination by a court of competent jurisdiction?