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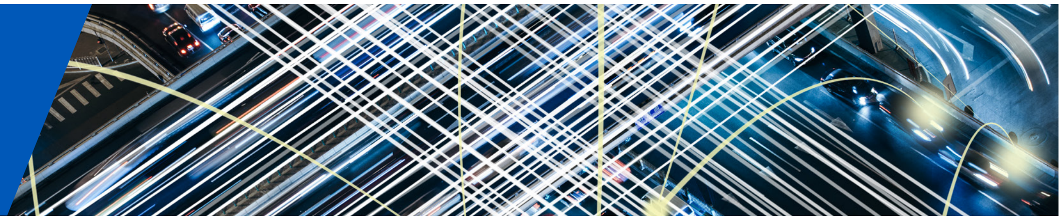

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Private Equity Fundraising; Notable Trends in 2020

The private equity fundraising market remains robust and competitive. Notably, the current fundraising environment is facing growing pressure from limited partners ("LPs") and regulators at home and abroad, each lobbying to impose more restrictive terms and regulations on general partners ("GPs"). Private equity economics, taxation, transparency and leverage practices are topics that are likely to be part of the political discourse in the United States in 2020. As markets may become less stable and valuations remain high, LPs may look for safety and the available dollars in the marketplace will continue to be allocated to the same privileged group of GPs. Staying informed about key trends in the marketplace has never been more important. We describe some of these trends below.

RELEVANCY OF THE ILPA MODEL AGREEMENT

The Institutional Limited Partners Association ("ILPA")[2] is on a mission to standardize private equity fund terms and documentation. ILPA released a model limited partnership agreement (the "ILPA Form") designed to provide a benchmark for fund terms across the marketplace. The ILPA Form reflects the aspirations of certain LPs with respect to key terms, including governance, economics, transparency and standard of care. Two of the proposals worth noting are the following:

Standard of Care

The ILPA Form proposes that a "prudent person" standard of care should apply to GPs. If adopted into fund agreements, this high standard could change the liability exposure of GPs significantly. The customary "gross negligence" standard has been a feature of the marketplace for decades. It allows GPs to exercise their business judgement in transactions that inherently entail risk, while also considering the interests of LPs. Private equity funds invest in complex — and sometimes troubled — assets. Adopting a "prudent person" standard would fundamentally shift the risk allocation between GPs and LPs — and would likely impact the types of investment opportunities that GPs would be willing to undertake. It is conceivable that the proposal amounts to a higher standard of care than that typically applicable to directors of public companies and GPs should assume that it will result in increased litigation exposure. The SEC considered and rejected imposing such a "prudent person" standard in its Final Interpretation of Standard of Conduct for Investment Advisers.

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[2] ILPA is an association of over 500 LPs representing more than $2 trillion of assets under management.

Economics

The ILPA Form contains a couple of anomalies in the economic provisions that could have significant consequences for GPs. In the typical distribution waterfall, the preferred return is measured in a manner to determine whether the LP has received, on a cumulative basis, the preferred return on all contributed capital. However, the ILPA Form only looks to the amounts distributed under the preferred return step. It does not take into account profits previously distributed to the LPs under other steps. Depending on the circumstances, the result would be that LPs receive a larger preferred return than intended and the GP would lose a portion of carried interest that it was otherwise entitled to receive. Another anomaly is the interim clawback. Under the ILPA Form, it could be triggered even though no realizations have occurred, and no mechanism is provided for the GP to recover distributed clawback amounts despite subsequent profitable investments.

Given the growing demand by some investors for customized arrangements, co-investments deals and single-investor products, it seems unlikely that the ILPA Form will result in mass uniformity. Further, the increasing number and length of investor side letters suggest that the quest for standardization may be of limited effect. The ILPA Form will not likely lead to significant changes to key fundraising terms in 2020, but it can be expected to frame discussions and negotiations with LPs across the marketplace.

FUNDRAISING TERMS THAT REFLECT MARKET REALITIES

Given the practical realities of today's private equity marketplace, GPs are encouraged to consider certain new governance and economic terms that respond to those realities. While forecasting terms is difficult, GPs are well-advised to consider the following enhancements to their fund documents: (i) the facilitation of secondary transactions (including "GP-led" transactions), extensions, restructurings and redomicilation; (ii) flexibility to waive, defer or calculate differently carried interest distributions; (iii) LP advisory committees that are more efficient, expert-oriented and provide more unconflicted responses to issues (which may involve the creation of sub-committees and the use of independent advisers); (iv) expanding the ability to call capital, borrow and recycle proceeds following the end of the investment period; and (v) use of subscription line credit facilities to assist with cash management, including facilitating distributions. GPs will likely push the envelope in 2020 for new fundraising terms that respond to market realities and developments in the above areas and others.

SITTING IN THE CROSSHAIRS OF POLITICAL DISCOURSE

Private equity businesses continue to be a popular target of politicians and regulators. Recent regulatory initiatives include state-level privacy laws, GDPR in Europe and similar regulations that have substantially increased compliance burdens. Senator Elizabeth Warren's *"Stop Wall Street Looting Act"* also raised the national profile of the industry and takes aim at the private equity business model by seeking to curtain the "abuses of private equity funds", increase taxes and transparency and codify and expand fiduciary duties. A House Financial Services Committee hearing focused on private equity practices also featured the proposal. Some government officials continue to regularly raise the issue of carried interest taxation. In 2020, the growing wave of populism in an election year will likely increase political pressure on — and cause a sense of uneasiness across — the private equity industry.

There are, and will continue to be, many other trends at work in the private equity marketplace that are not addressed in this article. The views expressed in this article are reflective of our experiences in the private equity marketplace.