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Client Alert: ILPA Releases Model Limited Partnership Agreement

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On October 30, 2019, the Institutional Limited Partners Association ("**ILPA**") released its first publicly available Model Limited Partnership Agreement (the "**Model LPA**").[1] The stated purpose of the Model LPA is to more closely align the interests of general partners and limited partners in private equity investment funds, in conformity with the ILPA Principles 3.0.

This is a fascinating development for fund managers, investors, and practitioners alike.

In the venture capital industry, we have seen the market move to an equilibrium in the model forms circulated by the National Venture Capital Association ("**NVCA**"). From the initial term sheet to the final stock purchase agreement, theses model documents form the basis—and provide the default terms—for the negotiation between investors and the subject portfolio company. For some time, established firms and funds clung to the use of their proprietary forms. But the efficiencies gained from a mutually agreed upon starting place have, unsurprisingly, won out over the long run. While each deal stands on its own, the importance of having the NVCA model forms as the baseline for negotiations should not be understated.

Does the release of the Model LPA signal a similar shift for private equity fund formation? That will remain to be seen, but the potential value-saving efficiencies of the Model LPA are not hard to see on its face.

Take the side letter process, for example. While the limited partnership agreement ("**LPA**") of any investment fund will typically function as the figurative spine, general partners will almost invariably enter into "side letter" agreements with limited partners that branch off from the LPA. Thus, if the LPA is the spine, then side letters are the figurative neurons that stem from it. Some limited partners gain preferential treatment via these pathways. Just how preferential will commonly depend on the size of a limited partner's capital commitment to the fund, its investment history with the general partner's prior funds, and a host of other reasons.

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Side letter negotiations typically occur in parallel with the negotiation of the LPA. But their ultimate resolution can be a bit of a prolonged dance because limited partners suffer from information asymmetry. While each limited partner negotiates its individual side letter, the general partner has the benefit of negotiating each of them. To resolve this asymmetry, limited partners have frequently pushed for, and received, what is referred to as a "Most Favored Nations" ("**MFN**") clause in their side letter.

Essentially, MFNs says "we [the limited partner] agree to the terms in our side letter, but if you [the general partner] give more favorable terms to any other limited partner in a separate side letter, we get the benefit of those terms, too." This makes sense. If one limited partner is committing 25% of a fund's capital, does it not stand to reason that they should receive potentially more favorable terms negotiated by a separate limited partner committing only 10%?

But even while acknowledging this sensibility, administrating MFN elections can be a major (and expensive) headache for the general partner. How should the process of awarding MFN terms work?

Over time, funds have established their own side letter best practices. Some funds rely on their form of side letter and argue hard for infrequent deviations from their form. Other funds establish sophisticated election processes through side letter books shared with limited partners based on capital commitments. But these practices do not eliminate the time, expense, or compliance costs for the general partner—especially if there are different forms of MFN clauses across differing side letters! And the amount of visibility that limited partners receive into the fund resolving their information asymmetry similarly varies by fund.

The Model LPA supplies a potential default answer to simplify this by standardizing the MFN process and placing the MFN in the LPA itself.[2] Specifically, section 20.6.2 of the Model LPA sets a default rule whereby:

- side letters are expressly incorporated into the entire LPA agreement;
- each limited partner will receive notice of the terms of all side letters reasonably following the fund's final closing; and
- each limited partner will automatically receive any more favorable rights given to any other partner (except for a few standard carveouts).

The appeal of these terms is almost self-evident. General partners get simplicity. Limited partners get transparency. The Model LPA does, in fact, appear to align interests here.

Of course, this is only one provision of the 73-page Model LPA, and the foregoing example is not meant as an argument that the Model LPA provides a holistic (or even preferable) solution. Indeed, it could raise more questions than answers.

If the Model LPA becomes more widely adopted, will limited partners investing smaller relative amounts free-ride on larger limited partners to negotiate the best terms? If so, will this have an equalizing effect on the amounts contributed by each limited partner to any given fund? And, stepping back to a 30,000 ft view, what is the purpose of contracting in the first place if not to permit parties to strike the deal they respectively view as optimal?

What is certain is that this is a bold initiative by ILPA and one whose effects we will continue to monitor in the investment fund marketplace.

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Sean Planchard is a member of the Investment Funds practice group of Wyrick Robbins, which represents clients across a broad range of industries in connection with fund formation and management, investor representation, and regulatory compliance. The firm publishes Client Alerts periodically as a service to clients and friends. The purpose of this Client Alert is to provide general information, and it is not intended to provide, and should not be relied upon as, legal advice.

[1] The Model LPA is available for download here from the ILPA website.

[2] To be sure, some funds already have made a practice of placing side letter MFNs in their LPA (as opposed to varying side letters) already, but the fact that it is included in the Model LPA is an intriguing signal nonetheless.