

And That's How Sally "Cs" It

Thoughts on Fund Terms and Governance Provisions

If you watch *Glee*, you understand the title to this article. If you aren't a *Glee* fan, the show features a middle-aged, tall, smart-talking, cynical blond named Sue Sylvester who offers up her opinions in a segment of the show titled, "And That's How Sue 'Cs' It." My kids have noted, let's just say, more than a few similarities between Sue and their mother.

This article is my view of certain fund terms and governance provisions for closed-end funds, and it is based on my participation in the sector since 1993. The past few years have been particularly instructive, as the effectiveness (or not) of fund terms in times of extreme stress has been tested. The following is not an exhaustive guide as I've left out areas that have been well covered, such as investment management fees.

GENERAL PARTNER/SPONSOR CO-INVESTMENT

The source of the co-investment matters a lot. Co-investment from the parent company of a general partner is not an effective way to align interests and can, in fact, be detrimental when the parent company's interests diverge from those of investors. Prior to the financial crisis, I viewed parent company co-investment as benign; it was a complement to, not a replacement for, investment by the team, but it was not a negative.

Investment by the individuals working day to day on the fund has always been important. The key is to make sure that co-investment is concentrated among those individuals with the most influence on the fund's activities and that the co-investment is meaningful to each. I have seen instances where the co-investment was contributed in small amounts by many individuals from the CEO to the analysts with the result that it was not particularly meaningful to any one person, diluting the impact. Thus, while requiring everyone to invest in the fund

sounds appealing, it only works if the senior members of the team contribute significant capital.

Cash contributions ("writing a check") to fund the co-investment is preferred over loans to individuals by

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the sponsor. Recourse loans present complications including potentially incenting the individuals managing the fund to engage in riskier transactions to recoup losses in order to repay the loans. When an individual leaves the organization (whether voluntarily or involuntarily), the sponsor must either forgive the loan or ask the employee to pay it back if the value of the individual's partnership interest is below the loan balance, a situation that is very common today. As you might imagine, this is a less than desirable conversation for both parties and creates certain management challenges ("I'm firing you, but you owe me money.").

Finally, co-investment that is provided by an outside investor or money partner or by another account managed by the sponsor does not count in any circumstance as sponsor co-investment, not even when the sponsor has discretion or if the third-party money source is passive.

CARRIED INTEREST AND CLAWBACK

The preferred-return and catch-up mechanisms shifted too far in favor of

the general partner, allowing GPs to be paid carry at very low returns relative to their target (e.g. the 8 percent pref on a 20 percent return strategy with a 60/40 GP catch-up). It is time well spent to push for a higher preferred return and modification to the catch-up mechanism to ensure carry is earned only at sufficiently high returns.

The clawback language is much more relevant now that we are in a scenario where clawbacks are being triggered. The form of security for the clawback is important. If it is an escrow, what is the formula for determining the escrow amount and who controls it? Is it a guarantee by the sponsor or the individuals? Is the guarantee several or joint and several? Will the guarantor be solvent when it is time to pony up the cash? Some GPs are disclosing the clawback liability, and some are waiting to be asked before disclosing the situation. Early and full disclosure of clawback liabilities and a plan for resolving the clawback should be standard practice.

Investors can greatly reduce the likelihood of a clawback situation by requiring portfolio-level distributions. We are seeing a switch from deal-by-deal distribution structures to portfolio-level distribution structures for value-added funds across the board, but some of the opportunity funds continue to be holdouts. Avoid them if you can.

GP REPLACEMENT AND FUND TERMINATION

There have been only a few general partner kickouts in this downcycle because investors have been relatively forgiving and because it is a herculean effort to replace a general partner. Lowering the thresholds for replacement would help. Earlier vintage funds featured 50 percent for cause removal and 66 2/3 percent without cause removal. In later vintage year funds these thresholds moved up to 66 2/3 percent and 75 percent, respectively. Investors should also

have an option to terminate a fund at any time with a super majority vote without exercising the general partner replacement provision.

INVESTMENT PERIOD, FUND TERM, EXTENSIONS

Extensions of the investment period and the fund term should be put to a vote of all limited partners (excluding those affiliated with the GP). A vote of the entire limited partner base is fair (it's everyone's capital after all), and, opening the vote to all limited partners rather than a subset of investors, somewhat mitigates concerns that investors with issues specific to their situation will control the outcome. The threshold should be high and require at least 66 2/3 percent approval to extend the investment period or the fund term. If extensions are at the discretion of the general partner, I would caution the general partner to not interpret the term as including the extension and instead work to wind up the fund by the termination date.

INVESTMENT LIMITS AND DIVERSIFICATION

Lack of vintage year diversification within a fund, concentration of a fund in a few investments, and the amount and structure of debt have been significant issues. The first two have been evident in underperforming funds of early and later vintages whereas issues related to debt are more recent. Rather than instituting too many prescriptive limits, I think it's better to simply pass on that fund if the sponsor has not shown discipline; however, I am supportive of certain limits. For example, in certain strategies, it is appropriate to lower the limit on any one investment from 20 percent to 15 percent of commitments. In addition, the provision that allows a general partner to exceed the limit if he/she reasonably believes the investment can be brought into compliance within a period of time should be disallowed or the timeframe for bringing the investment into compliance shortened. You never know when the music might stop, leaving a fund with overexposure. Leverage limits and a limit or outright prohibition on recourse debt are reasonable.

Cross-fund investments (those owned by multiple funds or other sources of capital controlled by the

general partner) are problematic. If an investment needs to be recapitalized, it may not be in the interest of every fund to participate, nor will every fund have the capacity to do so. How does the general partner represent each fund's interests? What about a situation where an earlier fund made the original investment and a later fund that did not have an interest in the original investment participates in the recapitalization?

With regard to cross-collateralization of debt, vintage year diversification and cross-fund investments, reviewing the sponsor's past behavior is a good clue to investment discipline and philosophy rather than using investment limits to attempt to modify behavior.

CONFLICTS OF INTEREST

Unless there is an overriding, clear benefit to engaging in a conflict of interest transaction, they should be avoided, and I would encourage sponsors to pursue another solution. Investors and general partners in other domiciles may not necessarily share the U.S. view of what constitutes a conflict requiring fund documents to explicitly delineate conflict of interest areas. To be clear, loans from an affiliate of the sponsor to the fund or its investments, loans to the fund or its properties from an investor in the fund or its affiliates, selling investments to or buying investments from an investor in the fund, and selling investments to affiliates of the general partner or other funds controlled by the sponsor all constitute conflict of interest transactions. Any transaction with an affiliate of the sponsor is a conflict transaction (unless pre-approved up front).

FUND-LEVEL EXPENSES

Fund-level expenses are often overlooked by general partners and investors. Fund-level expenses and use of affiliates should be monitored by the advisory committee and detailed by category (using the partnership agreement as a guide to what is allowed) in the annual audited financials both by year and on a since-inception basis with the impact on returns explicitly calculated. Investors should watch for outsourcing of activities that are rightfully general partner expenses (and covered by

the management fee) to third parties/affiliates and charged back to the fund.

DOCUMENTATION

There has been significant progress in the information available to limited partners; however, some sponsors are still missing the boat. For example, return projections are not uniformly available and some funds are still not including details on debt in the quarterly reports. There has been an upswing in requests from investors for Callan (or others) to verify capital calls, distributions, management fees, incentive fees/carried interest, and clawback obligations. This is, in part, because many pension funds are thinly staffed and need to make sure this information is adequately vetted to fulfill their fiduciary duties, but also because the general partners have not provided adequate documentation and transparency to allow for easy verification of these items. For example, we recently reviewed a capital call notice that only included the amount the investor was to wire. The total amount of the call (for all investors), the client's percentage interest in the fund and the uses of the money were missing from the notice.

CALL TO ACTION

There is an opportunity for investors to take the experiences of the recent past and push for next-generation/post-crisis fund structures and set a new normal. Indeed, this is happening. I support structuring new funds using the Institutional Limited Partners Association (ILPA) Principles (see www.ilpa.org) as a baseline; sponsors of funds that are not structured accordingly should be prepared to explain any deviations. Earlier generation funds (pre-2006) were structured more in favor of investors and had many of the ILPA principles, even before there were ILPA principles. As the closed-end fund sector was flooded with money, investors lost ground and terms became more favorable for the GP. Sponsors who have been in the sector over the longer term understand this; sponsors who entered the space during the peak may not, and their expectations will need to be adjusted.

And That's How Sally "Cs" It! ❖

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