

Investment Funds: Monthly Digest

May 22, 2019

HOW KEY PERSON EVENTS CAN LOCK FUNDS WORTH MILLIONS

A senior hire last year by global alternatives giant Kohlberg Kravis Roberts & Co (KKR) from CLSA Capital Partners (CLSA)¹ brought the spotlight on a significant clause in investments funds documentation – key person event. The purpose of such key person event provision is to ensure that the members of the fund management (GP) team critical to the fund's functioning devote substantial business time and attention to the fund. Failure to devote the requisite time can result in serious consequences for the GPs.

In May 2018, KKR appointed John Pattar, CEO of CLSA's largest real estate fund, Fudo Capital III as Member and Head of its real estate business.² Being a key person at Fudo Capital III, his exit triggered consequences for the live funds in the CLSA platform. In the instant case, the GP team pre-empted the triggering of key person provisions due to Pattar's exit and cancelled the remainder of the investment period³, effectively limiting its ability to call for around USD 350 million out of the USD 1 billion⁴ raised. While this episode undoubtedly throws up interesting issues from a business side, while negotiating fund documents with LPs, critical key person provisions such as identification of key persons, time commitment, triggers for key person event, ability to cure key person events and consequences of uncured key person events need special attention to protect the interests of GPs.

Identification of Key Persons: For most Indian focused funds, the quality and time commitment of GP team members is often a major consideration for LPs to invest in a fund. Typically, a few critical members (ranging usually around 2 – 4) are identified as key persons and their exits can trigger key person consequences. For first time GPs, the founders are usually designated as key persons. However, as GPs become more institutionalized, key person clauses tend to become more sophisticated and include more people further down the corporate pyramid. For example, in larger fund houses with numerous senior members, key person clauses may only be triggered if 2 out of 5 senior management officials leave the franchise. At the extreme, such clauses can be "personality-agnostic" and be "designation-driven" instead, although such level of sophistication is currently rare in the Indian context.

Time commitment: The private equity principles of the Institutional Limited Partners Association (ILPA)⁵ prescribe that key persons should devote substantially all their business time to the fund. The time commitment issue also ties in with the tiered approach to identification of key persons. In larger institutions generally, fund documents often permit the topmost GP team members to devote "sufficient" instead of "substantial" time to the fund since LPs recognize the multiple obligations that such senior members may have, while still providing that second-tier GP team members devote all their business time to the fund(s). In this way, a middle ground is reached between LP expectations and GP circumstances.

Key person trigger: Another point of LP-GP negotiation is the trigger for key person events. Common triggers include death, resignation, incapacity etc. LPs often seek to include even accusations of civil wrongs and / or criminal offences such as fraud, gross negligence, conviction for serious offences etc as triggers. Negotiations often centre around the stage of investigation which would lead to the trigger, ranging from the mere filing of an FIR to the passing of a final, non-appealable judgment of a competent court. While the level of detailing may vary across funds, Indian GPs are generally aligned with global LP expectations with respect to key person event triggers.

Ability to cure: GPs often seek to provide for a cure period before consequences of a key person event can ensue. A typical cure for a key person event is the replacement of key persons with new key persons. ILPA does not support such a cure explicitly. The oft-reached commercial compromise is that the consequences are triggered upon occurrence of a key person event and such consequences cease upon cure. Typically, including in India, cures need to be approved by the LPs or an LP Advisory Committee (representative body of LPs).

Consequences of key person event: One of the most common consequences of a key person event, seen even in the KKR-CLSA episode, is the suspension / termination of the investment period. Effectively, this curtails the ability of a fund to draw down balance commitments for making portfolio investments and reduces the exercise to one of asset management. At the extreme, certain fund documents also provide for winding up of the fund. Negotiations also centre around whether a key person event should lead to a reduction in management fees for the GP etc. In the Indian context, fund documents often elevate uncured key person events to be events of "Cause", providing leverage to LPs to remove the GP or terminate the fund in case of inordinate delay on inaction in curing a key person event.

The KKR-CLSA episode has highlighted the significance of key-person clauses. With billions of dollars being raised by GPs of India-focused funds, it is important for GPs to negotiate watertight key person clauses in fund documentation to avoid any major disruption to the continuity of the fund in future.

– Blanche Dsouza, Srikanth Vasudevan & Nishchal Joshipura

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¹ <https://www.vccircle.com/kkr-hires-clsa-exec-to-head-asia-pacific-real-estate-arm/> (last accessed on May 20, 2019)

² <https://media.kkr.com/news-releases/news-release-details/kkr-appoints-john-pattar-member-and-head-asia-pacific-real>

³ <https://www.privateequityinternational.com/kkr-hire-puts-clsa-property-fund-series-in-jeopardy/> (last accessed on May 20, 2019)

⁴ *Ibid.*

⁵ <https://ilpa.org/ilpa-principles/> (last accessed on May 19, 2019)

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