

# Investors Must Halt Erosion Of PE Most-Favored-Nation Rights

By Marc Lieberman (December 5, 2019)

Having reviewed hundreds of limited partnership agreements designed for private equity investment over the past few decades, I've seen more than my fair share of most-favored-nation, or MFN, clauses. They are intended to afford investors with the right to elect the same economic benefits and other rights enjoyed by fellow investors with similar or lesser capital commitments.



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Recently, a disturbing trend has taken root. Increasingly, the benefits of these clauses are being eroded by general partner-imposed limitations that render the clauses largely ineffective.

For example, a recent MFN presented to me purported to except from its application any provision in other investor side letters that discounted an investor's management fee or carried interest burden. I dare say that achieving economic parity with similarly-situated investors is the *raison d'être* of an MFN clause.

Similarly, I am seeing MFN clauses that contain a catch-all designed to render the MFN clause illusory, such as clauses that specifically prohibit the investor from enjoying "any most favored nation rights or benefits" afforded other investors (including all investors, without distinction).

If an MFN clause itself denies the benefit of any MFN clause enjoyed by one's fellow investors, the question becomes: What benefit is even being afforded by the MFN clause in the first instance?

Perhaps the recent hostility to MFN provisions by some general partners is simply a product of their greater leverage in the marketplace, as private equity becomes more of a mainstream allocation and more money is chasing fewer deals. According to data tracker Preqin, allocations to alternatives equaled \$8.8 trillion in 2017 and are expected to increase 59% to \$14 trillion by 2023.[1]

Given the flood of money into alternatives, general partners are taking advantage of their increased leverage by tamping down the utility of MFN rights. It is my sincere hope that investors begin to rein in this trend. Failure to oppose these tactics will effectively result in MFN clauses becoming useless, if not extinct.

So, what's the perfect MFN? In my view, it is one that is both reasonable in scope to both investors and investment managers. The following is my proposal:

First, the MFN should clearly afford the recipient the economic benefits enjoyed by those fellow investors with similar or lesser commitments.

Second, the list of exemptions to application of the MFN should not eat up the reason for the clause in the first instance.

Third, those exemptions should be conditioned upon reasonable carveouts, such as requirements that:

- The recipient not be in default;
- The recipient maintains at least half its commitment following transfer of a portion of its interest; and
- The recipient's adoption of another investor's rights comes with the obligations accompanying those rights.

It is also reasonable to prohibit investors from enjoying certain rights that either fall within the discretion of the general partner or are well established in the marketplace, such as:

- The right to become a member of any advisory committee;
- The right to enjoy economic terms afforded employees or affiliates of the general partner or investment manager;
- Rights that accrue due to an investor's specific tax, legal, regulatory, jurisdictional or sovereign status, as well as an investor's organizational or policy requirements not otherwise applicable to the electing investor;
- Rights relating to transfers or admissions of substitute partners if such rights are necessitated by regulations or policies otherwise applicable to the electing investor; and
- Rights relating to an investor's disclosure of information or the general partner's obligation to disclose information if such rights are necessitated by laws or regulations not binding the investor trying to elect them.

While there are additional exemptions to application of an MFN that might be reasonable in this market, investors should not tolerate MFNs that preclude investors from enjoying the economic benefits afforded similarly-situated investors or that purport to preclude MFN rights altogether.

MFNs are intended to increase equality of rights among peers. Efforts to curtail their efficacy can only breed distrust and decreased subscriptions.

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[1] As reported by Institutional Investor (October 19, 2018) (Alicia McElhaney, Report: Alternative Investment Industry Will Hit \$14 Trillion by 2023).