

How to fire a partner (if you must)

Given the complex economic and legal relationships among partners, reducing senior staff can be a tricky proposition

By Jennifer Harris

From mega-buyout houses to lower middle market shops, private equity firms have had to shut down offices and reduce staff in order to weather the downturn. But when some of the heads being cut are general partners, the process can get extremely gruesome.

Such individuals are typically involved in the management company and its funds in several capacities. They might be employees of the management company, a general partner in the fund, and an investor or co-investor in the fund.

Untangling all of these relationships is a complex and delicate job. At the partnership level, there is the matter of carried interest. Should the departing partner continue to receive the same pro-rata share of carried interest on the investments he worked on while at the firm, after he has departed? Or should the rate be reduced? In his capacity as an investor in the fund, should he be allowed to continue co-investing in future deals?

"Normally what happens is that people are allowed to retain their carried interest," says Ronnie Fox, an employment and part-

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nership attorney in London. "Not always. Sometimes the employment contract says you give up your carried interest at cost if you leave. Sometimes it says you can retain your carried interest, but you can't co-invest, so that if there's a call for more money you can't put in any more money, you're frozen at your existing level. Sometimes there can be provisions which purport to enable funds to confiscate the unrealised carried interests, but that's a very aggressive way forward."

Once the money matters have been sorted, there remains the question of how much influence, if any, the departing partner should have over investments he played an integral role in, and how much information about the portfolio he should have access to.

"Sometimes even though a partner who's leaving has got no influence and is denied an opportunity of exercising any influence, he

might still want to know what is actually happening, how close are we to a realisation event," Fox says.

If negotiations do not go smoothly, and either party decides to take legal action, everyone involved could be tripped up by the fact that a management company and its funds tend to be organised in different jurisdictions. And location does matter: minority shareholders in funds domiciled in England enjoy protection from prejudicial or unfair practices under Section 459 of the Companies Act of 1985. Shareholders in offshore funds typically do not.

Another issue that can be thorny is discrimination law. In an industry where everyone is expected to work long hours, a partner of a certain age is sometimes asked to leave, one he is no longer able to keep such a grueling schedule. But that could provide grounds for an accusation of age discrimination, Fox says. Similarly, there have been some firms in the past where the working environment for women "isn't necessarily a very pleasant one", and Fox has seen a few occasions when a female partner has been asked to leave, and she has asked him about her rights to claim gender discrimination.

"Sometimes these issues are raised in an effort to get more money," Fox says. "Somewhat cynical, but that's what happens."

And of course there are the psychological difficulties that come with being asked to leave by your partners, which Fox says shouldn't be overlooked. People in private equity "tend to put their heart and soul into the job"

The best defence against these problems is of course having a well negotiated employment contract and partnership agreement to begin with. When signing one of these documents, Fox advises would-be partners to consider carefully what would happen if things don't work out down the line. But of course, one can rarely plan for everything.

"At the end of the day employee contracts and partnership agreements rarely say what, with the benefit of hindsight, the management of the fund would like it to say," Fox says. "It's never quite as simple and straightforward as it seems. We spend a lot of our time looking at and analysing the precise wording of the members' agreement if it's an LP, the partnership deed if it's a conventional partnership, in terms of employment." ■