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PERSPECTIVE

Investor protections in private equity funds

By Sara L. Terheggen

Investors primarily focus on investment return when choosing a private equity fund. When conducting due diligence on a fund manager and determining whether to make an investment, no one wants to consider the ramifications if something goes wrong. Rather, the preference is to focus on the fund managers, the investment purpose, strategy, the fund's diligence process and ultimately their track record for generating superior investment returns. Investors tend to value all of the relationship factors and do not spend as much diligent effort focusing on the recourse strategies in the event there is an issue with the fund or its general partners. Some investors, especially family offices, who may be writing smaller checks may believe they do not have any leverage to negotiate terms in the limited partnership agreement (LPA). They may not even engage legal counsel to review. Of course, that is not the best strategy and even having certain protection mechanisms is better than having none at all. To best protect their investment, investors should determine whether the general partner has incorporated any recourse protections and suggest amendments in the event no such protections exist.

Options are Key to Mitigate Downside Protection

There are several provisions that offer investors some form of recourse protection. These include a limited partner advisory committee, key

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person, no-fault dissolution, no-fault removal of the general partner and removal of the general partner for cause. If an investor does not like the direction or is unhappy with the overall management of the fund and its investments, then these provisions may provide investors a way to salvage an investment before all the capital has been committed. This is often accomplished by suspension of the investment period, removal of the general partner or dissolution of the fund. It is imperative that an investor understand each of the possible resource mechanisms and request amendments if the LPA does not already address.

Limited Partner Advisory Committee

A limited partner advisory committee (LPAC) can be a great governance resource for a fund. Often, the members of such a committee are made up of investors who have

committed a large amount to the fund and often negotiate a spot on the LPAC as part of their investment process. An LPAC generally monitors the investment restrictions of a fund including approving or disapproving departures from the stated investment guidelines, approval of affiliate or other conflict transactions, valuation methodology and even serving as the front line for certain decisions such as a key person event. Decisions are commonly made by majority. Even if an investor is committing a smaller check, it does not mean they cannot ask a general partner to institute an LPAC if one is not contemplated.

Key Person Event

A key person event is a trigger in the LPA that centers around the most senior investment professionals. Investing in a fund is really about investing in the people who run the fund and many investors are weary that the fund managers into which they have placed their trust and their capital will not commit the necessary time to the fund or may even leave. This is where the key person event is a helpful protection mechanism. It identifies the primary senior individuals and outlines the expected time commitment requirements. A standard key person event is triggered when a certain number of the key persons cease committing the specified time requirement to the fund (substantially all of their business time, majority of business time, etc) and this can be as a result of death, disability, voluntary departure, involuntary termination or other matters. A key person trigger often results in suspension of the investment period which is permanent unless a supermajority of investors vote to reinstate the investment period within a certain period of time. This is an important protection mechanism to ensure continuity in the senior investment professionals but also assurance

that they are committing most of their professional time to the activities of the fund.

No Fault

Dissolution

This is an important protection mechanism as it allows investors in the fund to suspend or terminate the investment period with no specific reason upon the vote of the investors in the fund. This is helpful in situations where there is no provision that provides for no-fault removal of the general partner but the general partner's actions have not risen to the level of a cause event. While a general partner may be willing to add such a protection for investors, they are likely to not include such a right in the first draft of the LPA. If requested, the general partner will aim to keep the voting threshold as high as possible to make it more difficult to implement. The Institutional Limited Partners Association (ILPA) recommends a vote of two-thirds in interest of the investors should be required to suspend or terminate the investment period

and a vote of three-quarters in interest to dissolve the fund. This tiered voting threshold approach provides some flexibility to get to a compromise position with the general partner.

No Fault Removal of the General Partner

This is very similar in form and substance to the no fault dissolution but allows the fund to continue and the investors to elect a replacement general partner. In addition to the general partner pushing back on inclusion of this provision as it results in loss of accrued carried interest, they will also push for a high voting threshold. Further, since general partners work hard to formulate, start and raise their funds, they are less inclined to agree to allow this provision as it also gives investors the right to replace them. ILPA recommends a vote of three-quarters in interest of the investors be required to remove the general partner although some funds have implemented even lower thresholds than this.

Removal of the General Partner for Cause

This is a critical protection mechanism and one that no general partner should be inclined to reject regardless of an investor's check size. Cause can include many triggers and often covers material breaches of the LPA, fraud, gross negligence, willful misconduct, breach of fiduciary duties, bankruptcy and felony convictions. Investors should always request that a cause definition pick up as many triggers as possible and should always request that the cause trigger be based upon a preliminary determination as opposed to a final and non-appealable decision given that such cases can take a number of years.

It Never Hurts to Ask

While investors may believe that they have no negotiation leverage when it comes to funds in which they invest, it is important to do your diligence and review the LPA in an effort to identify which protection mechanisms are included and which would be helpful to add, and then request these

suggested amendments to the LPA. Without any such mechanisms, investors are often stuck in the fund with little recourse against the general partner and little ability to recoup all or a portion of their investment in the event the fund and its performance start deteriorating. ■

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