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PERSPECTIVE

DR. T ON SECURITIES

Defining fiduciary duties in private funds

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Surveys conducted through organizations – such as the Institutional Limited Partners Association – have documented a rising concern from limited partners that an increasing number of fund managers are not taking their fiduciary obligations seriously and are even going so far as to limit or eliminate such obligations in the limited partnership agreement. This slippery slope is pushing governance to its limit, thus skewing the alignment between fund manager and limited partner.

The Investment Advisers Act of 1940 (Advisers Act) establishes the key fiduciary framework for fund managers. This is generally assumed to mean that fund managers owe a duty of loyalty and a duty of care to their investors. These duties are enforced pursuant to the anti-fraud provisions of the Advisers Act. Most of the enforcement actions taken by the SEC have focused on breaches of these duties.

At its simplest formulation, the duty of loyalty is focused predominantly on conflicts of interest. Situations that tend to implicate the duty of loyalty include cherry picking, co-investments, portfolio company transactions and disparate treatment of limited partners. The duty of care, on the other hand, has more to do with whether the fund manager is tending to the needs of the limited partners. In other words, the duty of care measures whether the fund manager is committing the appropriate time and attention to the fund and the fund's investment decisions.

The key for any limited partner to protect their investment is to understand the duties owed to them by the fund manager and mitigate their concerns through key governance mechanisms that provide for transparency and oversight. When conducting due diligence on a fund manager and determining whether to make an investment, most investors are rightfully focused on track record and investment performance. Few are ensuring the right governance structures and fiduciary obligations are in place, but this is critical to providing the necessary foundation to manage conflicts and address issues as they arise. Without a solid governance framework grounded in a sense of fiduciary obligation, it is easy for fund managers to put their own interests above that of the limited partners – especially in times of turmoil.

Governance Mechanisms to Provide Fiduciary Duty Oversight

There are several provisions or mechanisms that offer investors some form of fiduciary duty oversight and protection. These include limited partnership provisions, investment allocation provisions, a limited partner advisory committee and key person mechanisms.

Limitation of Liability

Limited partners should take the time to understand the broader platform of the investment manager to whom they are committing an investment. While the limited partner may be making an investment to a particular fund, it is critical to understand the investment manager's breadth and depth of other investments, how other fund vehicles are allocated deals relative to the fund in which the limited partner is investing and how the investment manager describes the process by which it will handle any conflicts. The PPM and limited partnership agreement should provide clear guard rails, including disclosure obligations, so that limited partners can monitor and track conflicts throughout the life of the fund. Without a clear process in place, cherry picking and conflicts of interest will arise.

Limited Partner Advisory Committee

A Limited Partner Advisory Committee (LPAC) can be a great governance resource for a fund. An LPAC is made up of limited partners and are generally tasked with monitoring investment restrictions of a fund, 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.

Key Person Event

A key person event is a trigger in the LPA that centers around the most senior investment professionals. A key person event is intended to try to manage the duty of care by proscribing a time commitment on the part of the most senior individuals. To the extent those named individuals fail to commit the requisite time, a key person event is triggered which typically pauses the investment period until the situation is rectified.

Managing your Manager

Ensuring that the fiduciary duty mechanisms between a fund manager and its limited partners are established is key to aligning incentives and establishing a firm foundation of trust that lasts for several years. In times of turmoil and uncertainty, the importance of a solid governance platform becomes even more paramount. If limited partners take time at the outset prior to making a fund investment to ensure the key mechanisms to control and manage the fiduciary duties owed to them are implemented, they will be in a much better position later in the life of the fund.

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