

Taking an active role

In the midst of the financial crisis, limited partner advisory committees became more vocal and less 'limited'. Here are some of the legal implications of the evolving role of the advisory committee in various jurisdictions.

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Advisory committee service may at one time have been a relatively straightforward undertaking. However, as the private equity industry expanded significantly over the past decade and sponsors accepted capital from an increasing number of investors, the role of advisory committees gradually expanded. While this expansion seemed warranted and mutually beneficial, the recent financial upheaval resulted in a number of controversial proposals being submitted to advisory committees. At the same time, investors were focusing on their own liquidity concerns and began to focus more intently on potential liabilities, including the degree to which they are required to act in the interests of the other investors or solely in their own interests. This confluence of circumstances provides an opportunity to review the developments during the last few years, take a closer look at the incentives of the relevant parties involved and re-evaluate the fundamental assumptions, objectives and liability protections associated with advisory committees.

INTENDED ROLE

Historically, the typical purpose of the “advisory” committee (sometimes referred to as a valuation committee or conflicts committee) of a private investment fund was to serve as a sounding board for sponsor questions. Advisory committees would typically approve certain “conflicted” transactions where the sponsor had either dual loyalties to a fund and other clients, had a personal interest or was otherwise conflicted. Advisory committees would typically be involved to some degree with portfolio company valuations, whether approving proposed valuations, approving valuation guidelines or having a right to object to valuations.

The existence and authority of an advisory committee is appealing to both sponsors and investors. For sponsors, having a smaller, motivated and sophisticated subset of investors makes consent solicitations more convenient. Larger investors generally prefer the perception of preferable treatment afforded members of an advisory committee. Smaller investors rely on having well capitalised representatives with aligned interests monitoring the fund's affairs on their behalf.

Once recognised as an instrument of convenience, the advisory committee's role gradually expanded. Since funds generally survive in excess of 12

years and all contingencies cannot be fully anticipated and negotiated at the time of a fund's initial closing, advisory committees gradually were vested with increasingly important roles as representative bodies of investors. In many cases, advisory committees have the power to approve changes in the fundamental terms of a fund, such as the length of its term, its investment period, the obligations of its key persons to devote time to the fund (including the consequences if a key person clause is triggered) and investment limitations, among others.

While some argue based on fundamental fairness that each investor should have a voice in any significant revisions to the terms of its investment, the very popularity of the asset class and number of investors in each fund make the implementation of this ideal a logistical challenge.

FAST FORWARD

With the onset of the financial crisis, sponsors attempted to extricate themselves from deals gone bad, limited partners faced liquidity concerns and various fraudulent schemes fueled a general sense of anxiety. Against this backdrop, a number of complex and sometimes controversial measures were served up to advisory committees for approval. Even though the advisory committee had the authority to decide such matters, the balloon having deflated and the stakes being high, the members of the advisory committee suddenly focused on (1) their personal interests and (2) their perceived obligations to and potential liabilities vis-à-vis other limited partners more so than ever before.

STRUCTURE

Before discussing potential liabilities, it is helpful to briefly describe the typical advisory committee structure. An advisory committee typically consists of five to 11 members that are representatives of limited partners. Sponsors and their affiliates are typically excluded from being members; however some fund documents prohibit advisory committee meetings from being held without attendance by a representative of the fund sponsor.

Generally, the sponsor is permitted to select the advisory committee members. The largest investors typically negotiate for the right to appoint a designee to the advisory committee. While there are differing views on the

point, people – and not institutions – are the members of the advisory committee. Absent an express agreement with the sponsor, the investor does not have the right to select who will attend any given meeting or designate a replacement if a member resigns.

There is a fundamental tension between the investors' desire to have the privilege of advisory committee status and their desire to avoid liability or fiduciary status. However, based on mitigating factors discussed below and general business objectives, this tension is generally resolved in favor of serving on the advisory committee. Sponsors anticipate this outcome and use it to induce capital commitments. After successive fund raisings, an advisory committee may become larger than the ideal number for a well functioning committee. In response, investors often negotiate for a cap on the size of the advisory committee. If the advisory committee is full of members, new investors frequently request to be an “observer” on the advisory committee.

LIABILITIES

In a tightly knit industry where litigation between investors and sponsors is rare, it's not surprising that there is a lack of concrete judicial guidance articulating the potential liabilities of an advisory committee. While we offer a few observations below concerning potential liabilities, the analysis is neither complete nor does it fully internalise the fundamental discomfort that advisory committee members may actually feel when presented with “contentious” issues.

Generally speaking, the liability issues for advisory committee members can be broken down into two areas: whether advisory committee members (personally or the limited partners they represent) could become liable to third parties because they are involved in the “business” of the fund and whether the members of the advisory committee have any “fiduciary” duties or other liabilities to the other partners of the fund.

While an advisory committee can be compared to the board of directors of a corporation, there are significant statutory and procedural differences. Boards of directors are generally mandated by statute, whereas advisory committees are optional and created by contract. Generally advisory committee members are not tasked with being stewards of the enterprise and with oversight responsibilities over the fund to the same degree that members of a board of directors are so responsible. The advisory committee's role is generally more limited to approval of a specified subset of matters, and rarely if ever approval of a fundamental transaction like a merger or acquisition of a fund.

As a sample exploration of liability concerns, we look at funds formed in the following four jurisdictions: Delaware, Cayman Islands, England and Guernsey.

Delaware

For funds formed under Delaware law, the Delaware Revised Uniform Limited Partnership Act (DRULPA) provides that limited partners are not liable for

the debts or obligations of the fund, unless they participate in the control of the business of the fund. The DRULPA expressly states that serving on a committee of a Delaware limited partnership is not considered participating in the control of the business of the fund. Hence, outside of exceptional circumstances, a limited partner with a representative serving on an advisory committee would not be liable to third parties.

Whether an advisory committee member has fiduciary duties to other partners is a more nuanced question and heavily dependent upon the provisions of the fund's partnership agreement. The DRULPA permits the fiduciary duties and liabilities of a limited partner to be reduced or eliminated, subject to a floor that all parties to a contract are bound by an implied contractual covenant of good faith and fair dealing. Generally, current Delaware fund agreements eliminate the liability of advisory committee members (and limited partners they represent) to the other partners of the fund except in situations involving bad faith or willful misconduct. Often a fund agreement will expressly state that no limited partner owes any fiduciary duties to the other partners. However, it is not uncommon that in order to be relieved from liability with respect to claims by other partners of the fund the advisory committee members must have acted in the best interests of the fund. Typical Delaware fund agreements provide the advisory committee members (and usually the limited partners they represent) indemnity against third party claims (and legal defense costs) if they have acted in compliance with the same standards of care.

Cayman Islands

Funds formed as exempted limited partnerships in the Cayman Islands will be governed primarily by the 2007 revision of the Exempted Limited Partnership (ELP) Law, but they are also governed by the 2002 revision of the Partnership Law and general rules of equity and common law relating to the partnership to the extent that they are inconsistent with the ELP Law. As with Delaware funds, there is a dearth of case law dealing specifically with the liability of advisory committees and the fiduciary obligations of limited partners generally, but we are able to draw on English case law, which has persuasive authority in the Cayman Islands courts.

Unsurprisingly, since the ELP Law was largely based on the DRULPA, the principles governing the limited liability of limited partners are similar to Delaware. A limited partner will only become liable for the debts and obligations of the fund if it takes part in the conduct of the fund's business in its dealings with third parties, and then only for the period when it so acted and only to a third party who dealt with the fund believing the limited partner to be a general partner. As with the DRULPA, the ELP Law provides a list of safe harbour activities that will not be regarded as taking part in the conduct of the fund's business. Of most relevance are the safe harbours for “appointing a person to serve on any board or committee of the [fund]” and “consulting with

and advising a general partner or consenting or withholding consent to any action proposed, in the manner contemplated by the partnership agreement, with respect to the business of the [fund]”. The most common activities of an advisory committee are therefore expressly excluded from potential liability to third parties, and other activities will generally also be safe unless a limited partner’s representative oversteps the mark and deals with third parties on behalf of the fund.

Internally, limited partners owe fiduciary duties to each other, which will generally only comprise a duty to act in good faith (given the limited nature of a limited partner’s involvement in the fund). The extent to which a limited partner represented on the advisory committee (or the advisory committee member himself) might have broader fiduciary duties is moot, in the absence of judicial guidance. For example, it is unclear whether an advisory committee member, acting in good faith, can act solely in the interests of the limited partner he represents or if he should act in the interests of the fund as a whole. In practice, since the Cayman Partnership Law permits the mutual rights and duties of partners to be varied by consent of all the partners, a fund’s partnership agreement will generally contain express exculpation and indemnity provisions relieving limited partners represented on the advisory committee (and their representative members) of liability to the other partners, with certain exclusions (generally, liability for fraud, bad faith and willful default). The boundaries of enforceability of such exculpation and indemnification provisions are not clearly delineated, but there is thought to be an “irreducible core” of fiduciary duties that cannot be waived by contract, meaning that advisory committee members must always act in good faith; and any attempt to relieve liability for fraud is likely to be unenforceable as a matter of public policy.

The position of third party beneficiaries differs from Delaware law in that persons who are not party to the fund’s partnership agreement will not be able to enforce its terms directly. This means that exculpation and indemnification of a limited partner’s representatives on the advisory committee will need to be set out in a separate document. The available options include indemnity agreements (either bilateral agreements with each indemnified person, or one agreement with a governing law permitting third party beneficiaries) and deeds poll (one-way instruments that can be used to give undertakings to a class of persons).

England

With respect to funds established as English limited partnerships, the general partner of a fund is liable for all debts and obligations of the fund, whereas the liability of investors is limited to the amount of their contributed capital. However, Section 6(1) of the Limited Partnerships Act 1907 provides that a limited partner shall not take part in the management of the partnership business, and shall not have power to bind the fund – otherwise, such limited

partner shall be liable for all debts and obligations of the fund incurred while he so takes part in the management as though he were a general partner. The act expressly permits a limited partner (either by himself or his agent) to, at any time, inspect the books of the fund and examine into the state and prospects of the partnership business, and may advise with the partners thereon; however, it does not otherwise stipulate what constitutes “taking part in the management of the partnership business” (i.e. unlike under Delaware law, there is no list of “safe harbour” activities sanctioned by the act). Therefore, the function and responsibilities of advisory committees in the context of English limited partnerships must be carefully structured to ensure that limited partners maintain their limited liability. Typically, where an advisory committee is vested with the role of reviewing conflicts of interest between the fund and the sponsor (or other types of conflicts referred to the committee by the general partner), approving the continuation or termination of a suspension period (e.g. after a key person event), and/or generally reviewing the investment strategy and/or performance of the fund, then in each of those circumstances the advisory committee would not be considered to be taking part in the management of the partnership business. However, if the advisory committee is vested with more active management roles (e.g. the general partner must seek the advisory committee’s approval on all proposed investments of the fund), then the risk of limited partners losing their limited liability protection is greatly enhanced. It is therefore quite common to see language to the effect of “the general partner is not required to follow any advice or recommendation of the advisory committee and it will exercise the powers granted to it under this agreement at its own discretion” in an English limited partnership agreement. For completeness, the same analysis also applies with respect to Scottish limited partnerships.

Guernsey

Unlike English or Scottish limited partnerships, the Guernsey limited partnerships laws specifically allow limited partners to take on some role that relates to the management of a Guernsey limited partnership without losing their limited liability protection. Section 12(4) of the Limited Partnerships (Guernsey) Law, 1995, expressly provides that a limited partner shall not be deemed to have participated in the conduct or management of the partnership business by reason only of any one or more of the circumstances stipulated therein – for instance, to act as a contractor, agent or employee of the fund or of the general partner, to act as a director, officer or shareholder of a corporate general partner, to investigate, review, approve or is advised as to the accounts or affairs of the fund, or to approve the purchase or sale of fund assets or the incurrence, renewal, repayment or discharge of any debt by the fund. Accordingly, limited partners of a Guernsey limited partnership may serve on the general partner’s investment committee and approve investment recommendations in that capacity.

CONSIDERATIONS

Having summarised the potential liability issues and having seen advisory committees in action, we offer the following thoughts for consideration.

CONTROVERSIAL MATTERS

For a mixture of reasons that straddle the border of fiduciary duties and good corporate citizenship, sponsors should think twice about seeking advisory committee approvals of the types of controversial proposals that cause an advisory committee member to feel conflicted loyalties between an actual fiduciary responsibility to its constituency (e.g., beneficiaries of a pension plan, investors in a fund of funds) and any real or perceived obligation to the other investors in a fund. The Institutional Limited Partners Association's (ILPA) suggested private equity principles advocate that the advisory committees should retain the power to defer consents to the limited partners. Sponsors may wish to show a track record of having presented these proposals to limited partners rather than advisory committees and may want to draft fund agreements with the flexibility to control who makes that decision.

FULLY INFORMED AND COMMITTED

While fund activities and proposals may be complicated, sponsors should be providing full information to the advisory committee to carry out their functions, especially in cases where an advisory committee approval will insulate the sponsor from liability to the limited partners under the fund's documents. As a rule of thumb, sponsors should provide to the advisory committee the same level of details and with the same amount of advance notice they expect to receive from portfolio companies when a matter is brought to the board of directors. The ILPA principles suggest 10 days advance notice. Doing so should help alleviate some of the concerns that advisory committee members have about making decisions. Advisory board members should devote the time necessary to review the materials and ask relevant questions at the meeting.

SELF-INTEREST

The ILPA principles suggest that advisory committee members should be expressly permitted to vote in their own interests. While this aspiration is consistent with the general premise that members of the advisory committee do not owe the same fiduciary duties to the other limited partners as the members of a board of directors owe to the shareholders of a corporation, an express statement to this effect may concern the investors not represented on the advisory committee. This in turn may lead to demands for larger advisory committees or that in all instances where there is not complete alignment of interest between the members of

the advisory committee and the unrepresented limited partners, any vote should be a limited partner vote. Going down this path could undermine the efficiency benefits of the advisory committee.

VALUATION

While many fund agreements provide for the approval by the advisory committee of the valuation of fund assets, in the US in light of FASB ASC 820 (f/k/a FAS 157) the role of the auditor has been significantly expanded. Limited partners should consider whether to concede this role to auditors so long as they have information rights and access to the auditors.

OUTSIDE COUNSEL

In 2002, in response to corporate scandals and a perceived lack of oversight by US public company boards, the US Congress, as part of the Sarbanes-Oxley legislation, mandated that public companies provide their audit committees with the necessary resources to carry out their duties, including access to outside counsel. Recognising the roles and responsibilities that a member of the advisory committee undertakes, and depending on the degree to which important decisions are vested at the advisory committee level, it may be helpful to include in fund documents that the advisory committee has the authority to retain counsel at the expense of the fund. Having independent advice may reduce the likelihood that advisory committee members defer a vote to limited partners. Another alternative to provide comfort to the members of the advisory committee may be liability insurance provided by the fund (in addition to the standard indemnification). ■

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