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CLIENT ALERT

Considerations For Limited Partners When PE Funds Are Under Stress

April 3, 2020

Limited partnerships investing in private equity usually operate harmoniously: general partners (GPs) honor their fiduciary duties to their limited partners (LPs), and LPs can rely on the GPs' expertise in selecting and managing the portfolio and on the information they receive about the fund's investments. The partnership rises and falls together, based on the investments' performance.

But it is an unfortunate fact that from time to time portfolio companies may become distressed, LPs may default on their funding obligations, or entire portfolios that were recently showing positive returns may sink below the value of the invested capital. Those risks are only exacerbated in the current period of economic dislocation and decreased liquidity. In some cases, the interests of GPs and LPs will diverge, and LPs in private equity funds will need more or better information about the fund's investments as they consider strategies to preserve value, which may include changes to the management of the fund.

In this brief outline, we offer a checklist of things that LPs should consider when they find themselves in this situation:

1. Rights

Limited partnership agreements (LPAs) set out the respective rights of GPs and LPs, and are generally protective of general partners (GPs). But LPAs are written against a background of legal fiduciary duties under federal law or the laws of the place of registration (e.g., Delaware or the Cayman Islands). It is often important to retain counsel to understand the bedrock legal rights an LP may have in addition to its contractual rights in the LPA.

2. Information

LPAs often limit the information that an LP receives, when they receive it, and what they can do with it. GPs have also been known to offer more information subject to restrictive non-disclosure agreements (LPs can have the information, but they can't use it against the GP). LPs need to examine that bargain closely, particularly if the GP discloses the identities of other LPs on terms that may prevent their self-organizing and collective action. In addition, courts may grant relief to LPs who are able to show that broader disclosure is owed on the basis of general principles of fiduciary duty.

3. GP Misconduct

The vast majority of GPs conduct themselves legally and in conformance with their LPAs. But there may be unfortunate exceptions. GPs faced with a declining fund (and an evaporating carry) may act imprudently to preserve their own interests. LPs should be wary of GP self-dealing (e.g., investing fund assets in companies in which the GP has an interest); ignoring fund governance (e.g., not seeking approval for self-interested transactions, often from the fund's LP advisory committee); investing outside the scope of permitted investments or beyond the investment period; and co-investing with other funds managed by GP affiliates to preserve their carry in those funds when the current fund is under water.

4. The Price of Speaking Up

LPs need to understand what leverage the GP may have against them under the LPA. For example, if the GP calls capital during a time of stress while negotiating with an LP advisory committee, and an LP defaults on the capital call, draconian remedies may follow under the LPA. LPs may have to seek court relief to enjoin a capital call and preserve the status quo.

5. The Problem of Collective Action

LPs should pay attention to LPA provisions that set forth what percentage of the LPs are required for a successful demand to replace a GP. LPs must consider the possibility that they will have to coordinate with a substantial number of other LPs (representing a high percentage of the total committed or called capital) if they want to remove a GP.

6. LPA Clauses Applicable to Disputes

Is there a forum clause requiring submission to a particular court or will a dispute be submitted to arbitration? Is equitable relief available? Is there an exculpatory provision in favor of the GP? Is the GP entitled to an advancement of legal expenses and therefore is able to use the fund's assets to vigorously defend against LP claims? Does the LPA include a lengthy period of time during which the GP can "cure" the problems? Any LP considering taking an aggressive stand against a GP should consider these issues.

We are available to guide you through the issues that often arise quickly when a PE fund runs into trouble.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.