Ignorance is Not Bliss: Limited Partners, General Partners, and the Importance of Periodic Due Diligence

Few relationships outside of a Victorian romance experience the dynamic power shifts of investors and general partners in private equity funds.

While fundraising, general partners court investors, agreeing to extensive and intrusive due diligence and grant particularly favored investors special rights and privileges via private agreements (side letters) to secure an investment. A special few are offered seats on limited partner advisory committees where, investors hope, they can engage more substantively with the general partner.

Once the subscription agreement is signed and the marriage consummated, however, the power dynamic decisively shifts.

The previously feted investors become limited partners who are seldom seen and never heard and the general partner morphs from ardent suitor to indifferent mate. Even limited partners on the limited partner advisory committee find that such membership generally provides only slightly greater information and consent rights over conflict-of-interest transactions.

Traditionally, limited partners could rely on a general partner's fiduciary duties or at least a meaningful standard of care to protect their interest. As more capital has flocked to private equity however, seeking returns in a zero-interest rate world, even this basic level of protection has diminished. In its inaugural 2020 ILPA Private Market Fund Terms Survey (ilpa.org/wp-content/uploads/2020/06/2020-ILPA-Fund-Terms-Survey-Highlights_External.pdf), ILPA reported that 71% of the surveyed limited partners had seen fiduciary duties "contractually modified or eliminated altogether" over the last 12 months in at least half of the funds in which they invested. This has been accompanied by an erosion in the baseline standard of care, as ILPA reported that 52% of the limited partners reported that more than 75% of the funds in which they had invested over that time had a gross negligence rather than a negligence standard of care.

Once invested, limited partners who become dissatisfied with a general partner have limited avenues of redress: legal action against the general partner is effectively precluded without fiduciary duties or a meaningful standard of care, general partner removal, even if permitted without cause, generally requires a super-majority vote of limited partners and a replacement general partner, and selling a fund investment is difficult due to the limited liquidity of private fund interests and the need to obtain general partner approval for transfers.

Investors in private equity funds agree to this unfavorable balance of power in the hopes of realizing out-sized returns from their private equity investments. To mitigate the risks attendant upon a long-term illiquid investment over which they exercise limited power, Investors typically take full advantage of their pre-investment leverage to conduct extensive due diligence on the general partner, requiring detailed due diligence questionnaires, extensive document production, and in person interviews with key employees, to determine the capability and stability of the general partner. But once the investment is

made, limited partners, recognizing their limited power, often become inert, passively relying on information provided by the general partner to monitor their investment.

The 'set it and forget it' model of private fund investing may be adequate when dealing with well-established, institutional general partners, who have a track record of success and the institutional strength to handle unexpected stress. However, it exposes limited partners to excessive risk when dealing with newly established or emerging general partners who lack the experience and resources to handle adversity.

To mitigate the risk than an emerging general partner will be disrupted by stress, limited partners should engage in a proactive program of periodic due diligence on emerging general partners to identify and counteract stress before disruptions occur. While limited partners may have limited contractual rights to address such matters, emerging general partners are generally solicitous of their institutional limited partners and amenable to the moral suasion that such limited partners can apply to address such issues. Even if moral suasion fails, forewarned limited partners are better positioned to take proactive measures, such as rallying their fellow limited partners to remove the general partner or selling their interests before losses are incurred.

General Partners are Vulnerable to Stress and Disruption

As a general matter, most investors recognize the importance of thorough due diligence before committing capital to a private equity fund. Institutional investors have well-developed diligence programs that generally include detailed due diligence questionnaires, voluminous document reviews, background checks, and onsite meetings with key employees of the general partner covering, among other things, the general partner's governance structure, the qualifications of key employees, key policies and procedures (including compliance policies and procedures), and the general partner's financial condition. The purpose of this extensive due diligence is, among other things, to identify potential conflicts or weaknesses at the general partner, including turnover of key employees, conflicts of interests, histories of bankruptcy or defaults, legal and regulatory issues, and current or planned use of debt to fund ongoing operations and commitments.

Unfortunately, the stresses of running an advisory business can lead to problems developing over time that can adversely affect the general partner and its investment management. In my own experience, even well-established general partners with hundreds of employees and multiple billions of assets under management can be undone by poor managerial responses to internal stresses. Therefore, when dealing with any general partner outside the very largest and well-established institutions (e.g., Blackstone, Carlyle, KKR, TPG, etc.), limited partners must be cognizant that the general partner, no matter how large their portfolio, may be a relatively small organization reliant on a few key operatives and with a limited capital base.

Prior to the Great Recession, I worked at a highly successful general partner founded and managed by former Goldman Sachs partners. The firm had a long and successful track record, two hundred plus employees, multiple funds with over $20 billion in assets under management, and 40,000 square feet of

new office space on 7th Ave and 57th Street in Manhattan that it leased for $4 million a year. The firm was confidently expecting a public offering and entered into a short-term credit facility to clean up its ownership structure, fund the build-out of the office space, and to finance commitments to a newly raised private fund. When financial markets turned, however, the general partner was unable to either execute its IPO or to effect planned sales of existing fund investments to repay the credit facility. As a result, the general partner went into default under its credit facility. The founding partner refused to compromise with the lenders and, during months of fruitless negotiations, the general partner was forced to severely down-size its operations. While the remaining employees managed the existing investments to their best of their ability, low morale and concern for the future resulted in the departure of key employees. Ultimately, exasperated lenders sold out for pennies on the dollar to a disreputable vulture fund, who forced the general partner into bankruptcy and took over management of the funds.

In another case, a co-owner of the general partner engaged in a pattern of misconduct over several years that created a rift with his partner. The two owners engaged in a battle for control of the general partner for a full year in and out of court that resulted in the departure of key executives, loss of confidence by the investment community, and caused a large institutional investor to transfer two significant separate accounts to a different general partner. Frustrated limited partners in a comingled fund attempted to remove the general partner and, although a majority favored removal, they fell short of the required supermajority. The investors in the comingled fund were thus stuck with the weakened and discredited general partner, only a shell of its former self.

The ongoing mechanisms that limited partners rely upon once an investment is made are inadequate to identify the multiple stresses that can lead to general partner failure. For example, periodic information provided by general partners regarding the fund, including quarterly financial updates and annual financial statements, will not disclose stresses in the financial condition of the general partner. Periodic disclosure from the general partner on events that could have a material adverse effect on the general partner or its management of a fund (which may be required under side letters), depends on the general partner agreeing to voluntarily disclose potentially compromising information, and on the general partner determining that such events could have a material adverse effect. Finally, limited partner advisory committees generally have a limited mandate confined to conflict-of-interest matters.

Because none of the existing mechanisms will provide early warning of internal stress at the general partner, limited partners may not become aware of such stresses until the ability of the general partner to fulfill its duties is actually impaired. At such point, moral suasion is unlikely to be effective and the limited partner may be unable to exit its position without a severe haircut, leaving as the only alternative the difficult and time-consuming process of replacing the general partner.

Periodic Due Diligence Can Identify Stress Before Disruptions Occur

To protect themselves from disruption caused by internal stress, limited partners should conduct periodic due diligence of the general partner during the life of their investment. Such due diligence, though not as extensive as the pre-investment diligence, can identify problems before they become critical, and, equally

importantly, serve as an ongoing reminder to general partners of their ongoing obligations to limited partners. In particular, limited partners should require annual updates on:

1. changes in ownership and turnover among key executives and, if such changes or turnover occurs, the limited partner should insist on in-person interviews with key executives (including departing executives) to determine if there are underlying issues or a deterioration in the general partner's effectiveness;
2. the general partner's financial condition, including incurrence of debt, to determine if the general partner is properly capitalized and not using short-term debt to finance operations or capital commitments;
3. litigation or material disputes involving the general partner or key employees, including HR related disputes with employees. It is particularly important to inquire about cases that are settled or not in formal litigation, as a pattern of such matters can be indicative of fundamental issues; and
4. changes in governance procedures, including compensation and roles of key employees, and the reasons therefor.

Limited partners should also request copies of investment memoranda, investment budgets, and other meeting materials (agendas, minutes, books etc.) from key committees to insure that the general partner is operating essential committees (investment, valuation, asset management, etc.) as described in its disclosure documents.

Institutional limited partners should consider joining together in a group to share the costs and results of such periodic due diligence. Syndicating such due diligence both reduces the cost to the limited partners and the burden on the general partner by consolidating separate, repetitive due diligence into a single, comprehensive diligence exercise. Limited Partners should require the general partner to cooperate with such diligence in either the fund limited partnership agreement or their side letters.

Forewarned is Forearmed

Emerging general partners generally understand that their relationship with institutional limited partners is the cornerstone of their business. General partners want to grow their assets under management to realize economies of scale and increase profitability, and marketing to existing limited partners, who have already conducted due diligence and become comfortable with the general partner, is much more economical and efficient then marketing to new investors. Accordingly, limited partners have tremendous power to affect the general partner by suggesting that future investments may not occur if problems are not addressed. Further, because most institutional limited partners use a relatively small number of consultants to advise them on their investments, a general partner that alienates one institutional limited partner may find himself unable to raise money from other institutional limited partners that share the same consultant. All of these factors give limited partners leverage to effect change at a general partner under stress. In the event such moral suasion fails, limited partners, equipped with specific information,

can proactively rally other limited partners to remove the general partner before disruption occurs. Alternatively, limited partners can seek to exit their position before losses are incurred.

Conclusion

Limited partners accept a great deal of risk when investing in long-term, illiquid private funds to realize outsized returns. Such risks are magnified when investing with emerging general partners who are more vulnerable to stresses than established managers. To mitigate such risks, limited partners need to conduct periodic due diligence on emerging managers to insure that no adverse changes are occurring and be ready to use moral suasion to address any issues they discover. The effectiveness of such periodic due diligence is magnified to the extent multiple limited partners participate and share results.

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Eric Rubenfeld is a partner with Fragner, Seifert Pace & Mintz, LLP (f/k/a Fragner Seifert Pace & Winograd, LLP), a boutique law firm serving the legal needs of emerging and institutional business clients. Eric specializes in advising alternative investment advisers on all aspects of their business, including operational and transactional matters (including joint-ventures, financings, asset acquisitions and dispositions, fund formation and fund raising), dispute resolution, and regulatory compliance. Eric draws on his experience as a former principal, general counsel and CCO at multiple alternative investment firms and at top international law firms to deliver business savvy and cost-effective legal service to his clients.

Before returning to private law practice with FSPM in 2017, Eric spent over a decade as the general counsel and chief compliance officer of multiple multibillion-dollar institutional investment advisers specializing in private and public equity investments in real estate and corporate debt and equity. In addition to handling legal and compliance matters, Eric also managed HR and risk management and served on the management, investment, valuation, and risk and conflict committees.

Eric began his legal career practicing corporate law and litigation in New York City and Washington, D.C., including stints at Fried, Frank, Harris, Shriver & Jacobson and Arnold & Porter. Eric advised leading financial institutions, including Goldman Sachs, Morgan Stanley, Merrill Lynch and J.P. Morgan, in connection with their securities and structured product offerings, and represented private and public companies in litigation in both federal and state courts.

Eric earned his J.D., cum laude, from the Harvard Law School in 1995 and his B.A., magna cum laude and with college and departmental honors, from UCLA in 1991.

Eric recently:

- Represented a co-general partner in the formation of a new real estate private equity fund adviser and the formation of its first co-mingled fund
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- Represented a private equity fund in $200 million of secured, property financings
- Represented a private equity fund in a $75 million shopping center construction loan
- Represented a private equity fund in $50 million subscription credit facility
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