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LP boards: A liability shield

Don't discount the role of the limited partner advisory committee in managing conflict of interest risks, advise Edward Nelson (pic) and Timothy Abbott of Gibson Dunn.

Two recent developments have shined a spotlight on the importance of managing risk associated with conflicts of interest. First, guidelines issued by the Institutional Limited Partners Association (ILPA) have focused investors' attention on this topic and have resulted in many general partners agreeing to new procedures governing their ability to enter into potentially conflicted transactions. Second, thanks to the Dodd-Frank Wall Street Reform and Consumer Protection Act, previously unregistered managers are now subject to the increased SEC scrutiny that comes with registration as an investment advisor.

Indeed in early May the head of the SEC's Office of Compliance Inspections and Examinations, Carlo V. di Florio, put the private equity community on notice that conflicts of interest are a high priority for his office, stating that "[t]he best way to avoid attracting our attention would be to be very proactive and thoughtful about identifying conflicts and remediating [them] with strong policies, procedures and other risk controls…".

The limited partner advisory committee (LPAC) is an essential tool in responding to this increased scrutiny. LPACs are generally intended to provide advice to the general partner and to represent the interests of the limited partners, so a general partner can help to shield itself from liability arising from conflicts of interest by seeking out LPAC approval of conflicts of interest. After all, if LPACs represent the interests of the limited partners, then LPAC approval of a given transaction involving a conflict of interest should make it harder for limited partners to object later, in court or otherwise, to an alleged conflicted transaction.

In order for LPAC approval to have this effect of risk mitigation, a general partner should implement several precautionary measures. First, prior to entering into a transaction, such general partner should fully disclose to the LPAC any conflicts of interest, including affiliate transactions. Second, the general partner should maintain careful records of these disclosures, and the LPAC should be required to maintain detailed minutes of its meetings. Third, there is case law suggesting that Delaware courts would generally give deference to contractual limitations on a general partner's liability vis-à-vis the limited partners. Accordingly, the fund's partnership agreement should state clearly that the general partner, the investment manager and their affiliates shall have no liability to the fund or the limited partners in connection with conflicted transactions duly approved by the LPAC.

The above measures, however, may not be a perfect defense against all liability arising from a conflicted transaction, particularly if the interests of the general partner and the individual members of the LPAC are too closely intertwined. For example, if LPAC members have independent interests in fund transactions (aside from their interests in the fund), then those members themselves may be conflicted. In such circumstances, even carefully drafted language in the partnership agreement might not protect the general partner from liability.

Also, an LPAC stacked with the general partner's allies could undermine the very protection offered by LPAC approval of conflicted and affiliate transactions. To mitigate this risk, the partnership agreement should explicitly prohibit an affiliate of the general partner or investment manager from being a voting member of the LPAC. Even with such a prohibition, the general partner should exercise caution in appointing LPAC members too closely allied with the general partner or the investment manager. Although it is perhaps counterintuitive, maintaining an informed and independent LPAC is one of the best strategies for insulating the general partner from liability arising from conflicts of interest.

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