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Limited Partner Advisory Committees: Mitigating Manager Conflicts

By Peter Mixon


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Limited partner investors in private fund partnerships have limited liability because they do not participate in the management of the fund's operations. The general partner is responsible for overseeing the management and investment of fund assets. This separation of ownership from management creates inherent conflicts of interest for fund managers – they have economic incentives to favor their own financial interests over the interests of the fund investors. To mitigate some of these "agency" risks, limited partnerships often include provisions for the creation of a committee consisting of fund limited partners --the limited partner advisory committee (LP Advisory Committee).

While not mandatory, LP Advisory Committees can perform important functions in the governance of the fund. And if properly organized and managed, these committees can provide advantages to limited partners by mitigating agency risks in the management of their investments in the fund.

Advisory Committee Purposes

LP Advisory Committees are created and defined by the partnership documents. Typically, the committee performs several important roles, including: 1) evaluation of "conflicted" fund transactions, and 2) approval of valuation methods. Conflicts of interest arise when the general partner owes dual loyalties between funds or between investors, when the general partner has a personal financial stake in a fund investment, and when the general partner obtains services for the fund from an entity affiliated with the general partner. Similarly, the general partner has a strong financial incentive in the valuation of fund assets because manager compensation (fees and carry) is almost always tied to these valuations. If properly structured, the LP Advisory Committee will have the power to review these "conflicted" transactions as well as the asset valuation methodology and approve or disapprove them in the best interests of the fund and its investors. Having this right brings more transparency to the management of the fund and helps mitigate the risk that investors will be disadvantaged in "conflicted" transactions and asset valuations.

Well Drafted Provisions

There are several issues that should be addressed in the fund documents. First, voting membership on the committee should be restricted to limited partners not affiliated with the general partner to avoid biased votes. Second, the scope of the committee's authority should be well defined. Unless the general partner has a clear obligation to bring an issue to the committee, the issue likely will not surface and the LPAC will remain in the dark.

In addition, the potential liability of committee members should be very limited. The partnership agreement should provide that committee members are not considered fiduciaries to other limited partners and should allow committee members to represent the interests of their pension plan investor while serving on the committee. The members should also be entitled to a legal defense and indemnity from the fund for all but the most egregious actions (such as fraud or bad faith) as well as insurance coverage provided by the fund.

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Finally, the general partner should be required to provide full information to the committee to carry out its responsibilities. This should include details about any proposed transaction as well as sufficient notice to allow informed decision-making. For more complex transactions, many committees have the ability to hire outside counsel at fund expense to provide independent advice. And of course committee members should be allowed to conduct "in camera" sessions outside the presence of the general partner and its affiliates.

Conclusion

An effective LP Advisory Committee can mitigate many of the risks of manager conflicts of interest. Limited partners who serve on these committees must be willing to commit the time and resources necessary to function as an independent decision-making body. This includes attending all committee meetings, being properly prepared, and fulfilling the responsibilities of committee membership. Committees that are not properly structured or resourced will be ineffective or will be perceived as "rubber stamps" for manager decisions. ◆