Limited Partner Defaults And Other Unpleasant Aspects of the Post-Bubble Environment

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Introduction

- Recent months have seen several changes in the private equity industry, including:
  - Rising numbers of limited partners (LPs) in actual or threatened default of capital calls
  - Growing concerns that LPs faced with potential defaults may seek alternate ways to exit a fund (*e.g.* by seeking rescission)
  - Increasing numbers of Fund Managers (FMs) being removed from general partner entities (GPs)

Analysis of Proposed LP Default

- When an LP threatens to default, where should the GP look?
  - Limited partnership agreement (LPA)
  - Side letters and other agreements
  - State law re: enforceability of LPA, side letters and other agreements
  - Other defenses that the LP may raise (*e.g.* GP's breach of fiduciary duty and/or rescission rights)

LPA and Side Letters: Excuse Provisions

- When might an LP be excused from a capital call?
  - Illegality
    - ERISA
    - Bank Holding Company Act
    - FCC cross-ownership rules
    - Other
  - LP approval rights (*e.g.* investments are subject to LP approval)
  - Contractual triggers
    - Fund capital "impaired"
    - "Key-man" provisions
    - Other

LPA and Side Letters: Penalty Provisions

- Common penalty provisions
  - Reduce the defaulting LP's percentage interest in future profits, but not future losses
  - Reduce the defaulting LP's capital account balance
  - Sue the defaulting LP for specific performance and consequential damages
  - Require withdrawal of the defaulting LP from the fund
  - Cancel any or all of the defaulting LP's unpaid capital commitment

Penalty Provisions *(cont.)*

- Designate one or more non-defaulting LPs to assume and succeed to the rights of the defaulting LP's interest attributable to the defaulting LP's unpaid capital commitment
- Charge interest on the due and uncontributed portion of the defaulting LP's capital commitment
- Forced sale of the defaulting LP's interest to other partners in exchange for non-recourse notes secured by distributions in respect of the interest being sold

Problems with Penalty Provisions

- Regardless of how harsh the penalty provisions are, they may have a limited deterrent effect
  - An LP that is willing to abandon its interest in the fund will be unmoved by penalties that reduce or eliminate the value of such interest
  - Specific performance may not be feasible if default results from an LP's sudden decrease in net worth
  - Consequential damages may be difficult to prove

Problems with Penalty Provisions (*cont.*)

- Many LPs who began investing in recent years have no close ties to the private equity community
  - Such LPs may not care that default could damage their reputations within the community

Enforceability

- Delaware Law:
  - "A partnership agreement may provide that...a limited partner...shall be subject to specified penalties or specified consequences"
  - "The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter"
  - Any implicit expectation of fiduciary duties can be overruled by LPA terms

Enforceability (*cont.*)

- Potential Issues under Delaware Law:
  - Delaware law seems to authorize unconscionable terms in an LPA
  - If the statute is broad enough to allow unconscionable terms, is it so broad that it requires an implicit standard of fairness or reasonableness?

Enforceability (*cont.*)

- To help avoid the imposition of such an implied standard, terms of the LPA should be drafted so explicitly that an LP cannot argue that the terms were too harsh to be intended
  - Add a provision to LPA explicitly stating that the parties intend each penalty to be enforceable in accordance with its terms
- Defaulting LP may argue that the penalty provisions are unconscionable and therefore violate fiduciary duty
  - Such duties must be explicitly overruled by LPA

Enforceability (*cont.*)

- California Law:
  - New California law, applicable to all California partnerships as of 1/1/99, has no specific statutory authorization for penalty provisions, although the partnership "may maintain an action against a partner for a breach of the partnership agreement"
  - In the absence of statutory provisions, "the principles of law and equity" govern

Enforceability (*cont.*)

- Prior California law explicitly stated that penalty provisions were enforceable
  - For funds organized prior to enactment of the new law, this change is potentially destabilizing
  - However, many of these funds already have drawn down the bulk of their capital, so enforceability of penalty provisions may be of lesser concern

California Restrictions on LPA Terms

- Fiduciary Duties
  - Duty of good faith and fair dealing cannot be eliminated, but parties can prescribe standards by which performance of this duty is measured
  - Therefore, any default provisions must be consistent with GP's fiduciary duty to the defaulting LP

Common Law and California Law

- "Principles of law and equity" under current California law:
  - Penalty or liquidated damages?
    - Penalty provisions generally are not enforceable under the common law of contracts
    - Liquidated damages provisions generally are enforceable if the provisions were reasonable under the circumstances existing at the time the LPA was drafted

Calculation of Damages

- How do you calculate damages?
  - Inability of the fund to pursue business opportunities or satisfy obligations as a result of decreased capital
  - Cost of dealing with defaulting LP

Calculation of Damages *(cont.)*

- Potential LP Defenses to Damages Claim
  - Depending on LPA terms, a defaulting LP's defenses could include:
    - Fund had duty to mitigate capital shortfall by borrowing to bridge capital call, but failed to do so
      - However, many funds have limited borrowing ability
    - GP is permitted to form future fund before 100% of current fund is invested and, therefore, defaulting LP's capital is not necessary to current fund

GP Consent to LP Withdrawal

- Sometimes, letting an LP withdraw is the easiest response to a default
- If an LPA allows LP withdrawal in the GP's discretion, what factors can the GP consider in exercising that discretion?

GP Consent to LP Withdrawal (*cont.*)

- Generally, GP is not permitted to consider:
  - Effect on the ***GP's*** business interests
    - Ability of the GP to raise the next fund
    - Impact on the GP's personal relationships with the defaulting LP, entrepreneurs, etc.
  - Any proposed benefit for the GP rather than the fund

GP Consent to LP Withdrawal (*cont.*)

- Permissible considerations include:
  - Effect on fund's business interests
    - Loss of capital may:
      - Impair the fund's ability to make investments and cover expenses
      - Damage the fund's reputation in the private equity community
      - Reduce the fund's access to deal flow
  - Costs of litigation to force LP to meet capital call
  - Likelihood that action to enforce capital call will succeed

GP Consent to LP Withdrawal (*cont.*)

- Permissible considerations *(cont.)*:
  - Defaulting LP's ability to damage the fund if withdrawal is not permitted
  - Possibility of creating a race for the exit
    - Consent to withdrawal may encourage other LPs to consider withdrawal from the fund
    - GP may be setting precedent each time it allows a withdrawal

General Approach to Withdrawal Request

- Usually, a GP should refuse withdrawal requests because consenting potentially:
  - Exposes the GP to liability for breach of fiduciary duty to the other LPs
  - Starts a race for the exit
  - Impairs the capital or operational capacity of the fund
- Instead, GP should encourage LP to transfer/sell its interest

Suggested Consent Procedure

- If the GP decides to consent, it often will be appropriate to seek Advisory Committee (AC) approval prior to giving such consent
  - Terms in the LPA, side letters or other agreements will determine to what extent getting AC approval protects the GP from subsequent breach of fiduciary duty claims
    - Under the most GP-favorable provisions, LPs could be estopped from claiming breach of fiduciary duty ***if the GP gives full disclosure of all material facts and circumstances when seeking approval***

Suggested Consent Procedure *(cont.)*

- If AC procedures are inadequate (or no AC exists), consider seeking approval from majority-in-interest of LPs

Rescission Rights

- An LP that is in default or considering a default may attempt to withdraw from a fund without GP consent
- There are a number of circumstances that may provide LPs the right to withdraw from a fund (*e.g.* rescission rights)
- Many of these circumstances may provide the LPs other rights and remedies in addition to rescission rights

Potential Basis for Rescission

- Violation of private placement rules (*e.g.* activities that constitute a "general solicitation")
- Examples:
  - Mike Smith, an FM of New Ideas I, is seeking capital commitments for New Ideas II. He sends copies of the PPM to all of his former business school classmates
  - Writers for Fortune, San Jose Mercury News, and The Wall Street Journal interview Mike Smith about raising venture capital funds. Mike agrees to be interviewed in order to raise market interest and awareness of New Ideas II. When readers of the resulting articles call, Mike sends them a copy of the PPM

Potential Basis for Rescission *(cont.)*

- Failure to comply with strict formalities in admitting LPs
- Example:
  - The subscription agreement for New Ideas II includes a power of attorney provision that grants the GP the power to sign the LPA on behalf of the LPs so long as the LPA has not materially changed. Mike Smith decides that the open window for admitting additional LPs needs to be longer, so he extends it from 6 months to 12 months and immediately executes the LPA on behalf of the LPs

Potential Basis for Rescission *(cont.)*

- Inaccurate or misleading statements in offering materials
- Examples:
  - John Jones, one of the FMs of New Ideas I, made most of the investment decisions for the fund. John retires prior to the formation of New Ideas II. In the PPM for New Ideas II, Mike Smith proclaims that the same investment expertise will be used in New Ideas II that was used in New Ideas I
  - On March 1, 2000, New Ideas I had an IRR of 120%. On May 1, 2001, New Ideas I had an IRR of 30%. In the PPM for New Ideas II, Mike Smith includes a chart that shows the 120% IRR for New Ideas I in a manner which suggests that it reflects current data

Conclusion: LP Defaults

- To enhance fund position with respect to LP defaults, confirm that:
  - Provisions re: defaulting LPs in LPA, side letters, and other agreements are drafted clearly and explicitly
  - LPA, side letters and other agreements comply with state law re: enforceability of such agreements
  - GP complies with fiduciary duties, as modified by LPA, side letters or other agreements
  - GP avoids marketing and other mistakes that can give rise to rescission rights

Fund Manager Removal

- When FMs seek to remove another FM from GP, where should they look?
  - Operating agreement of GP (OA)
  - State law re: enforceability of OA
  - Other defenses that the removed FM may raise (*e.g.* breach of fiduciary duty by the other FMs and/or employment law claims)

Removal Provisions

- What impairs the enforceability of a removal provision?
  - Biggest impediment to enforceability that we have seen is a lack of clarity in the OA itself
    - Many OAs drafted during a "friendlier" era do not reflect careful focus on FM removal (FMs, like parties to a prenuptial agreement, may have avoided discussing such matters)
    - An expelled FM may be able to litigate based on ambiguity of a removal provision
    - To avoid ambiguity, make sure removal provisions are explicit and clearly drafted
    - Removal provisions often can be amended and enhanced without LP consent

Enforceability

- Delaware Law (same as for funds):
  - "A limited liability company agreement may provide that...a member... shall be subject to specified penalties or specified consequences"
  - "The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter"
  - Any implicit expectation of fiduciary duties can be overruled by OA terms

Enforceability (*cont.*)

- Delaware Law *(cont.)*:
  - Careful drafting should be employed to help avoid the imposition of an implied standard of fairness or reasonableness
    - Add a provision to the OA explicitly stating that the parties intend the removal provisions to be enforceable in accordance with their terms

Enforceability (*cont.*)

- Delaware Law *(cont.)*:
  - Unlike a defaulting LP seeking to challenge enforceability of penalty provisions, an expelled FM may argue that he/she has done nothing wrong and is merely a victim of predatory behavior by other FMs
    - If the removal provisions are not consistent with fiduciary duties, such duties must be explicitly overruled by OA
  - Avoid removal provisions that appear unconscionable
    - Example: Junior FM can work hard for years and then be expelled with no net compensation

Enforceability (*cont.*)

- California Law:
  - "The operating agreement may provide for the termination...of a member's interest"
  - "Any [such] provision...shall be enforceable in accordance with its terms unless the member seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the agreement was made"
  - OA may not "eliminate the right of a member...to assert that a provision...governing the termination of that member's interest...was unreasonable under the circumstances existing at the time the agreement was made"

Enforceability (*cont.*)

- California Law *(cont.)*:
  - Fiduciary Duties
    - "The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership"
      - Good faith and fair dealing (cannot be eliminated)
      - Duty of loyalty (cannot be eliminated)
    - Therefore, any removal provisions must be consistent with FMs' fiduciary duties to expelled FM

Possible Employment Law Issues

- An FM may claim he/she is an employee if he/she has little or no control over:
  - His/her compensation
  - Management of the GP
  - Terms and conditions of admission to the GP
  - Terms and conditions of withdrawal from the GP
- To help rebut this argument, OA should contain explicit acknowledgment by each FM that he/she is a member, not an employee

Possible Employment Law Issues (*cont.*)

- If an FM successfully claims employee status, his/her removal can raise such federal and state employment law issues as:
  - Claims that removal was based on impermissible reason (*e.g.* race, sex, disability, national origin, veteran status)
  - Claims that, as an employee, he/she is entitled to overtime wages
  - A successful lawsuit on these grounds could subject the GP to potential damages for back pay, attorney fees, and punitive damages

Conclusion: FM Removal

- To enhance GP position with respect to FM removals, confirm that:
  - Provisions re: FM removal in the OA are drafted clearly and explicitly
  - OA complies with state law re: enforceability
  - FMs comply with fiduciary duties, as modified by OA
  - FMs have all acknowledged their status as members, rather than employees, of the GP

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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