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LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation

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Limited partner (LP) advisory committees (LPACs) have become fixtures of PE funds, with 95 percent of funds having one. While general partners (GPs) have learned to live with LPACs, their attitudes toward LPAC design is often still reactionary. The actual size and composition of the LPAC, along with the precise scope of its authority, frequently evolve during the fundraising process as LP requests are received.

This article argues that GPs must take a more proactive approach to designing their LPACs and provides six practical recommendations for GPs to define the scope of an LPAC in fund documents before negotiating with LPs. Several of the recommendations directly respond to positions endorsed by the Institutional Limited Partners Association (ILPA).

See our two-part series on the evolution of LPACs: "Trends Toward Robust Procedures and Accountability for LPAC Members" (Oct. 8, 2019); and "Grappling With GP and LPAC-Member Conflicts of Interest While Avoiding Liability" (Oct. 15, 2019).

Role of the LPAC

The role of the LPAC has evolved from that of a sounding board for the GP to acting as a governance body with broader responsibilities and distinct meeting protocols. The baseline has continually moved in favor of LPs through ILPA initiatives such as the ILPA Principles 3.0 and the ILPA model limited partnership agreement (Model LPA), both of which were released in 2019 and attempt to institutionalize LPACs and expand their rights and tools.

The increasing role of LPACs has already forced GPs to pay closer attention to LPAC design. The ILPA Principles 3.0, and particularly the Model LPA, impose more than a gradual shift, though. The Model LPA includes provisions that go significantly beyond current market practice and in some instances are outright deficient or incomplete, regardless of the perspective taken.

While it is very unlikely that any fund will ever adopt the Model LPA wholesale as its final fund limited partnership agreement (Fund LPA), LPs will use it as a buffet for comments. Anticipating that LPs will take their pick from the Model LPA in their review of the Fund LPA, GPs need to counterbalance deficient or incomplete provisions ahead of any negotiations.

See our three-part series on the Model LPA: "Seeks to Empower LPACs and Increase GP Accountability for Fiduciary Duties" (Dec. 10,

2019); "Attempts to Redistribute Economic Risk From LPs to GPs" (Dec. 17, 2019); and "Faces Sizable GP Skepticism En Route to Becoming a Fixture in PE Fund LPA Negotiations" (Jan. 7, 2020).

Unalterable LPAC Features

Before proceeding, it is important to acknowledge two ground rules that are unlikely to change soon in the standard PE construct around LPACs. One is that the LPAC does not participate in the management of the Fund; its functions are limited to advice and approval, partly because LPs are concerned about exposure to GP liabilities.

The other is that LPAC members do not have fiduciary duties to the LPs. The Fund LPA typically reiterates this limitation and adds that each LPAC member is entitled to consider only the interests of the LP that the member represents. In short, the LPAC is not the equivalent of a board of directors.

For more on fiduciary duties, see "Navigating the Interpretation Regarding an Investment Adviser's Standard of Conduct: What It Means to Be a Fiduciary (Part One of Three)" (Dec. 3, 2019).

Recommendations for GPs

A PE fund's private placement memorandum (PPM) often includes a generic statement like the following:

> The [GP] will establish an advisory committee consisting of at least five representatives of [LPs]. The advisory committee will resolve certain conflicts of interest and advise the [GP] on any other matters presented to it by the [GP].

This broad statement offers LPs a blank canvas to impose their desires about how an LPAC should function. In contrast, this article advises GPs to be proactive and specify the LPAC's scope and duties at the fund formation stage.

To be clear, this article is not advocating a negotiating strategy that pits a GP against its LPs. Robust and transparent ground rules cope with the collective action problem inherent in fund formation and benefit both GPs and LPs. Some of the recommendations made below may not be novel, but their importance has increased in the new landscape.

With this background in mind, the PPM and draft Fund LPA posted by GPs should address the following points.

1) Size of LPAC

The ILPA Principles 3.0 recommend that the LPAC "be limited to a workable number." The Model LPA goes a step further and provides for "at least [three (3)] and a maximum of [seven (7)] members" - the brackets are in the original and indicate that the numbers are variables.

See "ILPA Issues 'Principles 3.0': Fund Governance and Disclosures (Part Two of Two)" (Aug. 6, 2019).

Funds of the 2018/19 vintage with a size of $1 billion or more have an average of nine LPAC members. A large proportion of smaller funds have five or six members. In any event, the final size of the LPAC is rarely the result of design, as 47 percent of funds with an LPAC did not place a limit on it in their Fund LPAs. When a limit is specified, it can go as high as 25 members.

GPs should specify the minimum and maximum number of LPAC members at the outset to avoid negotiations over LPAC size. A range instead of one number ensures flexibility to form an LPAC that represents a substantial percentage of total commitments, but having too wide of a range will defeat the purpose of setting clear expectations.

Smaller LPACs facilitate fund management, while larger funds tend to have larger LPACs. With that said, there is no inherent correlation between fund size and LPAC size. Large-cap public companies do not necessarily have more directors than smaller companies. Efficient decision making is more important.

2) Selection of LPAC Members

Game theory defines a collective action problem as a situation in which all participants would be better off cooperating but fail to do so because conflicting interests or a lack of communication impede joint action. Fund formation often seems like applied game theory. Consider the following typical LP comment:

> Please revise the Fund LPA to provide that the minimum number of LPAC members will be five and the maximum will be ten. We request a provision in our side letter confirming our right to appoint a representative to the LPAC.

What should a GP do if it receives 25 requests of this kind? The answer: lay out rules for the selection of the LPAC in the PPM and refuse to bend them in response to individual investor requests.

Below is an example of a transparent rule that is based on commitment size, rewards first closing investors and leaves room for one smaller investor:

- one representative for each investor in the initial closing with a commitment of at least $X million;
- one representative for each investor in a subsequent closing with a commitment of at least $X+ million; and
- one representative of an investor with a commitment of less than $X million, selected by the GP after the final closing.

See "Current Scope of PE-Specific Side Letter Provisions: Co-Investment Rights, LP Advisory Committee Seats and Parallel Funds/AIVs (Part Two of Three)" (Mar. 26, 2019).

3) Abstentions and Removal of LPAC Members

The ILPA Principles 3.0 contemplate LPAC decisions to be made at meetings and recommend a quorum of 50 percent of LPAC members to conduct a vote. The ILPA Principles 3.0 do not specify whether voting majorities should be based on the total number of LPAC members or those attending the meeting, and they further recommend:

> Any LP that seeks and accepts an LPAC seat should be expected to participate and vote. . . . The [Fund LPA] should clearly state expectations for LPAC participation including penalties for failure to uphold such expectations, *e.g.*, revocation of an LPAC member's seat for repeated failure to attend meetings or vote on matters presented.

Interestingly, however, none of those recommendations made it into ILPA's own Model LPA. There is no removal provision or

other penalty for failure to attend meetings or participate in actions. The Model LPA provides that all actions taken by the LPAC must be by written consent and, unless a higher threshold has been specified, be approved by a majority of all LPAC members, which exacerbates the abstention issue.

Many GPs and LPs are familiar with the challenges that arise when an LP insists on an LPAC seat but its LPAC representative refuses to attend meetings or participate in decisions. To remedy this issue, here are several specific recommendations for the Fund LPA:

- Contrary to the Model LPA, the LPAC should have the ability to make decisions at meetings at which a quorum is present.
- LPAC decisions should require a majority of the LPAC members present at the meeting, not a majority of all LPAC members. Sponsors should consider going a step further and determining the majority on the basis of voting LPAC members, thus ignoring members who are present but abstain.
- The Fund LPA should permit the removal of LPAC members who do not fulfill their duties.

Grounds for removal of LPAC members could include the failure to attend a certain number (*e.g.*, two or three) of consecutive meetings or participate in an equal number of consecutive votes. The provision can be drafted to include various options as to who can remove noncompliant LPAC members:

1. a majority or supermajority of LPs;
2. a majority of other LPAC members;
3. the GP with the consent of a majority of other LPAC members;
4. the GP unless a majority of other LPAC members object; or
5. the GP alone if a higher threshold of absenteeism or abstention is reached.

The removal of a particular LPAC member typically would not terminate the right of the LP to appoint a different representative, although that could be considered in egregious cases.

4) Scope of Authority

Two lines need to be drawn when setting the parameters for the relationship between a GP and an LPAC:

- actions by the GP that must be approved by the LPAC; and
- actions by the GP that cannot be approved by the LPAC and must be approved by the LPs instead.

Why should a GP draw these lines in the draft Fund LPA, rather than leaving it to negotiations with investors? Institutional investors are no longer likely to accept legacy language that the GP "may consult" with the LPAC on conflicts of interest. They expect approval rights – which manifest as veto rights – that are binding on the GP.

Proposing approval rights over precisely defined conflicts of interest, with appropriate exceptions and thresholds, is not only a response to market reality, but it also permits the GP to forestall requests for broader provisions inspired by ILPA. The Model LPA language on this topic would require LPAC approval of all conflicts of interest, without any de minimis exception and regardless of prior disclosure in the PPM.

GPs also benefit from including in the LPAC's authority the approval of matters that may otherwise require an amendment to, or waiver under, the Fund LPA (*e.g.*, exceptions to investment limitations or extensions of various time periods). Once the GP has established a working relationship with the LPAC, it is usually easier – from both an administrative and substantive perspective – to obtain consent to a proposal from the LPAC than from the fund's individual LPs.

See "Proper Use of Advisory Committees by Private Fund Managers May Mitigate Conflicts of Interest" (Dec. 17, 2015).

5) LP Consents

On the other hand, however, GPs should always retain the ability to seek the consent of the requisite majority of LPs, instead of the LPAC, to a proposal that requires LPAC approval. This should be expressed as an overriding right, not as an option between LPAC and LPs in the context of specific approval rights.

Below is a sample Fund LPA provision:

> Any matter required to be presented to the [LPAC] for approval may, in the discretion of the [GP], be presented to the [LPs] for their approval, which if given shall have the same effect as if given by the [LPAC].

This is an important provision, and it is not included in the Model LPA. There should be no legitimate arguments against reserving for the LPs the ultimate approval over any matter that falls within the LPAC's authority.

6) Engagement of Experts

Both the ILPA Principles 3.0 and the Model LPA recommend that the LPAC have the right to engage external counsel or other experts at the fund's expense. The Model LPA provision is clear-cut:

> The [LPAC] shall be entitled to appoint professional advisors, and the [GP] shall cause the reasonable fees and expenses of any such advisors to be paid by the Fund. . . .

While that provision seems appropriate at first sight, it is actually too clear-cut. The ability of the LPAC to engage experts at the fund's expense should be limited to matters presented to the LPAC for its approval or related to the exculpation and indemnification of LPAC members.

This limitation does not simply advance the GP's interests. It is one of accountability to all LPs, who should not be forced to bear the costs of an advisory body that does not have fiduciary duties to them and acts outside its prescribed authority.

For more on expense allocations in another context, see "Inadequate Disclosure of Expense Allocations May Carry Unintended Consequences" (May 14, 2015); and "Battle-Tested Best Practices for Private Fund Expense Allocations" (Oct. 10, 2014).

Offense Versus Defense

The negotiations accompanying fund formations are not productive if the GP, on one hand, and the LPs, on the other hand, view them as an exercise in winning points. Interests among LPs diverge as well, sometimes simply

because of the inherent collective action problem, and as a group, the LPs benefit if the GP takes the initiative in designing the LPAC in a manner that addresses those dynamics.

Experience has shown that GPs can be more successful if they convince individual LPs that they also need to think defensively in addition to offensively. An LP may find itself on the receiving end of every issue it may push for. If, for example, an LP asks for the experts' provision from the Model LPA, the GP could respond, "I will not agree to this." Or, alternatively, a GP could respond, "View this from the perspective of LPs who are not on the LPAC. They will not consider it fair that they must bear expenses incurred by the LPAC outside its authority, or they will all ask to be on the LPAC."

In any event, a GP will be well served by actively considering and addressing the aforementioned issues related to LPACs at the fund formation stage. By framing the conversation around the LPAC and setting the ground rules for parameters to be considered, the result is likely to be more efficient and beneficial to GPs during the fundraising process.

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