Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

LP Advisory Committees

The vast majority of private investment funds have limited partner advisory committees (a.k.a. advisory boards, conflict committees, valuation committees, etc.) (LP Advisory Committees). LP Advisory Committees are composed of representatives of limited partners, usually significant institutional limited partners, that are appointed by the general partner and almost invariably serve without compensation. While occasionally viewed by general partners as a potential burden, LP Advisory Committees can be a very useful tool for general partners, allowing them to have conflicts or investment restrictions waived by a subset of limited partners who are informed and responsive and by providing a useful sounding board for other matters. These LP Advisory Committees should be distinguished from the occasional fund manager's industry advisory board composed of persons who are experts in the fund's investment focus and who provide advice and market insight to the general partner, often in exchange for a share of carry or an opportunity to invest in the fund on favorable terms.

Role of LP Advisory Committees

The role of LP Advisory Committees varies from fund to fund but they are primarily related to three broad categories: (i) conflicts of interest, (ii) waivers of restrictions in the partnership agreement, and (iii) general oversight.

Conflict of Interest Transactions

The traditional role of an LP Advisory Committee is to act as a decisionmaking body with respect to conflicts that may arise between the interests of the limited partners and the interests of the general partner in the course of the life of the fund. In order to resolve these conflicts, the LP Advisory Committee is typically given the right to approve or disapprove conflict-of-interest transactions and, if approval is received, the terms of the partnership agreement typically provide that the general partner will be insulated from conflict claims by other limited partners with respect to an approved transaction. These transactions may encompass any of the following:

- Investments in portfolio companies of affiliated funds
- Purchases of securities from or sales to affiliates of the general partner
- Affiliates lending to the fund
- Service contracts with affiliates of the general partner
- Approval of the valuation methodology employed by the general partner or the right to review and approve or disapprove the valuations prepared by the general partner

Override of Partnership Agreement Restrictions

Another traditional role of LP Advisory Committees is to waive certain restrictions or thresholds set forth in the fund's partnership agreement. When such powers are included in the limited partnership

agreement and agreed to by all the limited partners, the LP Advisory Committee can exercise its discretion to take certain actions that may include, without limitation, any of the following:

- Approval of partnership term extensions
- Approval of new key persons
- Approval of follow-on investments after the expiration of the investment period
- Waiver of investment restrictions (e.g., caps on investment in a single portfolio company, in public securities or in foreign companies)
- Approval of a change of control of general partner or investment manager

General Oversight

An LP Advisory Committee sometimes takes on a greater role in oversight and provides transparency with respect to the activities of the fund and the general partner by receiving sensitive financial and other data that may include, without limitation, any of the following:

- Additional financial reports (e.g., detailed expenses, receipt of portfolio company fees)
- Access to fund auditors
- Approval of variances from GAAP accounting
- Reports on defaults, potential litigation, or other significant events

Understanding Limited Partner Concerns

Limited partners have limited liability because they do not participate in the day-to-day business of a fund. Service on an LP Advisory Committee generally will not jeopardize this status. In fact, Delaware law has a very clear list of what does not constitute participation in the day-to-day business of the fund,[1] and service on such committees is listed among many other permitted activities. However, as LP Advisory Committees appear to be taking on an ever-widening scope of responsibilities and oversight, there is some concern among limited partners that LP Advisory Committees may in some circumstances be taking on more responsibility than is prudent even if they do not rise to the level of being viewed as general partners. This concern arises when the LP Advisory Committee is making decisions that might best be considered by all the limited partners or when decisions fall beyond the scope of expertise or the functions of the LP Advisory Committee. For instance, some limited partners feel more comfortable having the right to approve valuation methodology as opposed to approving valuations, which they do not feel they have the expertise to do. Some limited partners prefer the LP Advisory Committee to have an ability to object to valuations but not have the burden of approving them.

Limited partners may also be concerned that their service on an LP Advisory Committee could result in their becoming fiduciaries to other limited partners. Absent express terms in the partnership agreement to the contrary, the case law supports this conclusion.

Best Practices

1. Delaware Revised Uniform Limited Partnership Act § 17-303 (2009) – Liability to Third Parties. Read the full text of Section 17-303.

When selecting and managing an LP Advisory Committee, we recommend that the following practices be followed:

- The voting members of the LP Advisory Committee should be composed solely of limited partners who are not affiliated with the general partner. However, the general partner generally serves as a nonvoting chair of the meeting, calling meetings and proposing agendas.
- Maintain a manageable number of representatives. We generally recommend that there be at least three and no more than nine members, but this will, in part, be driven by the fund size and the number of large institutional limited partners, many of whom will want to serve on the LP Advisory Committee.
- If you anticipate having multiple closings, plan ahead to determine who you think will be on the LP Advisory Committee so that you do not find yourself filling up with early closers only to be met with additional demands for committee seats from more significant late closers. One method is to insist on deferring from making any written commitments until after final closing in order to select the committee from the entire available pool, but this is often difficult in practice, particularly with lead limited partners.
- Facilitate communication among the LP Advisory Committee members by making available a contact list and providing updates when necessary.
- All of the duties and responsibilities of the LP Advisory Committee should be clearly set forth in the partnership agreement.
- Hold meetings at least once a year. This is often accomplished as a separate meeting held either immediately before or immediately after the fund's annual meeting for all limited partners.
- Take minutes of the meetings. We believe it is beneficial for all concerned to show that due consideration was given to the topics discussed, particularly conflicts and valuation issues.
- Provide insurance coverage. D&O liability insurance coverage should be extended to the members of the LP Advisory Committee. You should keep such insurance in place during the life of the fund and provide committee representatives with evidence of such coverage at their request.
- Provide indemnification from the fund. The partnership agreement should provide that (i) a member of the LP Advisory Committee and the limited partner he or she represents will not be liable to the fund or other limited partners and will be indemnified except for actions taken in bad faith and (ii) no LP Advisory Committee member owes any duty to any other partner or the fund other than the duty to act in good faith.
- Carefully consider requests for observer or information rights as opposed to actual service on the LP Advisory Committee. These requests can be problematic on a number of fronts if not handled appropriately. Because committee members have no duties to others, an observer status should be unnecessary and implies that some duty is actually owed. Typically, most favored nations clauses granting all limited partners similar rights will only carve out actual service on the LP Advisory Committee and not observer status, thereby opening up the fund to claims for observer rights from all limited partners. Furthermore, dissemination of sensitive and confidential information to a limited partner with information rights without context or discussion can be problematic.
- When requesting consents, provide adequate information to each committee member and hold a conference call to discuss the information prior to receiving consents. Most LP Advisory Committees are authorized to act without a meeting by a written consent of a majority of committee members. This is in contrast to a corporate board of directors, which can only act without a meeting by unanimous written consent. To avoid claims of inadequate disclosure of

conflicts or of seeking consent solely from friendly members, include all committee members in any decisionmaking process. Keep a record of all votes and actions taken.

- Stress that a limited partner should not consider his or her representative as freely interchangeable from one meeting to the next. Consistent attendance by the same individuals will help to develop a strong working relationship among the members and the general partner, which is important to the proper functioning of the LP Advisory Committee.
- Discourage designated representatives who are not directly affiliated with a limited partner but are, instead, third-party advisors whose interests may go beyond those of just the limited partner being represented and may even be competitive with the fund. Sensitive and confidential information will be disclosed and a third-party advisor must, at the very least, be properly bound by confidentiality agreements.
- Recognize that the committee may under certain circumstances benefit from outside counsel's evaluation of conflict issues and the fund should pay for such expenses.
- Allow for "in camera" sessions where the fund manager is not present.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

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Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our regulatory and industry-focused practices help clients craft and execute strategies to successfully address legal, government, and policy challenges in today's rapidly changing economic and regulatory environment.

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Delaware Revised Uniform Limited Partnership Act § 17-303 (2009) – Liability to Third Parties

(a) A limited partner is not liable for the obligations of a limited partnership unless he or she is also a general partner or, in addition to the exercise of the rights and powers of a limited partner, he or she participates in the control of the business. However, if the limited partner does participate in the control of the business, he or she is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) of this section by virtue of possessing or, regardless of whether or not the limited partner has the rights or powers, exercising or attempting to exercise 1 or more of the following rights or powers or having or, regardless of whether or not the limited partner has the rights or powers, acting or attempting to act in 1 or more of the following capacities:

(1) To be an independent contractor for or to transact business with, including being a contractor for, or to be an agent or employee of, the limited partnership or a general partner, or to be an officer, director or stockholder of a corporate general partner, or to be a partner of a partnership that is a general partner of the limited partnership, or to be a trustee, administrator, executor, custodian or other fiduciary or beneficiary of an estate or trust which is a general partner, or to be a trustee, officer, advisor, stockholder or beneficiary of a business trust or a statutory trust which is a general partner or to be a member, manager, agent or employee of a limited liability company which is a general partner;

(2) To consult with or advise a general partner or any other person with respect to any matter, including the business of the limited partnership, or to act or cause a general partner or any other person to take or refrain from taking any action, including by proposing, approving, consenting or disapproving, by voting or otherwise, with respect to any matter, including the business of the limited partnership;

(3) To act as surety, guarantor or endorser for the limited partnership or a general partner, to guaranty or assume 1 or more obligations of the limited partnership or a general partner, to borrow money from the limited partnership or a general partner, to lend money to the limited partnership or a general partner, or to provide collateral for the limited partnership or a general partner;

(4) To call, request, or attend or participate at a meeting of the partners or the limited partners;

(5) To wind up a limited partnership pursuant to § 17-803 of this title;

(6) To take any action required or permitted by law to bring, pursue or settle or otherwise terminate a derivative action in the right of the limited partnership;

(7) <u>To serve on a committee of the limited partnership or the limited partners or partners or to appoint, elect or otherwise participate in the choice of a representative or another person to serve on any such committee, and to act as a member of any such committee directly or by or through any such representative or other person</u>;

(8) <u>To act or cause the taking or refraining from the taking of any action, including by proposing, approving, consenting or disapproving, by voting or otherwise, with respect to 1 or more of the following matters:</u>

a. The dissolution and winding up of the limited partnership or an election to continue the limited partnership or an election to continue the business of the limited partnership;

b. The sale, exchange, lease, mortgage, assignment, pledge or other transfer of, or granting of a security interest in, any asset or assets of the limited partnership;

c. The incurrence, renewal, refinancing or payment or other discharge of indebtedness by the limited partnership;

d. A change in the nature of the business;

e. The admission, removal or retention of a general partner;

f. The admission, removal or retention of a limited partner;

g. A transaction or other matter involving an actual or potential conflict of interest;

h. An amendment to the partnership agreement or certificate of limited partnership;

i. The merger or consolidation of a limited partnership;

j. In respect of a limited partnership which is registered as an investment company under the Investment Company Act of 1940, as amended [15 U.S.C. § 80a-1 et seq.], any matter required by the Investment Company Act of 1940, as amended, or the rules and regulations of the Securities and Exchange Commission thereunder, to be approved by the holders of beneficial interests in an investment company, including the electing of directors or trustees of the investment company, the approving or terminating of investment advisory or underwriting contracts and the approving of auditors;

k. The indemnification of any partner or other person;

l. The making of, or calling for, or the making of other determinations in connection with, contributions;

m. The making of, or the making of other determinations in connection with or concerning, investments, including investments in property, whether real, personal or mixed, either directly or indirectly, by the limited partnership; or

n. Such other matters as are stated in the partnership agreement or in any other agreement or in writing;

(9) To serve on the board of directors or a committee of, to consult with or advise, to be an officer, director, stockholder, partner, member, manager, trustee, agent or employee of, or to be a fiduciary or contractor for, any person in which the limited partnership has an interest or any person providing management, consulting, advisory, custody or other services or products for, to or on behalf of, or otherwise having a business or other relationship with, the limited partnership or a general partner of the limited partnership; or

(10) Any right or power granted or permitted to limited partners under this chapter and not specifically enumerated in this subsection.

(c) The enumeration in subsection (b) of this section does not mean that the possession or exercise of any other powers or having or acting in other capacities by a limited partner constitutes participation by him or her in the control of the business of the limited partnership.

(d) A limited partner does not participate in the control of the business within the meaning of subsection (a) of this section by virtue of the fact that all or any part of the name of such limited partner is included in the name of the limited partnership.

(e) This section does not create rights or powers of limited partners. Such rights and powers may be created only by a certificate of limited partnership, a partnership agreement or any other agreement or in writing, or other sections of this chapter.

(f) A limited partner does not participate in the control of the business within the meaning of subsection (a) of this section regardless of the nature, extent, scope, number or frequency of the limited partner's possessing or, regardless of whether or not the limited partner has the rights or powers, exercising or attempting to exercise 1 or more of the rights or powers or having or, regardless of

whether or not the limited partner has the rights or powers, acting or attempting to act in 1 or more of the capacities which are permitted under this section.