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Structured Private Equity Fund Investments: More Demonstrable Governance, Please

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"If management is about running the business, governance is about *seeing* that it is run properly."[2]

The foregoing is an often quoted pearl of wisdom in the corporate context with reference to the director oversight role, but it also translates easily to many other stewardship contexts. Groups like the Institutional Limited Partners Association (ILPA), have already been calling for increased alignment of interests, governance and transparency in private equity investments, and have developed very useful best practice guidelines and templates that have received multiple endorsements.[3] My aim is to shine a light on moderately to highly structured limited partnership investments (or, sometimes, a limited liability company or corporate investment vehicle), where the investment target is often in an indirect subsidiary or portfolio company one or more levels below. Additional contractual requirements, to the extent that statutory or other legal mechanisms are not available, could be routinely considered in an attempt to ensure that governance goals are met throughout the fund structure. Assuming investors agree that this would be desirable, their front-line negotiators will need to advocate for and educate on the relative importance of these and additional governance terms in the face of competing interests.

Some investors and managers/advisors feel that sufficient governance already exists and do not view increasing the level of governance to be a significant priority. This feeling is particularly prevalent in trying economic times when investors' focus should be on sourcing desirable investment opportunities, economic return potential, carried interests, exit, structural flexibility, tax efficiency, and liability protection among other concerns. Investors are drawn to fund sponsors[4] because of their expertise, reputation, approach, research departments and track records, in addition to the investment opportunities they offer. Some of the common, and often merited, responses provided by these sponsors include: "Trust in the fund sponsor/investor relationship," "there is an alignment of interests," in addition to "this is not market," "we have never seen this before," "the other investors are not asking for it," and "it would create too much of an administrative burden." When requests for additional *demonstrable* governance provisions

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[2] My emphasis added – by Tricker, R. I. (1984). Corporate Governance.

[3] See Version 2.0 of "ILPA Private Equity Principles,", issued January 2011 at http://ilpa.org/principles-version-2-0/

[4] By *fund sponsor*, I refer here to those head office, investment account, fund sponsors and not necessarily, anyone within the investment portfolio itself that performs any portfolio asset management function. The latter is referred to as a *manager* (or *advisor).*

are made, often the answer is just plain "no," as if the investor's goal was to wrest away day-to-day investment decisions or the effective management of the target investment. This is rarely the case, I suspect, as many private equity fund investors do not have the resources to take on day-to-day management. Some may argue that requirements beyond the need for basic reporting and minimal high level votes, vetoes or decisions that extend beyond the limited partnership itself, could convert what should be an essentially passive investor role into active management. If this were true in the particular circumstances, this might offend some limited partnership, tax flow-through and pension investment regulation, inviting potential commercial and tax liability and adverse regulator action. These are key investor and fund sponsor considerations, but each structure and its underlying legal, tax and commercial circumstances need to be reviewed and considered before one should assume that governance improvements upset the balance. In many fund investments, some degree of improvement is desirable and possible. It would be imprudent to focus on governance only in good times.

To better understand what governance might look like in moderately to highly-structured private equity funds, consider a common sample scenario.[5] Investors are encouraged to invest in a limited partnership vehicle, formed in a familiar jurisdiction, which sometimes differs from the jurisdiction(s) of the ultimate investment target(s). The limited partnership will likely have a shell or very basic general partner that is theoretically charged at law and by the partnership agreement to actively manage and bear all liability (including, in some cases, to the limited partners) for the partnership's affairs, in return for the general partner's nominal carried interest. This is theoretical in that the general partner vehicle may not have an active management team with which to do so, and it typically has little in the way of assets against which the investor or the limited partnership, let alone a third party, would have recourse. It may have been structured to meet the minimum requirements for the role, to avoid investment manager or advisor characterization under certain laws, or to avoid adverse taxation. It is palatable when a creditworthy manager (subject to management fee clawbacks) is engaged at this level and is accountable to the investors for the entire structure.[6] However, this is not frequently the case. The effective *management* is often carried out one or more levels below the limited partnership at the investment target level by managers, or sometimes, simple *advisors.*

The limited partnership agreement, like other investor agreements, will set out its general purpose within the context of the broader structure, describe the investment term and guidelines, and contemplate subsidiary vehicles and management or advisory agreements. It will provide for

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[5] This is necessarily an amalgam of prior experiences, admittedly simplified for illustrative and informational purposes, and does not represent any one actual structure or situation, fund sponsor or the views of any specific investor or of Lawson Lundell LLP. This is not legal or structuring advice.
[6] See supra, Version 2.0 of "ILPA Private Equity Principles" for discussion on fund sponsor/manager/general partner alignment of interests and carry clawback considerations.

some level of investment reporting, but such reporting may be generic and on a consolidated or net basis. Where investors demand more detailed reporting, it is usually limited in scope (e.g. extreme regulatory action, material litigation), its materiality is measured against the value of the entire portfolio (as opposed to the specific vehicle or asset) and is not necessarily more current than in the next reporting cycle. If fund agreements place the onus on the manager/advisors to report conflicts of interest, the reporting may only be triggered or practically occur when the conflict arises at the time of a material acquisition, disposition or agreement. The dissemination of meaningful and timely, detailed information to investors may better enable them to monitor contractual compliance practices and to identify issues and concerns, but this may not practically change their reliance on the manager/advisor. Yet, without it, investors may find it difficult to evidence their own diligence and ability to take advantage of the other usual or *demonstrable* governance investor rights that require informed decisions or ask the necessary questions.[7]

The limited partnership agreement will commonly describe, in more or less detail, the capital structure, fund size, manager compensation and rights of the limited and general partners *inter se*, the sharing of risk and rewards, and the financing requirements and parameters, if any. The limited partners are usually required at law and by contract to be fairly passive to maintain their legal limited liability status within the limited partnership. This means that they should not exert much active control over the partnership, let alone the partnership's direct and indirect subsidiaries, including those that hold the investment target(s). Favourable taxation and investment regulation may also require some level of investor passivity. Despite this, limited partners often have at least some say on amendments to the partnership agreement, dissolution of the partnership, and extension of the fund's life. Some private equity funds are resigned to give those larger investors an *advisory* voice at the limited partnership level through an Investor Advisory Committee on such issues as conflicts of interest, valuation of the portfolio, auditors, and removal of the general partner.[8] Many of the foregoing rights are somewhat illusory given the investors' lack of meaningful and timely, detailed information and reliance upon the fund sponsor/advisors (typically affiliated or related). Most such rights typically stop at the limited partnership level not where the target asset(s) reside or, at best, apply on a consolidated or *net* portfolio basis.

One or more subsidiaries may be used to allow for maximum management flexibility, exit flexibility or efficiency, and to avoid burdensome manager/advisor regulation, for required or more favourable tax or financing reasons, as stipulated by investment ownership or other requirements**.** This use of subsidiaries will separate, by one or more degrees, the limited partnership with its limited partners (the investors) and their limited partnership agreement and

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[7] See supra, Version 2.0 of "ILPA Private Equity Principles" for detailed financial reporting best practices and references the concurrent development of standardized reporting templates.

[8] See supra, Version 2.0 of "ILPA Private Equity Principles" for detailed limited partner advisory committee roles and best practices.

other investor agreement requirements, and the ultimate target(s). Fund sponsor presentations, term sheets and confidential information memoranda do not often dwell on the impact of this separation. Investors are often not able to evidence how their limited partnership rights and protections will be respected and carried through the rest of the structure.

Each direct or indirect subsidiary will be legally governed by something akin to its own, often *nominal,* Board of Directors or Board of Managers. Depending upon the applicable law and the complexity of the structure, this Board will typically be legally accountable to its own subsidiary, and will, at best, maintain some vague duty to maximize profits for its direct shareholder(s). Depending upon the number of levels of subsidiaries, the direct shareholder(s) may not include the limited partnership. The subsidiary will usually not have a legally accountable (to investors or possibly, even to the limited partnership), skilled and experienced management team. Actual management and administrative services may be performed by an affiliated or related third party, with no direct duties to the investors or the limited partnership. Investors commonly would not have a choice as to the individuals who fill these Board or key management positions, beyond possibly, the *initial* appointees, if any. Fund sponsors resist *key person* provisions as an unnecessary interference or burden upon them.[9] Tax and residency requirements may sometimes prevent those few known *relationship* individuals within the fund sponsors from playing these roles in any event.

Particularly in the sphere of international private equity investments, there is no overriding law that extends the sometimes hard-negotiated, though often restricted, limited partner rights and protections throughout the various levels of subsidiaries in the investment structure and gives the limited partners direct rights to enforce. Further, conflicting rules or gaps in laws or regulatory requirements in certain key jurisdictions (e.g. where the target assets reside) may deny or significantly weaken such rights and protections. For example, it is not uncommon for private equity deals to be structured such that the agreement that contains the business deal – and often, key investor rights – is offshore. The rationales for this may vary from seeking to avoid regulation or taxation in some fashion in the subject jurisdiction or aiming to not include the business deal in documents that are theoretically public or would otherwise need to be disclosed to regulators.

Investment management or advisory agreements are utilized by the fund sponsor to earn fees, often for other members of their affiliate or related groups. If these agreements are not entered into at the limited partnership level, they are commonly entered into at the level of the ultimate investment, or through an aggregating holding company that maintains one or more investment-holding subsidiaries. These investment-holding subsidiaries are one or more levels below the limited partnership vehicle, sometimes in differing jurisdictions, and governed by unfamiliar laws. Some investors have difficulty bearing the legal and tax advisory costs that would be necessarily incurred in each jurisdiction to understand the legal implications of this splintering.

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[9] See supra, Version 2.0 of "ILPA Private Equity Principles" for specific discussion on *key person* provisions.

In this sample scenario, the limited partnership practically becomes a mere aggregating and funding vehicle, ultimately responsible for all capital required for the structure and investments, including for set up and organizational costs, operating expenses and manager/advisor fees. Yet, it is distant from the ultimate investment target(s), and where the functional manager/advisor is not directly retained for the benefit of the limited partners or the limited partnership, the investors often have no or limited contractual ability to monitor compliance with or enforce the actual management or advisory team obligations. This means there is often a lack of visible direct accountability by the directors or managers legally charged with direct oversight over the investments.

Where much of the structure is in Canada, some of these issues may be addressed through detailed individual entity-level and consolidated and portfolio company reporting, the prudent use of unanimous shareholder agreements or declarations[10] or similar requirements in or applied through the charter documents.[11] In addition, an important requirement will be that the subsidiaries and their Boards and management will be bound by the salient requirements and restrictions over the fund described in the limited partnership agreement and other investor agreements. ‘Key person-type’ rights or vetoes may be fashioned to provide the investors with greater certainty as to who will be sitting on the Boards of Directors or Boards of Managers of the relevant subsidiaries (or, at least, covenanting and reporting on the processes and principles these individuals will follow when exercising their authority), without necessarily fettering their legal discretion, where doing so is not permitted by law. Detailed investment parameters (qualitative, quantitative, and time-defined) can be applied at each level of the structure. These are but a few examples of contractual and legal mechanisms that can be utilized where there is the creative cooperation of fund counsel, investor counsel and local counsel (when involving more than one jurisdiction) and tax advisors, to identify the governance weaknesses and to seek to address them without unnecessarily jeopardizing the commercial, tax, liability and other important considerations.

Generally speaking, investors must voice (or continue to voice) their insistence on a higher standard of *demonstrable* governance within moderately to highly-structured private equity funds, at a level above “nice-to-have” terms. Those long-term, large capital investors, many of whom are subject to their own contractual, fiduciary or trust duties and specific due diligence and other investment mandates, have already issued the call. They follow the efforts in the public market sphere in recent years to increase shareholder democracy and develop stronger corporate governance.[12] Faced with this, fund sponsors will respond by designing fund structures to address these issues, or at least be sensitized to the concerns and work creatively with investors

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[10] See, for example, s. 146 of the *Canada Business Corporations Act*.

[11] See, for example, Part 5, Division 2 of the *British Columbia Business Corporations Act*.

[12] I am referring here to concepts such as shareholder engagement, majority voting, ‘say on pay’ and overall transparency and accountability, for their own benefits, but also to increase overall investor confidence and to promote ethical business principles.

and counsel. Smaller investors should benefit from the consequent changes indirectly, if not directly. Where business, tax or other considerations make some of these matters impractical, unachievable or inapplicable – as may sometimes be the case – something will still have been gained where investors and fund sponsors can evidence the inclusion of these considerations in the investment process.

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