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Five key litigation risks for private funds

From conflicts of interest to subscriptions lines, lawyers flag up the five issues most likely to trigger court action to *Victoria Robson*

Litigation is rare in the private funds industry. For both GPs and LPs, a public dispute runs the risk of reputational damage that could, not least, threaten a GP's ability to raise its next fund and an LP's ability to commit capital to other managers. The preference has been to resolve any conflicts behind closed doors.

However, while managers and investors have been reluctant to go to court, regulators in the US and Europe have stepped in to police the industry with some violations carrying a criminal liability, says Samuel Kay, head of investment funds at Travers Smith.

With regulators increasingly willing to fight the LPs' corner, key dispute triggers include:

CONFLICTS OF INTEREST

Conflicts of interest and valuations are areas of dispute that are commonly resolved privately and as a consequence, "the regulator has taken more of an interest," says Kay.

In relation to conflicts of interest specifically, regulators are scrutinising the allocation of investment opportunities between different funds in a family of funds, whether that is transparent, whether GPs are treating investors fairly and whether GPs are allocating costs correctly.

There have been a "number of disputes" between the regulator and GPs relating to co-investments and the allocation of deal expenses, Kay adds.

As firms grow in size and diversify into different strategies, the potential for conflicts of interest rises, says Eamon Devlin, managing partner at MJ Hudson. "Ten years ago very few investment firms had more than one strategy," he says. Today the situation is very different. In a big firm, "it's quite easy to find conflicts," such as managers hiring services from an affiliate company, he adds.

MULTIFACETED MANAGERS

As firms become more complex, the risk of friction between GPs and LPs will also rise and "the scope for litigation increases", Devlin says. That could manifest, for example, in disputes over key-man provisions and whether the executive cited in fund documentation was integral to the performance of the fund.

"If the fund loses money, were the individuals that were supposed to be spending most of their time there present? There are many mid-sized groups where individuals are named on different funds.

The key-man person is getting stretched across different business lines," he adds. Profit sharing, carried interest and fees and expense calculations are also more complex in larger firms. Put simply, "the opportunity for mistakes is higher," says Devlin.

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Samuel Kay

PERFORMANCE CALCULATIONS

Joining conflicts of interest and fees and expense disclosure in the top three areas of the Securities and Exchange Commission focus on private funds are performance calculations, says Joshua Newville, litigation partner at Proskauer.

As potential violations of the advertising rule, the SEC has highlighted risks relating to the preparation of a performance presentation, for example, presenting performance gross of fees rather than net of fees, cherry-picking recommendations, using benchmarks that are not comparable or only publicising winning investments, says Newville. As performance is typically a core metric on which LPs make a decision to invest, "these are things the SEC is going to focus on chis year," he says.

From the regulator's point of view, if a manager has not disclosed all material faces an LP might want to analyse when looking at performance they could view the performance presentation as misleading and potentially in violation of the advertising rule, says Newville. Managers must also retain documentation that supports any performance calculations communicated to investors, he adds.

In the instance of an SEC examination, not having supporting documentation puts a GP at risk. Managers should keep paperwork supporting and explaining the attribution of crack record performance between an individual and an investment team.

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SUBSCRIPTION CREDIT FACILITIES

Tue use of subscription credit facilities beyond shore-term bridge financing is also likely to be a future source of friction between LPs and GPs, say legal experts.

"The ILPA [Institutional Limited Partners Association] statement was a warning shoe for GPs to be careful," says Kay.

In June, ILPA issued best-practice guidelines on credit lines that highlighted LP concerns. Among them are the comparability of performance for levered and unlevered IRRs and associated clawback issues lacer in the fund's life; expenses; tax considerations; cumulative liquidity risk to the LP should several facilities be recalled; and legal risks including lender discretion over fund management decisions and joint liability.

Central to any dispute, including one about credit lines is what was disclosed in the limited partnership agreement, says Timothy Mungovan, litigation chair at Proskauer. "Have investors been given notice a subscription credit facility would be used by the manager, and has the manager executed consistently with what was agreed in the LPA?"

It would be a "mistake" for GPs using a subscription credit facility that impacts performance not to disclose it, Mungovan adds. "If they don't, then they run the risk the regulator may conclude that their performance presentation is not fair and in some way misleading."

LITIGATION FINANCING

Private fund structures can stand in the way of LPs wishing to make a claim. Litigation is also a major drain on resources. "If you are an LP, litigation is expensive and time-consuming and LPs are phenomenally under-resourced," says Devlin. With the evolution of the secondaries market it is easier for an unhappy LP to simply sell its stake, he notes.

However, the evolution of a new asset class of litigation funding - in which some GPs have even invested - is providing LPs with a new source of capital with which to pursue claims.

The number one concern LPs have, even if they feel wronged by a GP, is cost, says Mungovan. “Who will pay for the lawyers' fees if a claim is brought? Litigation funding is an incremental development that could alter the dispute landscape for private equity,” he says.

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He points to fund extensions as a possible area of litigation. An economic downturn would put pressure on LPs to insist on the “clean up” of long-dated funds, which an LP may wish to see liquidated but a GP may resist for fear of a clawback in excess of carried interest already distributed, Mungovan says. “Litigation funding could enable the LP to step up and bring a claim.”

Currently, the balance of power between GPs and LPs is heavily tilted in favor of GPs, and some LPs are “fearful of pushing back,” says Devlin. But should economic circumstances deteriorate and the balance tip back coward LPs, they may develop an appetite to litigate. “The sun is shining on the industry at the moment,” says Devlin. “[In a downturn] investors that lose money will be forced to make claims against a GP if there is a reason to. They have a fiduciary duty.”