



Client Alert



Contact Attorney Regarding
This Matter:

Matthew T. Harris
404.873.8118 - direct
matthew.harris@agg.com

Arnall Golden Gregory LLP
Attorneys at Law

171 17th Street NW
Suite 2100
Atlanta, GA 30363-1031

Two South Biscayne Boulevard
One Biscayne Tower 2690
Miami, FL 33131

1775 Pennsylvania Avenue NW
Suite 1000
Washington DC 20006

www.agg.com

An Overview of Limited Partner Advisory Committees and Private Equity Fund Advisory Boards

Introduction and Background

During the private equity fund formation process, private equity professionals routinely ask questions regarding the role and composition of a limited partner advisory committee (the "LPAC") and a private equity fund advisory board (the "Advisory Board"). Although private equity funds are not required to have either an LPAC or an Advisory Board, each serves an important function as highlighted in the discussion below.

This article is intended to give private equity professionals an overview of LPACs and Advisory Boards and to set forth the role and composition of each for consideration during the private equity fund formation process. The concepts and thoughts set forth in this article are based on the private equity fund formation assignments handled by attorneys at Arnall Golden Gregory LLP¹ and on third party sources, most importantly the Institutional Limited Partners Association Private Equity Principles, Version 2.0, released in January 2011 (the "ILPA Private Equity Principles").

Limited Partner Advisory Committees

(i) Role of the LPAC

Generally and as stated in the ILPA Private Equity Principles, LPACs are formed for purposes of addressing the following major issues, among others:

A. Conflicts of interest:

The general partner (the "GP") of the private equity fund should receive LPAC approval before entering into a related party transaction or entering into a contract with an affiliated party, unless otherwise disclosed and described in the governing documents of the private equity fund. For example, the GP should receive LPAC approval before the private equity fund acquires assets from or sells assets to an affiliated entity of the GP or the private equity fund to insulate the GP from potential future lawsuits from the limited partner investors regarding the terms of such transactions. The approval process for conflict of interest transactions

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is also beneficial to the limited partner investors since the GP is typically prohibited from entering into non-arm's length transactions which benefit the GP or one of the GP's affiliated entities unless approved by the LPAC.

B. Valuation methodology:

The valuation of the assets of the private equity fund is particularly challenging given the illiquid nature of typical private equity fund investments. The valuation methodology (and, in certain instances, the valuations themselves) should be submitted to and considered by the LPAC since the value of the assets of private equity funds, in certain circumstances, may drive the amount and timing of the GP's management fee and other distributions and may impact the performance and financial reporting of the private equity funds.

C. Consents or approvals pre-defined in the governing documents:

The limited partnership agreement of the private equity fund may contain certain provisions which require the consent and approval of the LPAC, such as, among others, the extension of the investment period, the extension of the term before an orderly liquidation of the assets is required, the removal of the restriction on the type of assets which may be acquired and the approval or replacement of key persons and team members making investment decisions.

By utilizing the LPAC, the GP and the limited partner investors each have a mechanism to address conflict of interest transactions. Additionally, the LPAC allows flexibility in the valuation of the private equity fund's assets and grants the GP flexibility, upon approval of the LPAC, to waive restrictions in the governing documents of the private equity fund as necessary for the benefit of limited partner investors. Institutional investors generally will not invest in a private equity fund unless an LPAC is included in the private equity fund's structure. Smaller funds without institutional investors typically do not include an LPAC.

(ii) Composition of the LPAC

In most instances, the GP will appoint limited partner investors to the LPAC. The criteria used by the GP to determine which limited partner investors to appoint to the LPAC is largely based on the amount of capital committed by limited partner investors. For example, anchor investors in the private equity fund will most likely receive a seat on the LPAC due to the amount of capital committed and due to the fact that the anchor investor is one of the earliest investors in the private equity fund. Also, as a condition to investing, certain limited partner investors making substantial capital commitments may require an appointment to the LPAC, which is typically evidenced by a side letter agreement between the private equity fund and such limited partner investors. GPs may attempt to remove themselves from the process of appointing limited partner investors to the LPAC to further insulate themselves from actual or potential conflicts of interest by setting a non-negotiable minimum capital commitment for members of the LPAC.

The typical LPAC has between 3 and 12 voting members comprised of limited partner investors in the private equity fund, and a representative of the GP usually serves on the LPAC as a non-voting member. The ILPA Private Equity Principles state that any replacements of LPAC members should be determined solely by the GP, and additional seats or eliminated seats should be determined by the GP with a majority vote of the then existing LPAC members.

Unlike the Advisory Board, the LPAC members are generally not compensated for their time and effort in serving on the LPAC. However, LPAC members should be reimbursed for their reasonable expenses incurred and should be indemnified by the private equity fund for all actions taken as a member of the LPAC, subject to limited carveouts for fraud, willful misconduct or similar bad acts.

Private Equity Fund Advisory Boards

(i) Role of the Advisory Board

Although the Advisory Board has no authority to act on behalf of or to control the private equity fund, a well-appointed Advisory Board could be valuable to the GP and the private equity fund during the fund formation process and throughout the life cycle of the private equity fund. The Advisory Board is generally formed to provide industry expertise and to assist with the sourcing of transactions. Additionally, the Advisory Board may provide credibility to the private equity fund and to the GP, particularly an emerging manager or the manager of a smaller fund.

On August 29, 2012, the Securities and Exchange Commission proposed rules related to the elimination of the prohibition against general solicitation and general advertising in certain securities offerings. Assuming the adopted rules are substantially similar to the proposed rules, in the near future Advisory Board members may also assist the GP in finding accredited investors to invest in the private equity fund, which may cause the GP to appoint some members to the Advisory Board who participate actively in the fundraising process and less in an ongoing advisory role to the GP and the private equity fund.

(ii) Composition of the Advisory Board

The GP should select Advisory Board members who are industry experts or service providers to the industry which is the focus of the private equity fund. For example, more established private equity fund managers may be willing to serve on the Advisory Board for an emerging manager or the manager of a smaller fund who is not a direct competitor. Also, the Advisory Board may contain an economic expert specializing in providing analysis related to a particular asset class which is the focus of the private equity fund. Service providers to the private equity industry may also be willing to serve on the Advisory Board of a non-client for purposes of questions and concerns related to ongoing fund operations, legal issues and accounting issues.

The number of members of the Advisory Board is usually less than the number of members of the LPAC. The compensation of Advisory Board members varies and, in many instances, no compensation is paid but certain concessions are made to Advisory Board members as limited partner investors in the private equity fund, such as allowing the Advisory Board members to invest in the fund on favorable terms or allocating a portion of the carried interest to Advisory Board members. Similar to the LPAC members, the members of the Advisory Board should be indemnified by the private equity fund and should be reimbursed for their reasonable expenses incurred.

Conclusion

The issues discussed in this article provide a starting point for the private equity professional who is considering the inclusion of an LPAC or an Advisory Board in their private equity fund structure. Please feel free to contact any of the Securities and Corporate Governance attorneys at Arnall Golden Gregory LLP with questions regarding LPACs and Advisory Boards and related private equity fund formation, capital raising and operational issues.

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