Fund management litigation

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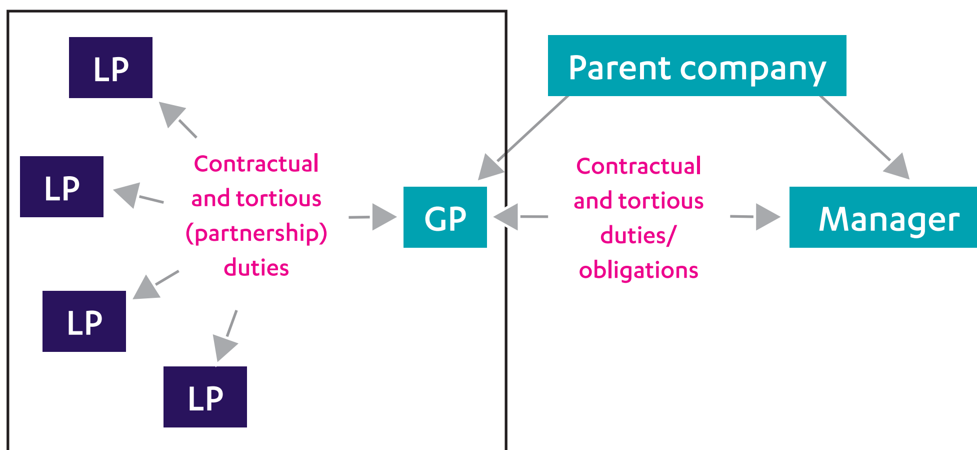
Recourse for LP investors when an investment goes wrong

Investors will often invest via a limited partnership fund structure such as this:



In this structure, as limited partners (LPs), the investors will take no part in the management of the limited partnership fund (the Fund) and will not be liable for its debts and obligations. The general partner (GP) is responsible for the Fund's management and its debts and obligations. The GP has contracted, on behalf of Fund, with a fund manager entity (the Manager) to manage the fund and invest the monies put in by investors. The GP and the Manager are subsidiaries of the same parent company.

Particular features of this structure can act as hurdles in the event investors wish to seek recourse when an investment by the Fund is (allegedly) negligently made or mis-managed:

- the LPs have a direct relationship with the GP – but the GP is not responsible for investment decisions and management of investments as it has sub-contracted these responsibilities to the Manager
- the LPs do not have a direct relationship with the Manager which has made the investment decisions and managed the investment
- the GP does have a direct contractual relationship with the Manager. Having entered into this

Any comments or queries?

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contractual relationship with the Manager, on behalf of the Fund, the GP can claim against the Manager in the name of the Fund. The commencement, conduct and settlement of proceedings is within the GP's role and responsibilities. However, the GP shares the same ownership as the Manager. In these circumstances the GP will be conflicted from taking action against the Manager on behalf of LPs to whom it owes duties
- as limited partners the LPs cannot commence proceedings in the name of the Fund, as to do so would be to take part in the management of the Fund, opening them up to liability for its debts and obligations.

Henderson: an attempt to overcome these hurdles

In the *Henderson* case[1] certain LPs in Henderson PFI Secondary Fund II LLP sought an order from the court allowing them to sue the GP and the Manager by way of a derivative action in the name of Fund but without potential liability either for the debts of the Fund or for the costs of the derivative action.

The classic example of a derivative claim is a claim by a minority shareholder who seeks to bring a claim on behalf of the company against wrongdoers who are in control of the company. In *Henderson* the LPs argued that there was no reason in principle why limited partners could not bring such a derivative claim on behalf of the limited partnership fund.

However, in its decision, the High Court found there was no need for a derivative action by the LPs against the GP in the name of the Fund as they could each individually sue it anyway. As to a derivative claim by the LPs in the name of the Fund against the Manager, the High Court decided that such a claim could be brought by the LPs – but only if they accept liability for debts and obligations of the Fund (as if they were the GP managing the Fund). This clearly is not satisfactory for LPs unwilling to lose key benefits of being LPs.

Other possible solutions to allow a claim to be brought against the manager

Other unsatisfactory alternatives floated in *Henderson* were:

- for the LPs to replace the conflicted GP by a new unconflicted GP free to sue the Manager in the name of the Fund. The problem with this approach, as noted in *Henderson*, was that it might not be practical or cost-effective to appoint a new GP willing to assume the debts and obligations of the Fund and the risks this entailed. It also might not be in the best interests of the Fund (and the LPs) to replace the GP in this way, having in mind the smooth management of all of the Fund's investments
- for the LPs to sue the GP for its failure to take action against the Manager. However, as noted in *Henderson*, the test for liability would be different from that which would apply to determination of liability of the Manager. Further, the test for damages and their measure would also differ. Such proceedings might therefore be unattractive by comparison to a direct claim against the Manager.

An alternative approach we have seen proposed is for an administrative receiver to be appointed by the conflicted GP (at the behest of complaining LPs) for the discrete purpose of investigating and if necessary pursuing a claim by the GP, on behalf of the Fund, against the

1. *Certain Limited Partners in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LLP (a firm) and others* [2012] EWHC 3259 (Comm).

Manager. However, as with the possibility of replacing the conflicted GP with another, this approach is likely to entail considerable expense and cause disruption to the management of the Fund and all of its investments. In our experience the parent company of the GP (and the Manager) resisted the appointment of an administrative receiver as it did not want such a receiver to be given control over (part of) the operations of its subsidiary.

The successful solution

We successfully pursued a different approach not explored in Henderson. In the case in question a group of LPs wanted a potential €160m claim for negligence against a Fund's manager to be investigated and pursued by the Fund's GP. The GP was conflicted but was able, acting in accordance with a provision in its company articles of association, to appoint an independent committee comprising non-conflicted reputable fund professionals to investigate, and ultimately pursue a claim against the Manager in the name of the Fund. This approach satisfied the complaining LPs as well as the GP and its parent. The board of the GP delegated power to the independent committee to fulfil this role and agreed to be bound by decisions it made within the scope of its competence but otherwise retained its other existing functions, enabling the smooth management of the Fund to continue and the claim to be brought with the minimum disruption and expense. The claim ultimately settled after proceedings had been commenced but before trial, following disclosure by the Manager and mediation.

This solution applied a provision in the GP's articles of association but even if a GP did not have articles of association permitting the delegation by the board of some of its powers to an independent committee than a variation of this theme would be to appoint a number of non-executive directions and then form them into a sub-committee of the board charged with investigating and pursuing a claim against the Manager (although this solution would not be as straightforward). Alternatively a GP could amend its articles to insert a provision permitting the appointment of an independent committee to which the board could delegate powers.

Advice for Fund Managers on structuring funds

The conflicted limited partnership fund structure highlighted in this note is not uncommon and although it presents difficulties to LP investors wishing to bring claims for recourse when an investment goes wrong, it also complicates life for conflicted GP entities. Such GPs must reconcile their relationship with sister company Managers with the duties they owe to LP investors. Failure to do so places the GP at risk of being targeted by a claim for breach of the duties it owes to LPs, for example, for failing to bring a viable claim against the Manager. Fund Managers should therefore carefully consider the pros and cons of this structure, including these issues, when establishing funds.

Final note of caution

Leaving aside the problems a conflicted structure such as this may cause for GPs and LP investors seeking recourse in the event an investment goes wrong, the conflicts inherent in the structure are also likely to give rise to problems for the GP, the Manager and the Parent Company as they address investor complaints. Documents may be created without thought as to who (the Fund, the GP, the Manager) owns or controls them, who the client is and whether legal privilege may be inadvertently be waived. Careful thought should be given by the GP and the Manager and their lawyers to these issues in these circumstances – and investors should have an eye to exploiting such difficulties if they can.

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