

## LPACs Move Into the Hot Seat

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Private Funds CFO: Fees and Expenses Survey 2020

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This latest iteration of our biennial survey examines how funds allocate fees and expenses between GPs and LPs. The survey started in 2016 and provides clear emerging trends. In the 2020 report you will find:

- Key findings from this year's survey and trends over the years
- The ILPA effect
- Role of the LPAC
- Conflicts over co-investment
- Who pays for outsourcing costs
- Fund term extension issues

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With increasing regulatory scrutiny on fees and expenses, fund managers are turning to their limited partner advisory committees (LPACs) more as a body with approval rights than for oversight by significant limited partners (LPs).

While managers seek greater transparency and protection from second-guessing with the benefit of hindsight, LPAC members' increasing responsibilities raise concerns of time commitments, conflicts, compensation, and liability. Compared with prior biannual surveys, the Private Funds CFO Fees & Expenses Survey 2020 shows this

tension and reveals many areas in which LPACs are increasingly relied upon.

## **Valuations Policy Reviews**

Valuation policies are a priority of SEC examinations and enforcement actions for funds. In the two years leading up to our 2020 survey, nearly half of firms visited by the SEC needed to make changes in their fund documents to adjust their valuation policies.

Although fund managers generally determine the valuation policies for fund-held securities, it is increasingly more common for the LPAC to approve changes to valuation policies. The SEC's focus on portfolio company valuations, particularly how valuations may impact management fees charged to LPs, adds pressure for the LPAC to review and approve these valuations, including the management fees based on them on occasion.

Typically, LPAC members have resisted approving portfolio company valuations based on liability risks and not having the same access to information as managers, focusing instead on confirming the consistency of valuation methodologies with market practice. Valuation policy changes require a more detailed review by LPACs, bringing them closer to actual valuation approval obligations. This increase in responsibility may also impact insurance coverage and an LP's willingness to serve on the LPAC.

The 2020 survey also showed a 5% decline (from 38% in the 2018 survey) in the number of firms that outsource some or all valuation services. For the firms outsourcing valuations, there was a 3% decline (from 44%) of management firms charging only themselves for the cost of outside valuation expertise.

This dynamic increases the need to obtain LPAC approval of in-house valuations to avoid regulatory issues upon examination. Managers fare better in a regulatory examination of valuations if the LPAC approved the valuations contemporaneously.

If the LPAC reviewed and approved the valuations, the manager's decision will be far less susceptible to revision, upon regulatory examination, with the benefit of hindsight. If the LPAC will not or cannot approve in-house valuations, the solution becomes an external valuation — but fewer firms choose that path, and those that do are more likely to charge it to the fund.

Since the 2016 survey, we have also seen a trend of fund managers disclosing deficiencies set forth in SEC examination reports to only those limited partners with a side letter requiring disclosure (16% in 2016, compared with 29% in 2020), who often have representatives on the LPAC, and not to all of the limited partners (50% in 2016, compared with 36% in 2020). Thus, LPs without an advisory board representative who want disclosure of deficiencies, particularly concerning valuations, should request disclosure requirements in a side letter.

## **Conflicts for Advancement of Expenses**

When principals are the subject of a claim brought by LPs, the advancement of expenses to those principals is often the means for them defending the claim. This is particularly true for smaller fund managers whose management fees cover operating expenses without much excess.

Absent an advancement provision in the fund's limited partnership agreement, the principals could receive indemnification from the fund only after the claim has been resolved in their favor. This year's survey shows a 7% increase (from 13% in 2018) in the number of managers who turn to the LPAC to approve the advancement of expenses. This approval may present a conflict of interest as the LPAC is frequently populated with representatives of the fund's largest LPs, who are often the ones to institute a claim. These LPs may even bring a claim based on information that the LPAC has gleaned from interactions with the management team. Managers need to consider conflicts carefully in negotiating advancement provisions if the advancement of expenses requires LPAC approval.

## **Approvals of Affiliated Transactions**

Using affiliates to provide fund services is a longstanding practice, which weighs economies of scale with conflict risk. Firms frequently use legal and human resources personnel to provide support to portfolio companies. The fund effectively bears the cost of such services.

A fund's offering documents typically disclose the manager's authority to hire affiliated service providers, so long as the rate charged does not surpass the market rate. The 2020 survey showed both a 5% decline (from 16%) in managers who charge the fund for such insourced services in addition to a management fee, and an 18% increase (from 29%) in managers who disclose evidence of the market rate of fees charged to the fund for insourced services.

We see in the 2020 survey that disclosures proving that the affiliated service provider does not charge more than an unrelated third party are becoming standard, and that the recipient of those disclosures to clear conflicts of interest is the LPAC.

Routinely, LPACs get requests to approve fees charged to a fund and receive evidence of the 'fair market rate' of the charges, but LPAC members may not be able to judge if the manager or its affiliate is the optimal provider of those services. Legal services may be easier to assess; analyst, insurance, property management, tax, or other services provided to the fund or its portfolio companies may be more difficult. The LPAC member usually does not know the market for these services and knowing it does not usually fall under the expected LPAC service role for the limited partner appointing that person to the LPAC.

## **Fund Extensions**

The 2020 survey found that 68% of funds require that the LPAC or LPs must approve all term extensions. The survey did not inquire which of these approvals is an action submitted to the LPAC or a majority in interest of LPs.

Decisions to extend the fund term are not easy for an LPAC. Some investors may prefer to wind down, even if some investments are sold at a loss, while others may encourage the manager to raise co-investment funds to support the remaining portfolio companies for a couple years.

If the fund agreement does not provide that the LPAC member can decide a question presented to the LPAC solely based on the best interest of the LP represented by that LPAC member, the LPAC member asked to approve an extension is conflicted. In addition, many funds allow the manager to extend the investment period

with the LPAC's consent, and we expect to frequently see this conflict here, as well in the wake of the coronavirus pandemic.

## **LPAC Friction**

As the survey shows, there is an increasing intertwinement of LPAC activities with the operational management of the fund.

LPACs were originally contemplated as an oversight function, akin to board observers in the corporate context. The 2020 survey evidences how the LPACs' role in fund operating activities has increased, which is more akin to the 'independent director' role.

Investors appointing LPAC members often express concern over the time commitment now required to serve on the LPAC. Members who serve on multiple committees may also find it difficult to manage inconsistent definitions of the LPAC role across different funds, often devolving to the common denominator across them all (*i.e.*, the most involved role becomes the standard), which leads to friction with managers that expected less involvement from the fund's LPAC.

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