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PE fund managers take kickbacks

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Breach of fiduciary responsibility, but not many remedies for investors.

Some top private equity fund managers, known as General Partners (GPs), are taking kickbacks from potential portfolio companies as inducement to committing capital.

According to two people familiar with the practice, at least two top GPs who quit full-time jobs to float their own private equity (PE) funds are recent offenders.

“It is very hard to establish, but very much prevalent,” one of them, an investment banker, who advises on such PE deals, said. He says, the kickback is often included in the total deal price. For example, of the Rs 5 crore invested in a company, Rs 5 lakh goes to the GP. The other way this can be done is through an investment banker in between. The fund appoints an investment banker to sell a stake. “The banker is paid a hefty fee, say five-seven per cent. The banker, in turn, passes on a cut to the general partner.”

Lack of regulatory oversight and inability of investors, known as limited partners in PE parlance, to monitor the activities of fund managers, is encouraging some black sheep to take this short cut to quick bucks, say advisors and lawyers.

“This is another example of corruption in the private sector. There are general provisions in the law that can be taken recourse to. In addition, there could be specific conditions in fund documents,” said Siddarth Shah, partner, Nishith Desai Associates, a Mumbai-based global advisory firm.

Shah said many PE funds abroad incorporate provisions in fund documents which say, if the manager receives any fee from the company, this would be offset against the management fee payable to the GP.

“In India, some of the institutional funds enforce these conditions, but not many offshore funds do so. Also, in funds where there are a number of retail investors as LPs, they may not have the wherewithal to detect or enforce the offset clause, even though the fund document provides for it,” Shah added.

The general partners have a fiduciary responsibility towards investors. General partnership contracts usually prohibit any conflict of interest. This includes insider trading in portfolio companies in the case of pipe investments, the GP is not allowed to be part of another fund, etc. This blanket provision covers kickbacks, say some limited partners.

An LP who is the India head of a fund of funds (FoF) that manages $3.5 billion and has investments in several Indian funds said private equity investors did not have any regulatory protection, being in the unregulated space. “I agree there is no regulatory protection. But there is reputational protection. The GP might be able to escape with a couple of deals. Eventually, if talk gets around, he may never be able to recover,” the LP said.

Investors say being doubly diligent is the only possible way out of the situation. Different investors follow different processes, depending on their abilities. “Our diligence processes can take as long as six months. Recently, when we committed capital, we did at least 30 reference checks on the manager.” the

Fof head said.