

Investment Funds: Monthly Digest

July 23, 2019

ADVISORY BOARD OR LPAC IN THE INDIAN AIF CONTEXT (JUNE-JULY 2019 EDITION, PART I)

The Securities and Exchange Board of India (“SEBI”) regulates Alternative Investment Funds (“AIFs”) in India under the SEBI (Alternative Investment Funds) Regulations, 2012 (the “AIF Regulations”). All categories of AIFs are permitted to raise from investors (“LPs”) from around the globe.

The governing documents of such AIFs often include terms which may not be required as a matter of law under the AIF Regulations, but are considered global best practices from a good governance perspective.

In this edition of the digest, we discuss one of such terms, pertaining to the role of an Advisory Board or a Limited Partner Advisory Committee (as globally known, an “LPAC”) in the context of AIFs in India. Given that there is no legal framework for a ‘limited partnership’ in India¹, the concept of an LPAC often gets stipulated as ‘Advisory Board’ or ‘Advisory Committee’ in the AIF documents.

INTRODUCTION

LPAC is conceptually different from both an investment committee, and any expert body (consisting of third parties) set up as a sounding board by the manager. Members of the investment committee owe fiduciary and other duties to the AIF and its investors, as they make critical investment and divestment decisions with respect to the AIF and retain the power to bind the manager with their decisions. If an expert body has been established with third parties, and such body also has the ability to bind the AIF (whether directly or through the manager) to its decisions, then such body should also be subject to fiduciary and other duties to the AIF and its investors. Due to such duties, the liability of members on such committees / bodies is generally unlimited.

On the other hand, the LPAC is set up on behalf of the AIF by its manager, consisting of natural persons as representatives of certain select eligible LPs in the AIF. The eligibility criteria for such LPs to qualify for representation on the LPAC is established by the AIF manager and is subject to its discretion.

Members of the LPAC (as representatives of investors of the AIF) are increasingly looking to limit their liabilities arising out of their membership on the LPAC. Exposing such members to fiduciary duties should lead to unlimited liability. It is therefore critical to maintain the distinction between the role, scope and powers of the LPAC versus other such bodies as described above.

LEGAL STATUS / CONSTITUTION OF LPAC

Although the power to establish the LPAC for an AIF rests with the AIF manager in the AIF documents, the LPAC is constituted for the benefit of the AIF and should not be considered as a committee of the manager. In other words, if the AIF manager is a company, the LPAC should not be considered a sub-committee of the board of directors of such company (should not be subject to corresponding provisions under the Indian Companies Act, 2013). Similarly, if the AIF manager is a limited liability partnership (“LLP”) under the Indian Limited Liability Partnership Act, 2008, the LPAC should not be considered a part of the management of the LLP and should not be subject to its regulatory purview.

The constitution of the LPAC is solely contractual, arising out of the AIF documents and should not become subject to any legal or statutory governance (other than in contractual capacity).

MEMBERSHIP OF LPAC

Typically, it is the AIF manager who retains the power to determine which of the LPs would be eligible to get a seat on the LPAC. For this purpose, the manager may retain complete discretionary power, or could also provide certain objective eligibility criteria in the AIF documents for such determination. For example, it is common for the managers to determine eligibility of investors with reference to a minimum interest percentage in the AIF.

The total number of available LPAC seats are generally fixed (both for a minimum, and maximum number of members). Out of the eligible pool, the manager selects a few LPs to have an LPAC seat, and this is generally captured in their side letters. One perspective is for LPACs to also include representation from a small number of LPs who are not selected by the manager by virtue of the quantum of their interest in the AIF but may add value (including through benefit of experience) to the LPAC out of their business experience or otherwise², instead of being comprised only of “bite-dogs” i.e. investors with large capital commitments.

Further, in some cases, a distinct class of investors (e.g., all entities within a corporate group, or all Indian financial institutions) may be permitted to collectively appoint a single member on the Advisory Board, with an inter-se arrangement.

ROLE AND FUNCTIONS OF AN LPAC

Conflicts

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Several actual or potential conflict of interest may arise with respect to operations of an AIF (whether with reference to one or more of the manager, investor(s), portfolio companies or the AIF itself), including without limitation (a) AIF's investment in, divestment from or any other business transactions with the AIF manager, or any fund or other vehicle managed by the AIF manager; and (b) the AIF manager's (including any investment vehicle managed by the AIF manager) investment in, divestment from or any other business transactions with any portfolio company in which the AIF invests.

Interested members / conflicted members of the Advisory Board (with respect to a decision to be taken by the Advisory Board) should disclose their conflicts to other members and excuse themselves if so requested by the other members of the Advisory Board.

Valuations

The LPAC is also consulted on matters pertaining to valuation methods and outcome.

In most VC/PE funds, valuations play an important role including for critical issues such as equalization premium determination, carried interest determination, distributions in specie, determination of carry clawback and affiliated transactions.³

Accordingly, while the LPAC does not actively engage in determining valuations, or valuation methods, it plays the role of reviewing appropriate application of governing valuation methods to the AIF's assets and seeks access to auditors, if so required.

Deflection from the Investment Strategy

An interpretation of the stated investment strategy by the AIF manager may require consultation with the Advisory Board. For example, if the stated investment strategy requires primary allocation towards infrastructure sector, the scope and meaning of "primary" or "infrastructure sector" may require discussion with the Advisory Board.

Further, any deviation from the stated investment strategy is also generally subject to discussions with the LPAC.

In addition to the above stated roles and functions, it is common to see AIF documents have certain other earmarked items for LPAC approval, which could be contextual / bespoke for such AIFs. Certain LPs may demand certain critical items to be undertaken by LP vote subject to the LPAC approval.

LIABILITY OF MEMBERS OF LPAC AND INVESTORS REPRESENTED BY SUCH MEMBERS

While the role of members of the LPAC (as being limited to review) are designed to ensure such members, and LPs nominating such members are not subject to fiduciary duties, the members would nonetheless be required to act in good faith. Accordingly, the limitation on their liability is not available in cases of *malafide* acts such as acting fraudulently, in bad faith, in a grossly negligent manner, willfully defaulting etc.

Some AIF managers also seek insurance to cover the members of LPAC for liabilities arising out of their role on the LPAC with respect to the AIF.

CONCLUDING REMARKS

As discussed above, LPAC members generally prefer not being subject to any fiduciary or similar duties towards fellow LPs or towards the AIF. LPACs may, for this purpose, also seek advice from an external counsel, if so required.⁴

Investors are increasingly looking to retain voting rights on matters which generally were subject to LPAC consideration (including matters such as replacement of key persons, extension of the commitment period etc.). Investors are beginning to demand that such matters should be referred to the larger LP base for its approval rather than merely to the LPAC. Such matters include LP voting matters (by value of their investment) which are governed by the AIF Regulations, and should not be diluted by way of shifting the voting rights to the LPAC (with one vote per member).

– Ramya Kumar & Nandini Pathak

You can direct your queries or comments to the authors

¹ For additional reading on this, please see our April, 2019 monthly digest on 'Trusts as AIFs in India' (available at http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/trusts-as-aifs-in-india-legal-considerations.html?no_cache=1&cHash=dbdb943927cadd3644db00eb9f7f83d6)

² BVCA's Limited Partner Committee and Investor Relations Advisory Group "Limited Partner Advisory Committees BVCA Perspectives Series" Summer 2014.

³ Closed-End Private Equity Funds: A Detailed Overview of Fund Business Terms, Part I, authored by: Seth Chertok and Addison D. Braendel; Legal studies research paper, The Pennsylvania State University, The Dickinson School of Law.

⁴ Noel Ainsworth "SHOULD LPS BE WORRIED ABOUT LPACS?", PRIVATE EQUITY MANAGER August 2014

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