



‘We want a divorce’

LPs who want to replace their GPs should know that it is very, very difficult – even in this market. By Robin Marriott

It doesn't happen often – in fact it is very rare. And when it does happen, it can get very nasty.

Limited partners deciding to replace the general partner of a fund is the financial market equivalent of divorce. It is painful in the extreme and often costly.

Yet in recent weeks, *PERE* has spoken to limited partnerships and their lawyers involved in this process. And what has become clear is those about to enter the murky territory of GP replacement have no clear road map. Instead, the LPs must judge for themselves the best way forward.

In July, *PERE* was told about a group of LPs that had become so disillusioned with their fund manager that they secretly organised to remove the GP. The LPs in question were lucky in one respect because among them is a fund of funds manager that has the internal resources and experience to

lead the process.

At press time, the LPs were biding their time in the hopes that somehow problems within the fund in question could be turned around. But *PERE* was left in no doubt that the divorce action would be taken if required. One person close to the situation acknowledged this was a very dark situation. “It is not nice,” he said.

This was an exceptional circumstance. In most cases, before entering into a secret divorce plot, most LPs try to iron out problems face to face. However, in this scenario, the situation had gone way beyond the talking stage.

GP removal is especially tricky because it is so rare. There have been very few documented examples of a GP being replaced. One of the few happened recently in Japan. In March, ING Real Estate Investment Management replaced New City

Asia Fund Management on a \$772 million Asia opportunity fund. This came after New City's parent company lurched into financial difficulties. In this instance, LPs did not use release triggers in the fund documentation, though they could have done. Instead, a process of holding a beauty parade was instigated by the GP. The LPs chose the Netherlands firm to continue managing the mostly invested vehicle.

One investor who did not wish to be named because he is involved in a process of replacing a GP says that bankruptcy or near bankruptcy is certainly a main reason why LPs would look to oust a manager. However, he adds it can also happen when trust in the manager has evaporated or if the manager of the fund is not staffed well enough to cope with the current challenging environment and is not willing or able to do so.

Life after divorce

There is a mountain of complex factors to assess when contemplating pursuing replacement action.

One issue is that not every LP will be in a position to take an informed view of whether the GP should be replaced. That view can sometimes only be formed by assessing each individual asset and considering what rectifying action might be achieved. If the LP does not have the resources or expertise to assess this, he is in a weak position. One LP that *PERE* spoke with questioned whether it was enough for an LP to replace someone only on "gut feeling", and how could the individual pension fund manager making that decision justify it to his boss?

Experts say a second issue preventing the action from being straight forward is it's possible that an LP might use the position to engineer benefits for itself. For example, if removing the GP requires a unanimous vote, an LP might threaten that he will not vote for the motion, thereby using this as a lever to obtain some form of preferential treatment – such as some form of asset buyout backed by the other LPs.

As lawyers will advise, the legal aspects of replacing a GP present severe challenges too. Generally, the event is covered in fund documentation using "for cause" terms (relating to fraud or insolvency or a material breach of documents), while "without cause" or "no fault divorce" is reserved for when LPs are unhappy with performance.

Typically, a vote to remove a GP "for cause" can require 75 percent of LP votes, and no fault divorce requires a higher majority still. In US fund documentation, the fund manager is often protected by a term that says if "for cause" is invoked because of material breach, then this has to be legally determined by a US court from which there is no right to appeal. Clearly, this could involve a wide ranging examination of the fund, and certainly be costly and time consuming. The legal expenses are often paid for by the LPs themselves.

This alone might be enough to put off many LPs. On the other hand, if the GP is removed under the no fault divorce clause, this could also have a cost implication if the GP demands compensation for loss of management fee and carry. There may also be additional cost if the GP has an agreement with an operating partner, because that partner will want to

be compensated as well.

Given that the voting threshold is so high in both "for cause" or "no fault divorce", there is great emphasis on LPs actually knowing the identities of the other investors - something that is not a given.

And an aggravating factor is that in some circumstances the successor GP may have an obligation to assume the original GP's capital commitment to the fund. This could be substantial cost. Just finding a replacement manager who is willing and

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able to take over the whole commitment may not be easy and might need addressing in the new agreement.

Lawyers also point out that when the general partner is removed, the investors need to consider if the GP should be allowed to retain an economic interest in the fund, and what happens to that interest should there be a turnaround in fortunes for the fund and the GP profits from his investment like every other investor. One answer is to convert the GP's interest into that of a special limited partner, i.e. without voting rights. Another option is to buy out the GP. There may be an obligation in the fund documentation on the LPs to repurchase the interest. But without an ability to issue loan notes for the outstanding redemption price, this could trigger a cash contribution obligation at exactly the time that LPs hope to limit further out-of-pocket expense. The equally unpalatable option would be to force a sale of assets in a difficult market.

Selling the kids

It is no wonder some investors end up concluding that it is better to liquidate the portfolio instead.

Mark Antoncic, a founder of US strategic asset manager Carpathia Real Estate Advisors, says: "Getting the LPs to act in unison with a single voice and orchestrate a management change is hard enough. But then you have the question of who is going to pull the trigger and the decision on who is going to be the replacement GP."

Antoncic says GP replacement issues are most likely to arise where you have inexperienced managers "in over their heads" in bad deals. "That's a tough situation to step into," says Antoncic. "The GP is out of the money, most of the managers have gone, and the lenders are crawling all over it. But the LPs still have some recovery value there, so maybe the best thing to do is to create a liquidating trust to get their money back."

Jonathan Cantor, a partner in the indirect investment team in the London office of law firm Nabarro, says his firm has been contacted by a number of LPs wanting to know the process, necessary legal steps, time, costs and likely outcome of a GP removal process. The time frame for due diligence on a replacement fund manager is likely to be so short, he says, that ultimately a better plan might be "the whole fund terminates and the investments get sold". □