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Investors Should Resist 'Giveback Inflation' In Partnerships

By **Marc Lieberman and Kenneth Witt** (April 17, 2020, 6:01 PM EDT)

Most limited partnership agreements memorializing private equity investments require limited partners to return a portion of the partnership's distributions in the event the partnership incurs liabilities (typically indemnity obligations) it cannot otherwise cover from other sources such as fund income, insurance proceeds or portfolio assets.

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Historically, partnership agreements mandated that limited partners be obligated to return up to a quarter of their distributions to cover partnership indemnity obligations, but recently we have seen a trend toward requiring the return of up to 100% of distributions.

Further, while investors' obligations to return distributions, often called "givebacks," typically have been limited to two years from the date of distributions, funds and their counsel are now demanding limited partner givebacks through termination of the partnership and beyond.

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We maintain that such inflation is unreasonable as it relieves general partners of too much responsibility for the partnership liabilities they alone incurred. We suggest best practices on the subject.

The trend for distribution givebacks to encompass 100% of distributions and to require such givebacks through fund termination is likely the product of the market being so awash in capital that general partners believe they can demand such terms with impunity.

Aside from sheer market power considerations, fund counsel sometimes argue that Section 17-607 of the Delaware Revised Uniform Limited Partnership Act, which governs nearly all domestic private equity funds, subjects 100% of limited partner distributions to a giveback obligation.

While that is literally true, the statute only requires limited partners to return improper distributions (made when liabilities exceed assets of the limited partnership). Moreover, even unlawful distributions must be returned only if the limited partner knew that the distribution was unlawful when it was made. Finally, unless otherwise agreed, limited partners are liable for the return of known unlawful distributions for three years from the date of distribution.

Whether the recent COVID-19 crisis will increase interest in alternative investments or cause them to be curtailed is uncertain, but regardless, the trend toward unlimited givebacks of distributions is decidedly contrary to the interests of investors and rewards general partners for their recklessness.

Historically, a fund (and ultimately, its general partner) bore responsibility for three quarters of indemnity liabilities, and such exposure caused general partners to make more cautious acquisition and investment determinations lest they and their funds bear the lions' share of liability. Requiring limited partners to now risk 100% of their distributions for periods running through fund maturity relieves the fund and their general partners of a significant portion of their exposure for an extraordinary amount of time. It is time investors resisted such efforts.

To that end, we propose that investors insist on distribution givebacks of no more than 30% of distributions, and that such givebacks be limited to no more than two years from the date of distribution.

This approach roughly conforms with the giveback scheme employed by the new Institutional Limited Partner Association model limited partnership agreement, which recommends that givebacks be limited to the lesser of 30% of distributions or 25% of capital commitments and that givebacks be called no more than two years after the date of a distribution (unless at the end of such period, there are ongoing proceedings which the general partner has advised are likely to give rise to indemnity liabilities).

The recent trend to shift indemnity liabilities from the general partner to the limited partner should be resisted by investor counsel mindful of their fiduciary responsibilities to their clients. This shift will encourage general partners to take greater risks, and while greater risks often produce greater rewards, they sometimes result in disasters which if the current trend accelerates, largely will be borne by investors alone.

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Disclosure: Lieberman sits on the Institutional Limited Partners Association's task force that drafted its model limited partnership agreement.

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