

More Certainty for Limited Partners

AREF considers the implications for investors and managers of the UK limited partnership law reforms taking effect in April 2017.

Tax transparent returns with limited liability are key attractions for investors committing into the UK limited partnership structure. This is a structure typically used as a fund vehicle for real estate indirect investment as well as private equity, infrastructure assets and venture capital, particularly when the fund manager is UK based. There is no direct tax at the level of the UK limited partnership itself. The investors - designated as limited partners and often including pension funds and other tax exempt entities - are taxed according to their individual status.

Limited partnerships are a vehicle of choice for managers and a range of investors: including many investors who wish to delegate discretionary management powers to the manager to other pro-active investors looking for more control. Limited partners enjoy limited liability provided that they do not take part in the management of the partnership business. This contrasts with the general partner (“GP”) - often an associated entity of the fund manager - who has unlimited liability for the debts and other obligations of the limited partnership. In practice, the risk of unlimited liability is ring-fenced by the GP entity being a special purpose company or other limited liability entity.

One longstanding challenge, has been clarity on the extent to which limited partners can monitor and protect their investments without “taking part in management” and avoid forfeiting their limited liability.

UK limited partnership law reforms - which in particular looks to address this challenge - will apply from 6 April 2017 so:

- limited partnerships, provided that they qualify as UK collective investment schemes, can then opt, subject to complying with administrative requirements, for a newly-created private fund limited partnership (“PFLP”) status;
- limited partners in PFLPs will then benefit from a “white list” of extensive, though not exhaustive, permissible activities similar to those available in other jurisdictions without forfeiting their limited liability; and
- PFLPs can operate more flexibly: for example, limited partners will no longer be required to make capital contributions if the limited partnership were registered after the PFLP reforms are introduced.

Post GFC investor expectation

As a reaction in part due to experiences during the Global Financial Crisis real estate market downturn, an increasing number of pension funds and other institutional investors are looking to be “pro-active”. Such investors want to monitor that funds operate within debt and other risk management parameters and comply with the fund’s strategic objectives. They require to be consulted on key strategic decisions and now frequently insist on representation within an investor advisory committee (“IAC”). Consultation is viewed as not taking part in the management of the limited partnership business.

The PFLP reforms “white list” will largely meet the greater control expectations of these investors, who as limited partners will be entitled - subject to formalising the arrangement in the partnership agreement - to:

- approve or authorise certain investment-related decisions and decisions related to partnership borrowings. This would provide an effective monitoring role over investments and taking on associated debt.
- take part in a decision about a change in the nature of the partnership’s business, disposal of the business or dissolution: for example, altering the strategic focus of the fund and/or implementing a restructuring.
- approve partnership accounts and valuations of underlying partnership assets. This provision would enable limited partners to scrutinise the real estate valuations of the PFLP.
- act as a director, member, employee or officer of the GP or fund manager, enabling, for example, the limited partner to exert influence via the GP entity.
- take part in a decision which involves an actual or potential conflict of interest relating to the partnership or its business. This provision may enable the limited partners to be involved in approving management fees.
- appoint a representative to a limited partnership committee, which would extend to membership of an IAC.

Other reforms: capital contributions

Typically, limited partners' contributions to a limited partnership are structured by way of nominal contribution to capital, with the balance being provided by way of debt. This split arises because there are stringent restrictions which apply on withdrawing capital from the limited partnership during its continuation: where capital is withdrawn, the limited partner becomes liable for the debts and obligations of the limited partnership up to the amount withdrawn. PFLPs limited partners will have the option - but no longer required - to make capital contributions and the capital will be withdrawable without further liability.

We would therefore expect that, in the future, investment is likely to be made as capital and not as loan.

Engagement

Limited partners and GPs interested in utilising the PFLP reforms should engage, in the context of UK limited partnerships established:

- before 6 April 2017 over opting for PFLP status, and it may be that limited partners (in light of their entitlement to vary the partnership agreement) seek wider powers consistent with the new "white list" activities.
- after 5 April 2017 on similar arrangements: PFLP opt-in and the limited partners being permitted to undertake "white list" activities.

Unit trusts and other feeder funds into UK limited partnerships could also be impacted. The feeder fund investors may wish the master limited partnership to opt for PFLP status, which might require changes to governance arrangements for the feeder funds so that they can properly exercise a more active role in the underlying PFLP.

Certain real estate indirect investors may well look to utilise the PFLP legislative reforms, particularly given the greater certainty on their decision-making powers and retaining limited liability.

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