

Fiduciary duties of a general partner of a Cayman exempted limited partnership

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The Cayman Islands (Cayman) continue to be the leading offshore jurisdiction for the establishment of hedge funds, private equity funds, and investment funds focused on other asset classes. A large number of Cayman funds are structured as exempted limited partnerships (ELPs) where the affairs of the ELP are managed and operated by a general partner and the investors join the ELP as limited partners. The general partner is typically a Cayman exempted company (General Partner). Limited partners are prohibited from taking part in the management of an ELP and face liability risks if they do.

The duties and liabilities of the General Partner are governed by:

- Cayman's Exempted Limited Partnership Law 2014 (ELP Law).
- Cayman's Partnership Law (as revised).
- The terms of the applicable Limited Partnership Agreement (Partnership Agreement) between the general partner(s) of the ELP and the limited partners of the ELP.
- The rules of equity and of common law applicable to partnerships so far as they have not been amended by Cayman statutory provisions.

This article focuses on the main fiduciary duties of a General Partner of an ELP rather than on the General Partner's duty of skill and care or other applicable duties arising under the ELP Law (for example, the duty to maintain a register of partners of the ELP and a register of capital contributions) that may apply to a General Partner.

FIDUCIARY DUTIES AND THEIR SCOPE

Duty to act in good faith in the interest of the ELP

The main fiduciary duty that a General Partner owes to the ELP and the ELP's limited partners as a whole is the duty of loyalty and good faith. Under Cayman law this is expressed as requiring the General Partner to act in good faith in the interest of the ELP. There is no specific guidance in the ELP Law as to the full extent of this duty. There are no decisions of the Cayman Islands' courts that have determined the full scope of the duty. However, as in other areas of Cayman law, it is reasonable to assume that the Cayman courts would refer to the decisions in English and Commonwealth cases, which are of persuasive authority if not binding authority, for guidance.

Before the ELP Law came into force in July 2014, a General Partner was under an absolute duty to act in good faith in the interest of the ELP. This duty could not be restricted, limited or varied by the terms of the Partnership Agreement between the General Partner and the limited partners. The requirement to act in the interest of the ELP often raises the issue of conflicts of interest for the General Partner, particularly when it acts as General Partner to more than one ELP.

Examples of where conflicts of interests can arise for the General Partner include:

- The General Partner causes the ELP to:
 - co-invest with other ELPs (in which it is also the general partner) in only certain transactions that benefit the General Partner; or
 - co-invest in disproportionate amounts, which causes its interests to be no longer directly aligned with those of the limited partners of the ELP.
- The General Partner causes the ELP to invest in a portfolio company in which the person(s) who control and/or own the General Partner, for example, the director(s) and/or shareholder(s) of the General Partner, have a personal interest.
- The General Partner causes the ELP to purchase securities from person(s) who control and/or own the General Partner, for example, the director(s) and/or shareholder(s) of the General Partner.
- The General Partner is responsible for valuing assets of the ELP where carried interest payable to the General Partner are based on such valuations.
- Treatment of limited partners: the General Partner owes a fiduciary duty to the limited partners of the ELP as a whole. Therefore the General Partner should treat each limited partner of the ELP in a similar manner. It should not benefit one at the expense of the others. Different treatment of limited partners sometimes arises in the context of default by a limited partner in performing its obligations under the Partnership Agreement. For example, where the limited partner fails to pay its contributions to the ELP when a call on its capital commitments has been made.

Often the Partnership Agreement provides that where a limited partner fails to perform any of its obligations under, or otherwise breaches the Partnership Agreement (for example, where a limited partner fails to commit additional capital when called on to do so), that limited partner may be subject to or suffer remedies for, or consequences of, the failure or breach specified in the Partnership Agreement. Such remedies or consequences can include, for example, reducing, eliminating or forfeiting the defaulting limited partner's partnership interest in the ELP. The ELP Law confirms that those remedies or consequences in the Partnership Agreement will not be unenforceable solely on the basis that they are penal in nature. This confirmation by the ELP Law reduces significantly the risk of those remedies or consequences in the Partnership Agreement being subject to legal challenge in the Cayman courts on the basis that they are penalties (that is, remedies that go well beyond a reasonable assessment and measure of the loss suffered as a consequence of the default) and may be unenforceable as a matter of Cayman law generally.

However, there is a risk of legal challenge by a limited partner where a General Partner fails to apply a clear and consistent approach to implementing such remedies in the Partnership Agreement against defaulting limited partners. The challenge

could be based on the ground that the inconsistent implementation of such default procedures benefits one limited partner at the expense of the others or vice versa.

Modification of duty to act in good faith in the interest of the ELP

The ELP Law modified the scope of the fiduciary duty of a General Partner to act in good faith in the interest of the ELP. There is still an absolute duty on the General Partner of an ELP to act in good faith on matters concerning the ELP. However, the duty to act in the interest of the ELP is now subject to any express provision in the Partnership Agreement to the contrary.

The Partnership Agreement can therefore stipulate the circumstances in which the General Partner may act in the interest of a party other than the ELP (for example, *see above, Duty to act in good faith in the interest of the ELP*). Including these circumstances in the Partnership Agreement should make it easier for the General Partner to manage interests that compete against the interests of the ELP.

However, where the Partnership Agreement has no express provision to state in whose interest the General Partner must act in given circumstances, then the default position is that the General Partner must act in good faith in the interest of the ELP (that is, in the collective interest of all limited partners of the ELP).

Duty to exercise its powers for the purposes for which they are conferred

A General Partner's powers derive from the ELP Law and the Partnership Agreement governing its relationship with the limited partners. The General Partner is under a fiduciary duty to exercise its powers for the purpose(s) for which they are conferred in the Partnership Agreement. The purposes in the Partnership Agreement can be stated in general terms, for example, to undertake any lawful activity under the ELP Law, or to act as an investment fund. They can also be expressed in specific terms, for example, to invest in a portfolio consisting primarily of securities of companies in the renewable energy, renewables, clean technology, environment regeneration sectors and to engage in all activities and transactions as may be necessary, advisable, or desirable to carry out these activities. Where the Partnership Agreement of an ELP is, for example, negotiated with a large institutional investor or seed capital investor, the investor will more than likely seek to have the purpose(s) of the ELP stated in more specific terms.

A duty of trusteeship of the ELP's assets

The ELP Law states that all "rights or property of every description of the [ELP], including all choses in action and any right to make capital calls and receive the proceeds thereof that is conveyed to or vested in or held on behalf of any one or more of the general partners or which is conveyed into or vested in the name of the [ELP] shall be held or deemed to be held by the general partner and if more than one then by the general partners jointly, upon trust as an asset of the [ELP] in accordance with the terms of the partnership agreement" (*section 16(1), ELP Law*).

As the General Partner holds the ELP's assets on trust, it follows that it should:

- Not make any secret profits from such assets or, without express authorisation, appropriate any benefits or opportunities that derive from such assets for itself.
- Disclose personal interest in contracts involving the ELP.
- Apply the ELP's assets for the purpose of the ELP.

ACTIONS TO REDUCE THE RISK OF BREACHING FIDUCIARY DUTIES

A General Partner can minimise the risk of breaching its fiduciary duties to the ELP and thereby the risk of being sued by one or more limited partners by adopting some or all of the following:

Avoid conflict transactions or establish advisory committees or votes of limited partners to approve conflict transactions or waive conflicts. An ELP's Partnership Agreement often provides for the establishment of an advisory committee to adjudicate on, among other things, conflict situations involving the General Partner. The use of advisory committees is a good way of mitigating the risk of the General Partner being found to be in breach of its fiduciary duties for failing to deal with conflicts or dealing with them inadequately. The ELP Law confirms that, subject to any terms of the Partnership Agreement to the contrary, a member of the ELP's Advisory Committee does not owe any fiduciary duty to the ELP or to the General Partner or to any of the ELP's limited partners, in exercising any of its rights or otherwise in performing any of its obligations as a member of the advisory committee (*section 24(2), ELP Law*).

Clear and consistent policies. The General Partner should ensure that the ELP, where possible, adopts clear and consistent valuation policies approved by the ELP's advisory committee. The General Partner should also ensure that the ELP, where possible, adopts clear and consistent policies for dealing with circumstances where limited partners default on their obligations in the Partnership Agreement (for example, failing to make contributions when a capital call has been made).

Internal compliance. The General Partner should establish clear internal procedures for identifying potential conflicts and dealing with them (for example, referral to the advisory committee for consideration).

Restrict the scope of fiduciary duties by agreement. The Partnership Agreement can be drafted in such a way as to minimise or eliminate fiduciary duties. For example, the ELP Law now permits the Partnership Agreement to set out circumstances in which the General Partner may act in the interests of parties other than the ELP (*see above, Modification of duty to act in good faith in the interest of the ELP*). The Partnership Agreement can also be used to clearly exclude fiduciary duty obligations of the General Partner in other areas but this will depend on the relative bargaining power between the General Partner and incoming limited partners and the degree of negotiation of the Partnership Agreement. However, the absolute duty on the General Partner to act in good faith in respect of the ELP cannot be excluded or eliminated.

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Publications

- *Introduction of the New ELP Law and the Contracts (Rights of Third Parties) Law 2014: Good news for Cayman Islands domiciled private equity funds. Private Equity and Venture Capital Global Guide 2014/15.*
- *Investment Funds: Cayman Islands, Practical Law Investment Funds Global Guide 2012.*
- *Introduction of Non-Petition Covenants, International Corporate Rescue Vol. 10, 2013, Issue 4.*
- *Cayman Islands' Court of Appeal Re-affirms Status of Segregated Portfolio Companies, International Corporate Rescue Vol. 9, 2012, Issue 6.*