

Burrill Controversy Highlights the Complex Path to LP-GP Divorces

August 2015

In 2013, investors in Burrill & Co.'s third fund faced what many dread: the fight to remove a fund manager over alleged fraud. In October of that year, three of the firm's managing directors alerted investors to what they considered unauthorized transactions that had drained a \$283 million fund of capital that could have backed deals.

The investors in Burrill Life Sciences Capital Fund III LP dismantled the fund's management team in 2014 before bringing on board health-care firm Kearny Venture Partners to take charge of the nine-year-old portfolio earlier this year. The fund is now suing its former general partner and Burrill & Co.'s namesake founder, G. Steven Burrill, over alleged fraud and claims more than \$17 million was embezzled from the fund between 2007 and 2013.

Mr. Burrill didn't respond to a request for comment, and Burrill & Co.'s phone lines have been disconnected. Parties including Mr. Burrill have denied similar allegations of misuse of the fund's capital that surfaced in a separate lawsuit filed last year by a former insider at the firm. An attorney at Villarreal Hutner PC, which has represented the parties in the past, didn't respond to queries.

Burrill Life Sciences Capital Fund III LP is one of only a few funds whose investors have replaced the fund's manager with another firm. Because such divorces are so rare, investors seeking them have few role models to follow, forcing them to rely on their own influence and creativity to move the funds forward.

Greater regulatory scrutiny, growing investor awareness and a rising tide of boom-era funds that have failed to measure up could increase the likelihood of these conflicts, according to industry experts.

"As the industry matures and investors have a better understanding of their rights, there could be greater prevalence of GP removal actions, which up to now have only been considered by investors in the most extreme circumstances," said Kenneth Latz, a managing director of the private fund services practice at financial and operational adviser Conway MacKenzie Inc.

Investors often can only terminate their managers if they have legitimate grounds for removal. This typically requires the LPs to demonstrate wrongdoing on their manager's part, a challenging task if the information is not readily available.

After three Burrill insiders alerted the limited partner advisory committee on alleged misuse of fund money, Fund III's investors launched an investigation into the portfolio's books in 2013. However, Mr. Burrill declined a request to be interviewed as part of the investigation, according to the complaint. "An interview of me is not contemplated nor required by the partnership agreement, and I respectfully decline your request," said an email excerpt from Mr. Burrill cited in the complaint.

When representatives of the fund advisory committee requested in November of that year that the general partner resign, the fund manager did not step down, court filings indicate.

Fund contracts typically also require a majority or supermajority of investors to vote to trigger a general partner's removal, a hurdle that can be difficult to clear without LP consensus. "Historically, limited partners have had limited motivation or have lacked an effective governance structure to organize themselves," said Paul Sanabria, a managing director and co-head of investment bank Houlihan Lokey's illiquid financial assets practice.

Often the fund's largest investors must lead the rest of the group. But even they may hesitate, in part because they may not want to develop a reputation of being too activist or to devote the necessary time and resources without a guarantee of success.

Among the key investors that pushed for change with Burrill's third fund was the \$90 billion North Carolina Retirement Systems, which originally committed \$50 million to the fund. In February 2014, the North Carolina State Treasurer sent a letter to Mr. Burrill, co-signed by 12 other investors that made up two-thirds of the capital in the fund. The note declared that the manager's exit would be effective in 30 days, on the grounds that it had breached its fiduciary duty, engaged in willful or reckless misconduct, and acted in bad faith to bring material injury to the fund.

"We worked with other limited partners to investigate the misappropriation of fund assets by the original general partner," said a spokesman for the pension system. "Based on the findings of that investigation, North Carolina Retirement Systems and the other limited partners removed the original general partner."

LIFE IN LIMBO

Life after divorce can cast a fund temporarily adrift. Investors may be forced to place their fund in the care of groups that don't have the knowledge or the incentives to be fully aligned with them. Fund investments may change hands and the institutional knowledge of the portfolio can get lost in transit.

After dismantling the fund management team, investors in Burrill Life Sciences Capital Fund III LP placed the portfolio, on an interim basis, in the care of three managing directors who had alerted them to the alleged misuses of capital. The fund then hired consulting firm StepStone Group to run a search for a new manager, according to two people familiar with the matter. Roughly a year later, they handed the reins to Kearny.

"Generally, it takes longer than it should for limited partners to bring on a new general partner," said David Philipp, managing director of Crestline-Kirchner Private Equity Group, a joint venture launched by Crestline Investors and Kirchner Group to buy, manage and restructure private equity and illiquid hedge funds. "During the deliberation and transition period, the investments are likely not getting better with time."

In 2009, limited partners of growth equity and buyout fund Brantley Partners V LP, a \$100 million-plus pool closed in 2008, mobilized to remove the fund's general partner, Brantley Partners. Robert Pinkas, the firm's founding partner, had come under investigation from the Securities and Exchange Commission for alleged misallocation of fund expenses, among other claims. Mr. Pinkas died in 2012, which led the SEC to discontinue proceedings over the claims.

The fund's documents contained a no-fault removal clause, which precluded the need for an onerous fight against the GP, according to another person. Conway MacKenzie initially came aboard as the interim GP of the fund following a pact between the previous fund manager and investors in 2010.

Kirchner Group stepped in a year later as the subsequent replacement manager of the fund, which was renamed Emerald Partners V LP. Preserving the institutional knowledge of a portfolio during these transfers is crucial, say industry experts.

"A lot of the time, the corporate records have to be moved, the historical information from years of running the assets have to be downloaded," said Neil Luria, senior managing director of investment bank SOLIC Capital Advisors. "If there is an art to being a replacement manager, it's the ability to synthesize and download all that information in order to properly monetize the underlying assets."

Professionals at the firm were appointed by a bankruptcy court to be the replacement manager of SageCrest II LLC, a hedge fund made out of subprime loans that filed for chapter 11 protection in 2008. They took over the mandate from Windmill Management LLC, which voluntarily stepped down in 2010, people said.

"Given the meltdown in the market, Windmill took steps that were clearly in the best interests of the SageCrest funds' investors," said William A. Brewer III, partner at Brewer Attorneys & Counselors and counsel to Windmill Management. "At the appropriate time, Windmill voluntarily stepped aside in order to allow others to implement the plan."

Cooperation from the former GP can be helpful in minimizing the disruption during these handovers, said Kenneth Garnett, a managing director at Conway MacKenzie's private fund services practice. "In situations where you take over from managers who are uncooperative or have been accused of misconduct and fraud, you may have to resort to litigation or other channels to obtain information or other required support," he said.

CLARITY UP FRONT

As more conflicts over GP removals emerge, investors may be getting wiser about negotiating clauses that allow them to dislodge their managers more easily the next time around.

More fund agreements now allow limited partners to vote out their manager without the need to prove cause, said Carl Metzger, a partner in the business litigation group at law firm Goodwin Procter LLP. Contractual language defining the grounds for GP removal also has broadened over time beyond the most egregious acts of bad faith and misconduct, he added.

But there is still little standardization around these documents, which can vary widely depending on shifts in the balance of power between investors and GPs. In hot markets, investors may be less likely to fight for fund terms to facilitate GP divorces with coveted, brand-name managers.

The Institutional Limited Partners Association, a trade organization representing fund investors, has been providing more guidance on GP divorce clauses over the years. In 2011, ILPA recommended investors seek provisions that allow them to remove managers without fault, so long as LPs making up three-quarters of commitments supported the removal. ILPA also recommended that for-cause removals of GPs be allowed to occur once a majority of LPs voted in favor. Additionally, it asked LPs to detail what conditions were necessary to trigger their evictions and specify how "removal mechanisms" would be meted out.

"As the industry has grown, it's not the tightly knit private equity community that it used to be. It's gotten more impersonal, and more typical of having the kinds of disputes in any other corner of the alternatives world," said Mr. Metzger. Yet fund documents aren't likely to anticipate all the complexities and the flaws of human nature that might surface. "When disputes do happen, it could be a meltdown scenario: a civil war with hand-to-hand combat."

###