

This article appeared in the September 2003 issue of *Venture Capital Journal*

## VIEWPOINT: How To Avoid the Open Records Spotlight

By *Joel Rubinstein, McDermott, Will & Emery*

Every couple of years, private equity funds are forced to review partnership agreement provisions that seemed like boilerplate when first drawn up. The primary reason is the events surrounding limited partners, such as when stock market decreases led many LPs to default on fund commitments, thus spurring a reexamination of default provisions. More recently, confidentiality clauses have taken center stage, due to the promulgation of requests for confidential fund information from public LPs under state open records laws.

What's specifically different this time is that while default provisions are essentially matters of contract law (that is, subject to agreement between the parties), confidentiality provisions are subject to state open records laws, which can mandate disclosure despite a confidentiality agreement. Similar in purpose to the federal Freedom of Information Act (FOIA), open records laws allow the public to access and copy records held by state agencies, subject to certain exceptions. Faced with the threat of having their confidential information disclosed, general partners have scrambled to employ a variety of means to try to prevent this from happening.

### Drawing the Battle Lines

To be sure, general partners have not taken a uniform stance regarding the types of disclosure they seek to prevent. Some have sought to resist disclosure of internal rates of return (IRRs), while others have decided that they can live with the release of such top-line data. GPs agree on one thing: They must resist the disclosure of portfolio company level data (underlying assets), because those data present a much greater potential for exploitation to the detriment of the funds and their portfolio companies. Many general partners also object to allowing public access to partnership agreements and side letters.

Venture capital funds seem to be much more active and vocal in fighting the disclosures than buyout funds. This may be due to the emerging nature of venture capital fund portfolio companies, whose revenues and valuations are subject to greater fluctuation and which historically treasured greater secrecy.

### Assessing the Options

The recent disclosures have illustrated how confidentiality agreements cannot always prevent confidential information from being legally disclosed. Although confidentiality provisions typically prohibit LPs from disclosing sensitive fund and portfolio company information, they

often contain exclusions for disclosures required by law. And even absent these exclusions, if a state open records law mandates disclosure, it will trump any confidentiality provisions.

Therefore, if a state agency (like a state pension fund) receives an open records law request for a fund's confidential information, it

must disclose the information unless it is determined that the particular information at issue falls under an exception from disclosure. The fund whose information is at risk of disclosure might not be invited to participate in this determination, unless its confidentiality agreement with the state agency requires the agency to do so.

In determining whether or not an exception from disclosure exists, each type of requested information must be analyzed separately under the applicable open records law. In general, a private equity fund's confidential information falls into three broad categories:

- IRRs and other performance data at the fund level.
- The management fee, carried interest and other terms of the operation of the fund contained in the partnership agreement and side letters with particular limited partners.
- Valuations and other data relating to particular portfolio companies.

Although open records laws vary significantly from state to state, some of the common disclosure exemptions include information constituting a trade secret and disclosures that would cause substantial competitive harm to the business that supplied the information to the state agency. Also sometimes excepted is information that, if disclosed, could harm the agency's ability to compete for a contract. Creating greater uncertainty is the fact that some exceptions require a balancing of the interests of the state agency and the fund in preventing disclosure, against the public's interest in having access to information.

In the battles that have already been fought under various states' open records laws, general partners have had a tough time arguing that IRRs fit within an exception. The first judicial decision on the issue involved a California Superior Court ruling that the University of California must disclose IRR data for the funds in which it has invested, rejecting claims that IRRs constitute trade



*Joel Rubinstein*

secrets. (See Case No. RG03 089302 in Alameda County Superior Court.) However, when it comes to portfolio company information, such as valuations and revenue figures, general partners so far seem to have been successful in keeping this information from being disclosed. The picture is less clear for the terms of funds' operations, which have been disclosed in some instances.

### **Back to the Drawing Board**

While these battles are taking place over information that already has been disclosed, many general partners have devised strategies for preventing future information dissemination. Current funds are generally stuck with their existing partnership agreements because amendments can be difficult to obtain, but not all of the information that GPs usually provide LPs - such as portfolio company data - is mandated by partnership agreements. In such cases, some funds are conditioning the disclosure of this additional information on representations by LPs that they are not subject to open records laws. Those limited partners who cannot make this representation may not be provided with the additional information, or they may be provided with such data verbally so that there are no records subject to disclosure. In some cases, even where portfolio company data is required to be provided under the partnership agreement, LPs subject to open records laws have agreed to be provided with this information verbally. Complicating this effort, however, is the almost ubiquitous requirement that funds provide LPs with audited year-end financial statements, which typically include particular portfolio company valuations.

Some general partners have been taking pains to prominently label each page of each document they distribute to investors as being "confidential" and containing "trade secrets," together with an explanation of the importance of keeping the information confidential. Although labeling something a confidential trade secret does not make it so, the determination of whether information is confidential or a trade secret can hinge, in part, on the measures taken by the fund to protect the information from disclosure.

General partners marketing new funds that wish to raise money from public agencies (and despite the well-aided grumblings, most of them still do) are taking a fresh look at standard provisions regarding information provided to limited partners. Many of these provisions were drafted before recent amendments to Section 17-305 of the Delaware Revised Uniform Limited Partnership Act (which governs many funds), which now permits the restriction of LP rights to information within the partnership agreement. Previously, the general partner could only withhold certain information, including trade secrets or other information that the general partner, in good faith, believes to be not in the best interest of the partnership or could damage the partnership or its business, leaving open the possibility of a

dispute over the appropriateness of any particular withholding. As a result, the information to be provided to LPs often is being narrowed to exclude sensitive portfolio company data.

Confidentiality provisions also are being revised, including new obligations that LPs notify GPs before releasing confidential information pursuant to a legal requirement, and to provide the GP with an opportunity to seek a protective order to prevent the release. In addition, because some exceptions from disclosure under open records laws can be waived by the public agency, assurances may be sought that the public agency will contest disclosures to the fullest permissible extent. Some general partners also are seeking to have the ability to require the return of confidential information held by limited partners at any time. Each page of the partnership agreement often is labeled as being confidential.

### **Looking Ahead**

The evolution of open records-related disclosure practices is likely to continue until the courts have sorted the issues out in a definitive manner, or until changes are made to open records laws that expressly deal with private equity fund information. Indeed, efforts are already underway in some states to advance such legislation so that, at the very least, portfolio company information is protected. At the same time, as private equity as an asset class continues its march toward greater institutionalization, and a new generation of asset managers rises to top positions at state agencies, the pressure against withholding certain information from public agencies is likely to increase. In any case, general partners have learned their lesson about thinking that some partnership agreement provisions concern theoretical possibilities, rather than realistic ones. The result is that many may find themselves spending spare time perusing partnership agreements, trying to get ahead of the game before the next big issue.

---

*Joel Rubinstein is a partner in the New York office of McDermott, Will & Emery. He represents private equity funds in their formation and investment activities, as well as private and public companies in corporate finance, transactions and securities matters. Ruchir Patel, a summer associate with the firm, assisted with the preparation of this article.*