Private Equity Fund Formation Conflicts of Interest

Jonathan Cohen

January 2015

Overview

PE funds manage multiple investment vehicles and/or engage in several different asset management and other related services that can give rise to a number of potential conflicts of interest:

SEC has recently warned PE fund advisors that they are concerned about **inherent conflicts of interest in the PE business model.**

- SEC has indicated that it will apply heightened scrutiny on conflict of interest situations and fund managers should carefully manage any potential conflict of interest situations and the SEC suggests that the PE funds should use **limited partner advisory committees** to help address the conflicts where possible.

Most Significant Areas of Conflicts of Interests and Examples of Potential Problems Recently Highlighted by the SEC

- **Fees and Expenses:** Shifting Expenses from GP to LP, charging Operating Partner salaries and overhead to the Fund, allocating transaction-related fees to the Fund and not to co-investors, Funds paying entire broken-deal fees with none of these expenses allocated to co-investors, hidden fees (monitoring fees and other undisclosed agreements which create additional Fund expenses).

- **Valuation**: Inflated valuations during periods of fundraising, cherry-picking comparables and changing valuation methodologies from one period to another, using valuation methodology different from that that was described in the Fund agreements.

- **Transactions with Affiliates**: PE firm acts as a creditor or lender to the Fund or one of its portfolio companies, PE firm buys an investment from or sells it to the Fund, a PE firm is engaged to act as a service provider for the Fund or one of its portfolio companies.

- **Competing Funds**: Fund Operating Agreements can provide that Funds have first priority on investments that the PE firm has sourced, while other Fund Operating Agreements will indicate that the Fund does not have a priority on certain opportunities that the PE firm has sourced because another firm managed by the PE firm has a priority over certain types of opportunities or a right to co-invest in such opportunities.

Use of Investor Advisory Committees

The SEC <u>strongly recommends</u> that PE fund managers, in light of their fiduciary responsibilities and the goal of transparency and disclosure for its Investors, should refer any potential Conflict of Interest issues to the Fund's Limited Partnership Advisory Committees ("LPAC"). Any potential or actual Conflicts of Interest should be disclosed to the LPAC for a vote and express consent to those Conflicts of Interest and their proposed resolution.

LPACs should be used by the PE Firms and the Funds to address Conflicts of Interest, Valuation Issues and certain other Standard Approvals required in the Fund Operating Agreements.

- **<u>Conflicts of Interest</u>**: LPAC consent should be received before the Fund enters into a related party transaction.
- **<u>Valuation</u>**: LPACs should carefully consider and expressly approve the valuation methodology of the Fund. Valuation of the assets of the Fund can be difficult because of the illiquid nature of the assets. The valuation determines the Management Fee, distributions and performance reporting of the Funds and therefore the Fund manager should have LPAC approval of the Valuation to avoid potential conflict of interest issues.
- **<u>Standard LPAC Approval Provisions</u>**: The Fund Operating Agreements may require the consent of the LPAC for changing specific provisions in the Fund Operating Agreements, such as the change of focus of type of investment or asset class, change in key managing people and investment advisors, extension of investment period or liquidation date.

Conflicts of Interest Over the Life Cycle of the PE Fund

Fund Raising Stage

<u>Size of the Fund</u>:

- Fund Managers want to maximize size of Fund to maintain market position and to increase the potential management fees.

- Investors want to be sure that whatever capital is raised can be utilized in only the most attractive investment opportunities during the term of the Fund.

<u>How Funds Manage this Potential Conflict</u>:

- The Funds and Investors will sometimes negotiate a hard cap on the size of the Fund, they will also carefully negotiate the amount of the Management Fees (which can be adjusted to a lower percentage if the Fund becomes a certain size) and certain performance incentives. Some PE Funds take it a step further by co-investing PE firm and management money with the Fund for alignment of interest.

Fund Raising Stage

Use of Advisors:

- PE firms use outside advisors to market a new Fund to a wider-range of institutional investors. The outside advisors will be compensated for the investment in the Fund that they originate. Frequently these costs are eventually paid by the Fund, not the PE firm. Further, these outside advisors have a conflict in that they are incentivized to recommend investment in the Fund, but do not disclose this in their provision of investment advice to potential investors.

- Investors will insist that any fees for outside advisors marketing the Fund during the fund raising stage should be paid by the PE firm who stands to benefit.

How Funds Manage this Potential Conflict:

- The PE firms and Investors should communicate very clearly about who is paying the outside advisor's fees and exactly how much they are. Often PE firms will pay the fees themselves or will be paid by the Fund with a corresponding reduction in the PE firm Management Fee. Also, outside advisor's should be required to disclose to any potential investors their potential commissions for any purchases in the Fund.

Investment Stage

Co-Investment:

- General Partners and individual Fund Investors may be offered opportunities to co-invest in Fund portfolio companies. Conflicts can arise if the General Partners or the individual Fund Investors are allowed to invest on different terms than the Fund and the allocation of expenses can be difficult.

- Co-investing is generally a positive development for Investors as it aligns the interests of the General Partners and the Fund, allows certain individual Fund Investors who are able to commit quickly to invest in opportunities without paying Management Fees and helps the Fund control the outside investment in a portfolio company to those affiliated with the Fund. Certain Investors may feel left out of an opportunity if they are not informed of the investment opportunity or if they are not able to commit capital quickly enough.

Investment Stage

How Funds Manage this Potential Conflict:

- General Partners and individual Fund Investors should not be offered preferential terms. All of the Investors should be made aware of a potential co-investing opportunity and the limitations (amount of investment and timing) of the opportunity at the same time. Depending on the circumstances, the LPAC should be engaged to expressly approve the offer of the opportunity to the General Partner and individual Fund Investors.

Investment Stage

Allocation and Investment Strategies –
Multiple Funds Investing in the Same Portfolio Company:

- PE firms typically do not raise new Funds with the same strategy until the earlier Fund is nearly exhausted (at least 75% invested). When they do raise a new Fund, there can be conflicts between allocation of investments in portfolio companies by the old Fund and the new Fund.
- Follow-on financing may be needed by a portfolio company of the old Fund. Conflict of Interest issues can arise when the new Fund is asked to provide the follow-on or rescue financing. The PE firm wants to avoid any allegations that the new Fund assets are being used to prop up the old Fund.
- Some PE Firms have several Funds with different investing strategies that may invest in the same portfolio company in different assets (debt, equity, etc.). The alignment of the investments (success of the portfolio company = success of the Investments) may be thrown off if the portfolio company experiences distress and the debt holders interests may no longer align with the equity holders.

Investment Stage

How Funds Manage this Potential Conflict:

- Usually the old Fund has priority over the new Fund in terms of allocation, but firms generally will try to negotiate for the new Fund to have an opportunity to invest. This should be done in a transparent way and the LPAC may need to be involved. In the rescue financing scenario, an independent valuation expert should be retained to value the new investment, to justify the price and remove any insinuation that the new Fund assets are being used to unfairly prop up the old Fund. When the PE firm has different Funds with different investment strategies invested in the same company, the PE firm should be sure that the funds have well-defined mandates and exit requirements. Further, the PE firm should be sure to maintain separation of the investment decisions and information between the funds and to keep the Investor's informed when a potential issue arises of how the PE firm and the Fund's are handling the conflict.

Investment Stage

Costs, Fees, Expenses:

- Shifting of Expenses from the PE firm to the Fund, including operating expenses, fees paid to advisors, broken deal expenses, is frequently an issue. An advisor and his/her fees could be allocated 100% to the Fund, while the firm maintains the advisor as an employee on its website and the Fund Investors think he works for the PE firm, not the Fund.

- Allocation of 100% of transaction fees to the Fund and none to co-investors or General Partner investors.

- PE Firms often charge portfolio companies fees as a placement agent or a transaction fee. This negatively effects the portfolio company balance sheet.

Investment Stage

How Funds Manage this Potential Conflict:

- The allocation of fees should be carefully and thoroughly disclosed in the Fund Operating Agreements. However, all such expenses cannot be anticipated and PE firms should be careful to disclose the allocation of expenses to the Funds and the rationale for doing so.

Post-Investment

Director Appointments and Other Potential Fees
and Conflicts Relating to Management of Investments:

- PE Firms regularly have members appointed to Boards of portfolio companies. Those members are often paid fees or granted options by the portfolio company. Investors may ask that these fees offset against the fund management fees and PE firms should consider, at minimum, providing disclosure of any fees derived by the PE firm as a result of its service on the Board of a portfolio company.

- Members of PE firms serving on the Boards of portfolio companies have a potential Conflict of Interest between the company and the Fund. This can arise when the portfolio company is distressed or is in negotiations with other investors or funding sources. Further, the director can have some disclosure Conflicts of Interest when certain portfolio company information is material non-public information (in the case of a public company) and his/her duties to the Fund would require disclosure of this information, but his duties on the Board do not allow such disclosure.

Post-Investment

Director Appointments and Other Potential Fees
and Conflicts Relating to Management of Investments:

- Funds which have Board members in public portfolio companies can also be conflicted in selling portfolio company securities, because the member of the Board may have inside information and the PE Fund may be expected, for PR purposes, to demonstrate its continued support of the portfolio company.

How Funds Manage this Potential Conflict:

- PE firms should educate its employees who serve on Boards how to manage any potential Conflicts of Interest that arise. PE firms should also disclose fees and equities received by its employees from portfolio companies for services rendered.

Post-Investment

Defaults and Rescue Financing:

- Most Funds operate with a capital call system and if Investors do not meet the capital calls, there are significant default penalties. The fund managers are often given some discretion in enforcement of default remedies and may, at times, have a conflict as it relates to certain defaulting Investors, and a PE firm's desire to continue a positive relationship with the defaulting Investor for future investments by the Investor in other Funds or opportunities.

- Another significant issue that can arise relates to rescue financing. As discussed earlier relating to Conflicts of Interest when multiple funds invest in the same portfolio company, a rescue financing can raise several difficult Conflicts of Interest. Rescue financing can create the possibility that one Fund's assets could be used (or be perceived to be used) to prop up or save the investment of another Fund. Another issue that arises when the portfolio company requires immediate financing, is that a PE Fund may not have any more available capital and a portfolio company may raise funds from a third party, significantly diluting the Fund.

Post-Investment

How Funds Manage this Potential Conflict:

- Investor Defaults should be handled uniformly and should be disclosed to the LPAC promptly. Rescue financing issues should also be referred to the LCAC and a Fund should negotiate a super-majority approval requirement for rescue financings with the portfolio companies at the time of investment to avoid dilution without its consent.

Fund Closing

Sales by/for/to Multiple Funds:

- On exit, one Fund may sell assets to another Fund managed by the PE Firm, which raises a Conflict of Interest.

- If two or more PE Funds managed by the PE Firm hold investments in the same portfolio company and one or more of the Funds desires to exit the investment, the timing of the exit can create a Conflict of Interest.

How Funds Manage this Potential Conflict:

- Generally two or more Funds invested in the same portfolio company will exit the portfolio company at the same time. The proposed exit rationale should be discussed by the LPAC. In the event of a transaction between Funds, the LPAC's should be engaged to approve of the pricing of the transaction.

Fund Closing

Extending Fund Life:

- Funds are generally for 10 years with three 1-year extension options. A Conflict of Interest can arise in relation to the extension options, in that the PE Firm stands to gain additional Management Fees if the Fund is extended.

How Funds Manage this Potential Conflict:

- LPAC approval should be obtained for any extensions and approval of Management Fees (or reduction of Management Fees) should also be approved by the LPAC.

EXAMPLES

Recent SEC Enforcement Actions Regarding Conflicts of Interest

Allocation of Expenses/Fees

Robert Pinkas:

Advisor misappropriated $173,000 from a PE Fund to pay his legal defenses in an unrelated SEC investigation. He told the Fund's Investor Advisory Committee that the Fund's law firm had confirmed that the Fund's indemnification provisions allowed him to use Fund assets to cover his legal fees. [1]

Onyx Capital Advisors:

Principal of a PE Fund, Roy Dixon, took more than $2 million as purported advance management fees. Dixon used misappropriated funds to pay for construction of home. He also misled certain public pension funds investing in his fund during fundraising regarding the involvement of certain other investment professionals. [2]

---

1. In re Pinkas, Adm. Proc. File No. 3-14759 (instituted Feb. 15, 2012).
2. SEC v. Onyx Capital Advisors, LLC, No. 10-cv-11633 (E.D. Mich. filed April 22, 2010).

Valuation

Yorkville Advisors:

Yorkville reported false and inflated values of certain illiquid assets for its hedge fund to increase the Funds' assets under management and to maintain the Funds' positive year-end performance to increase their Management Fees by as much as $10 million. [3]

KCAP Financial:

Advisor overstated the valuation of corporate debt portfolio and collateralized loan obligation funds. [4]

Oppenheimer Asset Management:

SEC charged two Oppenheimer investment advisors with misleading investors regarding valuation and performance in PE Fund. [5]

---

3. SEC v. Yorkville Advisors, No. 12 Civ. 7728 (S.D.N.Y. filed Oct. 17, 2012).
4. In re KCAP Financial, Inc., Adm. Proc. File No. 3-15109 (instituted Nov. 28, 2012).
5. In re Oppenheimer Asset Mgmt. Inc., et al, (March 11, 2013).

Misallocation of Investment Opportunities

Matthew Crisp:

An employee of Adams Street, funneled a very profitable investment opportunity to a private fund held by the employee and a friend, resulting in significant gain to the employee, instead of to the Adams Street Fund. [6]

6. In re Crisp, Adm. Proc. File No. 3-14520 (instituted Aug. 30, 2012).

Fundraising Fraud

Resources Planning Group:

A PE principal personally guaranteed a portion of the funds invested and raised further funds without disclosing to the new investors the prior personal guarantees. He then used the new Fund assets to repay the previous investors. Further, he failed to disclose the poor financial health of the Fund to new investors. [7]

Advanced Equities:

Misstatements were made to investors about the performance of a portfolio company (order backlogs in excess of $2 billion (actually less than $50 million) including $1 billion order from national chain (actually $2 million order with non-binding letter of intent for future purchases).[8]

---

7. SEC v. Resources Planning Group, Inc., No. 12-cv-9509 (N.D. Ill. filed Nov. 23, 2012).
8. In re Advanced Equities, Inc., Adm. Proc. File No. 3-15031 (instituted Sept. 18, 2012).

Insider Trading

Gowrish:

Former TPG Capital associate Vinayak S. Gowrish stole confidential acquisition information from multi-billion dollar PE firm and sold information to two friends who profited from the information from insider trading. [9]

9. SEC v. Vinayak Gowrish et al., case number 11-16956, in the U.S. Court of Appeals for the Ninth Circuit.

Further information

Jonathan Cohen, Special Counsel

Washington, D.C.

JCohen@duanemorris.com

+1 (202) 776-7807

Private Equity
Fund Formation
Conflicts of Interest

Jonathan Cohen

January 2015