Potential Conflicts of Interest in the Private Equity Industry

By: Javier Bleichmar, Erin Woods, Ross Shikowitz, and Thayne Stoddard

I. Introduction

Recent downward trends in financial markets have resulted in increased scrutiny of private equity (PE) firms and their managed funds. Investors and regulators, including the U.S. Securities and Exchange Commission (SEC), are increasingly concerned about potential and emerging conflicts of interest that may result in PE firms misvaluing portfolio companies and charging excessive fees, particularly when selling those companies to themselves through the use of "continuation funds."

Recent downward trends in financial markets have resulted in increased scrutiny of private equity (PE) firms and their managed funds.

The SEC has amped up inquiries concerning portfolio company valuations and fee calculations and has proposed rules requiring independent fairness opinions for continuation fund transactions. Nevertheless, investors should seek adequate diligence before participating in a continuation fund to ensure appropriate portfolio company valuations and fee calculations. Section V suggests steps that investors may take under their investment agreements and during diligence to address potential concerns.

II. The PE Fund Lifecycle

PE firms form investment funds through limited partnership (LP) agreements with large investors. The LPs provide capital, which the PE firm—as the fund's general partner—uses to purchase portfolio companies or other assets. Under the LP agreements, the LPs agree to the fees paid to the general partner for its services and delegate control over the investments to the general partner.

PE funds typically have a lifespan of five to ten years. During this time, the PE firm: (i) deploys committed capital to purchase portfolio companies; (ii) works to streamline and grow those companies to increase their value; and (iii) exits the fund's investments, typically through Initial Public Offerings (IPOs) or sales to other companies.

The fees the PE firm charges differ at each stage and incentivize the PE firm to rapidly purchase, grow, and sell portfolio companies. During the "investment period"—when the fund is buying portfolio companies—PE firms typically charge an annual management fee of 1.5%-2% of the total capital committed to the fund. After completing its investments, the PE firm charges less fees—typically around 1.5% of the total purchase price of the companies that have not yet been sold. The result is that PE firms make less in management fees later in a fund's life. To incentivize PE firms to quickly grow and exit the fund's investments, the LPs usually agree to pay PE firms 20% of the realized profits from the sale of portfolio companies, known as "carried interest." The remaining profits are distributed to the LPs.

The PE firm only earns fees by maintaining or increasing the value of portfolio companies. Typically, the PE firm must provide the LPs with a valuation for each portfolio company on a quarterly basis. If a portfolio company's value declines below its purchase price—*i.e.*, a write-down of the company—the management fees must be reduced. If the value of the portfolio company is reduced to zero—known as a write-off—the PE firm cannot charge any management fees as to that investment. And if the PE firm cannot sell a portfolio company at a profit, then it will not earn any carried interest. Faced with the prospect of reduced fees, there is a structural incentive for PE firms to avoid recognizing any reduced valuations of portfolio companies.

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III. Increased Scrutiny of Interim Valuations and Management Fee Calculations

Under LP agreements, PE firms typically have latitude when valuing portfolio companies. Though the agreements often provide some means for LPs to test these valuations, including by inspecting the books and records of a portfolio company, LPs may lack the time and resources to effectively exercise these rights. Without meaningful oversight, PE firms may potentially delay (or avoid) write-downs and thus inflate the value of portfolio companies, leading to excessive fees. For example, inflated valuations may result from potentially biased internal valuations of the company's current and/or future performance or a skewed selection of comparator peer companies.

Given recent market volatility, regulators and investors are concerned that certain PE firms have, in fact, avoided taking necessary write-downs. The SEC has increased inquiries to PE firms about reducing management fees when portfolio company valuations are reduced.[1] While the SEC occasionally posed these questions previously, it now regularly asks PE firms about these issues in detail during routine exams. SEC officials hope to address concerns that PE firms may be charging higher fees than contractually allowed.

For example, the SEC recently entered into a settlement with Energy Innovation Capital, LLC (EIC), relating to allegations that EIC charged excessive management fees.[2] From January 2020 to March 2022, EIC made several errors when calculating management fees, resulting in overcharges of $678,861. Those errors included failing to account for portfolio company write-downs and inflating the value of portfolio company securities. The SEC found that the overcharges violated the Investment Advisors Act of 1940 and settled the charges in exchange for EIC's agreement to return the excessive fees and inform past and current investors of the settlement. The SEC's increased activity in this arena suggests that investors should remain vigilant.

IV. Continuation Funds: Potential Misvaluations and Conflicts of Interest

A continuation fund is a PE fund whose purpose is to purchase portfolio companies from another PE fund, usually backed by the same PE firm and with many of the same LPs rolling over their interests into the new fund. Given the structure of these vehicles—with the PE firm essentially selling assets to itself—there is the potential for PE firms to distort the value of a portfolio company while simultaneously locking in their carried interest and increasing management fees.

The use of continuation funds has dramatically expanded in recent years due to the economic uncertainty caused by the COVID pandemic. While continuation funds once indicated that an investment had performed below expectations, requiring additional time to maximize profitability, they are now considered an acceptable and viable exit strategy. IPOs and other sales have become more difficult given recent market instability, and sales to continuation funds allow PE firms to keep deals going at higher prices, while shielding these companies from testing valuations in public markets. Indeed, the volume of these transactions dramatically expanded from $40 billion in 2015 to $132 billion in 2021.[3] At the same time, the number of IPOs has declined significantly, with a total value of $179.5 billion in 2022, a 61% year-over-year decline.[4]

Continuation funds present valuation and conflicts issues for LPs of both the original and continuation funds. As an initial matter, PE firms do not follow unified valuation standards for portfolio companies. Valuations, therefore, are somewhat subjective and investors cannot be sure that portfolio companies are fairly priced. A recent study determined that 42% of continuation fund deals valued the underlying company at less than the valuation the PE firm reported to the original fund's LPs, 50% valued the company at the same amount, and 8% were sold at a premium.[5]

PE firms suffer from apparent conflicts in continuation fund transactions because they enable the PE firm to revive the flagging fee base and monetize its carried interest in the original fund. For the continuation fund, the PE firm charges fees based on the amount the new fund invested in the portfolio company—invariably more than the older fund paid the PE firm when the portfolio company was purchased at a lower price. PE firms also receive carried interest payouts twice: once from the original fund when a company is sold to the continuation fund and again when that vehicle later exits that investment.

Compounding the issue, PE firms typically give LPs only a short time to decide whether to roll their investment into the continuation fund—as little as two weeks in some instances. These LPs may find it difficult to make a well-informed decision within such a truncated period without external advisors.

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Recognizing these concerns, the SEC recently proposed new rules to ensure fair valuations by requiring PE firms to obtain independent fairness opinions to pursue continuation fund transactions. In its release of the proposed rules, the SEC stated that such a requirement "would provide an important check against an adviser's conflicts of interest in structuring and leading these transactions," and may promote "increases in investor confidence."[6] The final rules may differ from the SEC's proposal and are scheduled to be finalized later this year.

V. Proactive Investor Actions to Mitigate These Issues

While increased SEC scrutiny may protect LPs, investors can take actions to help ensure reasonable portfolio company valuations, appropriate management fee calculations, and fair continuation fund transactions. At each step of a PE fund investment, from negotiating LP agreements, conducting due diligence of continuation funds, and assessing possible recourses in the event of suspected misvaluations, investors can potentially mitigate risks and address these concerns, as proposed below.

A. Negotiating the LP Agreement

The Institutional Limited Partners Association (ILPA) publishes widely-referenced model LP agreements that provide sample provisions to help protect investors' interests. Investors should consider including the following protections taken from ILPA's Model Limited Partnership Agreement (Whole-of-Fund Waterfall) in their LP agreements.[7]

Require the PE firm to disclose calculations of the value of fund assets to LPs on a regular basis.

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- Require the PE firm to obtain an independent valuation of the fund's assets by a different investment bank, accounting, or other appraisal firm on a periodic basis. At a minimum, consider empowering LPs to request an independent valuation. (§13.2.5.5)
- Require annual audits of the fund by an independent accounting firm. (§15.2.1) Consider requiring the use of a different auditor each year.
- Require the PE firm to disclose to LPs a list and the calculation of management fees on a periodic basis. (§13.2.5.2)
- Restrict the fund's ability to sell portfolio companies to affiliates of the PE firm. (§7.1.4)
- Require prior written consent of a majority of LPs for the PE firm to pursue transactions involving conflicts of interest. (§9.5)

B. Conducting Due Diligence of Continuation Fund Transactions

ILPA provides guidance on best practices for continuation funds led by the same PE firm as an original fund and recommends that LPs get involved in the transaction as early as possible.[8] Oversight by the original fund's LP advisory committee or a special committee formed to address continuation fund concerns further ensures a fair process and fair price for the transaction. LPs should also consider procuring an independent fairness opinion.

ILPA also publishes a model due diligence questionnaire that includes questions designed to ensure the fairness of continuation fund transactions by seeking the following information.[9]

- The details of any continuation fund transactions the PE firm has pursued over the prior five years, including any review of conflicts, and whether the PE firm carried over its interest in the original fund into the continuation fund. (§6.2)
- The rationale for pursuing a continuation fund as opposed to extending an original fund or pursuing a typical IPO or external sale. (§6.8)
- The process for valuing the underlying portfolio company, and the results of any prior independent valuations and audits. (§6.9)
- The structure of any fees associated with the transaction, including the management fee, and how carried interest in the original fund is distributed to the PE firm or committed to the continuation fund. (§6.10)

C. Potential Recourses for LPs

If an LP is concerned that a PE firm may have misvalued a portfolio company and/or miscalculated its management fees, the Model ILPA LP Agreement contains several provisions that may provide recourse.

- LPs can exercise their rights to access the books and records of the fund to independently assess the PE firm's valuations of the fund's assets. (§15)
- LPs may retain an independent appraisal firm to value the portfolio companies. (§13.2.5.5)
- If the PE firm has breached its fiduciary duties by, for example, misvaluing portfolio companies and/or charging excessive fees, the LPs may remove the PE firm as the fund's general partner. (§§10, 20.5)
- Upon removal, the LPs may seek to clawback funds that the PE firm should not have received, including carried interest. (§14.7)

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VI. Conclusion

In this period of market volatility, PE investors should exercise caution with respect to the fees charged and valuations provided by general partners. Although the SEC has increased its attention to these issues, investors should be vigilant and seek appropriate protections in their LP agreements, request adequate due diligence of continuation fund transactions, and be aware of potentially available recourses.

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Endnotes

[1] *See* Dawn Lim, *Private Equity Writedowns Spur Mounting Scrutiny from SEC*, BLOOMBERG (Sept. 24, 2022).
[2] *In the Matter of Energy Innovation Capital Management, LLC*, SEC Release No. 6104 (Sept. 2, 2022).
[3] Hugh MacArthur and Brenda Rainey, *Shifting Gears: Private Equity Report Midyear 2022,* Bain & Company (July 18, 2022).
[4] Paul Go, *EY Global IPO Trends 2022*, EY (July 18, 2022).
[5] Kaye Wiggins, *Selling to Yourself: The Private Equity Groups that Buy Companies They Own,* The Financial Times (June 21, 2022).
[6] "Proposed rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews," SEC Release Nos. IA-5955; File No. S7-03-22.
[7] *Model Ltd. Partnership Agreement (Whole-of-Fund Waterfall),* INSTITUTIONAL LTD. PARTNERS ASSOC. (Jul. 2020), *available at* https://ilpa.org/wp-content/uploads/2020/07/ILPA-Model-Limited-Partnership-Agreement-WOF.pdf (Model ILPA LP Agreement).
[8] *See* Mia Bacic, Elizabeth Dylke, Jonathan McCullough, *Continuation Funds: A Growing Trend,* Bennett Jones (May 26, 2022).
[9] *See Due Diligence Questionnaire 2.0*, §6.0, ILPA (Nov. 2021), *available at* https://ilpa.org/wp-content/uploads/2021/11/ILPA-DDQ-2.0.pdf.