LEGAL CHALLENGES

How to deal with conflicts of interest

With forethought, fairness and transparency, private equity managers and investors can recognise and resolve issues in everyone’s interest, write Pepper Hamilton’s Julia Corelli and Stephanie Pindyck Costantino

“Conflicts of interest” is a top priority of the Securities Exchange Commission (SEC) in its oversight of the private equity industry. By anticipating conflicts of interest, and creating a system to manage them, private equity managers will be able to afford all affected constituents (and regulators) transparency into the policies and procedures that enable them to better and more safely navigate conflicts of interest.

Life as a private equity manager is replete with such issues, and in the private equity world they do not always need to be resolved in favour of investors and against the PE manager. The only thing that is certain is that it is best to address conflicts with forethought, fairness, consistency and, perhaps most importantly, transparency.

What exactly is a “conflict of interest”? Wikipedia defines it as “a situation in which a person or organisation is involved in multiple interests, financial interest, or otherwise, one of which could possibly corrupt the motivation of the individual or organisation.”

We are not aware of any definition adopted by the private equity industry and would define it differently for private equity managers: a set of circumstances which allows a person in a control position to exercise that control in a manner which advantages that person without having asked permission of the controlled person prior to the control relationship having been formed. Though more highly publicised enforcement cases may lead you to believe otherwise, private equity conflicts do not necessarily involve corruption, fraud, ill will or undue influence.

As with other industries under public scrutiny, optics are crucial. Perceived and actual conflicts of interest can be equally deleterious for the private equity manager. There is also a fine line between conflicts that are curable and those that are not. Appropriately or not, the propriety or fairness of the cure is inevitably in the eye of the beholder (ie, regulator, investor, creditor or other interested party) and thus varies with each evaluator. This makes it extremely difficult to benchmark the appropriateness of the resolution. The means for resolving conflicts generally fall into one of four categories: adherence to policies and procedures, approval by the potentially disadvantaged party (or its representatives), disclosures, or abstinence.

POLICIES AND PROCEDURES

Rule 204A-1 under the Investment Advisers Act of 1940 requires each advisor who is registered or required to be registered to adopt a Code of Ethics which must “reflect [their] fiduciary obligations and those of [their] supervised persons”. A cornerstone of each Code of Ethics is the avoidance of conflicts of interests. History (even recent enforcement history) has taught us that ignoring conflicts does not make them less real or less impactful. However, it may lead to an enforcement action or give rise to breach of fiduciary duty claims.

Private equity managers should have policies and procedures in place which are designed to address both the prevention of conflicts and their handling as they arise. This helps to ensure a consistent methodology by the private equity manager in identifying, isolating and resolving conflicts, and that consistency leads to investor confidence in the propriety of the resolution.

In crafting a policy/procedure, the private equity manager should address questions like the following:

1. Does every conflict of interest need to be resolved through a process involving limited partners or only the material ones?
2. Should materiality be defined and if so what does it mean? Should materiality include a dollar threshold? Is a conflict material only if it could result in a positive financial impact on the managers; a negative impact on the investors; a present impact or a future impact; or all of the above?
3. If a conflict was disclosed in offering documents but the resolution was not, does the resolution need to be reviewed and approved by limited partners?
4. If a LPAC has not been established, should one be established only after a conflict arises and needs to be addressed?
Each of the foregoing questions should be asked and answered in a manner that is tailored to the private equity manager’s individual circumstances. Once the answers are formulated, it is important to build the answers into disclosure materials, due diligence responses and the fund’s governing agreement.

The private equity manager’s policies and procedures should address aspects of running a private equity fund that are unavoidable areas of conflict. Such areas include: allocation of investment opportunities (particularly when there are multiple funds with conflicting strategies); allocation and terms of co-investment opportunities (fees and carry, as well as ingress into and egress from the portfolio company, and intermediate financings of the portfolio company); valuation of assets; and use of affiliated service providers.

Co-investments deserve special mention as an area replete with conflicts. Two in particular are worthy of discussion: allocation and management of co-investment opportunities. By providing a comprehensive co-investment allocation policy/procedure to investors and potential co-investors, a private equity manager may mitigate some of the SEC’s concerns that the allocation of co-investment opportunities is often unfair to investors, while at the same time provide investors with a consistent rationale for the decisions made by the private equity manager with respect to co-investment allocations.

In order to demonstrate the implementation and effectiveness of an allocation policy and associated procedure, a private equity manager should implement compliance testing of its allocation policies and procedures. Such testing should be at least annually, if not quarterly or bi-annually in certain instances, and must be well documented.

The ongoing management of co-investments is equally pocked with pitfalls. If a fund and a successor fund are investing at the same time, and the successor fund invests in a follow-on investment of the prior fund and the manager also brings in a co-investor, the successor fund will have a much different interest compared with the prior fund.

There is a three-way conflict of interest here as the manager may owe fiduciary duties to the prior fund, the successor fund and the co-investor. This is a classic example where the duty to act in good faith would be an exceptionally favourable standard to have if you are the private equity manager. The incentives in how the manager looks at the deal for the successor fund are different from those applicable to the prior fund or the co-invest vehicle. In addition to having differing liquidity horizons, co-investors could also have contractual protective voting rights that are at odds with either of the two funds.

INVESTOR CONSENT

While a private equity manager may have policies and procedures addressing certain potential conflicts of interest, a private equity manager may also look to mitigate its exposure to potential claims by seeking the consent of the affected parties. In some cases, they effectively obtain consent by negotiating the fund’s terms at the time of investment, or investing based on terms negotiated by others.

Certain fund terms and conditions themselves have inherent conflicts of interest and the conflict is largely mitigated by the fact that the investors have an opportunity to negotiate the terms prior to investment in the fund. Such terms include: changes in size of the fund, treatment of transaction and monitoring fees, transfers of carried interest, charging placement fees or other expenses to the fund, limitations on time and attention requirements, side letter agreements.

In other cases, the consent is sought because a specific conflict has arisen. This may be addressed by having the proposed resolution of the conflict reviewed and approved by a committee of limited
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partners (LPAC or LP Committee).

In order to ensure that the referral by the private equity manager to the LPAC does not itself pose a potential conflict, the private equity manager’s policy and procedures about conflicts and/or the fund’s limited partnership agreement should address when a referral is warranted.

To leave the referral decision to the time when a conflict arises makes the referral decision itself potentially a conflict, particularly if it is a conflict private equity manager’s resolution of which would financially benefit the manager and likely raise objection from investors. When the private equity manager refers the conflicted issue and the proposed resolution to the LPAC, the LPAC’s job is to determine whether the proposed resolution is equitable or whether a different resolution should be adopted.

A fund’s LPAC should be a representative body of the limited partner group, but is often comprised of representatives of the larger investors who had the ability to negotiate a seat on the committee. While this should not make a difference in practice, private equity managers need to be conscious of whether the LPAC is truly a representative body of the larger investor pool as the investors as a whole are looking to the LPAC to protect their respective interests.

In addition, there may be situations where one or more members of the LPAC must recuse themselves from voting on a matter due to a conflict. For example, if the private equity managers are ex-employees of the anchor investor (eg, they were spun out due to the Volker Rule or other regulatory considerations) having the anchor investor’s representative on the LPAC is not likely to be unbiased because it would support the private equity manager’s view.

Whether a conflict resolution requires consultation with or approval from the LPAC should not matter to a private equity manager if the private equity manager considers LP relationships to be important. On the one hand, the investors appointing members of the LPAC feel the most secure if they have a veto right over certain proposed manager actions. However, veto rights may be more likely to yield potential liability to the LPAC member and its nominating limited partner (which is generally indemnifiable by the fund in the absence of fraud, gross negligence or willful misconduct). On the other, if the obligation is to consult with the LPAC and the LPAC’s recommendation is not followed, the resolution may undermine the all-important relationship between investor and manager.

Many investors require that all conflicts be referred to the LPAC, that the LPAC report its proposed resolution of the conflict and that the private equity manager report to investors how all conflicts were resolved. If the private equity manager took action that was not consistent with the LPAC’s recommendations, it will likely have to address its rationale and ultimate decision before all investors, not just the LPAC.

**DISCLOSURES**

There is an adage parlayed among regulatory lawyers that “disclosure cures all”. But that is not really true. Many private equity managers, rightfully (and thankfully) try to disclose, in the fund’s offering documents, any possible conflict they can foresee may arise. Crystal balls are often cloudy though, so there is usually also a conflict catchall contained in offering documents which says something like the following after the disclosure of specific potential conflicts:

“In the event of any potential conflicts of interest due to any of the foregoing and/or other investment or business relationship, [Fund Manager] will act in the manner which it in good faith believes to be in the best interests of the Fund. By acquiring an Interest in the Fund, each Limited Partner will be deemed to have acknowledged the existence of such actual or potential conflicts of interest, and to have consented thereto, and to have waived any claim with respect to the existence of any such conflict of interest. There can be no assurance that any conflicts of interest will be resolved in favor of the Limited Partners.”

Can conflicts of interest be waived even before they arise? Most likely the answer is yes, if (i) there is express disclosure prior to the disclosee’s investment about the potential existence of the conflict and what the resolution of it is to be, and (ii) the resolution of it when it does arise is as disclosed.

However, can conflicts be waived when they have not been expressly disclosed? The answer is a firm “maybe” or “probably not” or, at the very least, “it depends”. There is an extensive body of law about advance waivers of conflicts of interest which is well beyond the scope of this article. Suffice it to say that, if there is an argument about conflicts, private equity managers would rather be arguing from a position of having the catchall language than not; and limited partner investors should understand that it is impossible to...
foresee all conflicts that could possibly arise in the course of human beings managing an investment fund over 10-plus years. Conflicts of interest that were not foreseeable at the outset will undoubtedly arise.

Further, investors should understand that a reasonable catchall is not necessarily a bad thing. Allowing the private equity manager the defensive strength of the catchall may prevent a more expensive indemnity situation arising. The conflict waiver catch-all language defence reduces the potential liability on a claim by a lone unhappy investor and may cut short proceedings over the claim, thereby reducing the indemnifiable loss (assuming the standard of care is met and other indemnity exclusions are not applicable).

But even express disclosure will not cure some conflicts. For example, the following restrictions in the Investment Advisers Act of 1940 were implemented largely to avoid conflicts of interest: (i) the qualified client rule where the submission to SEC oversight is the only means of curing the conflict that arises by charging an advisory fee based on assets under management; (ii) the prohibition on principal transactions where there is no acceptable means of curing the conflict other than outright consent; and (iii) the prohibition on use of mails, etc., to perpetrate a fraud (which operates in parallel with the law of many states, such as Delaware, prohibiting exoneration of the duty to act in good faith). These are, of course, all non-waivable.

Finally, disclosure can come in many shapes. The fund’s PPM may have an express section on “Conflicts of Interest” or it may discuss conflict scenarios in risk factors or in responses to a due diligence questionnaire. All means delivered pre-investment are generally acceptable. After the fact disclosure in Form ADV is not effective and disclosure outside the PPM may expand what is considered offering documentation and have other ramifications.

One conflict often addressed only by risk factor disclosure arises when a private equity manager sits on a portfolio company board. While state laws vary, it is generally well known that, unless such duties are expressly limited in the fund agreement to not less than the obligation to act in good faith, those in control of a fund owe fiduciary duties to the fund and its investors.

The principal consequences of a failure to comply with such fiduciary duties are twofold: (1) the action taken will be subject to invalidation unless it is found to be protected by the “business judgment rule” or “entirely fair” to the fund and its investors, and (2) the persons in control may incur personal liability for the consequences of the action taken.

When a fund manager occupies a portfolio company board seat, the fiduciary obligation to the portfolio company may conflict with the manager’s fiduciary obligation – or even good faith obligation – to the fund. The manager/director may be challenged not to favour the fund in portfolio company board decisions or vice versa.

While constantly recognising and adhering to the bureaucratic formalities of the two roles will help mitigate the conflict, it is virtually impossible to avoid conflicts completely and reconcile the two roles (unless the fund owns 100 percent of the portfolio company and the portfolio company is not near insolvency). The fund’s PPM, therefore, will mention this situation as a risk factor; it simply exists as a possibility which limited partner investors have little to say about. Limited partners are not generally asked to waive this conflict expressly, but to take it into account and invest knowing it is a risk that could affect portfolio investments. That is the same as consent.

ABSTINENCE

Private equity managers may abstain from any decision about conflict, but abstention is the least effective tool for avoiding liability. While abstention, also known as sticking one’s head in the sand, could be construed as simply avoiding all situations where conflicts could or will arise, avoiding them may be tantamount to mismanagement itself, leading to a breach of fiduciary duty claim or a claim of lack of good faith. This is why the terminology around tainted situations gives equal credence to affirmative acts as it does to omitting to act.

In conclusion, conflicts is a complicated area where there are often no clearly right answers, only judgment calls balancing action against inaction. The only consistent guidance any one can offer is to do the very best to avoid surprises. That means private equity managers must educate themselves to anticipate and recognise conflicts of interest, understand the consequences of the different ways the conflict could be resolved, address them as quickly and as transparently as possible and in a manner which does what is possible to remove the taint of self-interest, document the reasoning, and be prepared to justify the resolution to current and future investors and co-investors, and to regulators.