Private Equity Risks in Today’s Turbulent Times

August 19, 2020
Disclaimer

The information and opinions expressed by our panelists today are their own, and do not necessarily represent the views of their employers or of PLUS.

The contents of these materials may not be relied upon as legal advice.
Questions

Please submit using the question tool on user dashboard
Meet Your Presenters

Jennifer Bergstrom, Esq.
VP, Management Liability & Financial Services Product Head at Hiscox USA

Alicia A. Garcia, Esq.
Complex Claims Specialist at Hiscox USA

Elan Kandel, Esq.
Member at Bailey Cavalieri, LLC

Jared Wood
Senior Vice President of Sales at HUB International Insurance Services Inc.
Agenda

- Private Equity Background
- Trends in the Private Equity Industry and the Impact of COVID-19
- SEC Enforcement Actions
- Portfolio Company Risks and Litigation Examples
- Q&A
Typical PE Structure

Private Equity Firm
(General Partner)

Limited Partners (Investors)
(public pension funds, corporate pension funds, insurance companies, high net-worth individuals, family offices, endowments, foundations, fund-of-funds, sovereign wealth funds, etc.)

Ownership of the Fund

Private Equity Fund
(Limited Partnership)

The Fund’s ownership of the portfolio investments

Investment
Investment
Investment
Top 10 Largest PE Firms*

1. The Blackstone Group
2. The Carlyle Group
4. CVC Capital Partners
5. Warburg Pincus
6. Bain Capital
7. EQT Partners
8. Thomas Bravo
9. Apollo Global Management
10. Neuberger Berman

* As per Private Equity International, based upon five-year fundraising totals.
Life Cycle of the PE Fund

1. **Formation**: This stage involves the solicitation of investors, the legal formation of the limited partnership, and the preparation and execution of the limited partner agreement (“LPA”).

2. **Investment**: The general partner will seek out appropriate investment opportunities, conduct due diligence and ultimately invest fund resources in portfolio companies. The investment period is typically finite (often around 10 years), as set forth in the LPA.

3. **Management**: As soon as the first investment is finalized, the general partner (“GP”) will begin to manage the portfolio company investments.

4. **Exit**: The obvious goal of private equity is to realize a return on investments. The GP will seek the appropriate time to divest its investment (via IPO, secondary buyout, or acquisition), but must do so upon the termination date set forth in the LPA.
Current Trends in the Private Equity Industry

• **Shift toward specialization:** Based on industry and sometimes also target size and investment strategy.

• **Environmental, Social, and Governance ("ESG") Standards:** ESG charters are being adopted in record numbers by limited partners.

• **Growth through 2019:** Assets under management by private equity firms rose by $595 billion in 2019 to $4.1 trillion; 2019 also featured a number of $10 billion-plus deals, such as:
  • Blackstone’s $18.7 billion purchase of the U.S. warehouse portfolio of Singapore-based GLP;
  • EQT’s $10.1 billion purchase of Nestlé’s skincare unit; and
  • The joint acquisition of Zayo Group by Digital Colony Partners and EQT for $14.3 billion.
Current Trends in the Private Equity Industry

Impact of COVID-19

• **Transactions Are Down**: U.S. private equity transactions were down nearly 20% in the first six months of 2020, and the number of global buyout transactions fell by 60% from January to April 2020.

• **Failed Mega Deals**: Juxtaposing 2019, the first half of 2020 has seen a number of failed mega deals (e.g., Sycamore Partners’ $525 million acquisition of Victoria’s Secret, KKR’s abandonment of a $555 million buyout of DecoPac, Inc.).

• **Sector-Dependent Impact**: Certain funds have weathered the COVID-19 storm well. Others, such as real estate funds, are particularly hard-hit.

• **Dry Powder to Spare**: Notwithstanding the downturn in deals, the amount of dry powder (i.e. committed but unallocated capital on hand) has never been higher, at $2.5 trillion.
  
  • **Valuation Difficulties**: Fund managers and their targets must grapple with whether and how to discount the effects of COVID-19 on traditional valuation metrics.
  
  • **Commitment Issues**: Investors are less willing to lock up substantial funds for a 10-year period when there is significant uncertainty in the market.
Regulatory Environment

SEC Office of Compliance Inspections and Examinations ("OCIE")
Examination Priorities for 2020

• Prioritized Advisers:
  • Fund advisers that have a greater impact on retail investors, such as firms that manage retail funds side-by-side with private funds;
  • Funds that have never been examined or which have not recently been examined;
  • Advisers that are dually registered as, or are affiliated with, broker dealers; and
  • Firms that use the services of third-party asset managers to advise clients’ investments (OCIE is interested in assessing the fund advisers’ due diligence practices pertaining to such third parties).
Regulatory Environment

• **OCIE Areas of Focus:**
  - Controls regarding the misuse of material, non-public information;
  - Conflicts related to allocation of investments (e.g., preferentially allocating limited investment opportunities to new clients or higher fee-paying clients);
  - Conflicts related to multiple clients investing in the same portfolio company (e.g., one client owns debt and another client owns equity in the same portfolio company);
  - Conflicts related to financial relationships between investors or clients and the adviser (e.g., a limited partner providing financing to the adviser);
  - Improper allocation of fees and expenses (e.g., charging fees not permitted by the LPA, or failure to follow travel and expense policies); and
  - Valuation practices contrary to those specified in the disclosures to clients.
Recent SEC Enforcement Actions

• *Monomoy Capital Management*, IA Rel. No. 5485 (April 22, 2020)
  - Private equity sponsor failed to adequately disclose certain fees it charged for the services of its in-house group of operating partners. In addition to charging a 2% management fee, the firm had been separately billing portfolio companies an hourly rate for its operating partners’ services.
  - The SEC alleged that the practice was not adequately disclosed in the applicable limited partnership agreement.
  - Monomoy did disclose that, in addition to receiving the management fee contemplated by the LPA, it “may” be reimbursed for services that would ordinarily be performed by third parties. However, the SEC found that disclosure lacking, because the sponsor *routinely* billed its portfolio companies such services.
  - SEC ordered disgorgement of $1,926,579 on a pro rata basis to each LP.
Recent SEC Enforcement Actions

- **Old Ironsides Energy, LLC, IA Rel. No. 5478 (April 17, 2020)**
  - The SEC alleged that Old Ironsides included a material misstatement in its fund marketing materials. Specifically, the PE firm’s brochure identified a large, legacy investment with strong, positive returns as an early stage direct drilling investment (“DDI”) over which the adviser “had direct management in partnership with project operators.”
  - In reality, Old Ironsides merely invested in that particular fund as a limited partner and did not manage the investment as a general partner.
  - As such, the SEC found that Old Ironsides’ inclusion of the fund in its “track record” of managed oil and gas investments constituted a willful violation of the Advisers Act and imposed a civil penalty of $1 million.
Recent SEC Enforcement Actions

- **Ares Management, LLC, IA Rel. 5510 (May 26, 2020)**
  - The SEC alleged that Ares failed to implement and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information.
  - The SEC found that an Ares employee served on the board of a public company while that same employee also participated in trading decisions at Ares regarding that public company.
  - The SEC found that Ares received material, nonpublic information about the company (e.g., information regarding changes to senior leadership, hedging strategies, etc.) and then purchased 1 million shares of the company’s common stock following receipt of that information.
  - According to the SEC, Ares compliance policies failed to adequately address this situation and Ares’ compliance staff failed to sufficiently inquire about the possession of material nonpublic information prior to approving these trades.
Recent SEC Enforcement Actions

• **SEC v. Abraaj Investment Management Limited, Case No. 19-cv-324-AJN, (S.D.N.Y.)**
  - Prior to its collapse in 2018, the Dubai-based Abraaj Group operated the largest private equity fund in the Middle East.
  - In 2018, investors began to suspect that Abraaj was mismanaging funds. When investigations confirmed these suspicions, Abraaj was forced into a supervised restructuring.
  - The SEC brought suit in April 2019, alleging that Abraaj and its founder, Arif Naqvi, defrauded two private funds that they advised. Specifically, the SEC alleged that Abraaj and Naqvi had been misappropriating investor money and siphoning money from Abraaj’s Growth Markets Health Fund in order to cover cash shortfalls, corporate expenses, and other things unrelated to the health fund.
  - The SEC’s civil lawsuit against Abraaj and Mr. Naqvi is still in its early stages and is proceeding in parallel with a criminal complaint against Mr. Naqvi.
False Claims Act Violations

  • In this case, the DOJ alleged that Patient Care America ("PCA") submitted improper claims for reimbursement to Tricare, a federal program providing health insurance to current military personnel, retirees, and their dependents. The claims were allegedly tainted by kickbacks paid to marketers for patient referrals.
  • The complaint further alleged that the pharmacy’s controlling stakeholder, private equity firm Riordan, Lewis & Haden, Inc. ("RLH"), managed and controlled PCA and participated in the charged misconduct.
  • The complaint asserted three false claims act violations against all defendants.
  • The government’s intervention to target both PCA and its private equity shareholder reflects a potential sea change in its approach to such cases.
  • The case ultimately settled for $21 million.
WARN Act Violations

• **Shameekalen v. TransCare Corp., et al. (In re TransCare Corp.), Case No. 16-10407, Adv. P. No. 16-01033 (Bankr. S.D.N.Y.)**
  - The Bankruptcy Court for the Southern District of New York refused to dismiss WARN Act claims against private equity firm, Patriarch Partners, LLC, and its owner, Lynn Tilton, resulting from the staggered Chapter 7 bankruptcies of several portfolio companies, TransCare Corporation and its affiliates.

  - A three-judge panel on the Third Circuit ruled in a nonprecedential opinion that Sun Capital Partners, Inc., and a subsidiary were not a "single employer" for the purpose of assessing potential liability under the WARN Act, and its New Jersey counterpart.
  - The court ruled, among other things, that the mere fact that a subsidiary is dependent on its parent’s loans and ultimately fails without them is inadequate to demonstrate dependency of operations.
ERISA litigation

- **Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund, Case No. 16-1376 (1st Cir. 2019)**
  - Eleven years after its portfolio company’s bankruptcy triggered a multiemployer pension plan’s demand that funds sponsored by private equity firm Sun Capital advisers, Inc. (“Sun Capital”) pay the portfolio company’s $4.5 million ERISA withdrawal liability, Sun Capital has won a long-sought victory.
  - On November 22, 2019, a three-judge panel of the First Circuit held that two Sun Capital funds were not required to pay for the withdrawal liability of the portfolio company.
  - While the decision represents a meaningful victory for Sun Capital, individually, it is unlikely to end attempts by the Pension Benefit Guaranty Corporation (“PBGC”) and multiemployer plans to seek payment from private equity funds for unpaid pension liabilities of their portfolio companies.
Going Private Litigation

• **Morrison v. Berry, C.A. No. 12808-VCG (Del. Ch. June 1, 2020)**
  
  The Delaware Chancery Court addressed a stockholder plaintiff’s claims that the target board’s financial adviser and law firm, as well as the private equity buyer (Apollo), aided and abetted a breach of fiduciary duty by the target board in connection with a take-private merger of grocery retailer The Fresh Market.

  • The court dismissed the aiding and abetting claim against Apollo, finding Apollo was upfront about its discussions and relationship with Berry, and had no reason to believe that Berry was hiding anything from the board.

  • Nor was the fact that Apollo participated in the back-channeling with J.P. Morgan (financial adviser to Fresh Market) enough to sustain an aiding and abetting claim against Apollo.
Going private litigation

  - Private equity firm Sycamore Partners obtained a minority position in Essendant.
  - Plaintiffs allege that Sycamore breached a fiduciary duty to Essendant’s other shareholders by pressuring the board to accept its inadequate offer to acquire the company. The fiduciary claim was premised on the argument that Sycamore was a “controlling shareholder” of Essendant prior to the acquisition.
  - The Chancery court reaffirmed the principle that a minority shareholder will only be deemed a controlling shareholder if it “exercises control over the business affairs of the corporation” such that “as a practical matter, it [is] no differently situated than if it had majority voting control.” The court held that Plaintiffs failed to “plead facts that allow a reasonable inference that Sycamore exercised such formidable voting and managerial power that, as a practical matter, it was no differently situated than if it had majority voting control.”
  - As such, the court dismissed the lawsuit.
Debt Restructuring Litigation

  - UMB is the trustee for a group of Neiman Marcus bondholders.
  - UMB alleges that Ares Partners, private equity owner of Neiman Marcus, executed a scheme to protect its own interests in Neiman Marcus at the expense of the company’s creditors. Specifically, UMB alleges that Ares caused Neiman Marcus to transfer its “crown jewel” asset, the profitable shopping retailer MyTheresa, to affiliates beyond the reach of the company’s creditors. According to UMB, the transfer did not involve the payment of any consideration.
  - UMB asserts causes of action against Ares for fraudulent transfer and tortious interference. The case remains pending.
‘33 and ‘34 Act - Controlling Person Claims

  • Plaintiffs (Cobalt shareholders) alleged that Cobalt misrepresented the value of certain Angolan oil wells after it learned that they contained very little or no oil. According to Plaintiffs, Cobalt continued to sell billions of dollars in Cobalt securities to investors while keeping this material information from them. Additionally, Plaintiffs alleged that Cobalt failed to disclose certain risks regarding the FCPA—namely, that it had dealings with Angolan companies it knew were owned by Angolan government officials.
  • Plaintiffs alleged that certain private equity firms exercised control over Cobalt, including the contents of Cobalt’s SEC disclosures, which allegedly contained material misstatements. As such, Plaintiffs alleged that the PE firms violated Section 15 of the Securities Act.
  • This matter was resolved in February 2019 pursuant a settlement that required the private equity sponsors to pay $146,850,000 to Plaintiffs.
NDA Litigation

  
  • Northern Stamping and Monomoy agreed to pursue a joint acquisition of Steel Parts Manufacturing, in connection with which, Monomoy signed an NDA barring it from using non-public information regarding Northern Stamping or its competitive position outside of its defined role in the joint acquisition. After Monomoy’s representative signed the NDA, Northern began sending Monomoy information that it had received or prepared regarding Steel Parts.
  
  • Monomoy ultimately decided to acquire Steel Parts without involving Northern Stamping. Northern Stamping argued that Monomoy’s acquisition of Steel Parts was, in and of itself, a misuse of the confidential information that it had provided Monomoy.
  
  • The court rejected Northern Stamping’s argument, finding that it had not presented any evidence to suggest that Monomoy actually used the confidential information in connection with its unilateral acquisition of Steel Parts. According to the court, the fact that individuals at Monomoy “had seen the information [and] had likely incorporated it into their thinking . . . . is not sufficiently definite grounds to find that Monomoy breached a contract.”
Bankruptcy Litigation

- The New York Times and the Wall Street Journal have each reported that the Coronavirus pandemic may cause debt laden companies to seek bankruptcy protection in record numbers.

- According to the American Bankruptcy Institute, Chapter 11 bankruptcy filings have risen from 1,380 in 2019 to 1,812 in 2020, with a 48% year-over-year increase in the month of May.

- Portfolio companies are often saddled with debt following their acquisition by private equity firms, making them particularly vulnerable to the current climate.
Common Claims Against PE Firms in Bankruptcy Context: Fraudulent Transfer

- In re: Nine West Holdings, Inc., et al., 1:18-bk-10947 (S.D.N.Y. Bankr.): Sycamore paid $120 million to investors in Nine West Holdings, Inc. in order to resolve claims that, following its 2014 buyout of Nine West, it rendered the portfolio company insolvent while enriching shareholders by over $1 billion. [Link](https://www.law360.com/articles/1132573/nine-west-s-ch-11-plan-ok-d-after-sweetened-creditor-deal)


- In re: Payless Holdings LLC, et al., 4:17-bk-42267 (E.D. Mo.): Blum Capital and Golden Gate Capital paid $25 million to Payless Shoes’ unsecured creditors following the bankruptcy of Payless. Payless’ creditors alleged that the private equity sponsors received $400 million in dividends in recent years, adding to the company’s debt. [Link](https://www.reuters.com/article/us-payless-bankruptcy-privateequity/exclusive-payless-settles-creditor-dispute-over-dividends-sources-idUSKBN19C05W)
Common Claims Against PE Firms in the Bankruptcy Context: Aiding and abetting breach of fiduciary duty

  - The Official Creditors Committee for Allied Systems alleged that Yucaipa, which had been the majority stockholder of Allied, attempted “to take control over all facets of the Debtors' capital structure in order to protect its equity investment over the legitimate rights and expectations of the Debtors' secured and unsecured creditors.”
  - Moreover, according to Plaintiff, Yucaipa caused Allied to foot the bill for this scheme, causing Allied to pay millions of dollars in fees to Yucaipa and to various advisers and agents whose services solely benefited Yucaipa.
  - Plaintiff also alleges that Allied’s board failed to take appropriate steps to avoid the conflict of interest that arose from Yucaipa’s control over the company.
  - The case is ongoing.
EPL Risks

  - Oaktree purchased a Hawaiian resort and, through a subsidiary, created a new entity—TBR—to manage the resort. A labor dispute arose in connection with the resort, in which it was alleged that TBR and Oaktree violated the NLRA by restricting union members’ access to the resort and barring the union from collecting dues from Resort employees.
  - The court recognized that, for purposes of the NLRA, “[w]hether two or more entities are sufficiently integrated to be deemed a single employer is determined by analyzing the following factors: (1) common ownership or financial control; (2) common management; (3) centralized control of labor relations; and (4) interrelation of operations.” The court observed that Oaktree “participated significantly in its financial control,” “shared common managers with TBR,” and controlled labor relations and negotiations between the resort and the union. As such, the court concluded that TBR and Oaktree constituted a single employer for purposes of the NLRA.
Product Liability Risks

  - Scientific Protein Laboratories (“SPL”), American Capital’s portfolio company, was named as a defendant in over one thousand product liability suits concerning SPL’s blood-thinner, Heparin. American Capital was also named in many of these suits.
  - Charter Oak took the position that the policies in question covered American Capital and its subsidiaries, but not SPL or any other portfolio companies of American Capital.
  - The court rejected Charter Oak’s argument in that regard, finding that the policy in question was ambiguous as to whether SPL or other portfolio companies were “insureds,” as the policy was modified by an endorsement that broadened the definition of “insured” included any entity in which American Capital held majority ownership.
  - That endorsement was attached to many of Charter Oak’s policies as a matter of course. However, in the context of a private equity policy, the endorsement had the unintended consequence of extending coverage to American Capital’s portfolio companies.
Thank you to the PLUS Diamond Sponsors
Thank you!