Private Equity In The Crosshairs

Law360, New York (July 11, 2012, 12:26 PM ET) -- As matters presently stand, it is shaping up to be a long year for private equity firms. The continued European crisis, speculation on whether countries will withdraw from or be forced out of the Eurozone, and conflicting economic data have, among other factors, caused uncertainty as to whether the world is on a continuing path to recovery, or headed back into recession. All of this is clearly weighing on the financial markets and impacting decision-makers at companies large and small.

Consequently, corporations continue to hoard cash and take a “wait and see” approach, rather than putting the money to use in M&A activity. Through the first half of the year, private equity firms have been involved in a total of 364 mergers and acquisitions in the United States and Canada, as the M&A market in North America is turning out to be less robust than had been hoped for at the start of the year.[1]

Further, even when M&A transactions do occur, private equity firms are drawing unwanted attention from shareholder lawsuits challenging various aspects of these transactions. In addition, in the wake of the Dodd-Frank Act, private equity firms are facing enhanced regulation and more public disclosure obligations. The U.S. Securities and Exchange Commission has also indicated that private equity is an industry upon which the SEC intends to focus this year.

And then there is the impending presidential election. Presumptive Republican nominee Mitt Romney’s previous work at Bain Capital has been, and likely will continue to be, a focus of political ads that seek to cast all private equity firms as “vulture capitalists.” All of this public attention and regulatory scrutiny cannot be comfortable for an industry that, in general, seeks to avoid the spotlight and does not subscribe to the maxim that “there is no such thing as bad press.”

Amid this flurry of information and activity, the first six months of the year have nonetheless provided insight into certain specific legal hurdles and challenges that private equity firms are likely to be faced with in the coming months.

Challenges to Valuation Methodologies

Until recently, the SEC appeared more focused on hedge funds than private equity firms generally. That has now changed. Robert B. Kaplan, co-chief of the SEC Enforcement Division’s Asset Management Unit effectively confirmed the SEC’s increased interest when he commented recently that the private equity industry lacked sufficient oversight and deserved more scrutiny.

In particular, at the end of last year, news broke in the Wall Street Journal and elsewhere that the Enforcement Division was undertaking an informal inquiry into how private equity firms value their investments, and in so doing, the SEC was seeking the production of financial statements, support for fund asset valuations, and other documents bearing upon the valuation of any assets a fund had owned over the past three years, as well as information regarding any agreements between the private equity funds and those who had valued the fund's assets.

The SEC is not the only one raising questions about how private equity funds value their investments. The Brockton Retirement Board and Quincy Retirement Board, as lead plaintiffs, have filed a putative class action suit against Oppenheimer Global Resource Private Equity Fund I LP (OGR Fund), sponsor Oppenheimer Asset Management, Inc., the fund’s administrator, its general partner and two executives in the United States District Court for the District of Massachusetts in Boston, alleging violations of Sections 12(a)(2) and 14 of the Securities Act of 1933. Notably, claims under Section 12 of the 1933 Act subject defendants to a near “strict liability” standard of care, rather than the fault-based standards that apply under most other provisions of the federal securities laws.

The lawsuit claims that investors who purchased limited partnership units in the OGR Fund were provided false and misleading information as to how the fund valued its investments. The OGR Fund is alleged to be a private equity limited partnership that functions as a global “fund of funds,” making investments in limited partnership interests and other investment vehicles. The OGR Fund had invested in the private equity fund Cartesian Investor-A, and the assets of Cartesian consisted solely of shares in S.C. Fondul Proprietatea SA. Fondul had been created in 2005 by the Romanian government to compensate citizens whose property had been unlawfully seized or otherwise misappropriated by the former communist government of Romania.

In soliciting limited partners, the defendants are alleged to have represented that "the General Partner expects that in most cases it will value the Underlying Funds in accordance with the valuations reported to it by the Managers of the Underlying Funds," and that "[a]s a fund of funds, we require our underlying fund managers to utilize third party valuation firms that provide valuations of the respective portfolios in accordance with FASB 157." FASB 157 states, among other things, that a "quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available."

Beginning in October 2009, the defendants are alleged to have changed the manner in which they valued the Cartesian assets, in order to facilitate their efforts to attract new limited partners. The defendants are alleged to have done this by valuing the Cartesian holdings at their par value of 1.00 Romanian Leu (RON), while Fondul shares were being valued at cost by the fund's manager and were trading over-the-counter (OTC) for less than 0.25 RON.

As a consequence, the plaintiffs allege that the value and internal rate of return for both the Cartesian/Fondul assets and the OGR Fund as a whole were distorted, turning what should have been reported as net losses and nominal gains, respectively, into robust profits. According to the Wall Street Journal, the alleged distortion helped push the fund's reported internal rate of return to 38 percent after fees, from a loss of 6.3 percent. The fund subsequently raised more than $55 million from individual and institutional investors.[2] In addition to facing a class action, both the SEC and the Massachusetts attorney general are reported to be investigating the defendants' actions.

Regardless of the outcome of this particular lawsuit, it is evident that private equity funds can expect to receive more inquiries from investors and from government regulators about how they value their investments.

Questions Regarding Business Methods

Critics of the private equity industry often focus on one of the industry's core investment strategies — leveraging their equity investments with significant debt — which, the critics claim, results in bankruptcies and layoffs. Stockholders often repeat these criticisms when challenging transactions involving private equity firms. For example, minority stockholders in Culligan Ltd. recently brought suit in the Supreme Court of New York, alleging that private equity firm Clayton Dubilier & Rice (CD&R) had burdened Culligan with an "insurmountable" amount of debt.

In 2004, CD&R invested about $200 million of equity in a leveraged buyout of Culligan for a total purchase price of approximately $600 million. Two years later, the plaintiffs allege that CD&R began to strip Culligan of its assets and fire employees. Then in 2007, CD&R is alleged to have effected a recapitalization in which it borrowed $800 million, using half of that amount to refinance the existing $400 million of debt. CD&R is then alleged to have declared a shareholder dividend of $375 million, of which CD&R or its affiliates received 92 percent. In essence, the plaintiffs allege that CD&R managed to extract from Culligan CD&R's original equity investment, as well as a substantial profit.

Then, as Culligan's fortunes declined, certain hedge funds, including Centerbridge Special Credit Partners and Angelo, Gordon & Co., began buying up Culligan's debt at a substantial discount. In May of this year, Culligan proposed an out-of-court restructuring by which Centerbridge would swap about $225 million worth of unsecured debt it had acquired at distressed prices in return for a 47 percent equity stake.

Centerbridge would also pay Culligan $90 million in cash, which Culligan would use to pay down its first-lien debt, a majority of which is reportedly held by Angelo, Gordon & Co. This would give Centerbridge an additional 51 percent equity stake, or a total of 98 percent of Culligan's equity. The plaintiffs, who are minority stockholders, have challenged the transaction, claiming, among other things, that CD&R as a controlling shareholder breached fiduciary duties that it owed to Culligan and its shareholders.

Suits such as this — which focus on instances in which the private equity firm appears to have made a profitable exit, while the operating company, its workforce and its other shareholders suffer losses — will doubtlessly continue to put private equity transactions in the spotlight, especially in the current political and regulatory environment. To be sure, larger industry and economic forces may play a substantial role in shaping such outcomes; the utter meltdown of the financial markets in 2008 comes to mind in this regard. The court of public opinion, however, remains skeptical of such defenses.

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