REPRINT FINANCIER WORLDWIDE

JULY 2013

FINANCIER WORLDWIDE corporatefinanceintelligence

PRIVATE EQUITY

Private equity review – highlights of recent litigation and regulatory proceedings

JACK YOSKOWITZ
SEWARD & KISSEL LLP

Private equity funds have come under increased scrutiny by regulators, investors and counterparties. This article addresses some of the current litigation and regulatory proceedings that have been brought involving or concerning private equity funds. Such proceedings highlight areas that warrant special attention for fund managers.

On the regulatory front, Bruce Karpati, former Chief of the Asset Management Unit of the United States Securities and Exchange Commission's Enforcement Division, gave a speech to the Private Equity Conference on 23 January 2013 in which he listed some of the areas of concern about the private equity industry. Mr Karpati cited the rapid growth in assets under management which has resulted in too many managers chasing too few deals and putting pressure on returns. These dynamics may lead to aggressive behaviour by managers, especially given that private equity funds often lack transparency in the valuations of their illiquid assets and in the operations of the portfolio companies. He also stated that the SEC was closely looking at 'zombie funds' – funds that are past

SEWARD & KISSEL LLP

Jack Yoskowitz is a litigation partner at Seward & Kissel LLP. He can be contacted on +1 (212) 574 1215 or by email: yoskowitz@sewkis.com.

their investment period but have not liquidated their investments and where the managers may have incentives to keep them open to continue to charge management fees.

Concerns about valuation are reflected in some of the recent proceedings the SEC has brought against private equity funds. For example, in *SEC v. Yorkville Advisors, LLC, et al.,* (US District Court, Southern District of New York, 12 Civ. 7728), the SEC has alleged that the manager violated the US federal securities laws by inflating the values of certain illiquid positions in its portfolio funds and making misrepresentations to investors. Yorkville recently moved to dismiss the complaint on the grounds that the SEC had not sufficiently pled its claims and specifically argued that under recent case law, valuations are subjective opinions and the SEC must allege that they were objectively false and that the valuations were disbelieved by the defendants at the time the valuation was expressed. *See Memorandum of Law in Support of Motion to Dismiss of Yorkville Advisors, LLC*, dated 12 December 2012. The Court has not yet rendered a decision on the motion. Similarly, two investment advisers agreed to pay $2.8m, without admitting liability, to settle charges, by the SEC that they misled investors about the valuation policies and performance of a private equity fund they manage. *See In the matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management LLC, SEC proceeding number 3-15238 (11 March 2013).*

On the civil litigation side, plaintiffs continue to bring lawsuits challenging the way deals are structured and priced. For example, on 13 March 2013, the United States District Court in the District of Massachusetts granted in part and denied in part motions for summary judgment of several large private equity funds against a putative class of former shareholders of a number of large public companies that were subject to leverage buyout transactions (LBOs) between 2003 and 2007. See *Dahl, et al v. Bain Capital Partners LLC, et al (US District Court, District of Massachusetts, No. 07-12388).* Plaintiffs brought antitrust claims under the United States Sherman Act alleged that the defendants illegally colluded to artificially fix the sale prices of the companies in which the plaintiffs held securities. Essentially, the plaintiffs alleged that the defendants suppressed competition and avoided bidding wars for companies by forming bidding clubs and banding together to put forth a single bid for a target company. The defendants, who were not part of the bidding club, would not compete for the business and therefore, reduced bidding.

In its decision, the Court rejected most of the plaintiffs' theories, stating that "the mere fact that Defendants are bidding together, working together, and communicating with respect to a specific transaction does not tend to exclude the possibility that they are acting independently across the relevant market". *Opinion at 26*. The Court did allow the plaintiffs to proceed at trial on the allegation that there was an alleged overarching agreement between the Defendants to refrain from 'jumping' or outbidding each other after transactions were announced. *Id. at 29*. The Court also allowed the plaintiffs to proceed on a second claim relating to a specific transaction. *Id. at 31-32*.

Similarly, in another closely watched proceeding, Norcast S.AR.L., the former owner of equity of Norcast Wear Solutions, Inc. (NWS), a manufacturer of mining products, is challenging its sale of NWS to Castle Harlan, Inc., a private equity fund, for $190m. In *Norcast S.AR.L. v. Castle Harlan, Inc.*, (US District Court, Southern District of

New York, 12 Civ. 4973), Norcast alleges that approximately seven hours after the sale of NWS to Castle Harlan, Castle Harlan resold NWS to Bradken Limited, an Australian company that competes with NWS. Norcast alleges that Castle Harlan earned $25m in the subsequent sale and that it took steps to conceal Bradken's identity as the ultimate purchaser. Norcast has asserted claims of fraud and negligent misrepresentation. Castle Harlan recently moved to compel Norcast to arbitrate the claims. Norcast has also sued Bradken in the Australian Federal Court and that Court issued a ruling against Bradken on 19 March 2013 which is currently on appeal.

Finally, the use of distributions-in-kind continues to be hotly debated. In January 2013, a US Bankruptcy Court rejected a Cayman Islands investment company attempt to redeem investors through distributions in kind. *See In re Stillwater Asset Backed Offshore Fund, Ltd*., (US Bankruptcy Court, Southern District of New York, Case No. 12-14140 (Jan. 17, 2013)). The company, Stillwater Asset Backed Offshore Fund Ltd. ('Stillwater'), was 100 percent invested in a related US fund, Stillwater Asset Backed Fund LP (the 'Onshore Fund') which held illiquid investments. When Stillwater was unable to pay redeeming investors in cash, it issued each of them a purported distribution in kind (DIK) of the investor's proportionate interest in the Onshore Fund. However, the Onshore Fund never executed or issued any documents in connection with the DIK. About a month later Stillwater sold all of its assets to Gerova Financial Group, Ltd., but its creditors, including the redeeming investors, received no cash or other property in return. Gerova subsequently ended up in a wind up proceeding in Bermuda. The redeeming investors of Stillwater brought an involuntary Chapter 11 case in the United States Bankruptcy Court. Stillwater contested the petition based on the DIK.

The Court dismissed Stillwater's objections and granted the petition. With respect to the DIK, the Court held that the "transmittal of a piece of paper that purports to pay a redeeming creditor an undivided percentage of some of the debtor's assets collected into a special purpose fund, and a slice of other assets that could not by their terms be further subdivided" did not satisfy the requirement under Cayman law that the creditor receive payment in full in portfolio securities or in specie. The Court cited the recent Cayman case, *In re FIA Leveraged Fund* (18 April 2012), No. FSD 0013 of 2012 at p. 26-28 (ASCJ) (Cayman Is.). ■