

## Beware Pitfalls In Private Equity Secondary Transactions

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As private equity funds approach the end of their lives, a fund's general partner is often encouraged by the fund's limited partners and third-party buyers to consider secondary liquidity solutions. Liquidity solutions can involve fund extensions, asset sales to third-party buyers, tender offers to limited partners, or other creative structures to maximize value in remaining fund assets. When properly executed, these structures can satisfy all stakeholders by allowing some to realize value while others remain invested in the assets. These structures, however, can be rife with conflicts of interest. A vivid example of the possible pitfalls — and the vigilance of the U.S. Securities and Exchange Commission regarding fair disclosure — can be seen in the Sept. 7 settlement of an administrative proceeding and fine against VSS Fund Management LLC. VSS was alleged to have failed to provide the limited partners of a private equity fund it advised, VS&A Communication Partners III LP (Fund III), with material information relating to a change in value of the assets of the fund in connection with a secondary offering led by Jeffrey T. Stevenson, the owner and managing partner of VSS.[1]

### Background

In April 2015, when Fund III was in its 17th year and held two remaining portfolio companies, several limited partners informed the manager of their desire to exit. The VSS investment committee, of which Stevenson was a member, decided to dissolve Fund III through an in-kind distribution. At the same time, Stevenson proposed that he would purchase the limited partners' interests at a cash price based on Fund III's December 2014 audited net asset value. When presenting this offer to Fund III's limited partners, VSS stated that the 2014 earnings before interest, taxes, depreciation, and amortization, or EBITDA, of both of Fund III's two remaining portfolio companies had declined from 2013 and that VSS had not pursued a sale of the investments due to the "recent down performance of the business." The vast majority of Fund III limited partners promptly accepted the April offer. In early May 2015, the VSS investment committee received updated first-quarter financial information from the two portfolio companies, which led to a material increase in Fund III's NAV for that quarter.



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By mid-May 2015, VSS decided to leave Fund III open rather than distribute its assets. VSS notified Fund III's limited partners that it no longer planned to do an in-kind distribution but that Stevenson would still be willing to purchase limited partnership interests at the same cash price offered in April. Notably, however, VSS did not inform the limited partners of the potentially significant increase in Fund III's value. More than 80 percent of the limited partners accepted the offer to buy their interests. By June 2015, VSS' internal valuations continued to show a potentially significant increase in value, and the information continued to be withheld from limited partners even though VSS was required to provide financials to limited partners within 60 days of quarter end. No explanation was given for the delay of first-quarter 2015 financials, which would have shown the material increase in Fund III's value.



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Based on these facts, the SEC found that the failure of VSS and Stevenson to disclose the potential increase in value was a material omission. In particular, VSS' uncorrected statements about the portfolio companies' declining EBITDA and "recent down performance" became misleading. By presenting Stevenson's offer "as an accommodation" with the same purchase price as the prior offer, the new offer appeared to provide limited partners with the full value for their interests; yet VSS and Stevenson had preliminary information indicating the value of Fund III had potentially increased significantly from the 2014 NAV. As a result of these actions, VSS violated, and Stevenson caused VSS' violations of, Section 206(4) of the U.S. Investment Advisers Act and Rule 206(4)-8.



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### **Practical Implications**

The VSS settlement demonstrates the SEC's continued focus on the conflicts of interest that can occur in several contexts. The increased popularity of general-partner-led secondaries during the last few years means that more managers are facing situations where the valuation of a fund's remaining investments will be a critical factor, particularly when the general partner seeks to increase its economic interest in the remaining investments. The SEC had previously demonstrated its focus on this issue in the Blackstreet case. While Blackstreet is more widely known for finding that the private equity firm was an unregistered broker-dealer, it also involved a conflict of interest in connection with the acquisition of limited partnership interests by a controlling person of the general partner.[2] As both these cases show, full and transparent disclosure of all relevant information by the manager to existing and potential investors is the best way to ensure a favorable outcome for all parties.

The conflict of interest in the VSS and the Blackstreet cases was particularly acute as a result of persons associated with the general partner being on the "buy side" of the transaction. In a more typical context, the general partner will take the lead in arranging the transaction, but the buyer will be the winning bidder, determined through an auction process, and unaffiliated with the general partner. Even in that more typical situation, both the general partner and the buyer should take heed from the decisions in these cases.

While the nature of the conflict may be less direct where the buyer is unaffiliated with the general partner, conflicts of interest may still be lurking, whether in the form of a "stapled commitment" from the buyer to a new fund being raised by the general partner or in the form of divergent economic interests between the general partner and its original investors.

The single most important point to be gleaned from the VSS case is the importance of full and timely

disclosure. In transactions of this type, material information that is provided to the buyer should also be made available to prospective sellers before they are required to make a decision with respect to the offer. If material information cannot be provided to the buyer or prospective sellers (for example, because of securities laws or confidentiality considerations), there should be clear disclosure to both the buyer and prospective sellers that the general partner may be in possession of information material to the contemplated transaction that it is unable to disclose. Derivative of the need for full and timely disclosure is the need to ensure that prospective sellers are given full access to all diligence materials that have been made available to the buyer.

Separately, as with any matter that gives rise to the potential for conflict of interest, the general partner should consider carefully its obligations under its fund documents to determine how such a potential conflict of interest may be waived and its disclosure obligations to the fund's limited partners with respect to such conflict of interest. Beyond what has been agreed in its fund documents, the general partner should also seek advice as to the legal and regulatory overlay to which it is subject and consider how that bears on the manner in which such potential conflict should be addressed.

Finally, while these obligations fall principally on the general partner, a buyer in this type of transaction is well-served by ensuring that the general partner has complied with its obligations in terms of disclosure and appropriate handling of potential conflicts of interest. While liability for failure to do so will likely rest with the general partner, the potential for litigation creates unappealing execution uncertainty and risks unwanted reputational tarnish.

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[1] In the Matter of VSS Fund Management LLC and Jeffrey T. Stevenson, Investment Advisers Release No. 5001 (Sept. 7, 2018) (Administrative and Cease-and-Desist Proceeding), available here.

[2] See In the Matter of Blackstreet Capital Management LLC and Murry N. Gunty, Investment Advisers Release No. 4411 (June 1, 2016) (Administrative and Cease-and-Desist Proceeding), available here.