Feature

KEY POINTS

- Expansion by a private fund manager into multiple investment strategies presents a number of potential conflicts of interest that require careful consideration and management.
- In some cases, third-party participants in transactions will expect debt funds affiliated with the equity holder to be contractually disenfranchised from most votes under the credit facility.
- The UK FCA's January 2020 policy statement, together with updates to insider dealing rules in the UK and EU with the implementation of the Market Abuse Regulation, may signal a new focus on private equity and some of the conflicts arising when it expands into debt.

Author John F Anderson

When private equity met private debt: conflict management in a multi-strategy world

As the prominence of private debt steadily increases within the alternative assets universe, there are an increasing number of PE firms and other financial institutions expanding their product lines to include a credit arm. At the same time, private debt fund sponsors are differentiating their investment focus within the debt space and in certain cases moving into private equity as well. Regardless of the starting point, expansion by a private fund manager into multiple investment strategies presents a number of potential conflicts of interest that require careful consideration and management.

This article examines certain key conflicts considerations and typical approaches to conflict management, including from a regulatory perspective.

EXAMPLES OF STRATEGIC EXPANSION

There are a number of ways that a private equity fund manager (whether a boutique or division of a bank or other financial institution) may expand into multiple alternative investment strategies that include both private equity and credit.

For example, a private equity sponsor may establish a credit platform that participates as a financier in PE transactions in the mid or large-cap buyout markets. While banks have historically dominated the leveraged lending market from their balance sheet (with separate capital markets units for debt issuance and trading), there has been a trend toward establishing direct lending and other private credit funds to compete with credit funds established by other managers. There are other instances of credit fund managers moving toward equity strategies over time.

The nature of the firm and its strategic expansion in part drives the conflicts that it faces in pursuing multiple investment strategies and the availability of options to manage those conflicts.

Once a private equity firm decides to expand into credit or another investment strategy, there are some threshold questions to ask. *Will the firm completely isolate the team for one strategy from the team for another strategy? Or will there be some integration of information, analysis and other resources?*

Regardless of the degree of overlap, the firm will need to implement – and monitor compliance with – policies and procedures designed to navigate and mitigate conflicts arising from the combination of investment strategies within the firm.

THE BASIC CONFLICT

The core conflicts between private equity and debt relate to information, control and contractual entitlements. The private equity owner of a portfolio company "holds the keys", with almost full visibility and control over a portfolio company's strategy and operations and a proprietary interest in the company.

A private lender to that portfolio company, by contrast, holds a contractual right to repayment of a debt, usually with limited information rights and a say only over typical creditor matters that are the subject of consent rights under a loan, such as waiving a financial covenant breach.

If management of two interest-holders (eg separate funds with different investor bases) is combined under one firm without appropriate policies and controls that recognise the differing perspectives of these interest-holders, the risk of encountering unmitigated conflicts and regulatory and legal issues is substantial.

INVESTMENT ALLOCATION CONFLICTS

Where a firm has overlapping investment mandates, the potential exists for "channel conflict" in terms of allocating scarce investment (and divestment) opportunities among funds and accounts. Fund managers (particularly first-time or single strategy) often agree contractual investment allocation priorities for the flagship fund as well as competing fund restrictions and key person time devotion covenants.

A PE firm expanding into debt is typically able to navigate these issues in defining its debt strategy and organising and adding to its human resources, but careful analysis is necessary where the debt strategy is also able to invest in equity (not uncommon for more subordinated debt strategies).

Separately, the potential for channel conflict can also arise among overlapping debt strategies. Implementing an investment allocation policy that minimises express contractual priorities and handles allocations reasonably and in good faith based on a number of criteria provides a fund manager flexibility to achieve balanced outcomes in various situations.

CROSS-INVESTMENT

Where a firm permits cross-investment across the capital stack in a portfolio company and a restructuring scenario arises, there are inherent conflicts of interest between holders of the equity and holders of debt at various tiers.

These conflicts typically surface when a portfolio company is undergoing financial stress and enters into discussions with its lenders, for example, to waive financial covenants or seek other relief under the credit facilities. The firm's ability to join an ad hoc creditors' committee may be impacted by its equity position/director seats, and the ability to trade in or out of the debt may also be limited based on inside knowledge.

One approach is to manage these conflicts with separate teams that represent the conflicting interests with appropriate information barriers built between the teams. Another approach is to limit the

Biog box
John F Anderson is International Counsel at Debevoise & Plimpton LLP.
Email: jfanderson@debevoise.com

size of participation by the debt fund in the transaction to ensure that third party lenders have the greatest stake and control over creditor-based decisions. In some cases, third-party participants in a transaction will expect debt funds affiliated with the equity holder to be contractually disenfranchised from most votes under the credit facility.

Even credit firms that prohibit equity holdings in a portfolio company still need to think through these types of conflicts if they hold debt at multiple tiers, as it is possible in a restructuring that a lower tier tranche of debt is equitized as part of the restructuring transaction, with more senior debt tranches remaining in place.

CROSS-SALES/REFINANCINGS

Private funds often restrict the ability of the fund manager to sell assets to other funds and accounts that it manages absent investor consent (or investor advisory committee consent), with certain exceptions that usually involve the presence of third party pricing and terms to help validate the related party transaction.

For a private fund manager running private equity and debt strategies, there are potentially firm-wide synergies, as being invested in a portfolio company can generate access to new deals, and historic knowledge of the portfolio company speeds the investment diligence process.

On the other hand, where a manager's debt funds are entering a portfolio company owned by the manager's private equity funds (or where new debt funds are entering and incumbent debt funds are exiting), the refinancing may appear as if the manager is arranging an exit for the incumbent funds with capital from the newer funds. From a practical conflicts management perspective, managers seek to ensure that third parties are involved in any debt refinancing to establish arms-length pricing and terms.

INFORMATION BARRIERS/MNPI

As noted above, a fundamental difference between private equity and debt is disparity in information rights, where the private equity sponsor and the portfolio company management are the "insiders" and the lenders have a varying degree of access to detailed financial information about the portfolio company, including projections, depending on the transaction.

For credit strategies, the ability to restrict access to information about a portfolio company that may be confidential and/or considered material non-public information (MNPI) may impact the fund's ability to buy or sell debt in the portfolio company on the secondary market.

In addition to insider trading laws and regulation in various jurisdictions (typically applicable to listed debt securities), loan market trade organisations have published non-binding guidance and policy statements regarding the use of confidential information and/or MNPI in transactions (eg the Loan Market Association's Transparency Guidelines and the Loan Syndications and Trading Association's MNPI Principles).

These rules and guidance generally provide a framework for market participants to operate information barrier policies and procedures that restrict access to information that may constitute MNPI to an insider team, with a compliance and administration team functioning "above-the-wall" to operate and monitor compliance with the policy.

Private fund managers looking to expand from private equity into credit will likely have policies for handling confidential information with respect to external third parties and the firm as a whole. However, such firms may not have had to consider and plan for the compartmentalisation of that information on an intra-firm basis, similar to how a trading group within a financial institution may be segregated from other parts of that institution. In this respect, larger institutions with a deeper in-house administrative function may be better equipped to operate effective barriers.

THE REGULATORY PERSPECTIVE

The US, UK and EU are key (but by no means the only) jurisdictions for private fund manager regulation. With respect to conflicts, there have been two principal regulatory themes evolving over time: first, a focus on ensuring transparency with investors through sufficiently detailed disclosure in the private placement memorandum or other offering documentation; second, as regulated financial services businesses, private fund managers must implement policies and procedures designed to identify and manage potential and actual conflicts of interest in the operation of their business.

The US regulatory compliance and enforcement process around conflicts policies and disclosure is generally more developed than it is in Europe, perhaps in part due to the alternative assets markets developing earlier in the US. The US SEC pursues its compliance policy objectives in part through its investment adviser examination process, pursuant to which it may issue a deficiency notice (or take further action), for example, if it finds that an investment adviser's conflicts disclosure is inadequate, or that the adviser is not appropriately implementing and enforcing its compliance policies and procedures.

As part of its process, the SEC makes its examination priorities known through public materials, such as the June 2020 Risk Alert published by its Office of Compliance, Inspections and Examinations (now renamed Examination Division), which highlighted a number of the conflicts identified above as key issue areas arising out of examinations of private fund advisers.

By contrast, in the UK the historic focus of insider dealing enforcement has been on banks and large financial institutions rather than private equity firms. However, there is some evidence that this focus is changing in the UK, with the issuance by the UK Financial Conduct Authority of a "Dear CEO" letter in January 2020, relating to its alternative assets supervision strategy and identifying market abuse as a key area of supervisory concern. This policy statement, together with updates to insider dealing rules in the UK and the EU with the implementation of the Market Abuse Regulation may signal a new focus on private equity and some of the conflicts arising when it expands its strategic horizons to encompass debt. ■

Further Reading:

- Issues between creditors and debtors when restructuring listed debt (2021) 1 JIBFL 44.
- The handling of material non-public information in the US and UK loan markets (2010) 10 JIBFL 624.
- LexisPSL: Corporate: Board control provisions: shareholders' agreement and articles – private equity or venture capital.