Published on *The National Law Review* https://natlawreview.com

SEC Charges Private Equity Firm and Four Executives with Failing to Disclose Conflicts of Interest

Article By:

Sean J Hill

Anthony M. Drenzek

Timothy W. Mungovan

Michael R. Suppappola

On November 3, 2015, the ***Securities and Exchange Commission (SEC)*** announced that it had reached a settlement with Fenway Partners, LLC, a New York-based private equity firm, and several of the firm's executives (the Respondents) in connection with a failure to disclose conflicts of interests to investors with respect to payments made by portfolio companies of a private equity fund to certain affiliates and former employees of the firm. In settlement of the matter, the Respondents agreed to collectively disgorge approximately $8.7 million, and pay an approximately $1.5 million civil monetary fine.

According to the SEC, Fenway Partners entered into certain management service agreements with several portfolio companies of Fenway Partners Capital Fund III, L.P. (Fund III), a private equity fund advised by Fenway Partners, pursuant to which the portfolio companies would pay periodic monitoring fees to Fenway Partners. In accordance with Fund III's governing agreements, 80% of the monitoring fees paid to Fenway Partners pursuant to these service agreements were offset against the advisory fee paid by Fund III to Fenway Partners.

Beginning in December 2011, Fenway Partners and the Respondents caused certain of the portfolio companies to terminate the existing service agreements and instead enter into similar agreements with Fenway Consulting, LLC (Fenway Consulting), an affiliated entity principally owned and operated by three of the Respondents. The services provided by Fenway Consulting were similar to those which had been previously provided by Fenway Partners (using the same fee structure) and often involved the same employees. This reassignment ultimately resulted in $5.74 million in monitoring fees being paid to Fenway Consulting that were not offset against Fenway Partner's advisory fee.

Pursuant to Fund III's governing agreements, Fund III's limited partner advisory board had the authority and responsibility to approve or disapprove matters which included a "direct and material conflict of interest or risk of such conflict of interest." The SEC alleged that the principals of Fenway

Partners failed to disclose the conflict of interest created by the assumption of the portfolio company services agreements by Fenway Consulting, as well as the corresponding loss of the advisory fee offset, as required by the governing documents of Fund III and in breach of Fenway Partners' fiduciary duty to Fund III. In particular, the SEC highlighted a meeting attended by advisory board members during which principals of Fenway Partners disclosed that Fenway Consulting had been retained by certain portfolio companies, but failed to concurrently disclose that the service agreements with Fenway Partners had been terminated and the related advisory fee offsets would cease.

In addition, the SEC alleged that Fenway Partners failed to provide proper disclosure in connection with the use of proceeds from a $4 million capital call notice issued in January 2012. According to the SEC, Fenway Partners represented to the limited partners of Fund III that the capital call proceeds were to be used to fund capital improvements with respect to a specific portfolio company. However, $1 million was ultimately used as payment to Fenway Consulting in connection with a consulting agreement executed simultaneously with Fund III's receipt of the capital call proceeds.

The SEC further alleged that Fenway Partners failed to disclose conflicts of interest which resulted in an award of $15 million in certain cash incentive plan interests (CIP Units) to a principal and certain former employees of Fenway Partners in connection with services provided by such persons to a certain portfolio company while they were employed by Fenway Partners. According to the SEC, Fenway Partners failed to disclose the conflicts inherent in the CIP Unit award, the proceeds of which were not offset against Fenway Partners' advisory fee and resulted in a reduced investment return to Fund III investors upon the subsequent sale of the portfolio company.

Finally, the SEC alleged that Fenway Partners failed to disclose the compensation received by Fenway Consulting from the portfolio companies as related party transactions in its 2011 and 2012 audited financial statements. Additionally, the CIP Unit payment awards were similarly not disclosed in Fenway Partners' 2012 audited financial statements.

As this enforcement action illustrates, the SEC staff remains focused on related party transaction and compensation arrangements between and among an adviser's affiliated entities which have the potential to result in actual or apparent conflicts of interest. Private fund advisers should specifically review disclosures concerning any consulting, management, monitoring or other services agreements between the adviser (and/or its affiliates) and fund portfolio companies to ensure that adequate disclosure of the relationships and any related compensation arrangements have been made to fund investors. In instances where investor or advisory board approval is necessary, advisers should meticulously document the presentation of the conflict and all material facts to ensure that the limited partners and/or the advisory board, as applicable, have received all necessary information to make an informed decision whether to approve any related conflicts. Advisers should also create and maintain a record of any such approvals by the limited partners and/or the advisory board.

National Law Review, Volume V, Number 309