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Investor Hazard: 'Zombie Funds'

By Susan Pulliam and Jean Eaglesham

Talbot Hall, a New Jersey facility that prepares prison inmates for release, drew an investment from a private-equity fund 16 years ago.

Today, the investment sits in a "zombie fund": a near-dead fund that ties up investors' money and continues charging them fees even as hopes of profiting from its remaining assets have faded.

It is a little-known horror show in the investment world. Of the roughly 10,000 private-equity funds raised over the past decade, at least 200 now qualify as zombie funds, accounting for as much as $100 billion of the $1.5 trillion currently invested in these vehicles, according to consultants TorreyCove Capital Partners LLC.

Zombie funds are among a growing class of financial assets that are hard to price and whose value is difficult to ascertain, part of a lack of transparency endemic in today's financial markets that increasingly challenges investors.

For public pension funds, which are significant private-equity investors, the zombie funds can drain resources otherwise available to help meet retiree benefits for teachers, firefighters or other employees.

Private-equity funds raise money from investors to buy businesses that the funds then restructure and try to sell for a profit, often after just a few years. The idea is that once the businesses are sold, investors will get back their capital plus any profits, minus fees of course.

Investors aren't free to pull out whenever they please. But the funds aren't meant to last indefinitely; they adopt a maximum life span when they are formed, usually 10 years.

Some, as the end of this life span approaches, find themselves nursing assets they can sell only at fire-sale prices, if at all. So they simply hang on to the assets and cling to life, as what are known in the industry as zombie funds. The term is a colloquial one and has no precise definition, but many investment professionals agree it can be applied to a fund that has lasted longer than its predetermined life span plus a two-year extension, and whose remaining are proving hard to sell.

Some investors complain that such funds often place unrealistically high values on their remaining, hard-to-sell assets. For pension funds, the result isn't only to inflate management fees but to prevent an accurate valuation of the assets available for paying retiree benefits.

Pension funds and other investors have billions tied up in near-dead buyout vehicles known as zombie funds. The zombies keep racking up management fees for private equity firms, with little hope of ever making a profit. WSJ's Susan Pulliam explains.

"The manager sometimes has a clear incentive to hold on to investments that have poor prospects for improvement, simply to get more out of the fund in the form of management fees," says Espen Robak, president of Pluris Valuation Advisors LLC. "In those cases, the incentive is also there to overvalue" the assets, he adds.

The Securities and Exchange Commission is delving into such issues as part of a broad look at private-equity funds and whether investors are being misled. "We're looking at zombielike funds that potentially have stale valuations," says Bruce Karpati, co-head of the SEC's asset-management enforcement unit. "The investigation into zombie funds is an important effort being driven across the country."

Investors in such funds have limited options. They can try to persuade the manager of the fund to close it and distribute shares in its remaining assets. But what the investors are likely to end up with is a bunch of hard-to-sell shares.

"If you push the issue, the [private-equity firm] can liquidate the fund and then we get stock certificates for private companies. What do we do with that?" says William Atwood, director of a board that handles Illinois's pension investments.

Another alternative for investors is to try to sell their stakes. But the stakes in aging or moribund funds tend to trade at an average of 30% to 40% below where the funds' managers value them, says Todd Miller, a managing director of Cogent Partners Inc., a private-equity investment bank that provides a secondary market to its clients.

Not all investors want out. Pennsylvania's retirement fund for teachers has stakes in 15 private-equity funds older than 10 years, totaling about $40 million, according to Charles Spiller, who heads the state's private-equity investments. He says he regards only a few of them as zombies and is willing to have patience with the funds' managers, because "if you don't sell at the right time, you're not going to get the full value."

Pension managers in some states are taking direct aim at the fees. Illinois did that.

The state paid $580,000 in management fees on zombie funds in 2010, from various fund firms, according information received by The Wall Street Journal through a public-records search. "Private-equity groups are taking us to the cleaners and asking us to pay them a fee for the privilege," Illinois's Mr. Atwood said in an interview.

In March, he wrote to Invesco Ltd. asking it to stop charging fees on a 13-year-old fund to which Illinois paid fees of nearly $340,000 in 2010.

In the letter, obtained in the Journal's open-records search, Mr. Atwood said that failure to waive fees on this fund, called the Invesco Venture Partnership Fund II LP, would "imperil" the state's $950 million of investments in other Invesco funds.

The fund at issue was set up in 1999, at which time Illinois put in $35 million. "When you are at the front end of these investments, you don't think about these things," Mr. Atwood says. "At year 12, you have these awkward, annoying exposures and you ask, 'How do we get out?' "

He didn't ask Invesco to close the aging fund. Neither has any other investor, Invesco says.

Doing so would be complicated. The case illustrates what a thorny problem aging funds can present.

Venture Partnership Fund II is a "fund of funds"—investing not in individual companies but in other funds. Those it invests in focus on early-stage companies, making it more of a venture-capital than private-equity fund.

To close the fund, Invesco says, it would either have to sell all the stakes this fund holds in other investment funds—at a discount of "perhaps 30% to 50%, if we were even able to find a buyer"—or distribute small slices of each of those other funds to its own investors.

Such a process, Invesco says, not only would be "time consuming" and "costly," but might require the consent of each of those other funds.

In any case, Invesco says, it doesn't want to close Venture Partnership Fund II. Others may think of it as a zombie fund, but Invesco believes its own management is continuing to "maximize value at the fund in a way that would not be able to happen if the fund were to 'shut down.' "

To eventually close the fund, Invesco says, more time will be required for all of the other funds in which this fund invests to wind up their own affairs.

And each of those others, Invesco notes, can request a multiyear extension of its mandate. Private-equity managers still holding on to struggling assets at the end of their 10-year (or sometimes 12-year) life spans frequently ask for another year or two to turn things around.

Even if Invesco voted against such extensions, the firm adds, its vote wouldn't be controlling; others might vote the other way.

After receiving Mr. Atwood's request, Invesco decided to lower the fees for all investors in the Venture Partnership Fund II.

For Illinois's pension board, this meant that instead of charging the state 0.97% of the $35 million Illinois invested 13 years ago, Invesco will charge 0.5% of the value of Illinois's slice of the remaining assets, which is about $6.4 million. The change will cut the annual fee Illinois owes by about 90%, to $32,000.

Investors who agree to lengthen mandates of private-equity funds can often negotiate waivers or reductions of management fees in return, notes Michael Harrell, a partner at law firm Debevoise & Plimpton LLP.

The Oregon Public Employees Retirement Fund has stakes in 34 funds that are more than a decade old but is paying management fees on only 12 of them, according to a spokesman. The fees on those 12 average 0.8% of the value of their remaining assets, lower than the 1% to 2% of assets typically charged.

Massachusetts has $83 million of its pension assets in aging funds, largely invested in 1999, the height of the dot-com boom, according to Stanley Mavromates, chief investment officer of the board that oversees the state's pension investments. He says the state is paying fees on only about six of the 21 largest aging funds. "Our preference is if there is going to be an extension" of funds' mandates, "it should be without fees," Mr. Mavromates says.

Investors in one fund pushed back by trying to force out the manager. The fund, called Brantley Partners IV LP, began in 1998. Investors filed suit in August 2010 alleging that the Ohio-based partnership that managed the fund, called Brantley Venture Management IV LP, no longer had "adequate resources to perform the basic tasks" and needed to manage the fund or wind it up.

Their complaint in Delaware Chancery Court also alleged that Brantley's principal, Robert Pinkas, used the fund "as a personal piggy bank," overcharging by millions of dollars in fees and improper expenses. At the time, a spokeswoman for Brantley and Mr. Pinkas, who were both defendants, denied the allegations.

The Brantley fund last year got a new manager and a new name—Emerald Partners IV. The SEC in February filed a civil administrative action against Mr. Pinkas, alleging he had improperly taken $805,000 from the fund, mostly to pay to settle an earlier, unrelated SEC action.

Mr. Pinkas died in March. Stephen Sozio, a lawyer who represented him in the SEC action, said his client "denied and was vigorously fighting, until he became critically ill late last year, the allegations made by the investors in the fund and the SEC."

A spokesman for the SEC said it was too early to say what the agency will now do about its civil administrative action. A lawyer for the investors declined to comment. The investors' suit in the Delaware court is still pending.

The Ohio Police and Fire Pension Fund, one of the Brantley Partners IV investors, still is paying fees to the fund. The state has so far gotten back $8.3 million of its original $10 million investment made some 13 years ago, a spokesman said.

It is unclear what the exit strategy might be for investors in a private-equity fund that has an interest in Talbot Hall, the New Jersey facility that prepares inmates for release and reintegration into society.

The Newark institution is part of a business called Community Education Centers Inc., or CEC, a prison-services company in West Caldwell, N.J. A group of investment funds that included BCI Partners, of Teaneck, N.J., took a stake in CEC in 1996.

BCI stopped operating in 2005. One of the original BCI managers, Donald Remey, continues as caretaker of remaining fund assets, collecting management fees on them from investors, which include pension funds in Illinois, California and Oregon.

During a conference call following a Sept. 30, 2011, report to investors, according to a person who was on the call, Mr. Remey said he could sell the remaining assets, but such a step would fetch only about half the value at which he is carrying them.

That value is $13.5 million, according to one of the investors in the fund. To value their own stakes, investors generally rely on the private-equity firm's valuation, rarely paying a valuation firm to try to come up with a different figure.

In the case of BCI, investors continue to pay a management fee, which was lowered voluntarily to a total of $100,000 for all investors in 2012 in an amended agreement with them signed about a year ago, according to information received in a public-records search. In 2010, according to data received in the search, Illinois pension funds paid fees of $14,000 to the fund on its remaining assets, including the CEC investment.

CEC itself has passed on opportunities to sell itself amid consolidation in the prison-services industry, people close to the situation say. BCI and Mr. Remey declined to comment.

Says Christopher McDermott, marketing chief at private-equity investor Coller Capital Inc.: "It's quite difficult for investors in zombie funds to do anything other than wait for their release."