



Mount Kellett: Conflicts And Other Violations Arising From A Personal Loan

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This case illustrates how an unresolved compliance violation, an undisclosed conflict of interest in the form of a personal loan, has the potential to snowball and to take on a life of its own. It also illustrates how difficult it is to capture and explicitly prohibit all conflicts in a Compliance Manual: In the Mount Kellett Capital Management LP (“Mount Kellett” or the “RIA”) case¹ a portfolio manager, Norman Louie (“PM”) made a secret and undocumented personal loan to the chairman of the board of directors of a public oil and gas company, Energy XXI Ltd. (“EXXI”), that Mount Kellett had made a substantial fund investment in. The PM then began a successful email campaign to become an independent member of EXXI’s board (aided by a vote from the loan beneficiary).

Mount Kellett’s policies and procedures alerted the PM to typical conflicts of interest such as those involving personal trading, outside business activities and gifts and entertainment but did not discuss conflicts of interest more broadly and in sufficient depth so as to train employees to recognize other violative conduct not specifically identified in the Compliance Manual. For example, there was no mention that transactions such as a personal loan to a senior officer of a portfolio company create a conflict of interest between Mount Kellett and its clients that must be disclosed to those clients. Consequently, the RIA did not have adequate policies and procedures in place to assist supervised persons in identifying this particular conflict of interest.

Mount Kellett, a New York based registered investment adviser with regulatory assets under management of \$7.5 billion in 2014, beneficially owned 6.3% of NASDAQ traded EXXI stock. Initially, the RIA filed Schedule 13G because it was a passive investor and did not make the investment for the purpose of changing or influencing control of EXXI. The PM oversaw Mount Kellett’s oil and gas investments including the investment in EXXI. In the summer of 2014, EXXI’s stock performance began to deteriorate as a result of a \$2.3 billion acquisition by EXXI that was not well received by the market. Consequently, the PM began a campaign to become an independent member of EXXI’s board of directors and to make operational and personnel changes at EXXI in an effort to improve the financial performance of EXXI and its stock price.

¹ *In the Matter of Norman M.K. Louie and Mount Kellett Capital Management LP*, Advisers Act Release No. 4968 (Jul. 16, 2018).

The loan created a conflict of interest for the PM and Mount Kellett and should have been disclosed to the RIA's clients. The PM's obligation was to exercise the utmost good faith in dealing with those clients which includes an obligation to disclose all material facts to avoid misleading those clients. It is the clients who have the right to evaluate the conflict and whether it presents a risk they are willing to accept. Clients, however, were not given this choice.

As a result of the PM's failure to disclose the loan to Mount Kellett and EXXI, the PM caused EXXI to file an inaccurate and misleading Form 8-K announcing his appointment to the EXXI board as an "independent" director. The PM also caused a failure by Mount Kellett to disclose the conflict of interest created by the loan to its clients. Mount Kellett also failed in its beneficial ownership reporting obligations (see the Timeline below). And Mount Kellett failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

Timeline

December 21, 2009	Mount Kellett files Schedule 13G holding 8.2% of EXXI stock.
June 2014	EXXI acquires an oil and gas company for \$2.3 billion and EXXI's stock suffers.
August 14, 2014	PM emails Mount Kellett analyst: "I need to get on board" of EXXI.
September 10, 2014	PM emails Mount Kellett management: "in dallas to get 2 board seats at exxi."
October 10, 2014	PM wires \$3 million to EXXI CEO, John Schiller, in an undocumented and undisclosed loan.
October 13, 2014	Mount Kellett presents Schiller with a proposal to strengthen EXXI's board, reduce employees and replace the CFO.
October 18, 2014	PM acting as a de facto board member attending board meetings.
December 15, 2014	PM and a second candidate become independent EXXI board members; EXXI files an inaccurate and materially misleading Form 8-K that did not disclose the loan.
December 22, 2014	Mount Kellett files a Schedule 13D (approximately 45 days late).
February 2015	Mount Kellett receives a document request from the SEC in connection with its investigation.
March 2015	PM discloses the loan to Mount Kellett and EXXI and shortly thereafter to the SEC.
March 31, 2015	PM leaves Mount Kellett.

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