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[CHRIS CHUFF]

Hey everyone, my name is Chris Chuff. I'm a Partner in Troutman Pepper's Business Litigation Group. I specialize in complex corporate and commercial litigation particularly in the Delaware Court of Chancery. I'm joined today by Taylor Bartholomew, an M&A Corporate Attorney from Troutman Pepper. Taylor who also sits in Delaware represents clients in a wide variety of public and private transactions, including, as relevant today, private equity deals. He also specializes in counseling clients in matters of Delaware corporate governance law. So we wanted to take a few minutes today to discuss a few drafting issues that we have seen crop up in connection with operating agreements of PE portfolio companies and then in a separate podcast we're also going to address drafting considerations in PE acquisition agreements but today we're going to focus on the operating agreements of portfolio companies. And on the operating agreement side, we're going to discuss fiduciary duty waivers, exculpatory provisions, indemnification provisions and the possible unintended consequences of those provisions. So welcome Taylor.

[TAYLOR BARTHOLOMEW]

Hey Chris. Thanks for doing this and thanks for having me.

[CHRIS CHUFF]

So let's start off with fiduciary duty waivers in PE operating agreements. I guess first, when should a party be negotiating for these waivers?

[TAYLOR BARTHOLOMEW]

So I think parties should be seeking to negotiate fiduciary duty waivers whenever possible assuming that the party is the private equity firm. So when we are on the buy side of private equity transactions, one of the first things I think about when I'm drafting an LLC agreement for a platform deal is how do we want to think about fiduciary duties, right. Do we want fiduciary duties? That's not to say that fiduciary duties aren't useful, and I'll get to that in a second. But really, private equity firms need to be concerned with having their designees on the board or their designees in officer positions at the holdco or the opcos following closing. They need to be concerned with these folks having fiduciary duties. That's not to say that fiduciary duties don't keep people honest. They very much do and we do think about those things in these types of deals except, as you and I have talked about plenty of times in the past, a lot of the big Court of Chancery cases coming out these days actually deal with private equity firms and their designees getting into hot water because they may have made a decision that is able to be second-guessed by a minority member or equity holder of some type, usually rollover members. So when I'm on the buy side of a private equity platform the acquisition, when I'm thinking about fiduciary duty waivers, I say hey guys, it's great to be honest, right, it's great to have fiduciary duties, but may not be the best thing if you guys don't

want to be second-guessed. So on the private equity side I would say those folks should be negotiating for fiduciary duty waivers. On the sell side, I would say, if I'm representing a rollover investor, right, someone who is selling their business to private equity, I would try, to the extent possible, to get some kind of fiduciary duties out of the private equity firm and the designees. Why – that gives me more of a voice as a minority investor. Whereas if I had a full-blown fiduciary duty waiver, I couldn't challenge anything based upon the duty of care, I couldn't challenge anything importantly based upon the duty of loyalty. Any kind of conflict transaction, right. So if I'm a minority investor, I like to think of fiduciary duties as a minority protection, especially in the private equity realm.

[CHRIS CHUFF]

So basically when you're on the PE side you should always be negotiating waivers but when you're a minority investor you want to try your hardest to negotiate for the inclusion of either full-fledge fiduciary duties or at least some contractual standard of conduct that keeps the board of managers in check, right.

[TAYLOR BARTHOLOMEW]

Exactly. That's not to say that it's binding, right. It's not necessarily the case that it's you either have a full-blown fiduciary duty waiver or you have full-blown fiduciary duties, right. So I've seen it on the ground level where PE firms will agree to, for example, I have fiduciary duties except in the sale context, right. Or on the flip side I have fiduciary duties in the sale context, except in limited circumstances. So you can get pretty creative with these things because, as everyone who is listening to this hopefully knows, LLCs and LPs are creatures of contract under Delaware law so we can really get pretty creative with when fiduciary duties apply, when they don't apply, it's not a one-size-fits-all approach. And a lot of times it really does boil down to negotiating leverage, right. How badly does the private equity firm want this portfolio company? How badly does it want to acquire this target? Is it an important issue for the sell side? Is sell side thinking about it in the same way that I just described it.

[CHRIS CHUFF]

Got it, got it. Now, assuming though that the deal that's reached is that we're going to have a full disclaimer of all fiduciary duties, how should such a waiver be drafted in a portfolio company's operating agreement?

[TAYLOR BARTHOLOMEW]

That is a great question. My take on it is simple is best. We want one or two sentences at most for it to be effective. And I think too often I see in, especially with form documents, which is a major, major pitfall in actual practice, too often do we see that these form documents have sentences upon sentences about the fiduciary duty waiver and carve-outs and whether they are intended or not intended. Ultimately I think a lot of practitioners are just kind of skipping the page when they get to the fiduciary duty waiver and saying, hey that's been in the form for so long, right, I don't need to read that or think about it. But you know there has been some recent case law that has shed some light on pitfalls and not thinking about that through more clearly.

[CHRIS CHUFF]

Yeah exactly. There's been some recent Delaware case law that has actually shown that the longer a waiver is, the more likely it is for a court to find a potential for that provision being regarded as ambiguous, which is going to allow a fiduciary of duty claim to at least surpass the motion to dismiss, which means there's going to be discovery, there's going to be depositions, there's going to be document production and that's exactly what a fiduciary duty waiver is trying to avoid. It's trying to provide complete clarity that there are no such claims so that that you don't have to deal with the litigation. And I agree whole-heartedly that the best waiver I think is just a sentence that says fiduciary duties of any members, managers, officers, etc. are hereby waived. That does it. You don't need to say any more.

[TAYLOR BARTHOLOMEW]

And I like to think about that, too, as I always break it down into a couple of elements, right. So its first of all what fiduciary duties apply, if any. And then who should get the benefit of that waiver. So to your point, Chris, it's you know the members, the managers, the officers, all of these folks.

[CHRIS CHUFF]

Right.

[TAYLOR BARTHOLOMEW]

And then do they get the full benefit of fiduciary duty waiver to the fullest extent of the law. And if it is a full-blown fiduciary duty waiver, that's a sentence. It shouldn't be more than one sentence. And any more than one sentence could make it ambiguous because the Court can say well why did the parties put all this additional language at the end of it? Why is there another 3 sentences, right. What's all this talk about gross negligence, willful misconduct, good faith, all this sort of stuff.

[CHRIS CHUFF]

Yeah, exactly, I agree. And then actually there's another aspect of this that can also affect the impact of a fiduciary duty waiver which kind of leads to my next question which is – what is the interplay between fiduciary duty waivers and exculpatory provisions and can the drafting of one of those provisions impact the effectiveness of the other?

[TAYLOR BARTHOLOMEW]

Absolutely. It's an interesting question and I think each case that deals with it just gets more clear with each passing case. I think the interplay is really stated simply – you can revise fiduciary duties simply by saying that a fiduciary will not be exculpated for acts done with gross negligence, willful misconduct or good faith and, by the same token, by including that kind of a carve-out in the fiduciary duty waiver, you can have the same effect.

[CHRIS CHUFF]

Right.

[TAYLOR BARTHOLOMEW]

So one can impact the other. In other words and revive fiduciary duties notwithstanding the fact that you have included in your waiver or exculpatory provision language intending there to be no fiduciary duties.

[CHRIS CHUFF]

Right and we see a lot of agreements that say first there's in one section says there's no fiduciary duties. But then in another section it says managers shall not be personally liable for monetary damages except in the case of gross negligence, willful misconduct or bad faith and what the Delaware courts have said is that those concepts – gross negligence, willful misconduct and bad faith – are akin to and the equivalent of the fiduciary duties of care and loyalty and so you have one provision that's supposed to completely get rid of these duties and then another provision that is saying essentially that a manager can be liable for monetary damages for the breach of duty of care and loyalty and therefore reviving the very duties that they were trying to get rid of usually earlier in the contract. And so is the takeaway there that for a PE backed fund, PE backed company, that they should avoid carve-outs altogether or, if not avoid them, limit them significantly?

[TAYLOR BARTHOLOMEW]

That's exactly the takeaway. And in my first approach is of course to include a full-blown waiver of fiduciary duties, right. Full stop, no exceptions. And then once we get the inevitable mark-up back from someone who is up-to-date on the law in Delaware that has all these carve-outs, right, or maybe it's just opposing counsel that says hey I have seen this gross negligence, willful misconduct, bad faith language in every form that I've dealt with in the past 10 years. What gives, why did you delete this? Or why shouldn't we insert this. And then I try to have the conversation about well, this is a PE-backed company, right. We're all in this together. Economically we all want the same result, which is to get a great exit, right. With a lot of return on investment. So let's try to do this together and just sort of preserve the fact that we're not going to have these fiduciary duties where you can second-guess the decision of the PE firm ultimately at the top. So I always start there and then if sell side counsel says hey, I think we should keep willful misconduct or good faith because we think loyalty, right, should be the line. And that's really a conversation I try to have with my client to say look, that means your fiduciary duty of loyalty kicks in. That means we need to be more wary of conflict transactions. That means we need to be a little more tight when we're doing things in the ordinary course.

[CHRIS CHUFF]

Got it. So basically if we're representing PE company we want to either avoid the carve-outs and the exculpatory provisions altogether, but at the very least, if we're going to have carve-outs, we want to get rid of the gross negligence carve-out because what we're doing is we're revising care claims which creates the possibility for second-guessing of management.

[TAYLOR BARTHOLOMEW]

Exactly. And I would even argue that if we're representing PE firms, right, because it is so often the case that in a buy-out situation the PE designees will control the board entirely. We want to get rid of that duty of loyalty. So if you wanted to offer some kind of counter-point, if

you wanted to accommodate the sell side with something other than a full-scale fiduciary of duty waiver, you could do what we talked about before, right. Which is to have context-specific fiduciary duties so I only have fiduciary duties in the sale context or I don't have fiduciary duties in the sale context but in the ordinary course I do, right. You can come up these creative accommodations to make sure that you're not cancelling business in the ordinary course with these you know equitable safeguards, but you're still giving the other side that they may want.

[CHRIS CHUFF]

Got it. So bottom line there is that you want to be very careful that you're not reviving and reinvigorating potential loyalty and care claims that you're trying to get rid of in the fiduciary duty waiver. Now does this same risk and consideration pose itself with carve-outs to indemnification provisions in the operating agreement?

[TAYLOR BARTHOLOMEW]

So I'm not aware of any cases that actually address whether including those terms in an indemnification agreement would revive fiduciary duties but after analyzing the cases that are out there that holds that those terms revive fiduciary duties in the exculpatory provision or the fiduciary duty waiver, ultimately I'm left with the impression that the Court would not say that those terms would revive fiduciary duties in the indemnification context. So what I always try to advise our clients is its purely a business decision as to whether you actually want to indemnify managers, officers, members for conduct that amounts to gross negligence, willful misconduct or bad faith. A lot of the times that is where PE firms will draw the line and say while you may not have fiduciary duties for those things but we certainly are not going to indemnify you for those things.

[CHRIS CHUFF]

Yeah, that's my reading of the case law as well. Basically an exculpatory provision expresses the circumstances in which a manager may be held liable and therefore it makes sense that carve-outs to those provisions have the effect potentially to you know reinstitute or revive fiduciary duties. Whereas indemnification, as you said, is just here are the circumstances in which I'm going to provide managers with indemnification or advancement and then it wouldn't make sense that carve-outs to those provisions would revive duties it's just these are the circumstances in which indemnification is going to be provided. And so that's my read of the case law, as well.

[TAYLOR BARTHOLOMEW]

And really at the end of the day that could be used as a bargaining chip to say look we don't want fiduciary duties but the way that we keep these folks honest is to say you may not have duties but we're not going to pay you if you do these things. You're going to be on your own dime.

[CHRIS CHUFF]

I like that. Alright, thanks again Taylor, that's all the time we have today to talk about the drafting issues regarding operating agreements of private equity portfolio companies. Tune in

next time when we're going to talk about specific drafting issues in PE acquisition agreements, including various provisions addressing fraud.