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Actions That Private Equity Fund Representatives on Portfolio Company Boards Can Take to Help Avoid Liability

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The 41.5 million settlement personally paid by directors of shoe retailer Just for Feet, Inc. in April 2007, following up on the $24.8 million settlement personally paid by WorldCom directors and the $13 million settlement personally paid by Enron directors, each in January 2005, all make clear that personal liability of corporate directors for actions taken in their capacities as board members is a real threat.

The Just For Feet directors included Warren Smith, who served on the board as a representative of Thomas H. Lee Partners, and Michael Lazarus, who served on the board as a representative of Weston Presidio Capital Management, showing that outside directors serving on behalf of their private equity funds are not immune from such claims.

This article summarizes some actions that representatives of private equity funds who serve on the boards of directors of their fund's portfolio companies can take to help avoid liability. It is intended to serve as a general reference tool with respect to such issues and although it necessarily touches on fiduciary duties concepts, it does not provide an exhaustive treatment of fiduciary duties law. Readers should consult with counsel concerning with any specific questions they may have relating to the matters discussed in this article or any other questions they may have concerning obligations in connection with serving on portfolio company boards.

BALANCING PORTFOLIO COMPANY FIDUCIARY DUTIES

Duties to your portfolio companies. Board members have fiduciary duties to the corporations on whose boards they serve and the stockholders of those corporations. These duties include the duty of care and the duty of loyalty. The duty of care requires directors to keep themselves informed about the affairs of the corporation and to seek out and use all reasonably available information when making decisions as a board member. The duty of loyalty requires directors to place the interests of the corporation and its stockholders ahead of their own personal interests and the interests of other parties. Under the business judgment rule, courts will defer to the judgment of a director if he or she acts on an informed basis, in good faith, with the care that a reasonably prudent person in a like position would exercise, and in a manner that the director reasonably believes to be in the best interests of the corporation.

Duties to your private equity fund. It goes without saying that a person who serves on a portfolio company board as a designee of his or her private equity fund employer also has duties to such employer. In addition to general employer-employee requirements, private equity fund designees are typically members and/or managers of the fund's management company, which in turn is the general partner of the private equity fund in which the limited partners made their investments. The general partner owes duties to the limited partner investors under the fund's partnership agreement. As a result of these relationships, the private equity fund designees owe duties to the private equity fund's investors to take actions to maximize the investors' return on their investment.

CONFLICT OF INTEREST SITUATIONS

In most instances, the interests of the private equity fund and those of the portfolio company and its stockholders will be aligned the private equity fund wants to maximize stockholder value to increase the rate of return on its investment, which also benefits the portfolio company's other stockholders. However, there are instances in which interests will come into conflict, which will put the private equity fund representative director in a position of tension between his or her fiduciary duties to the portfolio company and duties to his or her private equity fund employer. Some common conflict of interest situations are as follows:

Related party transactions. The most obvious conflicts of interest result from transactions between the portfolio company, on the one hand, and the private equity fund, on the other hand. These include private equity fund management fees and similar arrangements, debt and equity financing of the portfolio company by the private equity fund and its affiliates, and business deals between the portfolio company and another of the private equity fund's portfolio companies.

Differential benefit situations. More subtle conflicts of interest can result from situations in which certain transactions benefit the private equity fund's short-term goals but perhaps not the longer-term interests of the portfolio company and its other stockholders, such as whether to consummate an "exit" transaction now rather than later, whether to obtain additional equity or debt financing or instead grow at a slower rate using organic earnings to fund expansion, or effecting "dividend out" recapitalizations and other transactions that add leverage.

Class issues. Another common conflict situation involves portfolio companies that have done several financings over the years and, as a result, have different classes of stockholders with differing levels of seniority with respect to distribution of proceeds upon a sale of the company or liquidation. This structure could result in certain classes of stockholders (e.g., holders of common stock and junior preferred stock) being wiped out entirely or receiving much less consideration upon a sale of the company or liquidation while other classes of stockholders (e.g., holders of senior preferred stock) receive all or the majority of such consideration. Delaware courts have held that board approval of a transaction that results in most or all of the transaction consideration being allocated to one class of stockholders pursuant to the company's certificate of incorporation can occur in compliance with the directors' fiduciary duties, but private equity fund representative directors should keep in mind that differential consideration situations will inevitably draw attention and possibly litigation from the disadvantaged stockholders and so approach such situations with caution.

Another class issue can occur when a private equity fund stockholder is also, either directly or through one of its affiliates, a lender to the portfolio company, either through bridge loans effected in connection with an upcoming equity financing transaction or through asset-based debt financing, which could result in the "stockholder as lender" receiving proceeds upon a sale of the company or liquidation ahead of, or to the exclusion of, other stockholders that are not also lenders.

Action Items for Conflict of Interest Situations

Private equity fund representative directors can take the following actions to help ensure that they comply with applicable legal requirements.

Act according to your role. Recognize that you have a number of different roles when dealing with a portfolio company, focus on your role in the particular situation, and be sure to act accordingly, keeping in mind that process and perception are very important. Sometimes, you will be acting as a member of the portfolio company's board of directors. Other times, you will be acting as a representative of your private equity fund, which is a stockholder of, or lender to, the portfolio company. When wearing your "corporate director hat," your focus and actions should be based on the interests of the portfolio company as a whole, not on the narrower interests of your private equity fund or its affiliates (i.e., its other portfolio companies). You will have considerably more leeway, when acting only as a stockholder or lender, to champion the interests of your private equity fund.

Look out for conflict of interest situations and take appropriate actions. Be vigilant in identifying direct conflict of interest situations and other situations in which the interests of the portfolio company and those of your private equity fund diverge.

- *Notify other board members of a potential conflict.* In potential conflict of interest situations, the best practice is for the representative director to notify other board members of the actual or potential conflict (preferably in writing) and recuse him or herself from the participation in the board discussion of the matter, as well as from making the actual board decision.

- *Obtain disinterested director approval.* Whenever possible, interested party transactions should be submitted for review, negotiation and approval by the disinterested members of the board or a special committee of the board composed of disinterested directors, who should receive all material information regarding the proposed transaction and the nature of the directors' interests and take an active role in negotiating the transaction. For more significant transactions (e.g., a sale of the company), this may include engaging legal counsel and investment bankers for the independent directors, at the company's expense (which should not be the same counsel and investment bankers as used by the portfolio company or private equity fund). Sometimes, the special committee members will designate one of them who is experienced in transactions of the type being contemplated to act as chairperson to lead the negotiation process. Under Delaware law, a committee consisting of as few as one director can take actions on behalf of the full board. In addition, where interested directors constitute a majority of the board, the disinterested director(s) can take the lead in deciding upon the action and the remaining directors can adopt such decision. A record showing an active negotiation process in which improvement in key terms was obtained by the independent directors or a special committee of the board can be very valuable if an interested party transaction is later challenged.
- *"Plan B" is disinterested stockholder approval.* If disinterested director approval of an interested party transaction either cannot be obtained (e.g., if all of the directors are interested) or it is impracticable to do so, consider submitting the proposed transaction to the portfolio company's stockholders for approval. The portfolio company should fully disclose the nature of the conflict of interest and the material terms of the proposed transaction to the disinterested stockholders. If possible, shareholder approvals for the transaction should not include the shares held by the interested director(s) or the private equity fund that employs the interested director(s).
- *Exercise veto rights as a stockholder, not as a director.* Whenever possible, "veto right" decisions, in which the private equity fund's consent is required for the portfolio company to take actions like selling the company or doing a financing, should be made by the private equity fund representative in his or her capacity as a stockholder, not as a board member. Fiduciary duties require a representative director to take action in the portfolio company's best interests, which may preclude the representative director from vetoing a corporate action that is not in the private equity fund's interests but is in the best interests of the portfolio company. Stockholders are usually not subject to the same fiduciary duties constraints. Accordingly, corporate documents providing for veto rights should be structured to require approval of the stockholder class that necessitates the private equity fund's participation, rather than approval of the board members designated by the private equity fund. Although arguably form over substance, the cosmetics can be important in this case.
- *Consider adding carve-out to LP agreement for actions required by portfolio company fiduciary duties.* In certain circumstances, it may be advisable for a private equity fund representative director to limit duties to the limited partners of his or her private equity fund, rather than trying to limit fiduciary duties to the portfolio company. Although it may be impracticable to do so for existing funds due to political considerations with each fund's LPs, the limited partnership agreements of future funds can include a provision expressly authorizing the representative directors to satisfy their fiduciary duties to portfolio companies, even if such behavior conflicts with their duties to the private equity fund.

CORPORATE OPPORTUNITY DOCTRINE SITUATIONS

Corporate opportunity doctrine, which is part of a director's duty of loyalty, requires directors to bring corporate opportunities of which they become aware to the attention of the portfolio companies on whose boards they serve. The opportunity generally must be one in which the portfolio company has the capacity to engage and be reasonably related to the portfolio company's business. Courts apply a "facts and circumstances" test in determining whether corporate opportunity doctrine applies to a particular opportunity, often using "20/20" hindsight.

Typical Corporate Opportunity Doctrine Situations

Corporate opportunity issues can arise when a private equity fund representative director serves on the boards of two or more portfolio companies and those companies target the same customers, do business with one another, seek business relationships with the same counterparties, or seek to recruit the same key employees. This situation can result in the private equity fund representative director becoming aware of an opportunity through his or her service for one portfolio company that would be advantageous for the other portfolio company to pursue. Alternatively, the private equity fund representative director may learn from a third party of a corporate opportunity and then need to decide which of the two portfolio companies should be notified of the corporate opportunity.

Action Items for Corporate Opportunity Situations

Private equity fund representative directors can take a number of actions to address corporate opportunity situations that arise in connection with portfolio companies.

Use of portfolio company confidential information. If a private equity fund representative director learns of a corporate opportunity that constitutes propriety information of portfolio company #1 but would be beneficial to portfolio company #2 (on whose board the representative director also serves), the director's fiduciary duty to portfolio company #1 to not disclose or use its propriety information will generally "trump" his or her duty to bring corporate opportunities to the attention of portfolio company #2. If there is a portfolio company #2 board meeting at which it will be difficult for the director to avoid disclosure of portfolio company #1' s proprietary information, the private equity fund representative director should consider recusing himself or herself from the meeting.

Allocating corporate opportunities among portfolio companies. If a private equity fund representative director learns of a corporate opportunity from a third party that could be advantageous to two or more portfolio companies on whose boards he or she serves, the manner in which he or she learned of the corporate opportunity is important. If the representative director learned about the corporate opportunity because of his or her relationship to portfolio company #1, it may be that such opportunity should be presented to that portfolio company first. However, if the corporate opportunity did not result from the director's relationship with either portfolio company, it is a closer call as to which portfolio company should be availed of the opportunity. The conservative course of action would be to notify both portfolio companies of the situation and disclose the corporate opportunity to both of them.

Reassigning board representation within the private equity fund or substituting board observer rights. In situations in which there are likely continuing corporate opportunity conflicts resulting from a private equity fund representative director serving on the boards of two or more portfolio companies engaged in competing or similar businesses, the private equity fund may want to consider appointing a different person within the private equity firm who doesn't also serve on the board of the competing or similar business portfolio company to serve as a director of one of the portfolio companies. The private equity fund will then need to maintain an "ethical wall" in which neither representative director discloses to the other information learned from his or her board service. A less attractive alternative is for the representative director to resign from one of the boards and the fund to instead obtain non-voting board observer rights from that portfolio company. The person will still be prohibited from using or disclosing the proprietary information of the portfolio companies but will no longer have any going-forward corporate opportunity obligations to the portfolio company in which he or she only acts as a non-voting board observer. A downside to this approach is that boards can typically exclude non-voting observers from portions of board meetings where the observers' presence would cause loss of legal privilege or violate contractual confidential obligations of the portfolio company, among other things. Although these exclusion rights are seldom invoked, they could result in the private equity fund representative not learning potentially significant information about the portfolio company.

Amending corporate documents. Another approach is to add provisions to the certificate of incorporation or stockholders agreement of each portfolio company in which the portfolio company renounces any rights with respect to any corporate opportunities that may come to the private equity fund representative director's attention, agrees that it has no right or interest in any activities of the private equity fund representative director's private equity fund, and acknowledges that neither the private equity fund nor the private equity fund representative director is obligated to present investment opportunities to the portfolio company. Because overbroad corporate opportunities waivers may be void on public policy grounds or be inconsistent with fiduciary duty requirements, to the extent reasonably practicable, it may be advisable to make the corporate opportunities waiver apply to specific categories of opportunities of which the private equity fund is aware that result from the other portfolio companies' businesses.

A related point is adding a provision to each portfolio company's certificate of incorporation or stockholders agreement in which the portfolio company acknowledges that the private equity fund representative director may serve on the board of directors of competing companies and that the private equity fund representative director and his or her private equity fund may invest in competing companies. It is important to keep in mind that these provisions will not override or limit private equity fund representative directors' fiduciary duties to refrain from using a portfolio company's confidential or proprietary information for any purpose other than in connection with their service as a director at such portfolio company.

OBSERVE SOUND CORPORATE GOVERNANCE PRACTICES

Although it is always a good idea to observe sound corporate governance practices, doing so is particularly important in the context of situations involving private equity fund representative directors because there is always the possibility that a minority stockholder, including current or former members of management of a portfolio company that receive equity, will allege improper actions by the private equity fund and its representatives. Observing sound corporate governance practices can significantly assist the private equity fund in defending against these types of allegations.

Action Items for Sound Corporate Governance

Some specific sound corporate governance practices that private equity fund representative directors take, or ensure be taken by their portfolio companies, are as follows.

Attend "live" board meetings. Although corporate law allows board actions to be taken by signing a written consent in lieu of meeting, the best practice is to consider and adopt significant corporate actions at "live" board meetings (i.e., either in person or over the phone), as doing so allows the kind of interaction and deliberation among board members that can prove to be valuable if the board decision is later challenged. Private equity fund representative directors should try to attend all board meetings, both as a means of staying current with portfolio company developments as well as to help create a record showing that the directors' duty of care was satisfied. If scheduling conflicts make in-person attendance of board meetings impracticable, the bylaws of most corporations allow individual directors to attend board meetings by telephone, even if the other directors are all physically present at the meeting.

Document decision making and corporate approval process carefully. Corporate records should clearly demonstrate that the board understood and fully considered the chosen approach, deliberated in good faith, and acted in the best interests of the portfolio company and its stockholders in accepting the best alternative reasonably available under the circumstances. This can be accomplished in part by ensuring that the minutes of board meetings contain a clear record that: 1) the board considered alternatives to the proposed action, 2) it obtained outside financial and legal advice to help board members understand the financial and legal aspects, 3) it was supplied with the results of "market checks" on proposed significant deal terms, 4) any conflicts of interest were clearly disclosed to all board members, 5) non-interested directors or a special committee were used where appropriate, and 6) other appropriate measures were employed to neutralize any allegations of self-dealing and other conflicts of interest. To ensure that the board minutes create an accurate picture of the board process, consider having either an inside or outside attorney attend each board meeting and take notes, which can be turned into minutes. A records retention policy in which individual directors' notes taken in connection with board meetings are destroyed once the minutes are prepared can help to reduce the amount of discoverable documents that can be used by plaintiff's attorneys in litigation challenging corporate decision making. Private equity fund representative directors should be cautious about discussing board matters in e-mails, as they may be discoverable by plaintiffs' attorneys in litigation and used against the board members and the private equity fund.

Hold regular board and stockholder meetings. Because courts look to observance of corporate formalities in deciding whether to allow "piercing of the corporate veil" claims, which can result in imposition of liability on private equity fund stockholders for the actions of their portfolio companies, it is very important that each entity in the portfolio company ownership chain hold regular board meetings and at least annual stockholder meetings at which the stockholders elect directors and attend to any other matters that require stockholder approval. If there are separate holding and operating companies for a given portfolio company, this means that the holding company and the operating company must each hold its own separate board meeting, even if the same people are on the boards of both entities. In practice, these can be held sequentially on the same day. Beyond the "veil piercing" aspect, holding regular board meetings enables significant matters to be brought up, considered and decided upon by the board over the course of several meetings (rather than in just one or two meetings), which can assist in showing that the board used an appropriately deliberate and thorough process.

Obtain third party validation of deal terms and use outside experts. The board should ideally solicit and obtain multiple proposals or at least obtain a "market check" of proposed deal terms for any significant transaction like an M&A transaction or debt or equity financing, particularly if the transaction being proposed would be an interested party transaction. Doing so can help provide some measure of outside confirmation of the fairness of the terms of the transaction to the portfolio company. In addition, as discussed previously, the board should, where appropriate, obtain the advice of outside, independent experts such as attorneys, accountants, and investment bankers to help ensure that directors fully appreciate and understand the nuances and possible issues associated with a proposed course of action.

Interested party transaction? Provide notice, recuse yourself, and obtain approval from disinterested directors or stockholders. As discussed above, representative directors should notify the other board members of any actual or potential conflict of interest in connection with a proposed transaction (preferably in writing) and recuse themselves from the discussion of the proposal, as well as participation in the actual decision making concerning the proposal. Whenever possible, decisions regarding interested party transactions should be submitted for review, negotiation and approval by the disinterested members of the board, by a special committee of the board composed of disinterested board members or by stockholders (preferably disinterested stockholders).

Approach to aggressive deal terms. Private equity fund representative directors should ensure, with the assistance of legal counsel and other advisors, that proposed deal terms are the most favorable terms reasonably available to the portfolio company under the circumstances and, whenever possible, are "market" terms for the type of transaction being considered. If private equity fund representative directors are asked to approve a transaction involving terms that are very disadvantageous to the portfolio company or otherwise appear to be "non-market", they should be sure that the minutes reflect a determination by the board that the disadvantageous deal terms were the best reasonably available to the portfolio company under the circumstances, were both necessary and reasonable in view of the transaction as a whole, and if applicable, that the counterparty insisted upon the terms as a condition of going forward and that one or more concessions were received in exchange for agreeing to the terms.

SUMMARY

In summary, by taking the proactive actions described above, private equity fund representative directors can help effectively manage their risk relating to portfolio company operations.

DISCLAIMER

This article does not constitute legal advice from the author or the law firm of Kelley Drye & Warren LLP. If you have any questions about the matters discussed in this article, please don't hesitate to contact John McDonald at (202) 342-8805 or jmcdonald@kelleydrye.