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A Cautionary Tale About PE Principal Liability for Portfolio Company Operations

WRITTEN BY

Christopher B. Chuff | Taylor B. Bartholomew

Authors:
Tyler Wilson*
Christopher Chuff
Taylor Bartholomew

**Not licensed to practice law in any jurisdiction; application pending for admission to the Delaware Bar.*

In *In re P3 Health Group Holdings, LLC*, the Delaware Court of Chancery held that a principal of a private equity fund was subject to jurisdiction in Delaware for alleged actions he took on behalf of one of the private equity funds' portfolio limited liability companies, even though he was not an officer or the designated manager of the operating company. The court found that because, even though the principal was not the manager or titled officer of the portfolio company, the principal made decisions on behalf of the company, directed the company's management to take certain actions, instructed the company's advisors to perform work without authorization from company management, and enjoyed essentially unfettered access to company information. This decision serves as reminder that principals of private equity companies may be required to answer for the actions they take on behalf of the company even if the principal is not the manager or titled officer of the company. The opinion provides helpful guidance to private equity firms as it relates to the control and management of their Delaware-based portfolio companies.

Background

P3 Health Group Holdings, LLC (the Company or P3) is a Delaware LLC engaged in population healthcare management. P3 is a portfolio company of a private equity fund focused on the healthcare industry that provided the initial capital for P3. Hudson Vegas Investment SPV, LLC (Hudson) is a minority investor in P3.

In August 2020, P3 began exploring ways to raise capital by accessing the public markets.

In the original deal structure, P3 considered a three-way merger between another portfolio company, and a special purpose acquisition company (SPAC). Hudson felt the deal structure was too generous to the private equity fund and withheld its consent. Thereafter, P3 and the private equity fund pursued a de-SPAC merger, which removed the affiliated portfolio company to avoid the trigger for Hudson's consent right.

A principal at the private equity fund, who despite never holding any official role with P3, played a central role in the new deal structure, including negotiations between P3 and the SPAC, in addition to directing P3's financial and legal advisors to perform specific tasks. When Hudson objected to the new deal structure, P3 and the private equity fund moved forward with the transaction and excluded Hudson from the process. In May 2021 a majority of the board approved the merger, with the Hudson managers abstaining.

Hudson filed a complaint challenging the transaction after the merger closed. Count XI of the complaint asserted that the principal's role as part of the private equity fund team that engineered the de-SPAC merger "tortiously interfered with the contractual rights that Hudson enjoyed under the company's limited liability company agreement." The principal moved to dismiss Hudson's claim on the merits, and also moved for dismissal under Rule 12(b)(2) for lack of personal jurisdiction.

Court's Analysis

Under Delaware law, the exercise of personal jurisdiction has two requirements. First, the plaintiff must identify a valid method of serving process. Second, the exercise of personal jurisdiction must rely on sufficient minimum contacts between the defendant and Delaware such that the exercise of personal jurisdiction "does not offend traditional notions of fair play and substantial justice." (quoting *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

As a method of serving process, Hudson relied on Section 18-109(a) of the Limited Liability Act (the LLC Act), which provides a mechanism for serving process on a manager of an LLC. Section 18-109(a) defines the term "manager" to include persons that the governing LLC agreement names as managers (formal managers) and persons who participated materially in the management of the LLC (acting managers). The principal argued against the exercise of personal jurisdiction because he was not a formal manager or titled officer of P3. The court explained, "it is not necessary for the defendant to have an official role with the LLC."

The court reasoned that "[t]he complaint alleges specific facts, bolstered by contemporaneous documents, which support a pleading-stage inference that [the principal] qualifies as an acting manager for purposes of claims challenging the de-SPAC merger." The court found that the principal "made decisions on behalf of the company, directed the company's management to take action, instructed the company's advisors to perform work without authorization from company management, berated the company's outside counsel for not running documents by him before sending them out, and enjoyed access to information that even formal managers of the company did not have." The principal therefore qualified as an acting manager and can be served with process under Section 18-109 for purposes of claims that arise out of the actions he took and the decisions he made.

Further, when evaluating claims on the merits outside of the context of Section 18-109(a), Delaware decisions have recognized that a defendant can act as a *de facto* manager by making decisions for or taking action on behalf of the LLC despite not holding a formal position. The showing necessary to impose liability on a defendant as a *de facto* manager resembles the showing necessary to serve process on a defendant as an acting manager.

The court also found that the exercise of personal jurisdiction over the principal satisfied the minimum standards of due process. The court explained that as a chartering state, "Delaware has a strong interest in resolving disputes involving the internal affairs of the entities it creates." Those involved with the businesses "must expect to be

subject to suit in the court of the chartering state for actions taken on the entity's behalf."

Takeaways

A major takeaway of the decision is that principals of private equity companies can be forced to answer for the decisions they make for or on behalf of operating companies where the record is clear that the principal exercised authority similar to that of the limited liability company's manager or high-ranking officer. That is so even where the principal is not the designated manager or titled officer of the company. Principals of private equity firms may also want to account for this situation when negotiating any indemnification agreements in their favor to ensure their fees and expenses are covered in any ensuing litigation.

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