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Private Equity Portfolio Company Corporate Governance

November 14, 2012

10:45 a.m. – 12:00 p.m.

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**NATIONAL DIRECTORS INSTITUTE EXECUTIVE EXCHANGE
PRIVATE EQUITY PORTFOLIO COMPANY CORPORATE GOVERNANCE**

*Panel: Michelle A. Facktor, Renaissance Capital Group, Inc.
Gabor Garai, Partner, Foley & Lardner LLP
Marc Moyers, KPMG LLP
Selig D. Sacks, Foley & Lardner LLP*

Time: 10:45 a.m. to 12:00 p.m.

1. Introduction

a. A portfolio company's board of directors is responsible for managing the business and affairs of a company

i. Not involved in the day-to-day management of a company

ii. "Oversight" of a company's management is the key role

b. Typical responsibilities include:

i. Approving a long-range and near-term strategic plan

ii. Providing advice on all major policy decisions

iii. Approving annual financial, operating and capital expenditure plans and budgets

iv. Evaluating the performance of the company and its management

v. Determining the compensation of senior officers, and developing a succession plan for key management members

vi. Authorizing non-ordinary course transactions

vii. Approving material borrowing arrangements

viii. Approving material leases, contracts or other agreements

ix. Approving equity holder distributions, issuances and redemptions

x. Approving changes to the company's governing documents

2. Duty of Care

a. Duty of Care: A director has a duty to make fully-informed and well-deliberated decisions

i. A director may rely on information and reports provided by, and the advice of, management and experts within their area of expertise, provided that the director has no reason to believe otherwise

b. Breaches of Duty: Breaches result from the failure of a director to obtain adequate information or the failure to give thorough consideration to the pros and cons of an important decision (Ignorance is not bliss!)

i. A director may not close his or her eyes to red or even yellow flags

3. Corollary to Duty of Care: Business Judgment Rule

a. Business Judgment Rule: A court will not substitute its hindsight judgment for that of a director or impose liability on a director for his or her decisions, if the director:

i. Acted in good faith

ii. Was reasonably well informed; and

iii. Reasonably believed the action taken was in the best interests of the company

b. Business Judgment Rule Protections:

i. Protects against alleged duty of care breaches

ii. Protects the decisions made by a disinterested director from personal liability to the company and its equity holders, even if the decision turns out to be imprudent

iii. May not apply to conflict of interest situations involving your fund

4. Duty of Loyalty

a. Duty of Loyalty: A director has a good faith duty to place the company's best interests ahead of the interests of himself or herself and your fund (other than to the same extent as all other equity holders).

b. Duty of Confidentiality: A director owes a duty to maintain the confidentiality of a portfolio company's non-public information and internal affairs learned as a result of his or her position

c. Portfolio Company Specific Considerations

i. No use of position as a director to make a profit for personal or fund advantage to the detriment of other equity holders

ii. If your fund is the majority owner of the portfolio company, your fund owes a fiduciary duty of fair dealing to the minority owners

iii. Four areas presenting the greatest risk:

(1) Conflicts of interests

(2) Corporate opportunities

(3) Competitive activities

(4) Disclosure of confidential information

5. Conflict of Interest Transactions

a. Entire Fairness Standard:

i. Generally, not protected by the business judgment rule

ii. Rather, subject to an “entire fairness” standard. This means that conflict transactions involving your fund and the portfolio company generally need to be “fair” to the company and its other equity holders

b. In practice, generally no liability if:

i. Conflict is fully disclosed by the director in advance of any discussion/decision by the board or equity holders

ii. Transaction is “fair” to the company and its other equity holders

iii. Board or equity holders approve of the transaction by a disinterested vote

Potential Conflicts of Interest

1. Background: Conflict of interests are inherent in the role of one fund’s employee serving as a director of a non-wholly-owned portfolio company

a. Conflicts are a natural consequence of the duty of loyalty obligations that the employee owes to one fund and the potentially conflicting duty of loyalty that such director owes to the other portfolio company (both to the entity and all of its equity holders)

2. Risks in Practice: A director risks breaching his or her duty of loyalty (and your fund’s duty of fair dealing) to the portfolio company and its equity holders to the extent he or she:

a. Makes decisions as a director of the portfolio company that benefit your fund to the detriment of (or even to a greater extent than) the portfolio company and/or its other equity holders

b. Allows your fund to take advantage of business opportunities that are related to the business or prospects of the portfolio company, to the detriment of the portfolio company and/or its other equity holders, that were learned of by the director during the course of the director’s duties to the portfolio company

c. Fails to bring corporate/business opportunities that would benefit the portfolio company to the attention of the portfolio company

d. Facilitates competition by your fund (or others) to the detriment of the portfolio company

e. Discloses confidential information of the portfolio company to others at your fund (or otherwise) to the detriment of the portfolio company

f. Takes actions that allow or facilitate your fund to take advantage of a commercial relationship between your fund (or its affiliates) and the portfolio company to the detriment of the portfolio company and/or its other equity holders

Recommended Actions to Minimize Potential Liability From Serving as a Designated Director of a Portfolio Company

1. **Adequate Information:** Ensuring that adequate information is provided to the board in advance of all important decisions and that the pros and cons to all major decisions are thoroughly discussed at all board meetings
2. **Full Disclosure:** Fully disclosing in advance all conflict of interest situations that involve your fund to the other board members and equity holders, including the full range of potential advantages to your fund and detriments to the portfolio company and its other equity holders that will or could result from the conflict situation
3. **Third-Party Involvement:** Obtaining independent or expert third-party affirmation or support of the fairness to the portfolio company and/or its other equity holders of the terms of each conflict of interest transaction
4. **Non-Disclosure:** Not disclosing confidential information of the portfolio company within your fund (or otherwise)
5. **A Contractual Out:** Adopting contractual-type agreements by all equity holders that acknowledge and allow potential/actual conflict of interest situations between your fund and the portfolio company and affirm that your designated director may act solely in the best interests of your fund, even if to the detriment of the portfolio company and its other equity holders
6. **Policy Protection:** In the absence of No. 5, adopting written board of directors policies that acknowledge and allow potential/actual conflict of interest situations between your fund and the portfolio company and affirm that your designated director may act solely in the best interests of your fund, even if to the detriment of the portfolio company and its other equity holders
7. **Accurate Record Keeping:** Ensuring that the portfolio company maintains detailed and accurate board of director and equity holder meeting minutes that describe in detail the disclosure and disinterested approval of conflict of interest situations
8. **Maintaining Formalities:** Ensuring that the portfolio company maintains its corporate formalities and does not hold itself out to the public or otherwise acts as a mere alter ego or instrumentality of your fund
9. **Insurance:** Ensuring that your fund and/or the portfolio company maintains effective director and officer insurance coverage that specifically insures against liabilities resulting from potential/actual conflict of interest transactions and duty of loyalty breaches
10. **Indemnification:** Ensuring that your fund and the company's bylaws or operating agreement require the indemnification of a designated director against personal liability for his or her decisions as a director of the portfolio company
11. **Relevant Laws:** Determining whether the applicable laws of the portfolio company's state of organization include a statutory director liability shield and the prerequisites to the application of such shield to the director's decisions