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What Private Equity Firm Directors Need to Know

2007 NATIONAL DIRECTORS INSTITUTE

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Private equity firms are playing an increasingly important role in the American capital markets. This shift has been spurred by both businesses and investors. Companies find private equity more attractive in large part because of the Sarbanes-Oxley Act of 2002 (SOX), which imposes significant internal control, auditing, and reporting requirements on public companies. Institutional investors, meanwhile, have sought opportunities to add value to portfolio companies by managing the managers, bringing industry expertise, and adding needed capital to portfolio companies. Due to this increase in private equity financing, many principals and managers from private equity firms now serve as directors of the private equity fund companies in which those private equity firms invest. This trend has raised the prominence of legal and business issues related to the fiduciary duties of directors, as well as specific issues related to the intersection of private equity firms and the portfolio companies in which they invest.

At Foley's sixth annual National Directors Institute on March 8, 2007, these issues were addressed in a breakout session entitled "What Private Equity Firm Directors Need to Know." The discussion featured Foley & Lardner partners Paul Broude and Allen (Sandy) Williams, Jr., along with Sean Eagle, principal, American Capital Strategies, Ltd., and James Reddinger, executive director, UBS Securities LLC.

Topics covered during this lively discussion, which featured spirited participation by audience members, included: (1) the proper role of portfolio company directors; (2) balancing the fiduciary duties of private equity board members to the portfolio company with their responsibilities to their private equity firm employer; (3) potential conflicts of interest when investment opportunities may benefit several different portfolio companies; (4) the role of independent directors and outside consultants; (5) a comparison of private equity boards and public company boards; (6) board-management conflicts in the context of a sale; (7) the role of SOX controls in a private equity portfolio company; and (8) the structure of the board decision-making process.

A Primer on the Duties of Directors

In general, a company's board of directors is responsible for overseeing the company's business and affairs. Directors of portfolio companies, however, may want to be careful not to cross the line from oversight into day-to-day management, which is usually the province of the company's officers and employees. The board's typical responsibilities include the following:

- Approving leases, contracts and other material agreements
- Approving fundamental operating, financial, and corporate plans, strategies and objectives
- Authorizing the sale of company assets and other strategic transactions
- Evaluating the performance of the company and its management
- Selecting, evaluating, and fixing the compensation of corporate officers
- Reviewing and approving management plans
- Adopting policies of corporate conduct

In undertaking their responsibilities as board members, directors owe a fiduciary duty to the company and its shareholders, exemplified by the duties of care and loyalty. The duty of care requires directors to keep themselves informed about the affairs of the company and to seek out and use all reasonably available information when making decisions. Under the business judgment rule, a court will defer to the judgment of a director, if that director acts on an informed basis, in good faith, with the care an ordinary prudent person in a like position would exercise, and in a manner the director believes to be in the best interests of the company. The duty of loyalty requires directors to place the company's interests ahead of their own personal interests and the interests of other parties. Together, these duties form the baseline of directors' legal responsibilities.

Potential Pitfalls for Private Equity Firm Directors

The structure of private equity firms presents unique issues and potential pitfalls for directors. Conflicts of interest are particularly common. For example, a director's fiduciary duties to the portfolio company on which she serves may conflict with her duty to the private equity firm for which she works. This issue may seem counterintuitive, because the private equity firm is as much an owner of the company as its other shareholders, and thus presumably shares the company's interests. Nonetheless, a director may be tempted to make decisions that meet the private equity firm's short-term goals, but are not in the best interests of the portfolio company. This conflict can present itself in acquisition decisions, executive compensation, management fees and other arrangements, and the valuation and terms of additional financing provided by the private equity firm.

Another type of conflict may arise between two funds or portfolio companies managed in parallel by a private fund director. For example, a corporate opportunity may arise that could benefit more than one company on whose board a particular director sits, or two of those companies may decide to enter into a commercial transaction together. In each of these situations, a director serving on the boards of multiple companies finds himself on the horns of a dilemma, unable to balance his conflicting fiduciary duties to those various companies.

Beyond conflicts of interest, private equity firm directors should be careful not to blur the line between the private equity firm and the portfolio company board, or the corporate veil can be pierced, extending the reach of liability beyond the portfolio company to the private equity firm. This issue arises when a private equity firm director does not observe the appropriate level of corporate formality at the portfolio company level, by, at a minimum, keeping separate corporate records for the portfolio company and the private equity firm, holding regular board meetings, preparing authorizing resolutions for transactions outside of the ordinary course of business, and electing directors and officers.

The line between private equity firm and portfolio company can also be blurred when it is unclear whom a director represents when communicating with third parties. This issue often arises when a private equity firm owns a minority stake in the portfolio company, but is heavily involved in its day-to-day operations. It is recommended that directors be explicit about their roles in each and every third-party communication.

Private equity firm directors should recognize that fiduciary duties change over time. As a portfolio company nears insolvency, for example, the directors' duties begin to shift from the company to the company's creditors. In this zone of insolvency, even routine corporate decisions become subject to harsh scrutiny.

Similarly, when the company receives a legitimate buy-out offer, the board's duty becomes not merely to maintain the business, but to seek the best price for the sale of the company. James Reddinger pointed out that in this context, the interests of management are often contrary to the interests of the shareholders. In the event of such a conflict, he would always defer to the judgment of the board rather than management, because the board has a fiduciary duty to the shareholders. However, noted Sean Eagle, management sometimes can delay negotiations, forcing directors to compromise in order to close a deal that is ultimately in the best interests of shareholders.

A final pitfall is the private equity firm director's inappropriate use of material, non-public information. This issue arises when a director discloses such information to the private equity firm prior to other shareholders, which can violate SEC Regulation FD. It may also lead to insider trading, if employees or partners in the private equity firm decide to buy or sell securities using material non-public information learned from directors of portfolio companies.

Protective Measures

Directors may be able to shield themselves from the above pitfalls by observing certain protective measures. First and foremost, they should document decision-making and the corporate approval process in a deliberate and methodical manner, and should not "informalize" the process. Board minutes should be more than a mere mark-up of the previous year's minutes; they should adequately reflect both the substance and process of the board meeting and record all material decisions, though they should not become a full transcript of board deliberations. To ensure that all important issues are raised by management in board meetings, a whistleblower system can be instituted for employees.

Directors can insist on adding a further level of independence to the board's decision-making by employing independent directors and outside consultants. Independent guidance is particularly important in the context of mergers and acquisitions, executive compensation, and other extraordinary transactions. Sean Eagle noted that the boards on which he sits typically have at least one independent director. Such directors are primarily brought in, he said, to add expertise in a particular business area, but they also certainly add a measure of objectivity to the board, its audit and compensation committees.

Directors from private equity funds serve in several disparate roles, so they should know where their duties lie at any given time: when acting as a partner or manager of the private equity firm; when acting as the director of a portfolio company; when serving on multiple boards simultaneously; and when the portfolio company is in the zone of insolvency. They should be especially careful in communicating with colleagues at the private equity firm, to avoid the appearance of serving on a board merely as a "deputy" of the private equity firm, rather than looking out for the interests of all shareholders.

To meet the duty of care, private equity firm directors should ensure that they engage in a sound and thorough decision-making process. Directors should set aside adequate time to fulfill all of their obligations (attend meetings, communicate between meetings, review materials, and carefully consider decisions) and should put forth the time and effort required, which experts estimate generally requires 150-200 hours per year. Beyond time and effort, the legal system will focus on the details of the board decision making process:

- Were related party transactions approved by independent directors?
- How many meetings were held to discuss a particular issue, and how much time was devoted to it?
- What materials were reviewed, and were they received by directors far enough in advance of meetings?
- How many questions did directors ask?

Meeting the duty of care does not require day-to-day management by directors, and indeed, such an extraordinary level of involvement ultimately would prevent directors from seeing the big picture and appropriately weighing long-term strategic decisions for the portfolio company. Accordingly, Sean Eagle recommended that soon after joining a board, a private equity fund director should determine how and when decisions should be delegated to the management team.

To prevent going astray of Regulation FD, directors should carefully restrict the information they learn as directors of a portfolio company; they can do this by creating and consistently following strict procedures for disclosing such information to others within the private equity firm. If the portfolio company is a public company, the private equity firm may also want to create and follow certain procedures to ensure that partners and employees of the private equity firm do not intentionally or accidentally decide to buy or sell shares of the portfolio company's stock while possessing material non-public information.

SOX Compliance

Though SOX currently does not apply to private companies, there are many reasons that a private company board may nonetheless decide to implement SOX controls. First, SOX controls may be an effective tool to manage risk within the portfolio company. Second, SOX compliance may be required of the company in the future, either by public companies doing business with the portfolio company, by lenders or investors seeking additional assurances of internal controls, or by future amendments to the law. Third, and most importantly, however, SOX compliance prepares the portfolio company for two possible exit strategies: an initial public offering or a sale to third parties.

Conclusion

When serving as the director of a portfolio company, a private equity fund partner or employee must balance the interests of many parties: the portfolio company shareholders, the private equity firm, and the shareholders of other companies on whose board he or she sits. In balancing these interests, the director should never sacrifice the duties of care and loyalty, and should carefully consider and record the board's actions on behalf of the portfolio company. Directors should enact procedures to avoid the pitfalls that commonly befall private equity fund directors, without losing sight of the added value that sophisticated private equity investors can bring to portfolio companies.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7^{th} Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.