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Private Equity Director Issues

2008 NATIONAL DIRECTORS INSTITUTE

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INTRODUCTION

“Private Equity Director Issues” was a featured breakout session at the seventh annual National Directors Institute, hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The panel discussion was led by Foley Private Equity & Venture Capital Paul Broude and Anne Ross, Partners in Foley’s Private Equity & Venture Capital Practice, along with John Byrnes, Executive Managing Director of the Mason Wells Funds; David Payne, Senior Vice President of AON Risk Services; Sona Wang, Managing Partner of Ceres Venture Fund, L.P.; and Paul Winters, General Counsel for Denham Capital Management LP.

FIDUCIARY DUTIES OF A BOARD OF DIRECTORS

The board of directors is responsible for managing the business and affairs of a company. In doing so, certain fiduciary duties are required of any director, whether in the portfolio company context or otherwise. Each director owes a duty of care and a duty of loyalty to the company. Typically, these fiduciary duties are owed to the shareholders. In some cases, however, the fiduciary duties are owed to creditors as well. In addition, fund managers owe fiduciary duties to their own funds, which can create difficulties and conflicts for those fund managers who serve on the boards of directors of their portfolio companies.

To fulfill their obligations properly, directors of portfolio companies should spend adequate time to fulfill their obligations and diligently document decision making and corporate approval processes. Decisions that present a conflict of interest between the company and the private equity fund should be made by independent directors, and outside experts should be used when appropriate (for example, when substantial transactions are contemplated and in resolving executive compensation issues).

GENERAL FUNCTIONS OF A BOARD OF DIRECTORS OF A PRIVATELY HELD PORTFOLIO COMPANY

Ideally, the board of directors of any company is not involved in the day-to-day operations of the business. Directors make the most significant contribution when they are involved in focused, large-scale decisions such as those concerning growth and exit strategies. However, for smaller companies and those in the early stages of growth, directors often are required to become involved in day-to-day financial and marketing activities and to fill other deficiencies in human capital.

The culture of the board of directors of a privately held portfolio company differs substantially from that of a publicly traded company board. Portfolio company boards are more deeply and directly involved with management of the company and typically meet more frequently than a public company board would. The board of a private company is often small (three to five directors) and driven by a top-down agenda set by the private equity fund. Less emphasis is placed on quarterly results, and more on the company's progress toward a liquidity event.

BOARD PARTICIPATION BY MINORITY INVESTORS

In cases where a private equity fund is making a minority investment, the composition of the board is frequently a key focus of negotiations. A fund often appoints only one director (typically out of four to seven total directors), which can make impacting the board's decisions a challenge. In this context, it may be difficult to align the goals of the management team with those of the private equity fund investors, particularly where a company has a number of private equity investors. Based on the shelf life of private equity funds, each fund likely will have a different exit strategy and/or time horizon. The investors' objectives may differ substantially, with some focused on growth and others on a liquidity event. It is crucial that minority investors understand one another's objectives prior to making an investment in a portfolio company. In some cases, particularly where the investor is the "last piece of money" brought to the table, a super-majority voting provision can be negotiated, giving a minority investor "veto power" over critical decisions such as a liquidity event for the company.

In cases where a board seat is not obtained, minority investors often negotiate observation rights, whereby the private equity fund is allowed to appoint a representative to attend all board of directors meetings in a nonvoting observer role. Some funds prefer observation rights to the right to appoint a director because they feel this limits their exposure to liability. It is important to be clear on the role the observer plays, however, as contingent liability may attach if the observer is acting more like a director than an observer. The observer typically is not insured under the company's director and officer (D&O) liability coverage unless the company specifically obtains such coverage. In addition, the attorney-client privilege may be inapplicable where outside counsel is communicating with the company's board in the presence of the observer.

BOARD COMPOSITION

Outside directors are often brought in by private equity funds to serve on the board of directors of a portfolio company. The decision to bring in a director who is not affiliated with the private equity fund is most often made with the goal of obtaining the benefit of that person's specific expertise. It is important that the company's management and board work well together, so in many cases, the management team is consulted when making such a decision. Outside directors are usually compensated by the portfolio company, mainly with stock options but often with a small amount of cash as well, to cover expenses.

For mature companies, it can be particularly valuable to bring in an outside director who has executed a similar strategic business plan to that of the portfolio company. When a technology company is involved, funds often have a portfolio company establish a technical or scientific advisory board consisting of thought leaders in the industry. In the more typical business setting (e.g., manufacturing, sales, or service), an outside director with experience in sales and marketing can be a valuable asset.

For a portfolio company in the early stages of development, outside directors can be crucial to success. Fund managers suggest having at least one director with specialized industry expertise; one director who is a generalist investor with good contacts in the private equity arena; one geographically local investor who can provide day-to-day advice; and other outside directors who can bring added credibility to the enterprise.

In cases where the planned liquidity event for the private equity fund is an initial public offering (IPO), thought should be given to composing the board such that when the company migrates toward the IPO, the entire board of directors does not need to be replaced. Planning in advance to have independent directors who are qualified to continue their service following an IPO can establish consistency of the board — a valuable asset when offering securities to the public.

CONFLICTS OF INTEREST BETWEEN THE PRIVATE EQUITY FUND AND THE PORTFOLIO COMPANY

Portfolio company directors who serve at the behest of a private equity fund often find it difficult to balance competing duties owed to the portfolio company and to the fund. Issues that can raise this conflict include, among others, capital allocation, acquisition decisions, executive compensation, management fees, financing provided by the private equity fund, and conflicting interests of two or more portfolio companies of the fund. Independent directors should be used, wherever possible, to avoid conflicts surrounding these issues.

Where the line is blurred between the private equity fund and the portfolio company board, liability could arise for the private equity fund if a litigant were to successfully “pierce the corporate veil.” Liability may be incurred where a private equity fund uses a portfolio company as a façade for the operation of the parent or a related company; where the records of the portfolio company and the private equity fund are commingled; or where corporate formalities, such as board meetings, resolutions, and election of directors, are not observed.

DIRECTOR ISSUES IN DISTRESSED COMPANY SITUATIONS

Private equity funds are becoming more actively involved in acquiring distressed companies, whether in privately negotiated deals or through bankruptcy sales. The board of directors of a distressed company needs to be aware that duties arise in favor of a company’s creditors when the company enters the “zone of insolvency.” As a result of the duties owed to creditors, when a portfolio company nears insolvency, routine corporate decisions become subject to additional scrutiny.

Liability may arise for a private equity fund where it fully leverages the portfolio company and then withdraws funds as distributions. If the company later becomes distressed, liability may be incurred to employees and creditors of the portfolio company who remain unpaid.

Portfolio company directors and private equity funds also should be aware of the Worker Adjustment and Retraining Notification (WARN) Act, under which a 60-day advance notice must be given in many situations before a plant closing or mass layoff. Recently, private equity funds have been targeted, due to their deep pockets, for liability under the WARN Act, and this liability is not necessarily covered by D&O insurance.

MORE INFORMATION

For more information on the topics discussed in the "Private Equity Director Issues" session, please feel free to contact the panel moderators.

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