

# The Portfolio Company Playbook – Chapter 2: Navigating Risk from Conflicts of Interest

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Private funds frequently negotiate for special rights when making an investment in a portfolio company, such as the right to appoint one or more board directors, voting rights, and liquidation preferences. Fund sponsors often focus solely on the positive aspects of these special rights, such as increased control, without considering fully other implications. As the Peter Parker principle reminds us, with great power comes great responsibility. In the fund context, sponsors should remember the portfolio company corollary: with greater control comes greater exposure to liability.

Nowhere is the tension between control and liability risk more evident than where sponsors designate their own members as board directors for portfolio companies. The appointment of sponsor personnel to board seats is commonplace. The reasons are simple; among other things, it allows the sponsor to protect the fund's investment and many sponsors believe it enables them to deliver higher returns to their limited partners.

Where the objectives of the company and the fund align, this arrangement often benefits all parties. However, where the interest of the fund and the portfolio company diverge, or could simply appear to diverge—for example, where a major company transaction or, conversely, [insolvency](#) is on the horizon—the appearance of conflicts (and actual conflicts) can arise for sponsor-appointed board designees. This is due in part to the reality that the board designee may owe fiduciary duties to the company and its shareholders on the one hand, and to the fund and its investors on the other. Whether a conflict is real or perceived, it provides a tempting target for would-be plaintiffs at the portfolio company level who may be looking to challenge or invalidate board actions, second guess decision-making with the benefit of hindsight, or otherwise pull the fund, sponsors, and board-designees into litigation as perceived deep pockets.

In addition to major corporate transactions that produce materially different outcomes for different classes of shareholders, every existential threat at a portfolio company almost inevitably leads to claims against the directors and their affiliated private equity sponsor entities. Such claims run the full gamut of corporate activity, from claims arising out of mergers, sales, and insolvencies to claims resulting from data breaches, commercial disputes, regulatory investigations, and industrial accidents causing death, bodily injury, or property damage. The diagram below illustrates how a portfolio company may serve as the fulcrum around which potentially conflicting duties and imperatives of a fund complex may intersect.

Fortunately, fund sponsors can take steps to alleviate the risks associated with perceived conflicts of interests inherent in the dual fiduciary duties owed by sponsor-appointed board designees. First and foremost, sponsors should ensure that their board designees are sensitized to each of the duties they owe and to whom. While board members may owe duties of loyalty and care to the company, and potentially others, the duties they may owe to the fund and its investors can differ depending on, among other things, how the fund is structured, which jurisdiction's law applies, and what is provided for (or disclaimed) in each entity's organizational documents. Likewise, sponsors and their board designees should be on the lookout for any possible apparent conflict between the interests of the fund and the portfolio company. In cases of potential conflict, fund personnel should consult with counsel and coordinate with the company as necessary to ensure that procedures are implemented to protect against any argument of perceived or actual conflict tainting an otherwise beneficial transaction or board decision. Such procedures may include the formation of a special committee to evaluate a potential transaction, consultation with minority shareholder groups, and obtaining independent valuations.

For further information regarding risks and liability for fund sponsors in connection with portfolio companies, contact us regarding [\*The Portfolio Company Playbook: A Fund Sponsor's Guide to Risks and Liability\*](#).

Also be sure to tune in for Chapter 3, which will focus on risk that can arise from employee claims and the likely overlap between shareholders and employees at portfolio companies.

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