The Portfolio Company Playbook – Chapter 4: Navigating Direct Liability Risks to the Fund

The Capital Commitment Blog on **July 22, 2021**

As litigation claims against portfolio companies have increased, so have accompanying claims asserted directly against funds (and their sponsors). Plaintiffs' reasoning for including funds as defendants is no mystery: funds often have greater financial resources than the defendant portfolio company, particularly where the portfolio company is in distress, and thus represent the proverbial "deep pockets." This is especially true where a liquidity event involving the portfolio company either recently occurred or is on the horizon. Liquidity events, which range from major portfolio company transactions to liquidation or reorganization, often lead to substantial returns for funds.

Liquidity events simultaneously provide increased opportunities for would-be plaintiffs to bring litigation, and may also motivate them to do so where such events create perceived "winners" and "losers" by, for example, treating different classes of stock unequally. This can create the perfect storm for funds, allowing a carefully crafted transaction to be blocked or effectively undone, cutting into the fund's returns or, worse, preventing it from recouping years' worth of investments. Fortunately, having an awareness of some of the most common legal hooks plaintiffs use to drag funds into litigation can help funds and sponsors manage and mitigate risk.

Aiding and Abetting

As we highlighted in Portfolio Company Playbook Chapter 2, a fund sponsor's participation on a portfolio company board is an acute risk factor for the entire fund complex. Risk arises from potential conflicts of interest relating to sponsor board designees' competing fiduciary duties to the fund on the one hand, and the portfolio company on the other. In actions challenging a transaction that arguably benefited the fund more than the portfolio company and its other stakeholders, sponsor-appointed directors may be found to lack independence, triggering a harsher standard of review and increasing the risk surrounding the transaction. In addition to the fund's typical indemnification obligation to designee directors (which will be discussed in depth in the next installment in the Portfolio Company Playbook series), litigation challenging a designee director's actions can give rise to direct claims against the fund for aiding and abetting the director's alleged breach of fiduciary duty.

Though defenses to aiding and abetting claims may be available and will vary by jurisdiction, the easiest way to defeat those claims is by preventing them in the first place. Fund sponsors can consider preventative measures by ensuring that designee directors are fully aware of their duties and always mindful of situations where those duties could be perceived to conflict. In the transactional context, the fund and designee directors should consider whether the fund's interests align with those of other company stakeholders, and what board approval structures and legal safe-harbors might be available in the event that there is an arguable conflict.

Controller Fiduciary Duties

Funds (and sponsors) may also be vulnerable to direct breach of fiduciary duty claims where they are the majority shareholder or de facto controller of a portfolio company. Though the existence, extent, and triggering factors for controller fiduciary duties vary by jurisdiction, a fund should exercise caution when it assumes any significant degree of control over a company or transaction through majority stock ownership, majority board control, special voting rights, or by other means, as such control may give rise to direct fiduciary duties flowing from the fund to other shareholders. In some jurisdictions, the fund may be subject to claims even where it only exercises control as a member of a group of shareholders, sometimes referred to as a "control group." Thus, funds should be particularly mindful of conflict-of-interest allegations where they work with long-time investment partners or affiliates to form a stockholder or board majority approving a given transaction.

In situations where the fund is arguably a controller or member of a control group with sufficient power over the company or a specific transaction, it should research the relevant jurisdiction's law on controller and shareholder fiduciary duties, be mindful of the fund's direct involvement in negotiating and approving the transaction, and consider when appropriate structures like a special committee or ratifying minority shareholder vote could help safeguard against litigation risk.

Unjust Enrichment

Following liquidation events that benefited a fund to the perceived detriment of some other set of stakeholders in the portfolio company, the fund may have exposure to unjust enrichment claims. Usually such claims are follow-ons to the claims described above, and often rise and fall with them. However, in certain contexts such as company restructurings and liquidations, funds may be particularly vulnerable to unjust enrichment claims. In these contexts especially, sponsors should be watchful for potential conflicts of interest that could give steam to a plaintiff's narrative that the fund unjustly drained the company's coffers to benefit itself at the expense of the company, and particularly anyone to whom the fund or its designees potentially owe duties.

Stay tuned for our upcoming chapter on navigating fund indemnification risks.

For further information regarding sources of risks and liability for portfolio companies and fund sponsors, contact us regarding *The Portfolio Company Playbook: A Fund Sponsor's Guide to Risks and Liability*.

View Original

Related Professionals

- **Timothy W. Mungovan**
  Chairman of the Firm
- **Mike Hackett**
  Partner
- **Jonathan M. Weiss**
  Partner
- **Adam L. Deming**
  Associate