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More board seats, more problems

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GPs serving on multiple portfolio company boards have afew liability landmines to steer clear of, write legal experts Robert Little and JosephOrien.

Serving on boards of multiple portfolio companies is a common practice of private equity fund representatives. The portfolio companies frequently operate in the same line of business and may even share potential business partners, customers or employees. Although commonplace, this practice gives rise to a number of potential legal ramifications that may trap the unwary fund representative.

One of the most pressing concerns is the corporate opportunity doctrine. The corporate opportunity doctrine, which derives from the fiduciary duty of loyalty, prevents the directors of a corporation from taking for themselves a business opportunity that rightfully belongs to the corporation. Though simple in theory, the corporate opportunity doctrine becomes difficult in application when a fund representative holds multiple directorships.

Consider, for example, a private equity fund representative that sits on the boards of two portfolio companies. During a conversation with a business acquaintance, the fund representative learns of a business opportunity that would be advantageous to one of the portfolio companies. However, the fund representative believes that the other portfolio company might find the opportunity attractive as well, contingent upon further investigation. In this scenario the fund representative – who owes the same, undiluted duty of loyalty to both companies – must decide which, or both, of the portfolio companies to inform about the opportunity.

Although there is no one-size-fits-all answer, a fund representative in this situation can take several steps to mitigate his or her liability exposure. The fund representative should first determine, on a company-bycompany basis, to which portfolio company (or companies) the opportunity belongs. For Delaware corporations, four factors are relevant:

First, consider whether the company would be financially able to exploit the opportunity. A company does not have a right to a purely illusory opportunity.

Second, consider whether the opportunity is in the same line of business as the company. This “line of business” factor should be interpreted broadly.

Third, consider whether the company has an interest or expectancy in the opportunity. Reasonableness drives this analysis – it is not necessary to consider “every potential, future occurrence” the company might have. There must be a tie between the opportunity and its business.

Fourth and finally, consider whether designating the opportunity for one company would create a conflict of interest or be a breach of fiduciary duties with respect to the other company. This factor is an imprecise catch-all, requiring consideration of the totality of the circumstances.

Having concluded that a business opportunity belongs to one or more portfolio companies, the fund representative should inform that company or companies, with the most conservative approach being to inform all of the portfolio companies for which the representative serves as a director. If the fund representative learned of the opportunity because of his or her relationship to a particular portfolio company, it may be more appropriate for the opportunity to be presented first to that portfolio company. Of course, disclosure may not be possible if doing so would divulge the confidential information of another portfolio company. In that event the best course of action may be recusal from meetings where the topic might be discussed or, if similar conflicts are likely to arise, appointing a different representative from the same private equity firm to serve on the board. A less attractive alternative is for the fund representative to resign, possibly while retaining board observer rights.

A more attractive alternative is reliance upon a waiver of the corporate opportunity doctrine. Assuming the portfolio company has agreed or agrees, Delaware General Corporation Law permits a corporation to waive its expectancy in “specified business opportunities” in its organizational documents. If a business opportunity falls within the scope of a valid waiver, the fund representative has no duty to disclose, allowing the fund representative, the private equity firm itself or another portfolio company to pursue it. By putting such waivers in place, and by thoughtfully analyzing each situation that might implicate the corporate opportunity doctrine, private equity fund representatives can mitigate some of the liability associated with holding multiple directorships.

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