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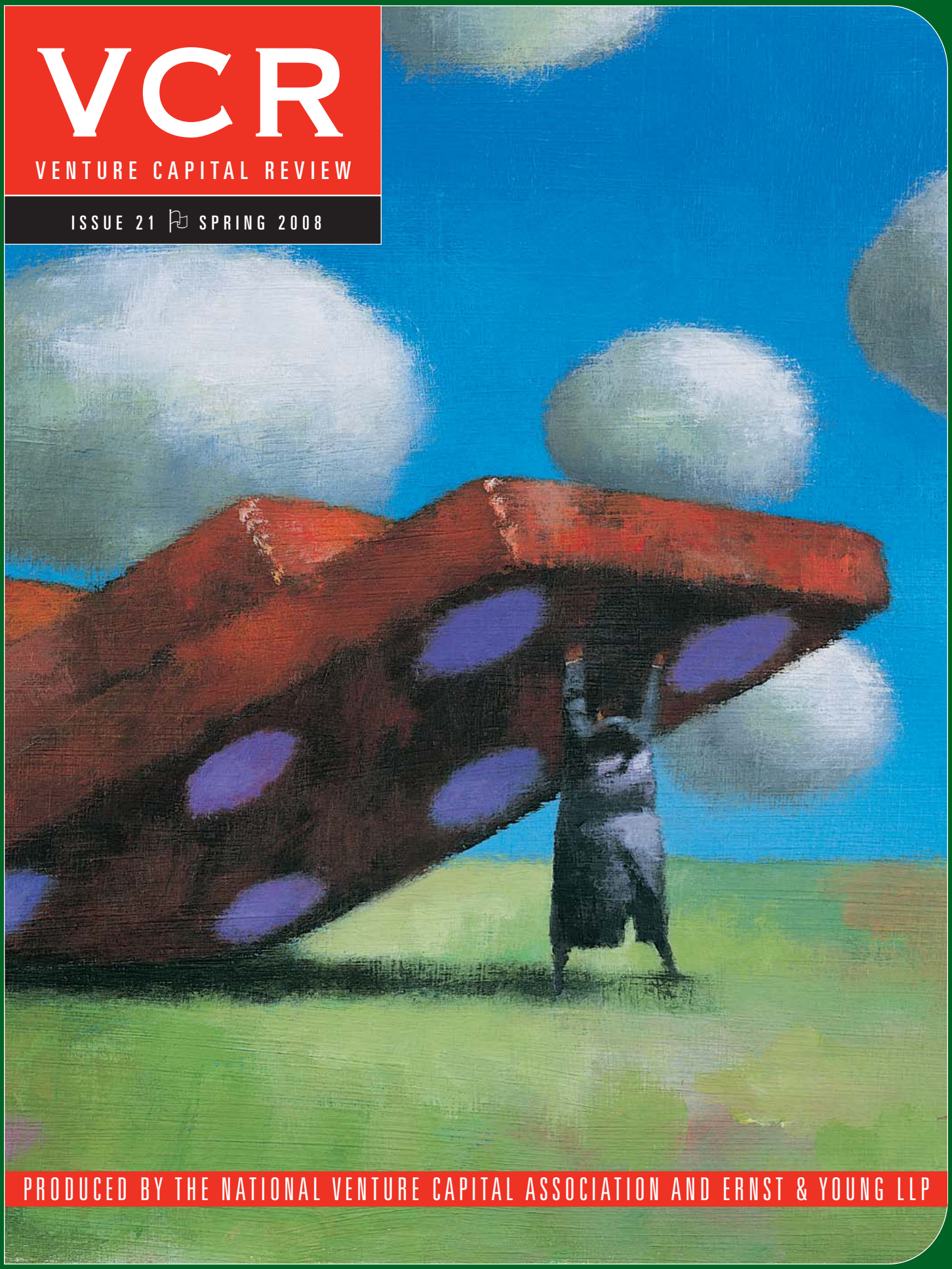

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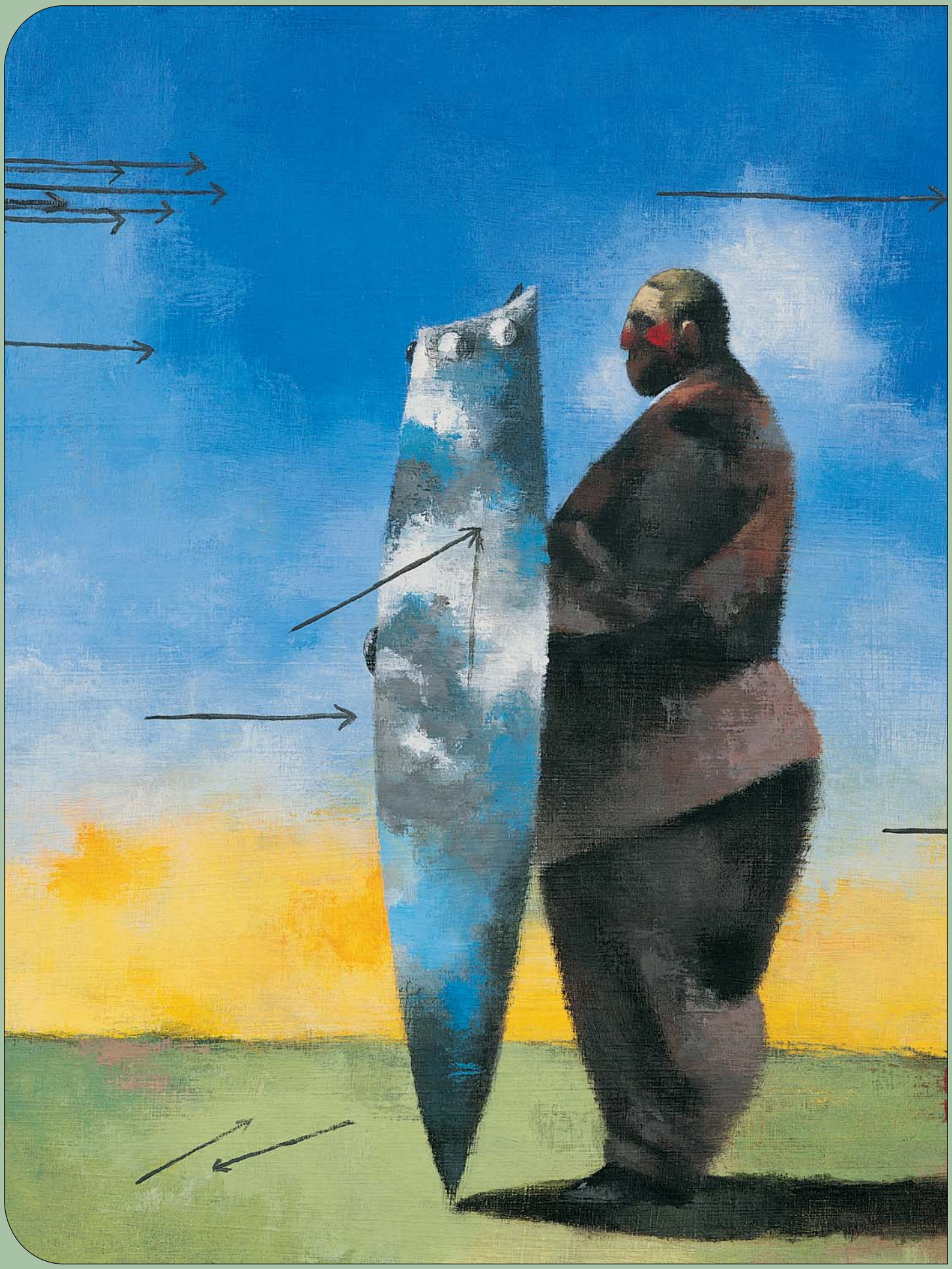

Best Practices for Managing Litigation Risks Facing Private Investment Funds

By
Hal S. Shaftel and Daniel P. Goldberger

As managers of private investment funds go about applying their business expertise, they should operate within a framework of organizational rules thoughtfully designed to manage potential litigation risks. Although it is necessary to customize risk management procedures to account for a particular fund's structure and goals, common issues involve how best to handle and preserve the enormous quantities of information that flow through funds; how best to structure the fund's relationships with its portfolio companies or other investment ventures; and how best to define the substantive and procedural rights governing internal disputes with limited partner investors and/or outgoing fund managers. The tail can't wag the dog; likewise, the risks of future litigation can't alone dictate how a business operates. However, prudent steps can be taken to minimize the threat of litigation and to maximize a party's position if litigation does arise.

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Handling and Preserving Important Information

To intelligently manage the diverse categories of information involved in a fund's operations, it is important to establish policies intended to (1) preserve information corroborating the fund's proper decision making and conduct in the event of future disputes; and (2) safeguard commercially or competitively sensitive information.

Information Preservation: The global economy generates inordinate numbers of emails each day, and fund managers contribute and receive their fair share. Given the huge volume of electronic and other written information, funds like virtually all businesses find themselves facing tough questions about what information to preserve, and for what period of time. Regardless of the size of the entity, it generally is preferable to promulgate document retention protocols rather than rely on a patchwork of individualized practices within a firm. That said, the protocols can be framed, at least in part, as providing advisory guidance so that, in particular instances, the protocols can be overridden without leaving a misimpression of having violated sacrosanct rules. Even if advisory in certain respects, a retention policy will need to require, without qualification, the preservation of information consistent with any applicable securities, employment or other industry-specific regulatory requirements.

Notice of litigation also triggers judicial rules that require preservation of relevant information.

To decide what voluntarily should be preserved apart from information subject to mandatory retention, fund managers need to identify the types of disputes the fund potentially could face and the nature of the information it then likely would want available. In the private equity realm, for example, several recent lawsuits have challenged attempts by firms to terminate proposed acquisitions (or investments) based on alleged material adverse events unfavorably effecting the target companies. Other lawsuits have challenged on antitrust grounds "club" or joint bidding practices among firms for allegedly depressing the levels of bids for target companies. Given the risk of disputes over negotiations and understandings surrounding proposed takeovers or investments, a firm should memorialize and then preserve the documentation evidencing its good faith conduct, its communications with the counterparty about expectations, and its reasonable reliance on the counterparty's statements. To that end, policies can require maintaining all transaction-related information (including emails at least on back-up tapes) for a discrete period of (perhaps one year or eighteen months) after closing or terminating a deal; thereafter, the firm can limit the information it retains on a longer-term/semi-permanent basis to defined items such as summary-type business plans, memoranda or meeting minutes reflecting internal strategy and decision making; email communications and other correspondence directly with the counterparty; and drafts of transactional documents that were exchanged with the other side.

Another potential area of litigation involves investors challenging fund managers' investment decisions on grounds of alleged violation of investment criteria or alleged breaches of duty of care or conflicts of interest standards. Claims of these kinds can be brought years after the investment decisions are made. Rather than maintain every scrap of paper involved in the analysis underlying an investment decision, a sensible practice for a firm can be to prepare a summary memorandum outlining the basis for the ultimate decision to make or to not make investments; thereafter, it can maintain, on a long-term basis, the summary memorandum together with only the key supporting material.

The information involved in a fund's operations does not exist only in written form, but also in the mental impressions and recollections of the fund's personnel. It therefore also may be helpful to access, in the future, the testimony of personnel, including personnel no longer working on behalf of the fund. As part of standard employment practices, consider structuring compensation or employment agreements, including with respect to the payment of severance benefits, so as to impose obligations on the part of outgoing personnel to cooperate in the future and make themselves reasonably available in the event the firm requires assistance in a dispute.

Protecting Confidential Information: In daily activities, the persons operating private investment funds generate and receive extensive amounts of confidential, commercially sensitive information: some of it relates to their firms' own business models and strategies; some of it relates to information received from potential target companies during due diligence activities; and some of it relates to the trade secrets and private business plans of portfolio companies. Depending on the type of information at issue, the failure to respect legal confidentiality obligations can expose fund managers to liability to various parties, including limited partner investors of the fund, third party target companies, co-investors in a portfolio company, or civil claimants and governmental regulators particularly if confidential information is wrongfully disseminated among competitors.

Because the prevalence of confidential information will only grow given the critical role of intellectual property rights in the economy, it is prudent to adopt written procedures governing the handling of confidential information. These controls should be set forth in written policies signed at regular intervals by personnel to acknowledge awareness and consent, including the signatory's recognition of ongoing obligations to protect confidentiality even after departing from the investment firm. Furthermore, confidential information should not be generally accessible in databases or

computer systems open to a large number of users. The same safeguards also should apply to where and how information is stored in hard copy form.

One scenario giving rise to confidentiality issues is where a fund manager is designated to serve as a board member or executive at a portfolio company, and that person receives at the private investment firm's offices confidential information from the portfolio company. It is important to implement practices that take account of the formal separation between the person's responsibilities on behalf of the private investment fund, on the one hand, and the person's distinct responsibilities on behalf of the portfolio company, on the other. Colleagues at the private investment fund do not necessarily have the same level of fiduciary and other duties owing to the portfolio company and are not entitled to access the same confidential information. Indeed, risks exist that other fund personnel are involved in activities directly, indirectly or potentially in competition with the portfolio company. In light of these varying roles for fund personnel, the portfolio company's confidential information must not be impermissibly shared even within the investment firm itself. Consideration should be given to the advantages of separate email addresses or at least electronic and hard copy document repositories dedicated to the portfolio company's private information.

Structuring Relationships With Portfolio Companies

The relationship between a private investment fund and its portfolio companies should be structured in order to avoid the fund assuming liability for the acts of the portfolio companies. In designating board members for portfolio companies, the fund also should protect against the risk of triggering antitrust liability to the extent the portfolio companies arguably are in competition with each other. In circumstances, however, where members of senior management of a portfolio company are subject to legal claims, the investment fund's board designees (and other affiliated executives) should be the beneficiaries of sufficient insurance protection maintained by the portfolio company. That protection for official corporate acts can be supplemented by insurance obtained by the investment fund itself.

Respect Corporate Formalities to Avoid Control Person Liabilities: Private investment funds face increased legal risks if they become intimately involved in the day-to-day management of their portfolio companies. To the extent a fund regularly is involved in routine decisions involving the portfolio company's personnel, accounting, or other operational/administrative matters, it then may expose itself to liability for the portfolio company's actions under a control person theory. Funds can best insulate themselves from that liability by respecting corporate formalities and allowing portfolio company management to take charge of running the routine activities of the company.

Under limited circumstances, courts have allowed aggrieved parties to seek compensation from a portfolio company's shareholders (i.e., private investment funds) when they have taken an active role in managing the company. In Vogt v. Greenmarine Holding, LLC, recently laid off employees of Outboard Marine Company ("OMC"), a portfolio company in bankruptcy, brought suit in the federal court for the Southern District of New York against several private investment funds that held a majority interest in OMC for federal employment law violations. The plaintiffs sought compensation directly from the private investment funds, rather than OMC itself. They alleged that the private investment funds and OMC were controlled by interlocking board members, who actually made the decision for OMC to file for bankruptcy. The court identified several factors to determine if the claims against the private investment funds could proceed, including whether the funds exercised substantial control over the portfolio company's daily activities and the inter-dependency of operations. Applying these factors, the court found that some of the private investment funds in the case potentially could be held liable, while others clearly could not as a matter of law and were dismissed from the case. The funds which potentially could be held liable were the funds that played a direct role in OMC's decision to declare bankruptcy and impose lay offs. That type of direct participation can be shown by tracing a chain of substantive deliberations about the

portfolio company's operations at the investment fund itself, followed by directions to the personnel running the portfolio company.

Similarly, in Dole v. Simpson, brought in the Southern District of Indiana, the court found an individual venture capitalist could be held personally liable as a statutory employer for violations under the Fair Labor Standards Act. The lawsuit, based on a control person theory, alleged that the individual defendant should be held liable for unpaid wages of portfolio company employees. The defendant was an equity partner in the portfolio company, and as the portfolio company began to struggle financially, he personally invested substantial time and capital into the business. The court held that the venture capitalist could potentially be subject to liability as a statutory employer because he exercised substantial control over the portfolio company's day-to-day management and that he was not "merely a passive investor."

Private investment funds may also face liability for securities law violations by their portfolio companies. In such circumstances, a plaintiff must show a securities violation by the portfolio company, control of the primary violator by the defendant firm, and that the firm was a culpable participant in the violation. In Mishkin v. Ageloff, a case from the Southern District of New York, a court appointed trustee sought to recover against one outside director under a control person theory for securities violations. The court recognized that a director involved in routine details of the company's operations could be subject to securities law liability arising out of those operations. But on the record in the case, the court refused to find control person liability due to the lack of particularized facts demonstrating the manner in which the outside director exercised control personally and participated in the alleged violations.

These cases exemplify why a private investment fund must take steps upholding corporate formalities between itself and its portfolio companies. The corporate formalities include, for example, keeping separate the investment fund and portfolio company's books and records, their respective board meetings and management discussions, and their banking accounts.

Even though corporate formalities must be respected, as a matter of routine practice, private investment funds still will want to have individuals at the firm take on a meaningful role in portfolio company management. Standing alone, nothing is inappropriate about that practice. To protect the interests of the private investment fund, it is not necessary to preclude personnel from taking on dual roles at the fund and portfolio company. However, it is important for such individuals to recognize their dual roles – that they are wearing two hats and to take steps to bifurcate their responsibilities to each entity, such as conducting portfolio company business at the portfolio company rather than the fund; maintaining separate expense records; and keeping separate files to avoid the intermingling of confidential information.

In recognition of the risks facing private investment funds arising out of its relationships with portfolio companies, it may want to obtain insurance coverage applicable to claims involving portfolio company operations. There are specialty insurance products available to investment fund, which, while typically expensive, should be evaluated as part of responsible risk management practices.

Selecting Board Nominees to Avoid Antitrust Issues: U.S. antitrust laws prohibit any "person" from serving as a director or officer of competing corporations at the same time. This prohibition has a unique impact on private investment funds that place their own members on the boards of their portfolio companies. A case brought against the private equity firm Oaktree Capital Management underscores the impact on private investment funds when their portfolio companies have interlocking directorates. In Reading International, Inc. v. Oaktree Capital Management, brought in the Southern District of New York, the plaintiffs alleged antitrust violations against Oaktree because it appointed two separate individual directors to the boards of two of its competing portfolio companies. Even though Oaktree appointed different individual directors to the boards of the competing portfolio companies, the court allowed the claim to proceed. First, the court found that a corporation can be considered a "person" under the law. Next, the court had to decide whether the appointed directors had been "deputized" by Oaktree – if the

directors "acted as the puppets or instrumentalities of [Oaktree's] will." If so, then Oaktree could be found liable for having itself "served" as a director for two competing companies, in violation of the antitrust laws.

The Oaktree decision identifies significant issues facing private investment funds, namely, that a private investment fund can be held liable for antitrust violations when the fund appoints different directors to competing portfolio companies. This is an important concern because many private investment funds are industry focused, which raises the likelihood that they will make substantial investments in portfolio companies sharing the same industry space, and potentially deemed competitors. However, there are numerous measures that private investment funds can adopt to minimize these risks and ensure the independence of the boards of portfolio companies in competition.

For example, private investment funds can nominate separate individuals to sit on competing portfolio company boards. If these individuals are not directly affiliated with the regular and day-to-day operations of the fund, it helps to dispel any allegations that the board nominees have been "deputized" by their fund. In addition, this will likely minimize the contact that the private investment funds' board designees have with each other, thus decreasing the chances of information sharing. As an extra level of security, private investment funds can set forth written guidelines advising all board nominees that they may not share any of the portfolio company's privileged or sensitive information with their colleagues. As a related measure, a private investment fund should expressly disclose the relationships that its board nominees have with the private investment fund, as well as any of its other portfolio companies that compete with the portfolio company at issue.

Furthermore, board members can always recuse themselves when board discussions cover topics that may jeopardize the board member's duty of loyalty or care. If a board member does not participate in board discussions, it will be extremely difficult to claim that the board member violated his duty of care or loyalty. However, if recusals occur too frequently, such that the board member can not adequately perform his duties to both the board and the portfolio company, the private investment fund may want nominate non-voting board overseers instead. A non-voting board overseer does not face the same level of conflict prohibitions, and will be able to monitor the operations of the portfolio company without exposing himself or his employer to antitrust or other liability.

Director and Officer (D&O) Liability Insurance: When a private investment fund places a member or partner on the boards of the fund's portfolio companies, the individual will face the risk of personal liability for acts committed as a director. Accordingly, it is imperative that any designee that sits on the board of a portfolio company obtain adequate D&O liability insurance. D&O liability insurance protects individual directors and officers from personal liability arising out of the corporation's business operations; and obtaining the right kind of D&O liability insurance will make it more likely that the protection is available when it is most needed, in times of financial distress.

Generally, there are three types of coverages under D&O liability insurance: Side A, Side B and Side C coverage. Side A coverage provides defense indemnity to a director when the portfolio company is unable to. This may occur when the portfolio company is in bankruptcy or where, as a matter of law, the claim is not indemnifiable. Side B coverage is triggered when the company is required to indemnify the director. The insurer will then reimburse the company for any losses that the company had to pay on behalf of the director's conduct. Finally, side C coverage covers the company itself.

In order to minimize potential personal exposure, directors should make sure that the portfolio company purchases and maintains adequate D&O insurance. As additional protection, a private investment fund can purchase a secondary policy. This secondary policy, referred to as "double excess", coverage protects against any judgments where the portfolio company's insurance is unable to cover the director's losses. A basic risk management strategy for any private investment fund requires its portfolio companies to obtain suitable D&O and other types of insurance.

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When purchasing D&O liability insurance, a private investment fund should consider retaining a coverage attorney or a specialized insurance broker to review the scope of the coverage and any relevant policy exclusions. D&O liability insurance should be tailored to the needs of the insured, as there are unique risks facing each individual fund or company, depending on the industry, the size of the fund or company, its past litigation history, as well as any other factors that may not be covered by a generic D&O policy.

Defining Rights and Remedies Governing Internal Fund Disputes

Internally within funds, the potential exists for disputes between fund managers and outgoing members of the management team, and between fund managers and limited partners or other investors. At the creation of funds and adoption of their governance documents, careful attention routinely is given to defining the rights and obligations of the parties. Under Delaware and other state laws, it is permissible to draft limitations on the scope of fiduciary duties owing either among the managers to each other, or owing from the managers to the investors. For example, common provisions in management partnerships state managers do not owe fiduciary duties to each other when making decisions to expel persons from the management team. Similarly, in agreements with investors, provisions can limit the duty of loyalty owed by managers to investors so the managers are free to engage in activities that exploit potential opportunities for the benefit of the managers or other ventures in which they are involved.

In the event of an internal dispute at a fund, it often is preferable from the perspective of fund managers to require, under the governance agreements, that the parties engage in mandatory alternative dispute resolution (ADR) procedures such as arbitration or mediation instead of public court proceedings. That said, ADR processes vary widely: sometimes agreements carefully define the prerequisite credentials for an arbitrator, which is necessary if the parties want to ensure that the dispute is presented to a person well experienced with fund management issues; sometimes agreements call for a panel of multiple arbitrators rather than a single arbitrator, which can effect both the timing and cost of the process. Increasingly, parties also are contractually requiring a pre-arbitration mediation process, which, given the extra procedural layer and time it adds, often puts further pressure on the parties to reach an early settlement. Certain types of disputes can be isolated for accelerated resolution, such as, for example, disputes over calls for capital contributions from investors.

Particularly from the perspective of fund managers, the benefit of ADR instead of public court proceedings includes confidentiality so allegations of improprieties are, in theory, kept out of the media. ADR also avoids the dynamics of a jury trial, with jurors in contrast to industry-experienced arbitrators often viewed as being more sympathetic to investors rather than fund mangers. To the extent that rule of thumb exists, it is questionable. But ADR also can be favorable to fund managers because it likely results in more limited discovery compared to court proceedings, particularly as related to third parties. It therefore can make it harder for investors to obtain information from target companies, bankers or other third parties. Discovery from third party sources like these conceivably could be useful to investors trying to develop a case against fund managers.

Conclusion

When it comes to risk management "best practices" for private investment funds, no one size fits all types of organizations. But as the magnitude of private fund investments in virtually all sectors of the global economy continues to grow, funds increasingly need to be aware of their exposure to significant legal liabilities and to take affirmative steps to manage their risks related to potential litigation. To do so effectively requires thoughtful attention to establishing internal practices and controls that will best position the fund to avoid, minimize or rebut the legal claims potentially facing it. ◎

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