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Portfolio Companies Continue to be a Source of Litigation Risk

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A significant ownership stake in a portfolio company has always raised the specter of claims against funds, sponsors, and sponsor-appointed board designees, if for no other reason than they are perceived by the plaintiffs' bar to be deep pockets. This risk has only increased in recent years, as it has become less taboo – indeed, it is becoming commonplace – for founders, management, significant shareholders, and even other sponsors to sue private fund sponsors in connection with change of control transactions. Every significant transaction produces relative winners and losers, even those that are perceived by the market as homeruns such as a unicorn IPO or merger with a SPAC. Fund sponsors, and especially those that hold board seats, should therefore use extra caution and remember that more control comes with greater risk of liability.

Especially in today's uncertain market landscape, it is imperative that fund sponsors and their board designees familiarize themselves with the risks associated with portfolio company disputes. For example, sponsors should ensure that GPs who serve on boards are aware of possible conflicts of interest that come from their dual fiduciary duties to the portfolio company and the fund, and should carefully evaluate change of control and/or liquidity events and consider whether procedural safeguards regarding process and price are necessary or prudent.

Insurance coverage, including D&O insurance, plays a critical role as a risk management tool.

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2021.

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