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Portfolio Company Risk: Plaintiffs Set Sights on Sponsors and Board Directors

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As our other Top Ten posts have demonstrated, there is no shortage of risks for private fund sponsors to navigate in today's economic and regulatory environment. Nevertheless, they need to prioritize the risk that hits closest to home – lawsuits by private litigants seeking to pull sponsors, their funds, and their board director designees into litigation. These suits most frequently arise out of portfolio companies and most notably sale, business combination, or other liquidity or change of control events at a fund's portfolio company. We have seen a considerable uptick in these types of lawsuits over the last several years, and we expect the trend to continue – and likely accelerate.

In our ongoing series, *The Portfolio Company Playbook: A Fund Sponsor's Guide to Risks and Liability*, the legal risks emanating from a fund sponsor's participation on a portfolio company board presents a risk factor for the entire investment structure, including the general partner, the management company, the individual members of the general partner and management company, and the fund. While a portfolio company is often the epicenter of a dispute, aggressive plaintiffs' lawyers are pursuing theories to reach beyond the portfolio company to assert claims against the company's board directors, and in particular those directors appointed by private funds as well as the funds themselves and their sponsors. These claims tend to be based on a single fundamental theory: control. The greater the control by the sponsor (or sponsor entities), the greater the risk that a shareholder or employee of the portfolio company will pursue some theory of wrongdoing against the sponsor (and its affiliates).

The types of disputes that can bubble up to the director and fund levels are broad. For example, we have managed claims involving employee compensation, discrimination, ERISA-related, and WARN Act. Some of the most threatening claims for sponsors, however, involve claims by company shareholders following a sale or other significant change or control event. Shareholders seeking to block or undo the action bring claims not only against the company (including in a derivative capacity), but also against the members of the board, private fund shareholders, and fund sponsors, including for fraud and breaches of fiduciary duties. The fiduciary duty claims can be particularly complex for sponsors and sponsor-appointed board designees who owe duties to their investors but also, depending on the circumstance, may be held to also owe duties to other company shareholders.

We are seeing more claims brought by allegedly aggrieved buyers – or simply ones experiencing buyer's remorse – seeking to avoid their obligations to close or post-closing to recoup some of the purchase price paid. These claims take many forms, including fraud, breaches of representations and warranties, and indemnification. In thinking ahead to those possibilities, sponsors and their funds and directors are well-advised to pay extra attention to both the sale process and the definitive agreements. As one example, fund sponsors with director seats should think through each specific representation and warranty being made, who is deemed to make it, who is charged with the requisite knowledge, and who may be – and may not be – held liable for an alleged breach.

The private funds industry is in its third generation (by some measures) and has undergone extraordinary growth, and in the process has become highly institutionalized, segmented, specialized, and competitive. Not surprisingly, the growth of the industry has attracted more litigation and regulatory scrutiny. That trend is not reversing itself any time soon. But the good news is that there are steps that every sponsor can take to identify and then mitigate the legal and regulatory risks inherent in their business, especially arising out of portfolio companies. For more information on these and other related topics, please follow our series, *The Portfolio Company Playbook: A Fund Sponsor's Guide to Risks and Liability.*

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2022.

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