

I N S I D E T H E M I N D S

Private Equity Fund Exposure and Protection

*Leading Lawyers on Weighing Investment Risks,
Structuring Prudent M&A Transactions, and
Preparing for Increased Government Involvement*



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Identifying and Minimizing
Risk for Private Equity Funds
and Fund Managers

David A. Rines

Partner

Thompson Hine LLP



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Introduction

The risks of litigation, liability, and loss for private equity funds have never been greater. Following several years of explosive growth, including the formation of many billion-dollar funds and the announcement of numerous billion-dollar, highly leveraged acquisitions, the private equity industry is now front and center in the public consciousness. As such, private equity funds are the most likely “deep pockets” in any potential litigation situation. In a 2007 study titled “Private Equity in the Spotlight: Allegations and Risks Facing the Industry,” Marsh reaffirmed its findings from a 2004 study that private equity was “increasingly under scrutiny, not just by investors but also by management teams, partners, and regulators,” and further noted that “the scope of potential claimants has continued to expand alongside growth in the industry.” This growth and the increasing impact and presence of private equity funds on the financial system have also significantly increased legislative and regulatory scrutiny. Needless to say, the current economic crisis will only magnify all of these risks for the private equity industry.

This chapter will discuss the various areas where private equity funds and fund managers are exposed to risk, the legal or contractual obligations of funds and managers with respect to such risks, and the measures that can be taken to protect against, or at least minimize, such risks. Given the breadth of transactions and relationships of private equity funds and their managers, this chapter will cover risks associated with the following:

- Portfolio company transactions
- Portfolio company directorships
- Portfolio company pass-through liability
- Securities laws matters
- Fund formation matters
- Fund partnership agreement terms
- Legislation and regulation
- Insurance and risk management

Consistent with the increased risks facing the private equity industry, there have been a number of important cases decided in the last few years,

particularly in Delaware, that will have a significant impact on private equity funds and fund managers. Several of these cases will be discussed in detail in this chapter.

Portfolio Company Transaction Risk

As noted above, the Delaware courts have issued a number of important decisions in the last several years affecting the private equity industry, particularly with respect to acquisition agreements and portfolio company director fiduciary duties. This section will discuss three recent cases decided by the Delaware Court of Chancery. Each opinion is an excellent case study in how things can go wrong in a transaction, and how risks can often be avoided, mitigated, or reallocated by the acquisition agreement.

Hexion Specialty Chemicals Inc. v. Huntsman Corp.: *The Limits of MAE Provisions and the Importance of the Contractual Allocation of Risk*

To date, the most significant risks to private equity funds have arisen through “broken deals,” which in this context means potential acquisitions in which the buyer has sought to terminate the acquisition prior to closing by (i) claiming the occurrence of a “material adverse effect” (MAE) or “material adverse change” (MAC) in the seller’s business since the signing of the agreement, or (ii) in some cases, paying a negotiated termination fee. Since the commencement of the economic crisis in 2007, there has been a steady stream of broken deals and resultant pending, threatened, or actual litigation.

In a case of major significance to the private equity industry, the Delaware Court of Chancery recently issued an opinion in *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch 2008), which addresses a number of important risks and risk allocation issues in connection with an acquisition agreement.

Hexion Specialty Chemicals Inc., a 92 percent owned portfolio company of private equity fund group Apollo Management, entered into a merger agreement in July 2007 pursuant to which it would acquire Huntsman Corp. for an estimated transaction value of \$10.6 billion. The merger agreement included several important provisions that were critical to the outcome of

the case, including (i) an MAE clause that permitted Hexion to terminate the transaction if an MAE had occurred to Huntsman’s business, (ii) a termination fee of \$325 million, which allowed Hexion to terminate the deal and cap its damages to the fee amount, (iii) a “further assurances covenant,” pursuant to which Hexion agreed to use its reasonable best efforts to take all actions and do all things necessary, proper, or advisable to consummate the transaction, (iv) an unlimited damages provision for any “knowing and intentional breach” of the merger agreement by Hexion, notwithstanding the termination fee provision, and (v) a specific performance provision.

After the signing of the merger agreement but prior to the scheduled closing, Huntsman reported disappointing quarterly earnings and one of its business segments had experienced a slowdown. As a result, Apollo began to discuss internally whether an MAE had occurred and whether the combined Hexion-Huntsman company, post-closing, would be insolvent. Apollo then retained a consultant to assess the insolvency of the combined post-closing entity, and the consultant concluded (not surprisingly, in the court’s opinion) that the post-closing combined entity would be insolvent. At no time during this period did Apollo or Hexion include Huntsman in the MAE or insolvency analysis, and the consultant did not talk with Huntsman management in connection with rendering its insolvency opinion. After Apollo and Hexion received the insolvency opinion, and without any prior notice to Huntsman, they made the opinion public as part of their lawsuit seeking a declaratory judgment that (1) Hexion was not obligated to close the transaction because Huntsman had suffered an MAE, and Hexion therefore had no liability to Huntsman, or, in the alternative, (2) Hexion was not obligated to close the transaction because the combined company post-closing would be insolvent, and Hexion’s liability would therefore be limited to the \$325 million termination fee. Apollo was not a party to the merger agreement. Hexion’s argument on the second point was that if the combined entity would be insolvent post-closing, then Hexion would not be able to deliver a solvency certificate to its lender and the transaction financing would not be available. Although this would put Hexion in breach of the agreement, it argued that its liability would still be limited to the \$325 million termination fee.

The MAE Claim

Under the merger agreement, Hexion’s obligation to close the transaction was conditional upon the absence of “any event, change, effect or

development that has had or is reasonably expected to have, individually or in the aggregate,” an MAE. MAE was defined, in pertinent part, as “any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole...” The MAE provision also included certain carve-outs specific to Huntsman’s industry, but the court held that such carve-outs were not applicable.

The most significant aspect of the *Hexion* decision is the Delaware Court of Chancery’s discussion of the stringent standard of review applied to parties seeking to terminate an agreement by invoking an MAE or MAC provision. Specifically, the court wrote:

For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. *A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence.* The ubiquitous material adverse effect clause should be seen as providing a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner. A short-term hiccup in earnings should not suffice; rather an adverse change should be material when viewed from the longer-term perspective of a reasonable acquirer. This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time

appointed for closing is irrelevant. Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future. (emphasis added; footnotes and citations omitted)

The court also held that the burden of proof for establishing that an MAE occurred is on Hexion as the buyer, but noted in a footnote that the parties could explicitly allocate the burden of proof in the contract.

Applying the above standard of review, the court held that Huntsman did *not* suffer an MAE, noting, among other things, that (i) Huntsman's 2007 EBITDA was only 3 percent below 2006 and the projected 2008 EBITDA was only 7 percent below 2007, (ii) current analyst estimates of Huntsman's expected 2009 performance exceeded two (out of three) of Hexion's financial models for Huntsman's 2009 performance at the time the transaction was signed, (iii) although Huntsman's net debt increased by over \$250 million after signing, this dollar increase constituted only a 5 to 6 percent increase in overall net debt, and (iv) the slowdown in two divisions represented only 25 percent of Huntsman's adjusted EBITDA, and the slowdowns were expected to be short-term in nature.

Another important aspect of the *Hexion* decision pertains to the evidence that the court did *not* consider in assessing whether an MAE had occurred. One of Hexion's arguments was that Huntsman repeatedly missed its own forecasts and that such failures were essential to the MAE analysis. As part of its transaction forecasts, Huntsman had projected 2008 EBITDA of \$1.28 billion. Through July 2008, Huntsman had revised the forecasted 2008 EBITDA to \$879 million, 32 percent lower than its original forecast.

The court held that Hexion could not claim an MAE based on the forecasts because the merger agreement explicitly disclaimed reliance upon any representations or warranties by Huntsman with respect to any projections, forecasts, or other estimates of future performance. The merger agreement provided as follows:

Each of [Hexion] and Merger Sub agrees that, except for the representations and warranties made by [Huntsman]

that are expressly set forth in Section 3.1 of this Agreement (as modified by the Company Disclosure Letter or as disclosed in the SEC Documents) and in any certificate provided pursuant to Section 6.2(c), neither [Huntsman] nor any other Person has made and shall not be deemed to have made any representation or warranty of any kind. Without limiting the generality of the foregoing, each of [Hexion] and Merger Sub agrees that neither [Huntsman], any holder of [Huntsman's] securities nor any of their respective Affiliates or Representatives, makes or has made any representation or warranty to [Hexion], Merger Sub or any of their representatives or Affiliates with respect to...any projections, forecasts or other estimates, plans or budgets of future revenues, expenses or expenditures, future results of operations (or any component thereof), future cash flows (or any component thereof) or future financial condition (or any component thereof) of [Huntsman] or any of its Subsidiaries or the future business, operations or affairs of [Huntsman] or any of its Subsidiaries heretofore or hereafter delivered to or made available to [Hexion], Merger Sub or their respective representatives or Affiliates.

Based on the foregoing provision, the court determined that the parties had specifically allocated the risk to Hexion that Huntsman might not live up to its projections. Accordingly, Hexion could not now claim that the failure to attain such projections constituted an MAE.

Damages: The Termination Fee versus Unlimited Damages

The second issue in the *Hexion* case was whether Hexion had committed a “knowing and intentional breach” of the merger agreement. If there was no “knowing and intentional breach” of the agreement, then Hexion’s liability for failing to close the transaction would be limited to the \$325 million termination fee. If Hexion did commit a “knowing and intentional breach,” Huntsman would be entitled to full contract damages, not capped or limited by the termination fee amount.

The phrase “knowing and intentional breach” was not defined in the merger agreement. Analogizing to criminal law meanings of “knowing” and “intentional,” the court held that knowing and intentional breach for purposes of the merger agreement meant “the taking of a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act.” Stated differently, any *knowing* act (as opposed to an inadvertent, accidental, or negligent act) that constituted a breach, regardless of Hexion’s intent or knowledge about whether such act was a breach, was a knowing and intentional breach that entitled Huntsman to unlimited damages. The court rejected Hexion’s claim that a knowing and intentional breach meant Hexion must have acted intentionally to breach the agreement and with actual knowledge that its conduct constituted such a breach.

The next question for the court was whether Hexion knowingly and intentionally breached two “further assurances covenants” in the merger agreement, which provided that Hexion (i) shall use its reasonable best efforts to take, or cause to be taken, all actions necessary, proper, or advisable to consummate the lender financing, and (ii) shall not, and shall not permit any of its affiliates to, take or fail to take any action that could reasonably be expected to materially impair, delay, or prevent consummation of the lender financing.

The court then held that Hexion knowingly and intentionally breached the further assurances covenants, stating, “Hexion’s utter failure to make any attempt to confer with Huntsman when Hexion first became concerned with the potential issue of insolvency, both constitutes a failure to use reasonable best efforts to consummate the merger and shows a lack of good faith.”

The Specific Performance Issue

The final issue before the court was whether Hexion could be required to close the merger transaction under the specific enforcement provisions of the agreement. The merger agreement provided that a non-breaching party could seek and obtain specific performance of any covenant or obligation set forth in the agreement. The merger agreement also included, however, a sentence that referred to circumstances under which Huntsman would *not*

be entitled to specifically enforce Hexion's obligation to close the merger. Determining that the sentence regarding the exception to specific enforcement was ambiguous, the court looked at extrinsic evidence and held that Huntsman could *not* specifically enforce Hexion's obligation to close. Thus, Hexion was still liable for full contract damages for failing to close the merger, but it could not be forced to consummate the \$10.6 billion transaction.

Lessons from Hexion

From a private equity fund risk of loss and protection perspective, the *Hexion* decision is instructive in a number of respects:

- *MAE clauses are strictly construed.* A buyer should not enter into any acquisition agreement with an expectation that it will be able to terminate a transaction if an MAE occurs. As the *Hexion* court held, the burden on establishing an MAE is high, and a court will look to the long-term prospects of the target. To the extent possible, a buyer should negotiate and draft MAE clauses that include specific circumstances or thresholds that would constitute an MAE (e.g., a 20 percent or more reduction in EBITDA over a defined period), and if relevant, expressly provide that performance over a specified short-term period can also constitute an MAE.
- *Acquisition agreements should be carefully drafted to ensure that the intended allocation of risk between the parties is clearly reflected in the terms of the agreement.*
 - *Damages and standard of care.* Hexion's liability for breach increased from the \$325 million termination fee to unlimited contractual damages, simply because the merger agreement did not define knowing and intentional breach. In the author's view, Hexion's interpretation at trial of knowing and intentional breach (i.e., an intentional breach with actual knowledge that the act constitutes a breach) is more consistent with the view of most transactional parties and counsel. Yet, because it was not defined, the court interpreted it much more broadly than the parties likely intended. The solution, of course, is for the parties to

clearly allocate the risk between them by agreeing to an unambiguous definition in the agreement.

- *Specific performance.* An ambiguous specific enforcement provision was critical in sparing Hexion from the obligation to close the merger and pay the full merger consideration. Again, careful drafting of the contract and a clear allocation of risk could have avoided this issue.
- *Reasonable best efforts and further assurances provisions have real meaning.* While these provisions are often boilerplate and overlooked by the parties, it is important to note that Hexion's breach of the merger agreement was its failure to use reasonable best efforts to notify and communicate with Huntsman during the insolvency analysis, and the court's determination that Hexion failed to act in good faith.
- *Understand the scope of legally enforceable representations and warranties.* One critical factor in Huntsman's success on the MAE claim was Hexion's express disclaimer in the merger agreement of any reliance on Huntsman's projections. As a result, all MAE claims relating to Huntsman's projections were excluded from the court's consideration of the matter. Sellers should clearly try to include such disclaimer provisions in any acquisition agreement. Buyers, on the other hand, should seek to exclude them or try to specifically list important documents, such as projections, upon which the buyer has relied.

It is important to reiterate the magnitude of risk that came into play because of the terms of the merger agreement and the court's holdings with respect thereto. Hexion believed it was entering into a merger agreement that included (i) an MAE provision with some specific industry carve-outs, (ii) a termination fee of \$325 million which would cap damages except for any knowing and intentional breach (which meant Hexion, in its view, would have to intentionally breach the agreement), and (iii) a provision prohibiting specific enforcement to close the transaction. In short, Hexion likely believed its liability for breach would not exceed the \$325 million termination fee. Instead, for all the reasons noted above, Hexion ended up in a situation where it had unlimited contractual liability for breach of a \$10.6 billion merger agreement.

Abry Partners v. F&W Acquisition LLC: The Limits to Freedom of Contract

In *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del.Ch. 2006), the Delaware Court of Chancery addressed the issue of whether contractual provisions in a stock purchase agreement which provided for an exclusive remedy of a capped termination of \$20 million for all claims, including claims of fraud and misrepresentation, were enforceable. At issue was the tension between freedom of contract principals on the one hand and fraud and lesser degrees of misrepresentation on the other hand.

Abry involved litigation between the private equity firms Abry Partners and its affiliates (as buyer) and Providence Equity Partners and its subsidiary portfolio companies, F&W Acquisition LLC (“Selling Stockholder”) and F&W Publications (the “Company” and collectively with Providence and the Selling Stockholder, “Providence”). Following the closing of the transaction, Abry believed Providence had made material misrepresentations in the stock purchase agreement, including among other things misstated financial statements. Rather than pursuing a claim for monetary damages, Abry Partners sought to rescind the stock purchase agreement by alleging fraudulent inducement and negligent misrepresentation. If Abry was successful on its rescission claim, the transaction would have been unwound and Providence would be required to return to Abry the \$500 million acquisition price. Providence sought to dismiss the rescission claim, arguing that even if Providence was found liable for misrepresentation, Providence’s liability should be limited to the exclusive, capped remedy of \$20 million provided for in the stock purchase agreement.

The Delaware Court of Chancery in *Abry* looked carefully at several important provisions in the stock purchase agreement, including the following:

- First, the agreement clearly defined what information Abry relied upon in deciding to execute the agreement. Specifically, the agreement provided, “Acquiror [Abry] acknowledges and agrees that neither the Company nor Selling Stockholder has made any representation or warranty, express or implied...except as expressly set forth in this Agreement...”

- Second, the agreement provided for comprehensive representations and warranties from the Company but only very limited representations and warranties from the Selling Stockholder (which did not address the financial statements). Notwithstanding this distinction, the Selling Stockholder did effectively sign on to all of the Company’s representations and warranties because of a certificate delivered at closing by Seller that all of the Company’s representations and warranties were accurate.
- Third, the Selling Stockholder was required to indemnify Abry for any damages (excluding consequential damages) arising out of or resulting from any facts or circumstances “which constitute an *inaccuracy, misrepresentation, breach of*, default in, or failure to perform any of the *representations, warranties, or covenants* given or made by the *Company or the Selling Stockholder* in this Agreement...” (emphasis in original) The aggregate liability of the Selling Stockholder and the Company under the foregoing indemnity was limited to \$20 million.
- Lastly, the agreement included an “exclusive remedy provision” which stated in part, “Except as may be required to enforce post-closing covenants hereunder...after the Closing Date the indemnification rights in this Article IX are and shall be the sole and exclusive remedies of the Acquiror...”

As a preliminary matter, the court held that the indemnification clause of the stock purchase agreement, by including damages arising out of “misrepresentations,” also included fraudulent misrepresentations. Thus, the court stated that, “*Absent an overriding public policy*, the plain terms of the Exclusive Remedy Provision would limit the Buyer to an Indemnity Claim for damages capped at [\$20 million] and would bar its claim for rescission.” (emphasis added)

The court then proceeded to discuss the legal tension between the freedom of contract principles and claims of fraud. On the one hand, the court noted that the Delaware courts recognize the enforceability of contractual provisions in which the parties clearly disclaim reliance on extra-contractual representations, noting that the courts have consistently held that “sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form

part of the basis for their decision to contract.” On the other hand, the court also noted that the Delaware courts have consistently “respected the law’s traditional abhorrence of fraud.” The issue in the *Abry* case, however, was different because *Abry* claimed that the Company and the Selling Stockholder had made fraudulent misrepresentations *within the express representations contained in the Agreement*. Thus, the critical issue in *Abry* was the extent to which a contract (i.e., the exclusive remedy provision for capped, monetary damages) may exculpate a party from a rescission or damages claim based on a false representation of fact made within the contract.

The court attempted to strike a balance between the need to recognize the parties’ freedom to contract while also recognizing the public policy interests against enforcing contractual limitations against fraud. Specifically, the court held:

[T]he public policy of [Delaware] will not permit the Seller to insulate itself from the possibility that the sale would be rescinded if the Buyer can show either: (1) that the Seller knew that the Company’s representations and warranties were false, or (2) that the Seller itself lied to the Buyer about a contractual representation or warranty. This will require Buyer to prove that the Seller acted with an illicit state of mind, in the sense that the Seller knew that the representation was false and either communicated it to the Buyer directly itself or knew that the Company had.

By contrast, the Buyer may not obtain rescission or greater monetary damages upon any lesser showing. If the Company’s managers intentionally misrepresented facts to the Buyer without knowledge of falsity by the Seller, then the Buyer cannot obtain rescission or damages, but must proceed with an Indemnity Claim subject to the [\$20 million] liability cap. Likewise, the Buyer may not escape the contractual limitations on liability by attempting to show that the Seller acted in a reckless, grossly negligent, or negligent manner.

Accordingly, the negligent misrepresentation claim against Providence was dismissed. The fraudulent inducement claim could proceed to trial, but Abry would have to establish at trial that the Providence representatives knew that the Company's representations were either false or that such representatives themselves lied to Abry.

Lessons from Abry

- *Sellers should clearly distinguish between representations and warranties made by the portfolio company and the selling stockholder.* To limit sell-side risk, selling stockholders should seek to limit the scope of their representations and warranties as much as possible. Second, the representatives of the private equity fund who are authorized to make representations and warranties on behalf of the selling stockholder should be specifically named in the agreement. In this fashion, the selling stockholder can best isolate itself from fraudulent misrepresentations made by the Company and its management, even if the selling stockholder acted in a reckless, grossly negligent, or negligent manner. Third, as noted in *Hexion*, the selling stockholder should include a provision clearly disclaiming any representations and warranties not contained in the agreement. Lastly, to the extent possible, the private equity fund should not be a party to the acquisition agreement.
- *Buyers should recognize the limits imposed by the Abry decision and ensure that the Selling Stockholder fully guarantees any fraud or misrepresentation by the Company.* To best protect the benefit of their bargain in light of the *Abry* decision, private equity buyers should seek to ensure that all representations and warranties of a seller, and in particular fraudulent misrepresentations, are fully guaranteed by the seller and all credit-worthy parties in the seller's ownership structure. In addition, of course, the buyer should seek to limit in the agreement all of the points noted above that sellers should take to mitigate risk.

Alliance Data Systems v. Blackstone Capital Partners V, L.P.: Potential Related Party and Affiliate Liability

In *Alliance Data Systems v. Blackstone Capital Partners V, L.P.*, 2009 WL 97708 (Del.Ch. 2009), the Delaware Court of Chancery addressed several issues concerning whether a private equity fund that was *not* a party to the merger

agreement could be held liable for alleged breaches of a merger agreement by the fund's merger subsidiaries. The decision in *ADS* arises out of the failed acquisition of Alliance Data Systems ("ADS") by Blackstone Capital Partners V, L.P. (the "Blackstone Fund"). In the transaction, ADS entered into a merger agreement with two newly formed merger subsidiaries of the Blackstone Fund, Aladdin Solutions Inc. and Aladdin Merger Sub (together, "Aladdin"). Importantly, neither the Blackstone Fund nor its controlling partner, the Blackstone Group L.P. (the "Blackstone Group," and together with the Blackstone Fund, "Blackstone"), were parties to the merger agreement. One of the conditions to closing the merger was the approval of the Office of the Comptroller of the Currency ("OCC"), and the merger agreement included a covenant that Aladdin would use *its* reasonable best efforts to obtain such approval. Aladdin did not make any covenants that it would cause the Blackstone Fund or any of its affiliates to undertake any affirmative action to obtain OCC approval. The merger agreement also included a termination fee, which was effectively a monetary cap on damages of \$170 million for any breach by Aladdin that resulted in the failure of the merger to close. The termination fee was separately guaranteed by the Blackstone Fund.

During the course of the transaction, the OCC required Blackstone (in addition to Aladdin) to provide additional financial support to one of ADS's financial subsidiaries. Although Aladdin made several concessions to the OCC, Blackstone refused to provide the additional support requested, and the merger was not consummated. ADS then filed suit against Aladdin and the Blackstone Fund alleging (i) that Aladdin breached the merger agreement by failing to cause Blackstone to come to agreement with the OCC, and (ii) that the Blackstone Fund failed to pay the \$170 million termination fee under its guaranty.

As an initial matter, the Court of Chancery held that any liability of Blackstone and Aladdin must be based on a breach *by Aladdin* of the merger agreement, since it was the only party to the agreement. The court then held that Aladdin did *not* breach the merger agreement because there was nothing in the agreement requiring Aladdin to force Blackstone to enter into any arrangement with the OCC. The applicable covenant concerning OCC approval provided that, "Each *of the Parties* shall use its reasonable best efforts to...do, or cause to be done...all things necessary, proper or advisable under applicable Laws to consummate...the transactions..." The

court noted that the foregoing language imposed no obligation on Blackstone to use *any* effort, or for Aladdin to cause Blackstone to use any effort. In contrast, the court then noted the covenant in the agreement concerning antitrust approval, which provided that Aladdin “shall, and shall cause each other member of the Parent Group [including Blackstone] to...offer to commit to take any action which it is capable of taking [to get antitrust approval].” Thus with respect to antitrust approval, the court stated that Aladdin would be liable for breach if it could not get Blackstone to do what was necessary to obtain regulatory approval.

Lessons from ADS

ADS highlights what at first glance appears obvious: the best means of limiting private equity fund risk is to exclude the fund as a party to the acquisition agreement and include as parties only the portfolio company and its parent equity holder. While sellers will require a credit-worthy entity to stand behind the acquisition entities, this can be provided by the fund through guaranty capped at a specified amount.

ADS also highlights, however, a more subtle issue, which is the extent to which the actions of non-parties to the agreement may cause a breach of the agreement. As the court pointed out, had the issue of breach concerned antitrust approval, Aladdin would have been in breach for Blackstone’s failure to obtain such approval. Thus, private equity funds, their managers, and fund counsel should carefully draft and review all acquisition documents to ensure that they are not inadvertently creating obligations for non-parties to the agreement, which could nevertheless put them in breach.

Portfolio Company Director Risk

Private equity funds and fund managers have significant risk exposure in connection with fund representatives serving as directors on the boards of their portfolio companies. Legal issues often arise as to whether a director has breached his or her fiduciary duties to the portfolio company and its stockholders, and if so, whether such a breach is protected by (i) exculpation or indemnification provisions in the company’s charter or bylaws and/or (ii) directors and officers insurance. Even if a portfolio company does have in place such protections, they may not be sufficient to

cover the losses incurred by a director who is a fund representative, and in such a case, the fund may be required to cover any losses through the indemnification obligations of the fund's partnership agreement. This section will discuss the legal obligations of directors under Delaware law, and the steps private equity funds and fund managers should take to minimize the risks of loss associated therewith.

Fiduciary Duties of Directors and the Business Judgment Rule

Directors of a corporation owe a fiduciary duty to the corporation and its stockholders. This fiduciary duty is comprised of a duty of loyalty and a duty of due care. The duty of loyalty includes a duty to act in good faith.

To fully understand directors' fiduciary duties, it is first necessary to discuss the "business judgment rule," which is a judicial presumption concerning the *process* by which director decisions have been determined. The Delaware Supreme Court has articulated the rule as follows:

[Delaware] law presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation. Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."

In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006).

Importantly, the business judgment rule does not establish liability. It is rather an evidentiary burden-shifting mechanism. Initially, the burden of proof is on the plaintiff to establish that the directors breached their fiduciary duty of loyalty or care or acted in bad faith. If the plaintiff satisfies this burden, the directors have the burden of establishing that the transaction was "entirely fair" to the corporation and its shareholders.

The Duty of Care

Under Delaware law, directors owe a duty of care to the corporation and its stockholders. This duty of care requires that “in making business decisions, directors must consider all material information reasonably available, and the directors’ process is actionable only if *grossly negligent*.” *Brehm v. Eisner*, 746 A.2d 244, 259, (Del. 1998).

The risk of director liability solely for a “good faith” breach of the duty of care is significantly lessened by Section 102(b)(7) of the Delaware General Corporation Law, which provides that a corporation’s certificate of incorporation *may* include:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 [distributions in violation of the Delaware General Corporation Law] of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

Del. Code Ann. tit. 8, § 102(b)(7) (2009).

Note that the benefits of Section 102(b)(7) are optional. A corporation may (or may not) choose to include it in its certificate of incorporation. Also, the provisions apply to directors but do not to officers. Needless to say, a private equity fund should ensure that all of its portfolio companies expressly include Section 102(b)(7) in their charters.

The Duty of Loyalty

Directors of Delaware corporations also owe a fiduciary duty of loyalty to the corporation and its stockholders. As will be seen, this duty has been

articulated by the Delaware courts in a number of different ways, but essentially a breach of the duty of loyalty arises when a director has engaged in an improper conflict of interest transaction or has otherwise acted in bad faith.

Conflict of Interest Transactions

The essence of a breach of duty of loyalty claim is that a director has engaged in a conflict of interest or self-interested transaction to his or her benefit and to the detriment of the corporation. For private equity funds, this is a particularly high-risk area for litigation, given that the fund is typically the majority or a controlling shareholder, and representatives of the fund manager serve on the corporation's board. This fact, coupled with the economic incentives of the fund managers at the fund level (i.e., carried interest) and their fiduciary duties to the fund's limited partners, can substantially increase the likelihood of a breach of duty of loyalty claim that the fund managers/directors are acting for the benefit of the fund and not the corporation (and all shareholders) as a whole.

In recognition that not all conflict of interest transactions constitute a breach of the duty of loyalty, Section 144 of the Delaware General Corporation Law provides three means by which a conflict of interest transaction may be approved and taken by the corporation. It provides, in pertinent part:

(a) No contract or transaction between a corporation and one or more of its directors or officers...in which [such directors or officers]...have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, *if*:

(1) The *material facts* as to the director's or officer's relationship or interest and as to the contract or transaction *are disclosed or are known* to the board of directors or the committee, and the board or committee in

good faith authorizes the contract or transaction by the *affirmative votes of a majority of the disinterested directors*, even though the disinterested directors be less than a quorum; or

(2) The *material facts* as to the director's or officer's relationship or interest and as to the contract or transaction *are disclosed or are known* to the shareholders entitled to vote thereon, and the contract or transaction is specifically *approved in good faith by vote of the shareholders*; or

(3) The *contract or transaction is fair as to the corporation* as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

Del. Code Ann. tit. 8, § 144 (2009)

For a private equity fund and its managers, “best practices” in any potential conflict of interest situation are to (i) ensure, *and document* (through a disclosure document or otherwise), that all material facts concerning the transaction are provided to the board of directors and/or the shareholders prior to engaging in the transaction, (ii) obtain the affirmative vote or approval of a majority of independent directors and/or shareholders, and (iii) obtain an independent fairness opinion. The fairness opinion is important because the approval in (3) above is not based on any disclosure requirement. In the cases of (1) and (2) above, there is always a possibility that the board or other shareholders could still bring suit after approving a transaction by alleging that the fund managers/directors failed to disclose all material facts. To address that risk, the fairness opinion provides a backstop means of approval under Section 144.

Duty of Good Faith

In *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court recently held that a director's duty to act in good faith is part of a director's duty of loyalty. Delaware case law for some time had been unclear as to whether directors had a “triad” of fiduciary duties (loyalty, due care, and good faith) or just the more traditionally recognized duties of loyalty and care.

Because of the protection against director liability under Section 102(b)(7) for good faith breaches of the duty of care, most claims against directors allege that the directors acted in bad faith. As such, the issue of whether a director acted in bad faith is often determinative of director liability.

The Delaware Supreme Court addressed the issue of good faith/bad faith in detail in *In re Walt Disney Co. Deriv. Litig. v. Eisner*, 906 A. 2d 27 (Del. 2006). The Supreme Court observed in *Disney* that there are at least three categories of fiduciary conduct that could constitute bad faith:

- The first category is “subjective bad faith,” which is fiduciary conduct motivated by an actual intent to do harm.
- The second category, on the opposite end of the spectrum from the first, is fiduciary action “taken solely by reason of gross negligence and without malevolent intent.” The court in *Disney* held that gross negligence, without more, does not constitute bad faith.
- The third category, which falls between the first and the second categories, is an intentional dereliction of duty or a conscious disregard for one’s responsibilities. The court in *Disney* held that such conduct also constitutes bad faith.

Duty of Oversight

The Delaware Supreme Court decision in *Stone* also clarified a director’s duty of oversight. In affirming the Delaware Court of Chancery’s 1996 opinion in *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959 (Del.Ch. 1996), the *Stone* court held that:

[T]he necessary conditions predicate for director oversight liability [are]: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system of controls, consciously failed to monitor and oversee its operations thus disabling themselves from being informed of the risks or problems requiring their attention. In either case, the imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to

act, thereby demonstrating a conscious disregard for their responsibilities, they breach a duty of loyalty by failing to discharge that duty in good faith.

By clarifying that the duty of oversight is part of the duty of loyalty, rather than the duty of care, *Stone* has increased director protections for oversight liability by requiring plaintiffs to show that directors “consciously disregarded their responsibilities” rather than establishing the lesser burden of “gross negligence” under a duty of care claim.

Fiduciary Duties in the Zone of Insolvency

In light of the economic crisis, one issue that fund managers/directors should be aware of is whether directors of a portfolio company that is insolvent or in the “zone of insolvency” owe a fiduciary duty to the *creditors* of the company. This is a question of state law, and the answer may differ significantly depending on the state of incorporation of the portfolio company. Fortunately, the Delaware Supreme Court decided this issue in 2007, holding that “creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert *direct* claims for breach of fiduciary duty against the corporation’s directors.” *North American Catholic Educational Programming Foundation Inc. v. Gheenwalla*, 930 A.2d 92 (Del. 2007). The court also recognized in the same opinion, however, that creditors of an insolvent corporation, as residual beneficiaries of any increase in the value of the corporation, may stand in the place of shareholders and bring a derivative (or indirect) claim against directors for breach of fiduciary duty to the corporation.

Revlon Duties

Of course to the extent that fund representatives are serving as directors for a portfolio company that has initiated a cash sale process, and unaffiliated third parties are shareholders of the company, then the fund representatives must be cognizant of their “Revlon” duties to get the best price for all stockholders. *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986). While it is beyond the scope of this chapter to address *Revlon* and other change of control transaction duties, fund representatives should carefully evaluate with legal counsel various deal structures and the fiduciary

duty issues associated therewith (e.g., “no-shop” and “go-shop” provisions, termination fees, voting agreements, etc.).

Indemnification

Section 145 of the Delaware General Corporation Law permits a corporation to provide broad indemnification protection for its directors, officers, employees, or agents of the corporation, provided that such persons acted “in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person’s conduct was unlawful.” Del. Code Ann. tit. 8, § 145(a) (2009).

Except for cases in which a director or officer is successful on the merits in defending any action subject to indemnification, a corporation’s power to indemnify is permissive and not mandatory. Accordingly, private equity fund managers should ensure that the charters of all of their portfolio companies provide that (i) the corporation “*shall* indemnify the directors, officers, employees and agents of the corporation to the fullest extent permitted by law,” and (ii) the corporation shall advance expenses incurred by directors and officers upon receipt of an undertaking from such persons to repay expenses if it is determined that indemnification is not available. In addition, fund managers serving as directors should also seek to obtain indemnification rights via contract to ensure continued protection after a manager steps down as director, or in the event a company’s charter documents are amended. In a 2008 case, the Delaware Court of Chancery surprisingly held that a company was *not* obligated to advance legal expenses to a former director where the company, in advance of suing the director, amended its bylaws to preclude the advancement of legal expenses. *Schoon v. Troy*, 948 A.2d 1157 (Del. Ch. 2008). The court held that even though the company’s bylaws provided for advancement of expenses at the time the director served on the board, the later amendment to the bylaws was valid to bar advancement of any expenses. Had the director in this case also obtained indemnification rights by contract, the amendment to the bylaws would have had no effect on the director’s ability to enforce his contractual rights. Fortunately, the Delaware General Assembly recently passed legislation overturning the decision in *Schoon*. The legislation amends Section 145(f) by providing that a right to indemnification or advancement of

expenses under provisions in the certificate of incorporation or bylaws of a corporation *cannot* be eliminated or impaired after the occurrence of the act or omission to which such provisions relate, unless such provisions contain, at the time of such act or omission, explicit authorization to eliminate or impair such rights after the applicable act or omission. Del. Laws, 145th General Assembly, House Bill #19, Signed on 4/10/09, www.legis.delaware.gov.

Another recent Delaware Court of Chancery opinion has created uncertainty about the priority, or lack thereof, of indemnification obligations to fund representatives/directors as between a private fund equity and its portfolio companies. In *Levy v. HLI Operating Co. Inc.*, 924 A.2d 210 (Del.Ch. 2008), the plaintiffs were private equity fund representatives who also served on the board of a portfolio company. The plaintiffs sought indemnification from both the fund and the portfolio company for losses arising from the settlement of claims for alleged securities violations. The plaintiffs had customary, broad indemnification rights from the portfolio company pursuant to its bylaws and separate indemnification agreements. They also had similar rights under the private equity fund's limited partnership agreement.

In the course of discovery, the portfolio company learned that the fund had already paid most of the settlement amounts on behalf of the plaintiffs. As a result, the portfolio ceased complying with the plaintiffs' demands for further advancements on the grounds that the plaintiffs no longer had indemnifiable losses under the portfolio company indemnification arrangements. The private equity fund in turn sought subrogation to the indemnification rights of the plaintiffs, and that the portfolio company should reimburse the fund for indemnification amounts paid by the fund to the plaintiffs.

In a decision surprising to many in the private equity industry, the Court of Chancery in *Levy* held that the private equity fund and the portfolio company were co-indemnitors. As such, the fund had only a claim for equitable contribution against the portfolio company for its fair share of the settlement amount.

As a result of *Levy*, private equity funds should now also enter into separate indemnification agreements with their respective portfolio companies which clearly specify, among other things, that (i) the portfolio company's indemnification and advancement obligations to directors who are also

fund representatives are primary to any similar obligations the fund may provide such individuals, (ii) the portfolio company will promptly pay pursuant to its indemnification obligations, and (iii) to the extent that the fund pays any indemnification or advancement of expenses under its fund partnership agreement to directors who are fund representatives, the fund shall be subrogated to the rights of such directors and the portfolio company shall fully indemnify the fund for all such amounts.

Of course, any indemnification right is only as good as the credit-worthiness of the corporation. Even in circumstances where indemnification of a private equity fund manager as a director may be proper, the corporation may not have sufficient assets to satisfy such obligation, particularly if the corporation is in a distressed situation, or other claimants have priority over indemnified parties. For this reason, as will be discussed later in this chapter, it is essential that portfolio companies have adequate directors and officers insurance, and that private equity funds have adequate insurance and indemnification coverage at the fund level.

Portfolio Company Pass-Through Liability

In the private portfolio company context, private equity funds and their managers exert significant control over the operations of their portfolio companies. It is through this control, of course, that fund managers hope to create value over time and sell the company (privately or through a public offering) at a significantly higher valuation. Fund control over a portfolio company has its risks, however, and there have been several instances in recent years where a private equity fund has been held liable for the obligations of a portfolio company.

The Employee Retirement Income Security Act and Pension Benefit Guaranty Corporation Liability

In a September 2007 opinion, the Appeals Board of the Pension Benefit Guaranty Corporation held that a private equity fund *and each of its controlled portfolio companies* were jointly and severally liable to the Pension Benefit Guaranty Corporation for the unfunded liabilities of a pension plan that was terminated by one of the fund's portfolio companies. Pension Benefit Guaranty Corporation letter dated September 26, 2007, "Subject: Company

A Pension Plan.” The Appeals Board sustained the Pension Benefit Guaranty Corporation’s prior determination that the private equity fund and its other 80 percent controlled companies were jointly and severally liable for over \$3.2 million in unfunded pension plan liabilities plus over \$770,000 in interest.

Under the Employee Retirement Income Security Act, liability for an underfunded single-employer pension plan upon termination of the plan extends to a contributing sponsor of the plan or a member of the sponsor’s controlled group. To impose termination liability on an organization other than the original employer, two conditions must be met: (i) the organization must be under “common control” with the original employer (typically an 80 percent ownership test), and (ii) the organization must be a “trade or business.” Although it is well understood that a private equity fund and its portfolio companies are usually under common control, the Pension Benefit Guaranty Corporation’s opinion was noteworthy for its determination that the private equity fund was engaged in a trade or business. This is contrary to the widely held view that private equity funds are “passive investors” in securities and are not engaged in a trade or business.

The implications of this opinion are significant, because it means that not only is the private equity fund liable for the unfunded liabilities of the pension plan, but also all of the other portfolio companies of the fund are liable as well. Because the Pension Benefit Guaranty Corporation opinion is based on how private equity funds operate, it will be difficult for funds to structure transactions or investments to avoid this risk. Because holding less than an 80 percent equity ownership is typically not a practical option for private equity funds, except in club deals, the best means of protecting against unforeseen Employee Retirement Income Security Act liability and minimizing such risk will be through the due diligence process and the indemnification, escrow, and pricing provisions of the acquisition agreement.

Employment Pass-Through Liability

Two federal court decisions in recent years have held that a private equity fund may be held liable for WARN Act violations of their portfolio

companies. *Vogt v. Greenmarine Holding LLC*, 318 F.Supp.2d 136 (S.D.N.Y. 2004); *In re Shelby Yarn Co.*, 306 B.R. 523 (W.D.N.C. 2004). Under the WARN Act, employers are required to provide at least sixty days advance warning prior to any plant closing or mass layoff that causes an employment loss. An “employer” is defined under the act as “any business enterprise” that employs more than one hundred employees. In both cases, the courts adopted the five-factor test issued by the Department of Labor to determine whether a parent-subsidary relationship constituted a single business enterprise, namely: (1) common ownership, (2) common directors and/or officers, (3) *de facto* exercise of control, (4) unity of personnel policies emanating from a common source, and (5) the dependency of the operations. The most important factor among the foregoing was the issue of *de facto* exercise of control exerted by the fund.

Private equity funds can effectively eliminate potential WARN Act liability by ensuring that their portfolio companies strictly comply with the requirements of the act. However, the *Vogt* and *Shelby* cases highlight another important issue fund managers should be sensitive to: specifically, the extent to which their funds exercise *de facto* control over their portfolio companies. In addition to WARN Act liability, such control may increase the risk of other “control person” and/or “alter ego” liability, such as liability arising from “piercing the corporate veil” claims or environmental claims.

Private Antitrust Liability

Private equity firms have been named as defendants in two recent federal court cases in which the plaintiffs alleged that various joint bidding arrangements among private equity firms violated federal antitrust laws. In *Pennsylvania Avenue Funds v. Borey*, 569 F.Supp.2d 1126 (W.D. Wash. 2008), the court dismissed the claims against the private equity firms, holding that (i) price fixing among rival bidders is not *per se* anti-competitive because, among other things, it permits less wealthy bidders to join forces and compete against wealthier bidders, thereby increasing competition, and (ii) under the “rule of reason” antitrust analysis, the plaintiffs failed to allege the existence of a relevant market in which the defendant private equity firms had market power.

In contrast, a federal district court in Massachusetts held in December 2008 that the plaintiff shareholders of a publicly traded company had pled sufficient facts to “plausibly suggest” an illegal agreement in violation of federal antitrust laws. *Dahl v. Bain Capital Partners LLC*, 589 F.Supp.2d 112 (D. Mass. 2008). *Dahl* involves a class action against thirteen large private equity funds in which the plaintiffs have alleged an “overarching conspiracy” with respect to leveraged buyout transactions between 2003 and 2008 and totaling more than \$2.5 billion. Specifically, the plaintiffs have alleged nine transactions in which the defendant private equity firms carried out a conspiracy by, among other things, (1) submitting sham bids, (2) agreeing not to submit bids, (3) granting management certain incentives, and (4) including “losing” bidders in the final transaction. The court in *Dahl* also held that the U.S. Supreme Court’s decision in 2007 in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264, 127 S. Ct. 2383, 168 L. Ed.2d 145 (2007), which held that the federal antitrust laws were pre-empted by federal securities laws in the context of the sale of securities by underwriters in an initial public offering, did *not pre-empt* plaintiffs’ antitrust claims against the private equity funds.

Securities Laws Matters

One of the most significant areas of risk for private equity funds and fund managers concerns potential liability under federal securities laws in connection with publicly traded portfolio companies. While it is beyond the scope of this chapter to discuss in detail the various laws and regulations (and associated risks and liabilities) that accompany private equity fund ownership and board representation in a publicly traded company, this section will list some of the more significant areas of risk and discuss in more detail two issues of particular importance to private equity funds and their managers: (i) limits on indemnification and (ii) control person liability.

The following is a brief list of the more significant federal securities laws and regulations applicable to private equity funds and fund managers:

Securities Act of 1933

- Public offerings of securities registered with the Securities and Exchange Commission (SEC) under Section 5 (e.g., initial public offerings, shelf-offerings, secondary offerings)

- Private offerings of securities under Section 4(2) and Regulation D
- Private offerings under Rule 144A to qualified institutional buyers
- The anti-fraud provisions of Rule 10b-5 and Section 17
- Section 11 strict liability for issuers
- Section 11 control person liability
- Section 12 liability
- Private resales of restricted securities under Rule 144

The Securities Exchange Act of 1934 and Sarbanes-Oxley Act of 2002

- Periodic reporting requirements (e.g., Form 10-Ks, Form 10-Qs, Form 8-Ks)
- The anti-fraud provisions of Rule 10b-5
- Section 20 control person liability
- Sarbanes-Oxley corporate governance matters
 - Code of ethics
 - Independent audit committee
 - Independent compensation committee
- NYSE or NASDAQ exchange listing requirements
- Proxy solicitations
- Going-private transactions, tender offers, and takeovers
- Section 13(d) and Section 13(g) shareholder reporting requirements
- Insider trading
- Disgorgement of short-swing trading profits and Section 16 beneficial ownership reporting

As the foregoing list makes clear, fund managers should proceed with the utmost caution and prudence in connection with securities matters. In addition to the various corporate governance requirements imposed by Sarbanes-Oxley, every publicly traded portfolio company should have one or more compliance officers to monitor securities matters. In addition, fund managers should have their own dedicated staff to further monitor securities matters, as they affect each portfolio company and the fund in general.

Limits on Indemnification

Fund managers should be aware that it is SEC’s policy that indemnification agreements for directors, officers, or controlling persons for violations of the federal securities laws are against public policy and are unenforceable. Specifically, Item 510 of Regulation S-K under the Securities Act of 1933 and the Securities Exchange Act of 1934 requires the following disclosure in a prospectus:

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officer, or persons controlling the registrant pursuant to the foregoing provisions, the registrant has been informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable.

To address the risk that an indemnification provision relating to a securities claim may be unenforceable, fund managers should ensure that applicable indemnification agreements also include “contribution” provisions that require a party that would otherwise have an indemnification obligation to contribute toward payment of any liability incurred by a party who would otherwise be entitled to indemnification.

Control Person Liability

Fund managers serving as directors on publicly traded portfolio companies should also be acutely sensitive to the fact that primary liability under the federal securities laws can, and often does, include directors, officers, and “control persons” of the portfolio company. For example, Section 11(a) under the Securities Act provides that any person who acquires a security pursuant to a registration statement that contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements made therein not misleading may sue, among others, every person who was a director of the registrant. In such a case, the director’s only defense is the “due diligence” defense in Section 11(b).

Fund Formation Risks

Private equity funds and fund managers can face potentially significant risks of liability in connection with the fund offering process, if such offerings are not done in compliance with applicable federal and state securities laws. This requires careful attention to exemptions under the Securities Act of 1933 (the Securities Act), the Investment Company Act of 1940 (the Company Act), the Investment Advisers Act of 1940 (the Advisers Act) (for unregistered investment advisers), and applicable state laws. The failure to qualify for such exemptions could result in civil liability to investors and SEC or state civil and criminal enforcement actions and any liability resulting therefrom.

The Securities Act of 1933

The issuance of limited partnership interests in a new private equity fund, as well the issuance of new interests in an existing fund, are issuances of “securities” within the meaning of the Securities Act. Section 5 of the Securities Act provides, among other things, that (i) no security may be offered by means of interstate commerce unless a “registration statement” has been filed with the SEC, and (ii) no security may be sold by means of interstate commerce unless a registration statement has been declared effective by the SEC. Fortunately, Section 4(2) of the Securities Act exempts from Section 5 any “transactions by an issuer not involving any public offering.” Section 4(2) is often referred to as the “private placement/offering exception,” and the critical task for fund managers and their counsel is to ensure that the offering of fund interests to prospective investors does not constitute a public offering.

Regulation D, promulgated under the Securities Act, provides three non-exclusive safe harbors under which issuers (i.e., funds) may comply and the offering of securities will not be deemed a public offering. In the private equity fund context, the most frequently relied upon safe harbor is Rule 506, which does not impose any dollar limit on the amount that may be raised by the fund. Rule 506 provides that for an offering to qualify as a “transaction not involving a public offering” under Section 4(2), the offering must satisfy *all* of the following requirements:

- *Limitation on number of purchasers.* There are no more than, or the issuer reasonably believes there are no more than, thirty-five purchasers (i.e., no more than thirty-five non-accredited investors) of securities from the issuer.
- *Limitation on manner of offering.* Neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of *general solicitation or general advertising*, including, but not limited to, the following:
 - Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio
 - Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising
- *Limitations on resale.* Securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under Section 4(2) of the Securities Act and cannot be resold without registration under the Securities Act or an exemption therefrom (e.g., under Rule 144). The issuer must exercise reasonable care to ensure that the purchasers of the securities are not underwriters within the meaning of Section 2(a)(11) of the Securities Act, which reasonable care may be demonstrated by the following:
 - Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons
 - Written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act and therefore cannot be resold unless they are registered under the Securities Act or unless an exemption from registration is available
 - Placement of a legend on the certificate or other document that evidences the securities, stating that the securities have not been registered under the Securities Act and setting forth or referring to the restrictions on transferability and sale of the securities
- *Information requirements:* The issuer must furnish the information specified in Rule 502(b) to all *non-accredited* purchasers prior to sale.

- *Nature of purchasers.* Each purchaser who is not an accredited investor either alone or with his purchaser representatives has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

Because of the specific information requirements applicable to non-accredited investors, such investors are typically excluded from any Rule 506 offering.

The most significant risk to private equity fund managers in the offering process is a potential violation of the general solicitation and advertising prohibitions described above. The SEC construes permitted communications under the general solicitation/advertisement requirements very narrowly. In fact, inadvertent communications, advertisements, presentations, and, in particular, Web site postings by issuers may often be deemed general solicitations/advertisements in violation of the rule. The most common factor the SEC has cited as evidence that a communication is *not* a general solicitation or advertisement is whether there is a *pre-existing substantive relationship* between the issuer (or the person acting on the issuer's behalf) and the offeree. Because the number of offerees known by issuers is often limited, issuers often need to retain third-party brokers or placement agents who have a much broader list of pre-existing substantive relationships, whom the broker may contact on the issuer's behalf as potential investors in the fund.

Liability for Section 5 Violations

If an offering intended as a private placement fails to qualify for the Section 4(2) exemption, any "persons" offering or selling such securities will have violated Section 5 of the Securities Act and will have *strict liability* for rescission damages plus interest to any purchasers of the securities. Section 12(a)(1) of the Securities Act provides:

Any *person* who offers or sells a security in violation of section 5...shall be liable, subject to subsection (b) [a loss causation provision], to the person purchasing such

security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

The Supreme Court has held that “persons” who could be liable include not only persons who pass title (such as the issuer), but also any persons who “solicit securities purchases provided they are motivated at least in part by a desire to serve their own financial interests or those of a securities owner.” *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 658 (1988). Thus, with respect to offerings of private equity fund interests, Section 12 liability would include not only the fund, but also any fund representatives involved in the selling process and any brokers engaged to solicit purchasers.

Protections against Violations of Section 5 for Private Offerings

Prior to and throughout any private offering of securities, private equity fund managers should be proactive and diligent in ensuring that the offering complies with all of the Rule 506 safe harbor requirements noted above. This will require close and ongoing communications with legal counsel, brokers, and any marketing or public relations groups. Specific protective steps that a fund should take include:

- Treating the private offering period as a “quiet period,” pursuant to which all public communications, advertisements, Web site postings, speaking engagements, and so on are vetted in advance by appropriate fund personal and legal counsel
- Ensuring that all communications concerning the offering are handled by designated fund personnel and broker personnel
- Distributing fund offering materials only to accredited investors with whom the fund or the broker, as applicable, has a pre-existing substantive relationship
- Obtaining an indemnification provision in the brokerage agreement pursuant to which the broker will indemnify the fund and the fund representatives against any losses incurred by them if the fund is held liable for a Section 5 violation due to the acts of the broker

- Obtaining a legal opinion at closing that the offering is exempt from registration under Section 5

Rule 10b-5 Liability under the Exchange Act

Although it is widely recognized that Rule 10b-5 prohibiting fraudulent and deceptive practices applies to public offerings and publicly traded companies, it is sometimes not understood that Rule 10b-5 also applies to private placements under Section 4(2) of the Securities Act. Rule 10b-5, promulgated under Section 10(b) of the Exchange Act, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

In connection with any offering of private equity fund interests, fund managers must ensure that all written and oral disclosure concerning the offering complies with Rule 10b-5, and in particular, the prohibition against omissions of any material facts necessary to make statements made not misleading.

To establish liability under Rule 10b-5, a plaintiff must prove that:

1. The defendant made a misrepresentation or failed to disclose a material fact
2. The defendant acted with an intent to defraud
3. The plaintiff relied on the misrepresentation
4. The misrepresentation or omission occurred in connection with a purchase or sale of a security
5. The defendant's actions caused plaintiff damages

Persons potentially liable under Rule 10b-5 include any person or entity who made, or was responsible for making the material misstatements or omissions. In the private equity context, this would typically include the fund, the general partner, the fund manager entity, and applicable directors, officers, or affiliates involved in the offering. Section 20(a) of the Exchange Act also imposes liability on “control persons,” providing as follows:

Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

The Investment Company Act of 1940

To avoid registration as an investment company under the Company Act, private equity funds typically rely on either the Section 3(c)(1) or Section 3(c)(7) exemptions. Section 3(c)(1) exempts from the definition of investment company:

Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by *not more than one hundred persons* and *which is not making and does not presently propose to make a public offering of its securities...* For purposes

of this paragraph...beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, and is or, but for the exception provided for in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company's outstanding securities (other than short-term paper). (emphasis added)

For funds relying on the Section 3(c)(1) exemption, fund managers and legal counsel should carefully draft and review all subscription materials to ensure that the fund does not inadvertently exceed one hundred investors. This can occur if the fund is required to look through an investor because such investor (i) is or would be an investment company and owns 10 percent or more of the fund's voting securities, (ii) an investor was formed solely for purposes of investing in the fund, or (iii) has more than 40 percent of its assets or commitments invested in the fund.

Section 3(c)(7) exempts from the definition of investment company “[a]ny issuer, the outstanding securities of which are owned *exclusively* by persons who, at the time of acquisition of such securities, are *qualified purchasers*, and *which is not making and does not at that time propose to make a public offering of such securities*” (emphasis added). Again, fund managers and legal counsel should carefully review all subscription materials to ensure that *all* investors are “qualified purchasers” as defined under the Company Act. A single investor that is not a qualified purchaser will preclude the fund from relying on the exemption.

Both the Section 3(c)(1) and 3(c)(7) exemptions are dependent upon the fund not making, or proposing to make, any public offering of securities. Thus, if the fund violates Section 5 of the Securities Act, as discussed above, because its “private offering” failed to qualify for the Section 4(2) exception, the fund will also fail to qualify for the Section 3(c)(1) or Section 3(c)(7) exemptions under the Company Act. Absent another exemption, the fund will then have violated the registration provisions and various other provisions of the Company Act.

Liability under the Company Act

Any private equity fund that fails to qualify for either the Section 3(c)(1) or 3(c)(7) exclusion from the definition of “investment company” (unless another exclusion applies) will have violated Section 7 of the Company Act, which makes it unlawful for any investment company, unless registered with the SEC, to engage in any business of interstate commerce or to offer, sell, or deliver by any means of interstate commerce any security of itself or any other person. In addition, the fund, now an investment company, will have likely violated most of the other material provisions of the Company Act, including provisions concerning performance fees, composition of the fund’s board of directors, fiduciary duties, approval of advisory contracts, reporting requirements, sales literature, and public availability of information.

The Investment Advisers Act of 1940

Any investment adviser with assets under management of \$25 million or more is required to register with the SEC unless an exemption from registration is available. The most common exemption relied upon by private equity funds is Section 203(b)(3), which exempts from registration:

[A]ny investment adviser who during the course of the preceding twelve months has had *fewer than fifteen clients* and *who neither holds himself out generally to the public as an investment adviser* nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to section 54 of title I of this Act and has not withdrawn its election. (emphasis added)

For purposes of Section 206(b)(3), each private equity fund advised by a manager is counted as only one client. The statute does not require a “look through” to count the number of investors in each fund. As a result, private equity fund managers can advise up to fourteen funds over the preceding twelve-month period without registration under the Advisers Act, provided they do not hold themselves out to the public as an investment adviser.

The SEC has interpreted the prohibition against “holding oneself out to the public” broadly to prohibit or restrict, among other things (i) advertising related to investment advisory activities, (ii) maintaining a listing as an investment adviser in a telephone or building directory, (iii) solicitation by word of mouth or otherwise that the adviser will accept new advisory clients, or (iv) using letterhead or business cards referring to investment advisory activities. Lemke and Lins, *Regulation of Investment Advisers, 2008 Edition*, “Securities Law Handbook Series,” Thomson West, § 1:36. In addition, public information available on an Web site may be deemed as “holding out” for purposes of Section 203(b)(3), although the SEC has provided some limited relief pursuant to several no-action letters. *Id.*

Advisers Act Anti-Fraud Provisions and Fiduciary Duties

Notwithstanding that an investment adviser may be exempt from registration under the Advisers Act, it is essential that private equity fund managers understand that certain provisions of the Advisers Act apply to both registered and *unregistered* investment advisers. This includes the anti-fraud provisions of Section 206, which prohibit, among other things, any investment adviser from (i) employing any device, scheme, or artifice to defraud any client or prospective client, (ii) engaging in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client, or (iii) engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.

To ensure that the anti-fraud protections extend to *investors* and *prospective investors* rather than clients or prospective clients (i.e., funds), the SEC promulgated Rule 206(b)(8) in 2007 which, similar to Rule 10b-5 under the Exchange Act, provides:

(a) Prohibition. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the [Advisers Act] for any investment adviser to a pooled investment vehicle to:

(1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the

statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

(2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

(b) Definition. For purposes of this section “pooled investment vehicle” means any investment company as defined in section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act.

In addition to the anti-fraud provisions, the Supreme Court has held that the Advisers Act imposes fiduciary duties on investment advisers (whether or not registered) by operation of law. In *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d. 237 (1963), the Supreme Court described these duties in part as an affirmative duty of “utmost good faith, and full and fair disclosure of all material facts,” a duty to disclose all conflicts of interest, and an affirmative obligation “to employ reasonable care to avoid misleading” clients.

Adviser Act Liability

Fortunately for investment advisers, the Supreme Court held in *Capital Gains* that clients of investment advisers do *not* have a private cause of action under Section 206. A private cause of action is available, however, under Section 215, which provides that investment contracts whose formation or performance would violate the Advisers Act shall be void against the violator. Relief under Section 215 is specific and limited to “customary legal incidents of voidness,” which include the ability to sue to rescind the contract and recover any consideration paid under the contract.

Transamerica Mortgage Advisors Inc. v. Lewis, 444 U.S. 11, 100 S. Ct. 242, 62 L. Ed. 2d 146 (1979). An example of a voidable contract, in the private equity context, would be a partnership agreement for a fund managed by a registered adviser that charged a performance fee to an investor that did not meet the criterion of a “qualified client” under Rule 205-3.

State Investment Adviser Regulation

Investment advisers with assets under management of less than \$25 million are prohibited from registering with the SEC unless an adviser advises a registered investment company. Fund managers within this category need to carefully review with counsel all applicable state investment adviser regulations. Some states include a “private exemption” from state registration, similar to federal laws, for funds that have a limited number of clients. Other states, however, do not have a similar exemption and advisers may be required to register within such states.

Registered Investment Advisers

An increasing number of private equity fund managers have become registered under the Advisers Act, either because they no longer qualify for an exemption (e.g., they advise more than fourteen funds) or the nature of their advisory business and investor base makes registration worthwhile. Of course, to the extent that a fund manager is registered, the managers must ensure that they comply with all of the aspects of the Advisers Act.

One potential drawback for private equity funds managed by registered investment advisers is that in order for the general partner/fund managers to earn a performance fee, all investors assessed a performance fee must be “qualified clients,” defined under Rule 205-3 under the Advisers Act as follows:

The term “qualified client” means:

- (i) A natural person who or a company that immediately after entering into the contract has at least \$750,000 under the management of the investment adviser;
- (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

(A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$1,500,000 at the time the contract is entered into; or

(B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or

(iii) A natural person who immediately prior to entering into the contract is:

(A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

(B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least twelve months.

For private equity funds relying on the Section 3(c)(1) exemption under the Company Act, the “qualified client” net worth requirements can impose a significant barrier to raising capital from individuals.

Fund Level Matters

At the private equity fund level, risk is allocated between the fund managers (i.e., the general partner) and the investors (i.e., the limited partners) by the terms of the fund’s limited partnership agreement and the applicable state limited partnership statute. In discussing the allocation of

risk between the partners, this section will examine key provisions of the Delaware Revised Uniform Limited Partnership Act (the LP Act) and some typical risk allocation provisions of a private equity fund limited partnership agreement.

Delaware Limited Partnership Law

Under Delaware law, a limited partner is “not liable for the obligations of a limited partnership unless [such partner] is also a general partner or, in addition to the exercise of the rights and powers of a limited partner, [such partner] *participates in the control of the business.*” Del. Code Ann. tit. 6, § 17-303(a) (2009). The LP Act includes a non-exclusive list of activities a limited partner may engage in that are *not* deemed to be “participating in the control of the business,” including without limitation (i) consulting with the general partner on any matter, (ii) serving on a committee of the partnership, and (iii) voting on the removal of the general partner. Del. Code Ann. tit. 6, § 17-303(b) (2009). In contrast, the general partner of a limited partnership may be liable for all of the obligations of the limited partnership. The potential for unlimited general partner liability is typically minimized by structuring the general partner as a newly formed limited liability entity, usually a limited liability company.

One of the primary concepts underlying the LP Act is to give “maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.” Del. Code Ann. tit. 6, § 17-1101(c) (2009). Consequently, the partners have broad flexibility to allocate their respective rights, obligations, and duties in the limited partnership agreement. Section 17-1101 provides in part:

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, *the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.*

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the *limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties)* of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; *provided that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.* (emphasis added)

As the foregoing provisions make clear, subject only to the contractual duty of the implied covenant of good faith and fair dealing, the liabilities and duties of the partners, and in particular any fiduciary duties of the general partner, may be “expanded, restricted, or eliminated” by the terms of the partnership agreement.

Key Limited Partnership Agreement Risk Terms

Because of the deference given to the freedom to contract under the LP Act, the allocation of risk at the fund level is a matter of negotiating leverage between the general partner and the limited partners (or, more typically, one or more “lead” limited partners). This section will examine some typical fund agreement provisions and how risks are often allocated between the general partner and the limited partners.

Indemnification and Exculpation

Most private equity fund limited partnership agreements have broad indemnification and exculpation provisions. For example, a typical indemnification provision will require the fund to indemnify the general

partner, the investment adviser/management company, and any of their respective affiliates (including directors, officers, partners, and members) against any losses, damages, or expenses incurred by any of them in connection with the affairs of the fund *unless* such losses, damages, or expenses resulted from an act or omission of the person seeking indemnification that constituted (i) gross negligence, (ii) bad faith, (iii) willful or intentional misconduct, or (iv) a knowing violation of law (“disabling conduct”). Similarly, a typical exculpation provision will provide that none of the persons referenced above will have any liability to the fund or the limited partners *except for* fund losses resulting from an act or omission that constitutes disabling conduct.

To further protect the general partner and its affiliates in circumstances where indemnification may not be available (e.g., securities claims), an increasing number of private equity fund agreements now also include a “contribution provision” which allows the fund to contribute toward any payments owed by fund representatives in lieu of indemnification.

Conflicts of Interest

If not properly addressed within the partnership agreement, one of the most significant areas of risk for fund managers at the fund level could be conflicts of interest. Fund managers often serve as general partners and investment advisers to multiple funds and co-investments at any one time, and they usually have a variety of investment relationships and opportunities unrelated to the funds they manage. As such, it is essential that fund managers clearly and specifically address the following issues in the fund partnership agreement: (i) investment objectives and guidelines, (ii) time commitment to the fund, (iii) allocation of investment opportunities (particularly if there is any potential overlap between the fund’s investment objective and any other funds advised by the managers), and (iv) the right to engage in other investment activities independent of the fund.

In addition, conflicts of interest matters can also be addressed by establishing an independent advisory committee comprised of representatives of the limited partners. The advisory committee is a useful means for the general partner to consult with, and in some cases receive the

approval of, the limited partner members of the committee. From a legal perspective, this provides the general partner with additional protection against conflict of interest claims (assuming, of course, that the general partner has fully disclosed all material information to the committee). Also, from a practical perspective, a general partner is less likely to engage in a potential conflicts of interest transaction if the advisory committee has expressed concern over such a transaction.

Limited Partner Claw-Back Provisions

One of the more controversial and heavily negotiated provisions of certain fund agreements is what is frequently referred to as an “LP claw-back,” which permits the general partner to recall prior distributions to limited partners to cover fund indemnification obligations. As an example, notwithstanding whether limited partners have paid their full capital commitments, the general partner would have the right to make additional capital calls for indemnification obligations (i) at any time during the term of the fund (or even in some cases for a one-two year period following dissolution), and (ii) in an amount that could not exceed the lesser of (A) 25 percent of a limited partner’s commitment to the fund or (B) 25 percent of the dollar amount distributed to such limited partner. To the extent that the general partner received distributions of income in excess of its carried interest, the general partner would be required to return such excess amounts pursuant to the customary GP claw-back provision.

From the general partner/fund manager’s perspective, the LP claw-back clearly provides additional indemnification protection against any potential liabilities that may arise toward the end of the fund term. The argument from the fund manager’s perspective is that the LP claw-back more fairly allocates the economic gain or loss of the fund among all of the partners. From a limited partner’s perspective, however, the LP claw-back can be problematic, because it makes it more difficult to plan capital contributions and calculate portfolio-wide returns. Also, to the extent that a limited partner makes distributions to its investors, such as a fund-of-fund, the limited partner must be able to make similar recalls of distributions from such investors.

Legislation and Regulation

Even prior to the current economic crisis, the hedge fund and private equity fund industries were under increasing legislative and regulatory scrutiny. Legislation and regulation now seems a certainty in light of the collapse of the banking industry, several hedge fund fraud scandals, and concerns over unregulated investment funds and the trading of unregulated complex securities, such as credit default swaps and asset-backed securities. In March 2009, the Treasury Department outlined certain proposed hedge fund and private equity fund regulatory measures as part of the Obama Administration's comprehensive financial regulatory reform initiatives. Specifically, the Treasury Department outlined the following proposals:

- Requiring all advisers to hedge funds, private equity funds and venture capital funds whose assets under management exceed a certain threshold to register with the SEC
- Mandating that all funds advised by an SEC-registered investment adviser be subject to investor and counterparty disclosure requirements and regulatory reporting requirements
- Requiring such funds to report, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability; and
- Requiring the SEC to share fund reports with the systemic risk regulator, which would determine whether such funds could pose a systemic risk and should be subject to prudential standards established by the systemic risk regulator

In addition to the foregoing proposed regulation, as of the writing of this chapter, the Grassley-Levin "Hedge Fund Transparency Act" (the Fund Act) was pending in the Senate. Despite its name, the Fund Act would apply to hedge funds, private equity funds, and other private funds with assets under management in excess of \$50 million. The Fund Act would make a number of amendments to the Investment Company Act, including:

- The Section 3(c)(1) and Section 3(c)(7) exemptions would no longer be exemptions from the definition of “investment company.” Rather they would be moved to Section 6, which would mean private equity funds would be investment companies but would not be subject to the act except as set forth below.
- In order to be exempt from the Company Act, new Section 6(g)(1) would require private equity funds with assets under management in excess of \$50 million to:
 - Register with the SEC
 - Maintain books and records as required by the SEC
 - Cooperate with any request by the SEC for information or examination
 - File an annual information form with the SEC electronically, in which the fund would be required to disclose:
 - The name and current address of each individual who is a beneficial owner of the investment company
 - The name and current address of any company with an ownership interest in the investment company
 - An explanation of the structure of ownership interests in the investment company
 - Information on any affiliation with another financial institution
 - The name and current address of the investment company’s primary accountant and primary broker
 - A statement of any minimum investment commitment required of a limited partner, member, or investor
 - The total number of any limited partners, members, or other investors
 - The current value of the assets of the company and the assets under management by the fund

The SEC would also be required to make the filed information form available to the public at no cost and in an electronically searchable format.

The Fund Act would also require private equity funds subject to Section 6(g)(1) to establish anti-money laundering programs and report suspicious activity as required under the Bank Secrecy Act. Under current law, only registered investment advisers are required to establish anti-money laundering programs.

In addition to new legislation and regulation, private equity funds will likely be subject to increased scrutiny by regulators with respect to many of the securities matters discussed in this chapter, and thus the risk of potential reviews, investigations, and enforcement actions will also likely increase. Fortunately for the private equity industry in this respect, more regulatory focus will likely be on hedge funds in light of recent fraud scandals, the liquid nature of their assets and trading activities, and the ability of investors to invest in and redeem out of such funds on a fairly regular basis.

Insurance and Risk Management

Essentially, all of the various risks discussed in this chapter may be protected to some extent by insurance. At the portfolio company level, fund managers should ensure that each portfolio company has directors and officers insurance commensurate with the risks of the company, and in particular, whether it is publicly traded or privately held. Fund managers, together with their risk management advisers and legal counsel, should carefully review policies for, among other things, (i) the scope of claims covered, (ii) the amount of coverage, (iii) the persons and entities covered, and (iv) the exclusions from coverage. Most directors and officers policies contain exclusions for any conduct that constitutes dishonesty, fraud, illegal profit, or advantage. To the extent that an insurer denies coverage, such conduct may likely be outside the scope of any indemnity coverage provided by the portfolio company or by the private equity fund.

At the fund level, many insurers now provide products tailored to private equity firms that combine both “errors and omissions” coverage and directors and officers coverage. Such combined policies are intended to cover risks at the fund level and the portfolio company level. Such policies, of course, should be in addition to, and not in lieu of, any policies at the portfolio company level.

Conclusion

As noted at the outset of this chapter, the risks of litigation, liability, and loss for private equity funds and fund managers has never been greater. First, with access to large pools of capital, funds and fund managers will likely increasingly be named as defendants in litigation arising out of broken deals, securities actions, and bad investments. Second, increased regulation and regulatory oversight is essentially a certainty. Third, the nature of the private equity industry exposes funds and fund managers to risk in a number of different areas. Fortunately, as discussed in this chapter, there are a number of steps funds and fund managers can take to minimize such risks to the extent possible.

David A. Rines is a partner with Thompson Hine LLP in the firm's corporate transactions and securities practice group. He has substantial experience in private equity and venture capital financing, and he has represented a number of private equity funds, hedge funds, joint ventures, general partners, limited partners, and portfolio companies in fund formations, venture capital investments, and general operational matters. He also has significant experience in mergers and acquisitions, initial and follow-on registered public offerings, 1934 Securities Exchange Act reporting requirements, and general private and public company representation.

Mr. Rines is admitted to practice in Ohio, Massachusetts, and Connecticut. He is a frequent author and speaker on his areas of expertise, and he is a member of the American and Cincinnati Bar Associations. He earned his B.S. in physics and government, with high honors, from the University of Notre Dame and his J.D. from the University of Virginia School of Law.

Dedication: *I would like to dedicate the chapter to my wonderful family: Sheryl, Andrew, Kaitlyn, and Matthew.*



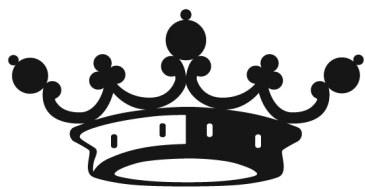
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