Fairness opinions and private equity litigation

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Private equity (PE) funds and board members appointed by them are often exposed to unforeseen legal risks when making investment decisions related to mergers, acquisitions, divestitures or financing transactions. These legal risks have been increasing in recent years due to a growing trend by plaintiffs to name funds and their appointed board members, also known as board-designees, as defendants in portfolio company litigation.[1]

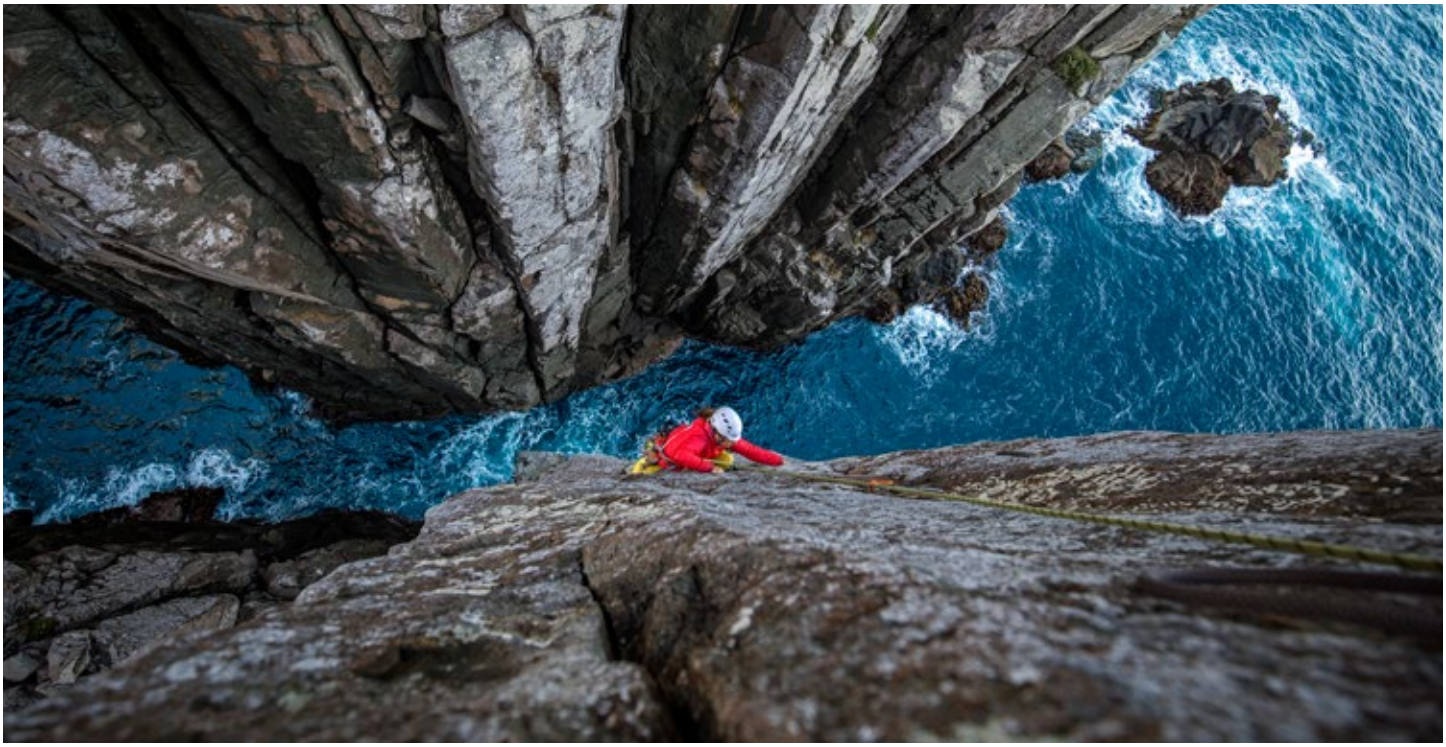
In the event of litigation, the burden of proof may be on the fund and its board-designees to demonstrate the transaction is fair to minority shareholders. In this case, a fairness opinion from an independent financial advisor can help mitigate potential liability. While fairness opinions are obtained less frequently for PE deals than for corporate deals, there are specific transaction types for which they are highly recommended given the enhanced level of scrutiny courts will implement during shareholder litigation.

1 Portfolio company litigation

Portfolio company litigation resulting from a transaction can involve both the board-designees and the PE fund. In these situations, the plaintiff shareholders are often suing the defendants for alleged breaches of fiduciary duties.

Litigation against board-designees

The appointment of a board-designee can create legal complications and incite litigation because a board-designee owes its fiduciary duties to both the portfolio company shareholders and the fund it is affiliated with.[2] During portfolio company litigation, a board-designee can be sued for alleged breaches of fiduciary duties if common shareholders feel a transaction favors the interests of the fund to their detriment. When the fund's investment in a portfolio company is in the form of preferred shares, a board-designee should consider the interests of common stockholders first since Delaware courts view the rights of preferred stockholders as contractual in nature.[3]



Litigation against the fund

When a fund is considered a controlling shareholder, it can be sued during shareholder litigation for a breach of fiduciary duties just like the board-designees. This is because the fiduciary duties owed by the board to the minority shareholders extend to a controlling shareholder when the shareholder exerts control over the enterprise in a manner similar to the board itself.[4] Regardless of its ownership stake, a fund is a controlling shareholder when it has significant influence over the portfolio company's board, either through the appointment of board-designees or personal relationships with board members.

Even if the fund is not a controlling shareholder, it can still be roped into portfolio company litigation for aiding and abetting breaches of fiduciary duty owed by the portfolio company's board members. In this situation, the plaintiff shareholders assert the fund knowingly assisted the portfolio company's board members in breaching their fiduciary duty to the detriment of the minority shareholders.[5] This type of claim may occur when the fund and the minority shareholders have conflicting interests in a transaction.

2 The entire fairness test

A PE fund and its board-designees need to be aware of not only how they can be sued by shareholders, but how their actions will be reviewed during such litigation. This is because a more rigorous standard of judicial review will increase the defendant's risk of liability.

The most stringent level of judicial review during shareholder litigation is the entire fairness test, which is implemented when a majority of the board has an interest in the transaction different from shareholders or a controlling shareholder stands on both sides of the deal.[6] The entire fairness test shifts the burden of proof from the plaintiff to the defendant, who must then demonstrate the transaction is objectively fair to minority shareholders in both dealing and price.

A PE fund or its board-designees will likely need to demonstrate the fairness of the transaction when the fund is a controlling shareholder and its economic interests diverge from the interests of the portfolio company's common shareholders. For these reasons, the following transaction types are subject to the entire fairness test:

- **Third party sale with differential consideration to various classes of equity** – a controlling shareholder entitled to a liquidation preference is conflicted because it is competing with minority shareholders for consideration during a sale.
- **Squeeze or freeze out transaction** – a controlling shareholder can acquire shares it does not already own by exercising control on both

sides of the transaction to force the sale of the remaining shares at a price lower than their intrinsic value.

- **Potentially dilutive additional round of financing by the fund** – a controlling shareholder can dilute minority shareholders by providing additional equity financing at terms favorable to the controller. This primarily occurs during down-round financings when other financing sources may be limited.
- **Other related party transactions** – a controlling shareholder can impact the value of a minority stake in the company when transacting with an affiliate. Example transactions include related party joint venture formations, lending arrangements and service agreements.

When a transaction may be subject to the entire fairness test, a PE fund and its board-designees are highly advised to obtain a fairness opinion from an independent and qualified financial advisor in order to mitigate their potential liability.

3 The value of a fairness opinion

A fairness opinion is a critical risk mitigation tool for the fund and its board-designees because it is viewed as one of the best ways to demonstrate fair price during the entire fairness test. When combined with other procedural safeguards, a fairness opinion may even rebut the entire fairness test altogether and subject the transaction to a less stringent form of judicial review.[7] This can significantly reduce legal expenses for the defendant because the entire fairness test usually results in a full trial, which can be costly and time consuming.[8]

Obtaining a fairness opinion from an independent financial advisor can help mitigate liability and reduce legal costs for a defendant, especially in transactions that may be subject to the entire fairness test. Prior to engaging in a transaction, a PE fund and its board-designees should carefully assess whether there are any conflicts of interests that may result in the entire fairness test during shareholder litigation.

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2. Simmerman, Amy and Bochner, Steven. "The Venture Capital Board Member's Survival Guide." Harvard Law, https://corpgov.law.harvard.edu/2016/12/15/the-venture-capital-board-members-survival-guide/. Accessed 16 October 2019.
3. Same as footnote 2.
4. 4 and 7. Berchem, Kerry; Deutsch, Ron and Houpt, Nicholas. "Duties of Controlling Stockholder - Murky Waters: Tread Carefully." Akin Grump Strauss Hauer & Feld LLP, June 2012, pp. 2-6.
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6. "In Re Trados Incorporated Shareholder Litigation." The Court of Chancery of the State of Delaware, https://courts.delaware.gov/Opinions/Download.aspx?id=193520. Accessed 16 October 2019.
7. Same as footnote 4.
8. "Minimizing Exposure in Controlling Sponsor M&A Transactions." Kirkland & Ellis LLP, 8 March 2017, p. 1.

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