Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Managing Legal Liabilities and Litigation Risks of Being a Fund Manager

Venture capital and private equity fund managers face an array of potential legal liabilities that arise from the many facets of their operations. While many of these liabilities are related to customary business operations, others are a product of the specific circumstances involved in operating an investment fund. In general, the risks can be categorized according to the various relationships that a fund manager enters into with business partners, employees, limited partners, portfolio companies, and other third parties. Thankfully, once identified, these risks can be mitigated through a combination of legal structuring, clear documentation, and sound business practices. The following is a brief summary of potential legal liabilities and the steps recommended to mitigate them. The list is by no means exhaustive, and in many cases a full explanation of the risks and the steps necessary to mitigate the risks identified will be beyond the scope of this article. As the facts and circumstances with respect to each potential legal liability will vary, fund managers should consult with legal counsel to ensure that they select the best mitigation strategies and take adequate precautions going forward.

Risks Arising from the Relationship Among Business Partners

Disagreements among individual fund managers are inevitable, and hopefully they do not rise to the level of disputes requiring formal mediation, arbitration, or litigation. However, we must plan for such eventualities, as they do occur. In reality, the agreements among principals in a new fund are often the last to be negotiated and signed because the priority understandably is on raising the first fund, without which there is no firm. It takes time, effort, and money and involves making uncomfortable decisions right at the outset of a new relationship. However, in the absence of clear written agreements, claims of entitlements based on undocumented oral agreements or putative partnerships will inevitably arise and cost resources to settle.

- Mitigation Strategy: The best practice is to make sure that your relationship is clearly documented at the outset, because disputes are generally born from ambiguity about the relationship, whether it's about control or economics.
- Mitigation Strategy: Utilize Separation Agreements upon a separation to clearly document waivers of all claims and any ongoing economic entitlements.

Risks Arising from the Relationship with Employees

The potential liabilities of a fund manager as an employer are generally no different than those of all other employers, and sound employment practices will mitigate such liabilities. Occasionally, employees participate in the investment opportunities of a fund manager; such relationships can be especially problematic if appropriate employment and securities laws safeguards are not put in place when such opportunities are made available.

- Mitigation Strategy: Adopt customary employment procedures such as clear offer letters with the right to terminate at will.

- Mitigation Strategy: Clearly document that principals are not employees in order to forestall employment-related claims when a separation occurs.
- Mitigation Strategy: Offer investment opportunities only to employees that are accredited investors.

Risks Arising from the Relationship with Limited Partners

Offer and Sale of Securities

The relationship with a limited partner begins with the offer and sale of a limited partnership interest. Limited partnership interests are considered securities and are therefore governed by the securities laws of the jurisdiction in which the offer and sale is made. Potential liabilities arising out of this transaction are claims of fraud or inadequate or misleading disclosures to investors and failure to comply with applicable securities laws when engaging in a private offering.

- Mitigation Strategy: Produce a thorough and legally reviewed private placement memorandum that includes risk factors, fee disclosures, and regulatory disclosures.
- Mitigation Strategy: Obtain representations from investors regarding their sophistication, financial standing, and review of and reliance on specified offering materials like the offering memorandum described above.
- Mitigation Strategy: Engage legal counsel to guide you through the regulatory requirements for ensuring compliance with private offering exemptions in the relevant jurisdictions where offers will be made. Chief among such requirements will be refraining from any public announcements, whether in writing, on websites, or at industry conferences, regarding the fundraising during the entire offering period.

Breach of Contract

Once the limited partner has purchased a security, the relationship is governed by a contract, the limited partnership agreement, and any other agreements such as subscription agreements and side letters.

- Mitigation Strategy: Adopt procedures for ensuring compliance with the myriad contractual obligations set forth in a partnership agreement and side letters. These will include compliance with investment restrictions, reporting requirements, notice requirements, economic obligations, and handling of conflict transactions. Counsel can provide a compendium of side letter obligations or annotate the partnership agreement to facilitate compliance.

Breach of Fiduciary Duty

The fund manager of a limited partnership owes a fiduciary duty to the limited partners, which is generally defined as a combination of a duty of loyalty and a duty of care. Courts have similarly found fiduciary duties are owed by managers of limited liability companies in similar circumstances. Below is a summary of the various ways in which the breach of fiduciary duty claim can arise.

Duty of Loyalty (e.g., Conflict of Interest). The duty of loyalty is primarily implicated by conflict of interest transactions where the fund manager has an opportunity to benefit itself at the expense of the limited partners. Examples of such transactions are:

> *Cherry Picking*: The fund manager coinvests with the funds it manages in only certain deals or in disproportionate amounts so that its interests are no longer directly aligned with those of the

limited partners, leading to claims that the fund manager has acted in its own self-interest rather than the best interests of the fund.

Cross-Fund Investing: The fund manager causes one fund to invest in a portfolio company of another fund. Depending on the circumstances, the danger is that a fund manager may be neglecting its duties to one fund at the expense of the other fund, which would be particularly egregious in situations where the fund manager stands to earn greater carried interest in one fund and not the other.

Other Conflict Transactions: Additional conflicts arise when a fund invests in a portfolio company in which the fund managers have a personal interest or when a fund purchases securities directly from a fund manager. Valuing assets often presents a conflict if the fund manager's carried interest or management fees are based upon such valuations.

Disparate Treatment of Limited Partners: The fund manager should take care to treat each limited partner to whom it owes a fiduciary duty in a similar manner and not benefit one at the expense of the others. Disparate treatment in the context of defaults should have a sound and reasonable business rationale and not be based, for instance, on the limited partner's relationship with the fund manager.

Duty of Care (e.g., Negligence). The duty of care is primarily implicated by the amount of time and attention paid by the principals to the fund or by investment decisions that may appear risky or reckless in hindsight.

Fund managers should take the following actions to avoid a breach of the duty of loyalty or the duty of care:

- Mitigation Strategy: Circumscribe or eliminate fiduciary duty by contract. While most limited partners and their counsel will not allow for complete elimination of the fiduciary duty, it can be narrowed, in particular by defining the fund manager's standard of care as being liable only for acts of "gross" negligence (which loosely translates as "reckless disregard") as opposed to simple negligence (which translates to "fault").
- Mitigation Strategy: Consider the use of a limited liability company instead of a limited partnership when forming the fund. A limited liability company may afford additional protection from fiduciary claims.
- Mitigation Strategy: Avoid conflict transactions.
- Mitigation Strategy: Make use of LP Advisory Committees or votes of limited partners to approve conflict transactions and waive conflicts.
- Mitigation Strategy: Adopt clear and consistent valuation policies approved by the LP Advisory Committee, if possible.
- Mitigation Strategy: Adopt internal compliance procedures for identifying and handling conflicts.
- Mitigation Strategy: Adopt a procedure for performing due diligence and approving transactions. Follow the procedures and document your steps along the way.
- Mitigation Strategy: Obtain fiduciary liability insurance.

Risks Arising from the Relationship with Portfolio Companies (and *Potential* Portfolio Companies)

Service on Boards of Directors

Service on the board of directors of a portfolio company allows fund managers to monitor and exercise greater control over a portfolio company. However, a fund manager serving on the board owes fiduciary duties to the portfolio company's stockholders that are similar to the duties the fund manager owes to the fund's limited partners, thereby opening the fund manager to claims similar to those discussed above from the portfolio company's stockholders. Another consideration is that the fiduciary duties owed to the fund's limited partners and the portfolio company's stockholders may be in conflict, which could expose the fund manager to even greater liability.

- Mitigation Strategy: Obtain indemnification from portfolio companies and ensure such companies have adequate directors and officers insurance.
- Mitigation Strategy: Comply with fiduciary duty requirements to portfolio companies.
- Mitigation Strategy: Consider resigning from the board when the portfolio company approaches initial public offering.
- Mitigation Strategy: Consider resigning from the board if the portfolio company approaches bankruptcy.

Sale or Distribution of Portfolio Company Securities

Fund managers may become the target of fraud claims in connection with follow-on financing rounds of portfolio companies or the sale of the fund's securities in portfolio companies. Such claims may arise when a fund manager fails to disclose material information regarding a portfolio company to other investors or purchasers of the portfolio company. When a portfolio company becomes publicly traded, the fund manager must also comply with the securities laws, including, without limitation, Rule 10b5 and Section 16 of the Securities Exchange Act, as amended.

- Mitigation Strategy: Adopt internal insider trading compliance policies and reporting procedures.
- Mitigation Strategy: Comply with trading windows imposed on board representatives of publicly traded portfolio companies, including for distributions from funds.
- Mitigation Strategy: Avoid making any recommendations to limited partners regarding disposition of securities distributed in-kind.
- Mitigation Strategy: Avoid disclosing any material nonpublic information to limited partners regarding publicly traded companies held in the fund's portfolio.
- Mitigation Strategy: Discourage limited partners from trading in securities of undistributed portfolio companies (e.g., hedging against the fund's position).

Financing Commitments

When negotiating financing terms with a portfolio company, a fund may create an expectation that the portfolio company will receive financing at some later date. If the financing does not occur, a portfolio company may sue the fund alleging fraud or reliance on the potential financing commitment. Liability can arise during negotiations or even after a successful financing if the fund made a commitment to future financing rounds. Statements regarding future financing commitments made by a representative of the fund manager sitting on the board of a portfolio company could also expose the fund manager to liability.

- Mitigation Strategy: Ensure term sheets and letters of intent are clearly nonbinding by use of forms with appropriate disclaimer language.
- Mitigation Strategy: Avoid expressing binding oral or written commitments for current or follow-on financing.

Misappropriation of Intellectual Property

A portfolio company seeking financing will often want to limit a fund's ability to disclose its confidential information by having the fund execute a nondisclosure agreement (NDA). However, signing an NDA can expose a fund to liability from the inadvertent disclosure of confidential information or information that is included in the NDA's overbroad definition of confidential information. For a more in-depth discussion regarding why funds should avoid signing NDAs, please see our article, *Should Venture Capital Firms Sign NDAs?*

- Mitigation Strategy: Avoid signing NDAs with potential portfolio companies.

Risks Arising from the Relationship with Third Parties

Control Person Liability

Due to a fund's large equity holdings in a portfolio company, the fund may be named as a defendant in third-party lawsuits that assert claims against the portfolio company, whether such claims are contract claims, employment claims, or otherwise. This liability argument is premised on the fact that the fund should be considered a "control person" of the portfolio company and held liable for the portfolio company's actions. However, for a plaintiff to prove that the fund is liable as a control person, it must prove that the fund exercised control over the specific action that gave rise to the claims as well as show that the fund exercises general control over the portfolio company.

- Mitigation Strategy: Avoid involvement in daily operations of portfolio companies.

Personal Liability

Principals must be careful to avoid becoming individually liable to third parties for actions taken on behalf of the fund manager or the fund. Such individual liability could result from a principal ignoring his or her different roles as an officer of the fund manager or the investment manager. Ignoring corporate formalities by failing to maintain separate bank accounts or corporate minute books evidencing the authorization of corporate acts could lead to a court finding that each principal is liable for third-party claims made against the fund manager or fund.

- Mitigation Strategy: Employ limited liability entities as fund managers or as fund vehicles.
- Mitigation Strategy: Follow corporate formalities to ensure they are respected, such as adequate capitalization, separate books and records, and no commingling of assets.
- Mitigation Strategy: Avoid use of the title of "General Partner" for individual principals as it may imply a legal status of a general partner with personal liability.
- Mitigation Strategy: Obtain indemnification from funds managed and from portfolio companies when serving on boards of directors, and maintain proper insurance.

Risks Arising from Regulation

Myriad statutory and regulatory obligations can give rise to additional areas of potential liability if not properly followed. While it is beyond the scope of this article to identify and address each one, the main areas of focus are (i) securities industry regulation, including compliance with the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, each as amended from time to time, and additional similar regulations in foreign jurisdictions; (ii) anti-money laundering and know-your-client regulations, including the PATRIOT Act; (iii) regulations imposed due to the nature of your investors or your investments, including ERISA, the Bank Holding Company Act, and FCC ownership restrictions; and (iv) compliance with tax reporting and withholding laws and regulations.

- Mitigation Strategy: Engage legal counsel in order to guide you through the regulatory requirements for ensuring compliance.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

About Morgan, Lewis & Bockius LLP
Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our regulatory and industry-focused practices help clients craft and execute strategies to successfully address legal, government, and policy challenges in today's rapidly changing economic and regulatory environment.

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