Trendwatch Series

August 2010

gowlings

Lawyers • Patent and Trade-mark Agents

The Re-birth of Private Equity in M&A and the Role of the Board

by Harold Chataway

Harold Chataway, Partner
416-862-4495
harold.chataway@gowlings.com

Harold Chataway is a partner in Gowlings' Toronto office and a member of the Firm's Financial Services and Business Law Groups. He practises in the areas of senior and subordinated debt finance, private and public equity finance, and mergers and acquisitions, in both a domestic and cross-border context.

Over the last year, strategic investors with cash or readily available credit lines have been the drivers of mergers and acquisition activity. Over this time, private equity firms have largely limited their activity to “follow-on” investments necessary to improve the weakening balance sheets of their portfolio companies or, in some cases, to facilitate growth. As economic conditions stabilize, private equity firms have been considering recapitalization opportunities to releverage their portfolio companies and receive back invested funds. As credit conditions and equity markets further improve, private equity firms are expected to re-exert their influence and rejoin the strategic purchaser in pursuing target companies.

A private equity firm will generally prefer to be majority shareholder with decision-making power over the target company. Depending on the circumstances, however, it will consider a minority shareholder position or an investment in the debt of a company with a view to taking a larger equity stake under different conditions. Minority shareholders (such as management) often participate in a transaction, and a shareholders’ agreement will typically dictate governance of the target company including “veto rights” for minority investors. The board of directors will also play a major role in a target company’s corporate governance.

Private companies with significant outside equity investors often have an active board of directors composed of representatives from the equity investors and other independent directors. Like their public company counterparts, these private company boards have a fiduciary duty to act in the best interests of the company, taking into account the competing interests of the various stakeholders. This duty is often misunderstood by directors and the public in general, who sometimes believe that the board’s duty is to act in the best interests of shareholders only, and to focus exclusively on maximizing shareholder value.

This misunderstanding can lead to problems, particularly when separate classes of shares have competing interests. For instance, the capitalization of many companies is arranged such that a preferred shareholder investor is entitled to earn a fixed return on its investment which, once realized, entitles the common shareholder to achieve a pre-determined return, following which returns will accrue to the preferred shareholder.

A board member representing either a common shareholder or a preferred shareholder is required to act and vote in a manner that satisfies his fiduciary duty to act in the best interests of the company, even if such action conflicts with the interests of his particular class of shares.

In the *In Re Trados Securities Litigation* case, private equity preferred shareholders nominated four of the seven directors to the board of a portfolio company. The board approved a change of control transaction whereby preferred shareholders, on account of their liquidation preference, and the management team, under a management compensation program, received all consideration while the common stockholders received nothing. The board of directors was sued by the common shareholders who alleged, among other things, a breach of fiduciary duty to the company. The argument was as follows: had the company been allowed to carry out its business plan and to appreciate in value, and had the board not approved a sale of the company, the common shareholders would have ultimately derived some value. The Delaware Chancery Court held in favour of the common shareholders, stating that the presumption in favor of the business judgment of the preferred directors had been successfully rebutted given the conflict of the interests between the common shareholders and the preferred shareholders. The preferred director defendants' motion to dismiss the suit was denied although a determination of the actual liability of the defendant directors will be a matter for trial at a later date.

In this example, the board of directors would have been well advised to keep a careful record of its deliberations, illustrating a sensitivity to the needs of the common shareholders and other stakeholders. It is important to remember that there are other stakeholders (such as bondholders) whose interests must be considered by a board, particularly in the context of a change of control transaction.

In the context of an acquisition or a divestiture, a board of directors should establish a special committee of the board to determine if the proposed transaction is in the best interests of the company. The special committee is often advised by independent counsel and other third party experts, and acts free of the influence of directors with an interest in the transaction.

In summary, as private equity firms increasingly resume an acquisition strategy, it is important to remember that a board is at risk if it acts under the premise that it must act in the best interests of the shareholders, or any particular stakeholder, rather than the company as a whole. Private equity investors usually occupy board seats of their portfolio companies. In their position as board members, they must be aware of the duty to act in the best interests of the company even when those actions are not expected to accrue value for their particular shareholding.

Articles and materials provided as part of Gowlings' *Trendwatch* are for information purposes only and are not be taken as legal advice. Never disregard professional legal advice or fail to seek it based on information provided here.

Gowlings is a leading Canadian law firm offering a diverse range of services to help domestic and international organizations achieve their business objectives. Recognized for excellence in business, advocacy and intellectual property law, Gowlings provides dedicated industry expertise in a number of sectors including natural resources, energy, infrastructure, government relations, life sciences, financial services, technology and manufacturing. The Firm combines traditional legal services with innovative solutions in areas such as transfer pricing and tax, and occupational health and safety, to provide business entities with a competitive advantage. Characterized by national strength and regional focus, Gowlings has over 700 professionals across offices in Montréal, Ottawa, Toronto, Hamilton, Waterloo Region, Calgary and Vancouver.

The Firm also provides intellectual property services in Russia and the CIS through its office in Moscow, and energy, resource and infrastructure expertise through its office in London, U.K. Visit us at gowlings.com.