Critical Governance Issues for Controlled Companies
By Lois F. Herzeca

In the wake of recent financial scandals involving controlling shareholders of public companies, the spotlight has focused on corporate governance at “controlled companies” (i.e., companies that have a single shareholder or group of shareholders controlling more than half of the company’s voting power). In particular, commentators have warned that controlled companies which take advantage of the exemptions from the director independence requirements under the New York Stock Exchange (NYSE) and Nasdaq corporate governance rules provide inadequate protection to public investors. In 2004 alone, over 30 companies filed initial public offerings indicating that they intend to take advantage of these controlled company exemptions. Of particular concern are those controlled companies which have dual classes of stock permitting a controlling shareholder to have a majority of the voting power with less than 50% of the economic interest in the controlled company, and which have significant related party transactions. A notable example of such a controlled company is Hollinger International, Inc., whose tangled relationship with continued on page 2
its controlling shareholder, Conrad Black, spawned countless investigations and lawsuits. Although the desirability of utilizing the NYSE and Nasdaq director independence exemptions is subject to debate, there are corporate governance measures and disclosure practices that all controlled companies can adopt that will enhance their governance structure and provide greater transparency to public investors.

A “controlled company” is defined under the corporate governance listing standards of the NYSE as a listed company of which more than 50% of the voting power is held by an individual, a group or another company. These standards provide that a controlled company is exempt from complying with the requirements of having:

- a majority of independent directors
- a fully independent nominating/corporate governance committee
- a fully independent compensation committee, and
- the requisite nominating/corporate governance and compensation committee charters.

A controlled company that avails itself of any of these exemptions must disclose in its annual proxy statement that it is a controlled company and the basis for such determination, as well as that it has elected to take advantage of such exemptions. The Nasdaq rules regarding the exemptions for controlled companies are substantially similar to the NYSE rules.

The articulated rationale for the controlled companies exemptions is that if a shareholder has majority voting control of a company, and therefore can appoint all of the directors (absent other legal or contractual restrictions), it should be entitled to appoint a majority of the company’s directors, without regard to independence issues. The greatest problem arises, however, where the shareholder has majority voting control but a lesser economic interest, so that there is a weaker alignment between the economic interests of the controlling shareholder and those of the public investors. Although a significant number of controlled companies, including Primedia Inc. and Weight Watchers International, Inc., have chosen to take advantage of the controlled company exemptions, other controlled companies, such as The New York Times Co. and Dow Jones & Co., have decided it is appropriate as a public company to abide by all of the corporate governance standards of the NYSE or Nasdaq, as the case may be, and have corporate boards with a majority of independent directors and nominating/corporate governance and compensation committees composed solely of independent directors.

Even those controlled companies that do not have a majority of independent directors, however, can adopt corporate governance measures that provide greater structural protection to public investors. They can have a chairman of the board of directors, or a lead director, who is independent of the controlling shareholder. They can establish governance and compensation committees composed solely of independent directors (i.e., choose not to avail themselves of the director independence exemptions for those committees). They can adopt corporate governance guidelines with strict policies on conflicts of interest and corporate opportunities. And, since all companies listed on the NYSE or Nasdaq (whether or not they take advantage of the director independence exemptions) must have fully independent audit committees, they can expand the role of their

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Preference Shares in French Corporations
By Frédérique Jaïs-Emery and James Gillespie

On February 10, 2005, the French government issued a decree bringing into effect a Ministerial Ordinance eliminating several special types of shares previously permitted under French law (priority shares, non-voting dividend priority shares, and investment certificates) and introducing “preferred” shares, based on a more flexible U.S. model. The Ordinance applies to all preferred shares issued after June 24, 2004, and no new shares of the three types abolished by the Ordinance may be issued unless authorized by shareholder resolutions prior to that date. The reforms instituted by the Ordinance are significant in that they substantially increase a company's options in determining the specific rights that will attach to its preferred shares.

Broad Ability to Prescribe Rights and Obligations

The classes of shares that have been eliminated were generally considered too rigid to offer companies and investors the flexibility desired for optimal corporate financing and group restructurings. By contrast, the Ordinance provides that preferred shares may have different economic and voting rights than ordinary shares, and leaves a company great flexibility in determining what those rights shall be. The rights and obligations attached to preferred shares are to be determined by the company's bylaws. Such rights can take many forms, including increased or priority dividends, preferential treatment in liquidation, the right to vote as a class to veto certain decisions, and board representation. Such rights may be granted permanently or for a fixed period of time.

Voting Rights

One of the most dramatic changes instituted by the preferred share provisions is the right to issue shares having less than one vote per share. Traditionally, French law has required that all shares be treated equally for voting purposes, in strict proportion to their share of the company's capital. Pursuant to the Ordinance, however, preferred shares' voting rights may be modified by the company's bylaws. Voting rights can be reduced, suspended until the occurrence of a specific event (such as a default), or eliminated completely, except in special meetings of preferred shareholders. However, preferred shares can probably not be granted more votes per share than ordinary shares.

Listed companies may issue non-voting preferred shares, but such shares are to be limited to one-quarter of the company's capital; non-listed companies may issue up to one-half of their capital in the form of non-voting preferred shares. The issuance of preferred shares with voting power is not subject to a cap. In the case of a merger or spin-off, the holders of preferred shares must approve the transaction separately from the ordinary shareholders if an exchange for equivalent preferred shares is not possible.

Conversion and Redemption

Significantly, the Ordinance explicitly permits the creation of convertible preferred shares. The terms for the conversion of the preferred shares may be established in the bylaws or may be determined by the shareholders' general assembly.

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In general, the Ordinance provides that the issuer’s bylaws may prescribe the conditions for the repurchase of preferred shares. In the case of listed preferred shares, the Ordinance requires that holders of such shares be given the right to put their shares to the company if the market is illiquid. The Ordinance does not define the term “illiquid”, and this question will need to be resolved by companies’ bylaws, subject to any regulations promulgated by the French securities authorities.

**Shares with Rights Associated with Parent and Subsidiary Companies**

The Ordinance also permits companies belonging to corporate groups to issue shares that give voting rights concerning other members of the group. For example, a majority-owned subsidiary may issue preferred shares that confer voting rights in its parent company, and conversely, the parent company may issue preferred shares with voting power in its subsidiary. The issuance of such preferred shares must be approved by the shareholders of both companies involved.

**Requirements of Issuance**

The issuance of preferred shares is subject to certain limitations. The company's shareholders must approve the issuance, and the company's auditors must review the transaction. If named shareholders will receive the new preferred shares, the auditors must provide the shareholders with a special report on the rights attached to the preferred shares and the value of the consideration received by the company. The issuance must be approved by a special vote of the shareholders, with the new preferred shareholders abstaining. Similarly, if ordinary shares are to be converted into preferred shares, the holders of such ordinary shares must abstain from the shareholders’ vote approving the conversion. Creditors with claims arising prior to the conversion of ordinary shares into preferred shares can formally oppose the conversion if it would result in the reduction of the company’s stated capital.

French preferred shares, like common shares, must have preferential subscription rights to subsequent issuances of shares of the same class, though a shareholders meeting may suppress this right in the context of a capital increase or decrease.

**Limitation on Dividends**

Despite the fact that the reforms put in place by the Ordinance are based on a U.S. model, French preferred shares will not be identical to their U.S. equivalents. French companies may not declare dividends if they have no “distributable profits”, i.e., net profits after subtracting prior losses and adding prior reserves. U.S. corporations, in contrast, may pay cash dividends even if there is no such net surplus, so long as there are profits in the current fiscal year. French corporations without distributable profits are also forbidden to pay PIK dividends, in contrast to American corporations. French law does, however, permit preferred dividends to accrue in years in which no dividend is paid.

The creation of preferred shares in French corporate law is a welcome reform. The regime established by the Ordinance provides significantly more freedom than the previous system, and should facilitate the structuring of private investments in French companies. Certain legal questions have not yet been resolved, but shareholders and new investors should both benefit from the increased flexibility.
Maintaining VCOC Status When Using Hybrid Instruments in International Transactions

By Richard I. Ansbacher

A private equity fund with U.S. pension plan investors generally must structure its investments so that the fund qualifies as a venture capital operating company (VCOC) and the assets of the fund are not deemed pension plan assets under the Department of Labor regulations under ERISA. Planning and an understanding of the VCOC rules are essential when the fund is making investments in non-U.S. companies, as many of these investments involve the use of a hybrid instrument that is considered debt from a local, non-U.S. law aspect, but equity for U.S. tax purposes. Although one can generally devise a structure that satisfies local business, regulatory, and tax requirements and still allow a VCOC to make a qualifying investment, a private equity fund must carefully analyze hybrid investments and structures to address the implications for the fund’s VCOC analysis.

VCOC Rules

Prior articles in Fried Frank PEP Talk™ have detailed the requirements that investments by a private equity fund must satisfy in order to allow the fund to qualify as a VCOC. In very general terms, for a fund to qualify as a VCOC, over half of its investments (based on cost) must be investments in “operating companies” with respect to which the fund has direct contractual management rights and the fund must regularly exercise such rights with respect to at least one of its investments. An “operating company” is a company that engages directly, or indirectly through majority-owned subsidiaries, in the production of goods or the provision of services (other than the investment of capital). When making international investments with hybrid instruments, the way in which “majority-owned subsidiaries” is to be interpreted can affect how the deal must be structured.

Illustrative Example of Using Hybrid Instruments

The following is a typical example of the use of hybrid investments by private equity funds: Three private equity funds joined together to buy 100% of a European target company (or a single fund comprised of three separate investment vehicles). For non-U.S. tax reasons, the investment is structured with a relatively small portion of the investment made in ordinary common stock with the rest of the investment made in preferred equity certificates, which are instruments that are junior to third party creditors and that pay or accrue a periodic payment that will be treated as interest expense for Luxembourg tax purposes. The common stock investment is made into a top-tier Luxembourg holding company (Topco), which makes a corresponding common stock investment into another Luxembourg holding company (Midco). The funds invest in preferred equity certificates issued by Midco and not Topco—which is done in order to protect the deductibility of the interest on the preferred equity certificates under Luxembourg tax law. Midco uses the proceeds of Topco’s common stock investment and the funds’ preferred equity certificate investment to make common stock and preferred equity certificate investments (on back-to-back terms) in the target company. See the diagram below:

diagram...

diagram...
In order to avoid potentially adverse U.S. tax consequences to the U.S. investors in the funds, the preferred equity certificates are structured so that they are to be treated as equity (rather than debt) for U.S. tax purposes. The amount of the funds' investment that will be made in preferred equity certificates (instead of common stock) depends primarily on non-U.S. tax and regulatory considerations, including any applicable thin capitalization rules.

**VCOC Analysis**

The first step in the VCOC analysis is to determine which of the companies in the investment structure will be operating companies. This determination depends on whether the preferred equity certificates will be treated as a debt investment for VCOC purposes (i.e., the way they are treated under local law) or as equity (i.e., the way they are treated for U.S. tax purposes). Regrettably, there is no legal authority for determining which (if either) of these characterizations the VCOC rules would follow.

If the preferred equity certificates are treated as debt for VCOC purposes, Topco would be an operating company, since the target would be a wholly owned indirect subsidiary of Topco. Accordingly, if Fund 1 enters into a management rights agreement with Topco, Fund 1’s common stock interest in Topco would be a qualifying investment for VCOC purposes. In addition, Midco would also be an operating company, since Target would be the wholly owned subsidiary of Midco. Accordingly, if Fund 1 enters into a management rights agreement with Midco with respect to Fund 1’s preferred equity certificate investment in Midco, Fund 1’s preferred equity certificate investment would also be a qualifying investment for VCOC purposes.

If, on the other hand, the preferred equity certificates are treated as equity for VCOC purposes, the VCOC continued on page 17
Lock-ups and Lock-outs: Orman v. Cullman Provides Guidance on the Use of Voting Agreements as Deal Protection

By Robert C. Schwenkel, Philip Richter, and Abbott Cooper

When acquiring (or selling) a public company, one of the most negotiated aspects, along with economic terms and conditions, is deal protection. The importance of deal protection to buyers is clear: buyers are rarely willing to act as “stalking horses” for higher bids, nor do they wish to expend the resources necessary to sign up a deal without assurances that it will be completed or, at the very least, that the buyers will be compensated for their efforts. For financial buyers who are often precluded (due to constraints imposed by leverage ratios) or disinclined (in order to protect expected returns) from engaging in a bidding war with an interloping third party, protecting an agreed-upon deal may be even more important, particularly when the interloper is a strategic buyer who may be willing to pay a higher price as a result of synergies unavailable to financial buyers. While there are a wide range of contract terms, including termination fees, no shop/no talk provisions, and “force the vote” provisions, that may be used, alone or in combination, to safeguard a deal from an interloping third party, one of the most effective ways to protect a deal is a voting agreement. Where a target company has one or more significant shareholders (other than institutional holders such as mutual funds), it is common for the buyer to require that, as an inducement for the buyer to enter into the transaction, those shareholders agree (i) to vote for the agreed upon transaction, (ii) to vote against any other competing transaction and (iii) not to sell their stock during the term of the agreement, thereby “locking up” some material portion of the target shareholder vote needed to approve the transaction.

The extent to which a deal can be “locked up” through voting agreements and other contract provisions was the focus of two recent Delaware cases, Omnicare, Inc. v. NCS Healthcare and Orman v. Cullman. In the first case, in a ruling that surprised many in the M&A community, the Delaware Supreme Court struck down a voting agreement that locked up a majority of the target’s vote. The facts in Omnicare were particularly stark: the holders of a majority of the target’s vote were committed to vote for the transaction and the merger agreement obligated the target’s board of directors to submit the merger agreement to the target’s shareholders for their approval, even if the target’s board no longer recommended the merger (a so-called force the vote provision). In addition, the merger agreement did not provide a fiduciary out permitting the target’s board to terminate the agreement in order to accept a higher bid. In the face of a topping bid made by a particularly unwanted suitor, the Delaware Supreme Court struck down the voting agreement in Omnicare as invalid and unenforceable since it rendered the target shareholder approval “a fait accompli;” the outcome of the shareholder vote was guaranteed since the required shareholder approval had, in effect, already been obtained and the target’s board could neither terminate the merger agreement nor fail to submit the merger agreement for shareholder approval.

When issued, the Omnicare decision generated significant comment and was widely questioned. In particular, there was considerable speculation as to whether the decision would be confined to the particular facts of the case (i.e., more than 50% of the target shareholder vote locked up, no fiduciary out, and a force the vote

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provision) or expanded to apply to other instances in which voting agreements assume a portion of the shareholder vote will vote to support a proposed transaction.

Based upon the recent decision of the Delaware Chancery Court in Orman, it appears that the Omnicare decision will, as hoped for by one of the dissenting Justices in the Omnicare case, “be interpreted narrowly and will be seen as sui generis.” In Orman, the Delaware Chancery Court was confronted with a similar situation as faced the court in Omnicare, viz., shareholders controlling a majority of the target’s voting power had agreed to vote their high vote shares in favor of the transaction and against any competing transaction and the target had agreed to a merger agreement with a force the vote provision and no fiduciary out. However, unlike in the transaction at issue in Omnicare, the Orman transaction required the approval of a majority of the minority shareholders, effectively giving the public shareholders a veto over the transaction. Specifically, the transaction was subject to the approval of the low vote shareholders, and the controlling shareholders (those who had entered into a voting agreement) agreed to vote their low vote shares pro rata in accordance with the vote of the low vote public shareholders. At the same time, the controlling shareholders in Orman agreed to vote their shares against any alternative transaction for eighteen months following any termination of the merger agreement. Thus, while the voting agreement permitted the minority shareholders to vote down the transaction, it foreclosed the possibility of any competing transaction being completed for at least eighteen months.

In upholding the voting agreement, the Court in Orman relied upon three significant points:

- Majority shareholders, in their capacity as shareholders, have no duty to sell their stock, even if the sale would profit the minority, and have “an absolute right to sell or exchange their shares with a third party at any price.”
- The bidder insisted upon, and would not proceed without, adequate deal protection, and because the transaction would not have occurred without the voting agreement, the voting agreement was “an integral part of the merits of the transaction” and, therefore, not impermissibly coercive.
- The voting agreement did not render the required target shareholder approval a foregone conclusion since the public shareholders were free to reject the proposed transaction (albeit with the knowledge that no other transaction would be available for at least eighteen months).

The decision in Orman illustrates a type of deal protection offered by voting agreements that is acceptable following Omnicare and reiterates the right of significant shareholders to sell (or not sell) on terms of their own choosing. Specifically, so long as the outcome of the target’s shareholder vote is not preordained (or, alternatively, the target’s board can terminate the agreement to accept a better deal) a voting agreement with significant shareholders, in their capacity as shareholders, should be upheld, even if it precludes an alternate transaction for some period of time, if the voting agreement is “an integral part of the merits of the transaction.” Perhaps most importantly, however, Orman acknowledges the importance of deal protection to sellers (as well as buyers) in agreeing to enter into a transaction. ■
Takeovers of Public Companies in the United Kingdom

By David J. Sheldon and Jonathan Woolf

Introduction

Many U.S. private equity sponsors continue to look to Europe and the United Kingdom for investment opportunities, including acquisitions of publicly traded companies. Private equity investors weighing the merits of an investment in a U.K. publicly traded target should be aware that, due to a different regulatory regime and market practice, there are certain significant differences facing a bidder conducting a public bid under U.K. takeover rules when compared to U.S. takeover rules. This article gives some brief background on the U.K. regulatory regime and market practice, then examines those key differences.

Background to U.K. Takeover Regime and Market Practice

Regulation of Bids

Bids are regulated by the City Code on Takeovers and Mergers (the Code). The Code does not technically have the force of law, but in practice all participants in bids accept it as if it did. The U.K. courts will also not interfere during the course of a bid as a matter of policy, so the ability of parties to litigate while the outcome is in the balance is very limited.

The Code’s overriding aim is to ensure equal treatment of all target shareholders. Underlying the Code, also, is the philosophy that shareholders, not target management, should ultimately be allowed to judge the merits of a bid.

The Code is administered by the Panel on Takeovers and Mergers (the Panel) who in practice function as an adjudicator and arbiter of issues that arise during the course of a bid. The Panel takes a spirit over form approach to interpreting the Code and ruling on transaction issues and, as part of that, its policy is for corporate finance professionals, not lawyers, to take the lead in dealing with the Panel. The Panel will become involved before a proposed transaction is announced and will stay involved until it is closed. The Panel will respond in real time to questions and issues that arise in connection with a bid and both bidder and target can consult the Panel at any time.

Typical Bid Timetable

A typical U.K. bid will move through these basic stages:

• Pre-announcement negotiations between bidder and target board
• Announcement of a formal bid
• Making of a formal bid to shareholders by the dispatch of formal documentation
• Closing of the bid
• Payment of consideration, and
• Compulsory acquisition of shares of non-tendering holders if possible (i.e., a backend squeeze-out), and the granting of security interests for any acquisition debt, again, if possible.

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Commitment at Announcement

Permitted Conditionality

As in the United States, bids in the United Kingdom are typically made subject to a raft of business and other conditions. However, the Panel will only allow subjective conditions to be invoked in extreme circumstances, and so for practical purposes bidders are committed to close once a bid is announced.

The Panel’s position means, in practice, that there is no financing condition and that there are no market or target material adverse change conditions to U.K. takeover bids.

A limited number of objective conditions are permitted:

- Acceptance conditions: an offer must be conditioned on a majority of target shares being tendered and may be conditioned on up to 90 percent being tendered. Normally offers are made conditioned upon 90 percent of the shares being tendered, with the bidder reserving the right to reduce the required amount of tendered shares to a simple majority of the shares outstanding.
- Regulatory conditions: if E.U. or U.K. antitrust approval is needed, it must be a term of the offer that the bid will lapse if this approval is not forthcoming at the first stage.
- Shareholder conditions: where the bidder is publicly held, a bid can be conditioned on the approval of bidder shareholders to the making of the bid. If non-cash consideration that requires bidder shareholder approval is part of the offer (e.g., listed shares), this approval can also be a condition to the bid.

Financing—Certain Funds

The inability to have a financing condition in a bid means that, on announcement, the bidder’s financing must be on a “certain funds” basis for at least the duration of the bid. In practice, therefore, a bidder’s debt and equity financing must be fully committed at announcement of the bid. This usually means full debt facilities and equity agreements, with limited conditionality, will be signed no later than immediately prior to a bid being announced.

In addition, the bidder’s financial adviser is required to confirm that the bidder has all the cash available that would be necessary to pay for 100 percent of the shares for which the bid is made. If the financial adviser fails to take reasonable steps to establish that this is the case, it will itself be liable to pay the bid consideration. Unsurprisingly, therefore, the financial adviser will instruct its own legal counsel to confirm certain funds by undertaking due diligence on all relevant debt and equity financing documents.

Exclusivity

Duties of Target Board

The target board will negotiate with a bidder on behalf of target shareholders. Nearly all bidders will seek a recommendation (even if they end up making a hostile bid). The target board’s basic fiduciary duty during a bid is to act in the best interests of its shareholders, not in the directors’ interests. Its assessment of any proposed bid should therefore center on price and certainty of closing.

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The Problem of “Corporate Opportunities”—Managing Potential Conflicts of Interest Between a Private Equity Fund and Its Portfolio Companies

By Karen C. Wiedemann

Private equity professionals serving on a portfolio company board often face the issue of how to manage potential conflicts of interest arising out of the professional’s day to day business: conflicts between the fund and a portfolio company or between different portfolio companies. One challenging area involves business opportunities that are potentially of interest to a portfolio company but that the private equity firm may wish to pursue separately. If a private equity firm with representatives on a portfolio company board becomes aware of an available acquisition candidate that is in the same or similar business as the portfolio company, or a business that the portfolio company chooses to enter, may the private equity firm pursue the acquisition? Or do the firm representatives sitting on the portfolio company board have an obligation to present the deal to the company? What if the acquisition is potentially of interest to more than one portfolio company?

This article discusses the Delaware doctrine of corporate opportunity and makes some practical suggestions for managing the corporate opportunity issues that arise in private equity investments in a way that will preserve the private equity firm’s ability to protect proprietary information and dealflow, maintain the ability to invest outside the “club” formed for any particular transaction, and generally allocate investment opportunities as it sees fit. These suggestions should allow private equity firms and their portfolio companies to continue to benefit from the guidance and assistance available through fund representation on the board while protecting the core private equity business. While the article is focused on private equity investments, the suggestions also apply to joint ventures or other similar arrangements where investors in a particular business wish to preserve the ability to make related investments outside that business.

Corporate Opportunity Doctrine

The Delaware law doctrine of “corporate opportunity” distinguishes between business opportunities that are personal to the directors and officers of a corporation and can be pursued by them in any way they choose and “corporate opportunities”, which properly belong to the corporation. Corporate opportunities cannot be pursued in a manner that advances the individual interests of a corporate fiduciary, such as a director or officer, to the detriment of the corporation. Misappropriation of a corporate opportunity is a breach of the duty of loyalty and can give rise to an obligation to pay damages, including amounts in compensation for any corporate resources expended in pursuit of the opportunity and disgorgement of profit realized from the opportunity.

In its most often cited formulation, a corporate opportunity may not be taken by an officer or director as his or her own if:

• the corporation is financially able to exploit the opportunity
• it is within the line of business of the corporation
• the corporation has an actual or expectant interest in the opportunity, and
• the director or officer, by taking the opportunity, would be placed in conflict with his or her duties to the corporation.

This standard casts a very broad net, and case law in the area does little to guide decision-making. It is easy to argue that any acquisition or project that is related or potentially related to a company’s business could be considered a corporate opportunity.
viewed as a corporate opportunity that should be presented to the company first, and pursued by a director or officer only if the company rejects it.

**Sourcing in Corporate Capacity Is Not a Requisite; Shareholder Veto Is Not an Exception**

It bears noting that the test for corporate opportunities discussed above does not require that a business opportunity come to a director in his or her capacity as a corporate insider. The fact that a potential transaction has come to the attention of a private equity fund through its normal deal flow, as opposed to a company-specific contact, is not by itself enough to enable the fund to pursue the opportunity freely.

It also bears noting that a transaction that can otherwise be vetoed by the private equity fund acting in its capacity as shareholder may still be a corporate opportunity. If the fund, as a major or controlling shareholder, could prevent the corporation from availing itself of the opportunity—by, for example, vetoing the transaction itself or the financing required to complete it—one may be tempted to conclude that the portfolio company would not be financially able to exploit the opportunity or would have no expectant interest in it. There is arguably no real decision for the board to make and therefore no possible conflict between the interest of the corporation and its directors. Delaware precedent, however, does not fully support this view; more analysis is required.

**When Is an Opportunity Not a “Corporate Opportunity”?**

Under the relevant case law, there is a corollary to the corporate opportunity doctrine that sets out circumstances when an individual officer or director is permitted to exploit an opportunity personally. There is no corporate opportunity issue if:

- the opportunity is presented to the officer or director in his or her personal and not corporate capacity
- the opportunity is not essential to the corporation
- the corporation holds no interest or expectancy in the opportunity, and
- the director or officer has not wrongfully employed the resources of the corporation in exploiting the opportunity.

This standard is helpful in providing the touchstones of an opportunity that may be pursued by insiders free from doubt about their obligation to a corporation. However, the practical application of this standard is limited since it is applied in the conjunctive (i.e., all four elements are required to qualify for this “safe harbor”). Since the question of corporate opportunity generally arises in circumstances where one could at least argue that the opportunity was essential to the corporation, or that the corporation had some interest or expectancy in the opportunity, these two elements are difficult to satisfy. Thus, these tests often function only as elements in a weighing of facts and circumstances.

**Pre-Clearance of All Opportunities May Not Be Practical or Desirable**

In light of the uncertainty suggested under the case law, what steps can a company or a group of shareholders take to ensure that potential corporate opportunities can be handled in a way that provides clarity and certainty for all involved? The most obvious route is to require presentation of all potential opportunities to the company’s board of directors. The board would be given the chance to consider every opportunity as it arose, and no possibility of conflict could arise where the board turned a matter down after full and appropriate disclosure. While this may be the safest choice, it is not always practical or desirable. Problems with such an approach include:

**Protection of Transaction Sourcing**

The ability of private equity firms to develop and uncover investment opportunities is a proprietary asset of a private equity firm, and is not an asset that private equity firms will be anxious to share with portfolio

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Survey of Portfolio Companies of Private Equity Firms

By Michael A. Levitt and Kevin M. Bloss

In the Winter 2003 issue of Fried Frank PEP Talk™, in an effort to understand how private equity firms were reacting to the Sarbanes-Oxley Act of 2002 and related corporate governance initiatives, we surveyed the board and committee composition of 95 publicly traded portfolio companies of major U.S. private equity firms where the private equity investor owned at least 15% of the voting equity. Now we have updated this survey for 2004 proxy filings. We reviewed the board and committee composition of 100 publicly traded portfolio companies of major U.S. private equity firms where the private equity investor owned at least 15% of the voting equity.

Major conclusions we reached while conducting our update were that: 1) over half of the private equity designees were deemed independent notwithstanding their respective firm’s equity stake in the company, suggesting that companies are not basing their independence determinations solely on the percentage of the private equity firm’s beneficial ownership, and 2) private equity designees were 50% less likely to serve on audit committees than they were last year, suggesting that private equity firms may be actively steering those designees away from audit committee membership. Major results of our updated survey include the following:

Average Board Size

The average board of the 100 companies in our survey consisted of approximately 8.5 directors, with an average of two directors representing private equity funds. This is consistent with our 2003 survey.

Number of Private Equity Director Designees

Of the 100 companies, 89% include at least one representative of private equity funds, including 26 with one designee, 30 with two designees, 14 with three designees, 8 with four designees and 11 with more than four designees. This is consistent with our 2003 survey and shows that private equity investors are staying on boards despite a perception of enhanced risk to directors of public companies.

Audit Committees

All 100 companies had an audit committee. These audit committees consisted of an average of approximately three members. Only 14 of the 100 audit committees included at least one private equity designee. In last year’s survey 31 of the 95 audit committees included at least one private equity designee, suggesting that private equity designees are becoming less likely (or willing) to serve on audit committees.

In addition, of the 13 companies in our survey with private equity investors affiliated with investment banks, only 3 audit committees included representatives of the investment bank-affiliated private equity firm; this is similar to last year’s survey (5 of 21 audit committees included representatives of the investment bank-affiliated private equity firm). We believe that some investment bank-affiliated private equity firms may not want their representatives to serve on audit committees because investment banking fees might jeopardize the independence of these audit committee members under SEC rules.

Compensation Committees

Ninety-nine of the 100 companies had a compensation committee. These compensation committees averaged

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approximately three members. Approximately 79% of the compensation committees included at least one private equity designee. These results are consistent with our 2003 survey.

**Nominating Committees**

Sixty-three of the 100 companies had a nominating committee, an increase from last year’s survey when only 32 of the 95 companies in our survey had a nominating committee. This reflects the effectiveness of the new NYSE rules that require nominating committees and the new Nasdaq rules that require that nomination decisions be made either by a nominating committee or by a majority of the independent directors. The nominating committees in our survey averaged approximately 3 members. Approximately 54% of the nominating committees included at least one private equity designee, compared to approximately 75% in our 2003 survey.

**Executive Committees**

Only 25 of the 100 companies had an executive committee. These executive committees averaged approximately four members. Approximately 93% of the executive committees included at least one private equity designee, with each executive committee averaging approximately 1.5 director-designees of private equity funds. These results are consistent with our 2003 survey.

**Financial Experts**

Eighty-four of the 100 companies specifically identified an audit committee financial expert in their proxy statements. Private equity fund director-designees served on 14 audit committees and in 6 of them they were identified as the audit committee financial expert. At the time of the 2003 survey, when the audit committee financial expert was not yet a requirement for most companies, only 19 of the 95 companies identified an audit committee financial expert in their proxy statement.

**Code of Ethics**

Ninety-five of the 100 companies disclosed that they had adopted a code of ethics for their senior financial officers. In the 2003 survey very few companies had disclosed a code of ethics because that requirement had not yet become effective.

**Independence**

Of the 217 director-designees of private equity funds serving on the boards of the 100 companies we surveyed, approximately 53% were identified as independent, approximately 13% were identified as not independent and the independence status of the remainder was not clearly addressed in the public filings. In the 2003 survey, of the 223 director-designees of private equity funds serving on the boards of the 95 companies reviewed, approximately 16% were identified as independent, approximately 11% were identified as not independent, and the independence status of the remainder was not discussed. The NYSE and Nasdaq both included statements in their final rules that the mere ownership of stock should not in and of itself determine whether a director is independent. Our data show that companies are still frequently considering the director-designees of private equity firms to be independent.

**Controlled Companies**

Twenty-two of the 100 companies were eligible to be “controlled companies” because one person or group of persons owned more than 50% of the common stock. Controlled companies are not required to have a majority of independent directors or all-independent compensation and nominating committees. Of the 22 eligible companies, 17 elected to utilize the controlled company exception.
audit committees to include greater legal and regulatory oversight and appoint a corporate compliance officer who will report directly to the audit committee. Similarly, they can appoint fully independent special committees of the board of directors to consider related party transactions and other matters where there may be conflicts with the controlling shareholder. Most importantly, controlled companies can have more than a token number of independent directors; they can have a significant number of strong independent directors who are forceful in safeguarding the interests of public shareholders. As the Delaware Chancery Court in *Hollinger Inc. v. Hollinger International, Inc.* dryly observed in commenting on the directors appointed by the controlling shareholder, Conrad Black: “Despite their distinguished careers, the outside directors of Hollinger International were not, to put it in an understated way, universally perceived as effective monitors of Black. This perception triggered the course of events that resulted in this (and other) cases”, alluding to numerous allegations of self-dealing involving non-compete payments and management contracts discussed in the court’s opinion.

In the current environment, controlled companies, but particularly those which avail themselves of the independence exemptions, have a greater need to be proactive on disclosure. Such companies should be particularly forthcoming in their annual reports and proxy statement disclosures, notably in the areas of executive compensation, related party transactions and legal proceedings, so as to provide a clear picture of their relationships with their controlling shareholder.

Alan Beller, the Director of the Division of Corporation Finance of the Securities and Exchange Commission, in a recent speech before the National Association of Stock Plan Professionals and the Corporate Counsel, strongly urged all issuers to provide transparent and full disclosure in the executive compensation area. In particular, Mr. Beller noted that executive compensation disclosure too often seeks to provide as little information as possible while seeking to avoid liability. Item 402 of Regulation S-K requires “clear, concise and understandable” disclosure in the proxy statement of all plan and non-plan compensation “awarded to, earned by or paid to” the named executive officers and directors “by any person.” In the case of controlled companies, this would include compensation awarded or paid by the controlling shareholder. Therefore, participation in parent employee benefit plans, use of parent aircraft or housing, or similar arrangements must be disclosed.

As reflected in the recent SEC enforcement proceeding against General Electric Company, it is not sufficient to simply disclose that an agreement or arrangement has been entered into. The company must provide sufficient detail so that it fully and accurately describes the financial impact of the compensation arrangement, allowing the reader to understand the nature and amount of any contractual commitments. In the General Electric proceeding, the SEC noted that General Electric had included in its proxy statement disclosure to the effect that the board of directors had agreed to provide Chairman and CEO Jack Welch with “continued lifetime access to Company facilities and services comparable to those which are currently made available to him...”
by the Company”, and had filed as an exhibit to the Company’s Form 10-K a copy of Welch’s employment and post-retirement consulting agreement. The SEC found, however, that General Electric had violated the Securities Exchange Act of 1934 because it failed to fully disclose specific information about the nature and cost (which was approximately $2.5 million in Welch’s first year of retirement) of such facilities and services.

If a controlled company elects not to have a fully independent compensation committee, there is an increased need to prepare a detailed and informative compensation committee report for the proxy statement. The report should integrate any compensation received from the controlling shareholder into the analysis of the rest of the executive’s compensation. All sources of compensation should be aggregated and compared to appropriate industry benchmarks and company performance.

Similarly, in the area of related party transactions, in response to Item 404 of Regulation S-K, it is not sufficient simply to provide the dollar amounts and a brief description of transactions between the controlled company and the controlling shareholder. Rather, the disclosure should address the financial or strategic implications of the related party transaction and any adverse impact it may have on the controlled company. For example, is the arrangement at least as favorable to the controlled company as a similar arrangement would be with a non-affiliated party? Does it impose restraints on the business of the controlled company or otherwise disadvantage the controlled company? Did the controlling shareholder receive special payments in connection with the transaction?

Another critical area of disclosure is the legal proceedings section of periodic reports. Item 103 of Regulation S-K provides that a company must describe in its periodic reports any material legal proceedings, other than ordinary routine litigation, to which the company or any of its subsidiaries is a party or to which their property is subject, and any such proceedings known to be contemplated by governmental authorities. A disclosure issue may occur if, for example, the controlling shareholder is involved in a governmental investigation and has requested that the controlled company produce documents, allow a review of files, allow the interviewing of witnesses or otherwise develop data, but the controlled company has not been specifically named in the investigation or in any subpoena. Good disclosure practices would suggest that the controlled company consider disclosure of the request either in a legal proceedings section or a recent developments section of its periodic reports. Of course, the extent of the disclosure, if any, would depend on the factual circumstances—whether the controlling shareholder had publicly disclosed the existence of the government investigation, whether the controlled company was conducting its own internal investigation and whether it had any reason to believe that it was involved in the conduct that was the subject of the government investigation.

In sum, even if a controlled company determines not to have a majority of independent directors, as a public company it can and should adopt structural safeguards in its boardroom and full disclosure practices in its SEC filings. Such measures improve accountability, minimize unpleasant surprises and reduce the risk of government enforcement actions and shareholder suits.
Maintaining VCOC Status When Using Hybrid Instruments in International Transactions

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analysis of the investment becomes much more complicated due to the lack of guidance on determining whether a company is a “majority-owned subsidiary.” Thus, while Fund 1’s preferred equity certificates investment in Midco can continue to be good, since the target would continue to be a wholly owned subsidiary of Midco, it is possible that Topco would no longer be an “operating company.” The VCOC rules do not indicate whether a “majority-owned subsidiary” is based on a parent owning a majority of the voting stock, a majority of the value or both. Accordingly, if the value of the preferred equity certificates represents more than half of the investment in Midco, it could be the case that Midco is not a majority-owned subsidiary of Topco, in which case Topco would not be an operating company. Additionally, it may not be easy to determine the relative values of the preferred equity certificates and the common stock; moreover, the relative values may change over time. The preferred equity certificates, which typically have an increasing liquidation preference in the nature of accrued interest, may increase in value by the amount of their accrued but unpaid yield, while the common stock will increase by any residual value in the target.

If there are other investors in the target other than Midco (e.g., public investors or managers), it raises the issue as to whether the “majority ownership” is met on a level-by-level basis or whether the test is applied by looking through the various levels to the indirect ownership in the target. For example, if Topco’s common stock interest in Midco represents 60% of Midco (the rest being attributable to the preferred equity certificates) and Midco owns 60% of the target, it could be argued that (a) Topco is an operating company because the target is a majority-owned subsidiary of Midco, and Midco is a majority-owned subsidiary of Topco or, alternatively, (b) Topco is not an operating company because Topco indirectly owns only 36% of the target. Although the first position may be supported by the intent of the VCOC rules, there is no authority in this regard. Thus, as a matter of prudence, a fund performing its VCOC analysis should plan on the Department of Labor and a U.S. court as following the second position.

Even if the common stock investment in Topco is not a qualifying investment from a VCOC standpoint, there should not be an issue so long as the preferred equity certificate investment in Midco is a qualifying investment, since under the illustrative example above, the bulk of Fund 1’s investment in the target will be made through the preferred equity certificates (which is what would cause the common stock in Topco to be a non-equalifying investment). Accordingly, from an overall standpoint, the investment will help Fund 1 meet the VCOC test, since such test requires only that more than 50% of the investments be good VCOC investments. If during the course of the investment the preferred equity certificates are repaid in part or in full as part of a partial exit from the investment, it could cause Midco to become a majority-owned subsidiary of Topco, thus turning the Topco common stock into a good VCOC investment.

Conclusion

The uncertainties inherent in the VCOC rules are brought to the forefront when a private equity fund engages in sophisticated cross-border strategies. It is important to ensure that each such structure is properly analyzed from a VCOC standpoint and that such analysis is done during the early stages of the planning process.
Takeovers of Public Companies in the United Kingdom

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As soon as the target board becomes aware an offer is possible, it is also obliged to appoint an independent financial adviser (typically a leading investment bank). This adviser, in practice, will see its role as advising the target board on behalf of shareholders, which acts as a check on any board that might otherwise be inclined to view bids in light of the directors’ own interests.

If there is any conflict of interest for individual directors (as for directors who are also part of a bidder’s management buyout team) the target will establish an independent committee to negotiate with the bidder and advise shareholders on the merits of any bid. Conflicted directors will be excluded from these discussions and deliberations, but will remain on the board and subject to their directors’ duties and service contract obligations.

Exclusivity—What Can be Agreed with the Target?
The target board’s fiduciary duty to shareholders means, in practice, that exclusivity for any bidder cannot be obtained. The target board will often agree not to solicit other bids during the pre-announcement, negotiation phase, usually in return for a standstill commitment from the bidder. Once a bid is announced, and the target is publicly in play, then the target board’s fiduciary duties will require the target board to discuss any approach from other bidders, even if the first bid was recommended. If a second bid is a clear improvement on price and/or certainty of closing, the target board will be forced to change its recommendation. In a competing bid situation, recommendations from target boards can change several times where revised bids are issued repeatedly.

Deal Protection and Break-up Fees
If a bid is recommended by a target board, it is now market practice for the target to agree to a break-up fee to be payable to the bidder. The precise circumstances where this would become payable are subject to negotiation, but typically this would be the case if the recommendation is withdrawn and another bid succeeds. The Code restricts the level of the break-up fee to 1 percent of the equity consideration, although well-advised targets will not concede 1 percent as a matter of course, particularly if the deal size is large, as the idea behind break-up fees is to compensate a bidder whose bid fails for its deal costs.

Irrevocable Undertakings to Accept the Bid
The Code allows a limited number of institutional shareholders to be approached by the bidder, pre-announcement, so the bidder can try to secure undertakings (which vary in how irrevocable they are and how soon they must be honored) to accept the bid. Institutions may or may not give such undertakings and they may or may not decline to be made privy to the fact of the bid or the price, as they will otherwise become subject to the insider dealing restrictions discussed below. In practice, it is now unusual for a bidder to obtain any undertaking beyond one to accept the bid if no higher price is offered; increasingly, institutions in particular are only prepared to give letters of comfort (i.e., mere statements of intention to accept the bid in the absence of a competing offer).
Target directors recommending a bid normally give wholly irrevocable undertakings to accept the offer in respect of any personal shareholdings even where the director subsequently votes to recommend a subsequent offer.

**Market Purchases**

In the United Kingdom, bidders are permitted to make market purchases during the period from announcement to closing. There are, however, various restrictions on making market purchases, as follows:

*Insider Dealing Legislation.* Generally, the possession of non-public, price-sensitive information will prevent the making of market purchases. In contrast to U.S. insider trading laws, in the United Kingdom the fact that a bid is contemplated at a particular price will usually constitute price-sensitive information in the hands of the bidder, and so will preclude purchases pre-announcement. It is possible to agree to purchases, typically done off-market with large shareholders, shortly before announcement, conditional on announcement (though the sellers will be made “insiders”), and/or make purchases on-market immediately on announcement.

*Code.* The Code contains prohibitions on share acquisitions that would take the bidder over 30 percent of a target, and on share acquisitions by a bidder holding 30 percent but less than 50 percent of a target. There are exceptions to these restrictions, key ones being acquisitions made immediately prior to and following announcements of recommended bids or acquisitions made with the target’s agreement.

*Compulsory, Unconditional Bids.* Share acquisitions also have certain consequences for a bid if acquisitions take the bidder’s stake beyond certain levels. If any person at any time (including after they have made a formal bid) acquires more than 30 percent of a target or potential target, that person is required to make a mandatory cash offer to all target shareholders, at the highest price paid over the previous 12 months, conditional only on acceptances for over 50 percent being received and any mandatory antitrust conditions.

In practice, if a bidder acquires a stake in target of just under 30 percent by making market purchases, it will generally deter most competing bidders.

*Exclusivity of Target Information—Information Disclosure*  
The Code, in seeking to ensure shareholders receive the most favorable transaction terms possible, provides that any possible bidder must be given the same information as any other bidder. If any “bona fide potential bidder” (in practice, an easy threshold to meet) makes a request for information to the target, the target is effectively required to pass on all information given to any other bidder (even if given under the terms of a prior confidentiality undertaking). In practice this will place constraints on how much information a target is prepared to divulge to any bidder and thus may limit the scope of bidders’ due diligence. For this reason and because the target, pre-announcement, will be concerned to limit the risk of leaks and business disruption, due diligence on bids for public targets is often far less extensive in time and scope than would be the case in a private acquisition.

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Financing—Security Restrictions
Due to U.K. financial assistance legislation, acquisition debt cannot be secured on target assets until some time after a bid has closed.

Under U.K. law, the grant of a security interest in target company assets to secure acquisition debt is illegal financial assistance, absent a prescribed statutory process to “whitewash” the giving of such security. If a grant of security constitutes illegal financial assistance, the security will be void, and the directors of target will have committed a criminal offense. Financial assistance issues do not arise when facilities used for purposes other than to acquire target shares are secured (e.g., working capital facilities, even if they provide working capital to the target). The whitewash procedure is typically done at the conclusion of the compulsory acquisition procedure on an offer and takes approximately six weeks from the offer going wholly unconditional. This period, although lengthy, is more protracted and more complex if the whitewash is undertaken when the target is not 100 percent owned by the bidder.

Considerations for Management Buyouts
Arrangements with Management
A fundamental principle of the Code is that all shareholders must be treated equally. Therefore, there is a prohibition on giving any particular subset of target shareholders a more favorable or “special” deal without Panel consent.

Since most private equity firms desire to partner with management, management often has a financial interest (e.g., an equity stake) in the bidding vehicle. If any members of management hold target shares, this type of arrangement requires Panel consent, which will normally be granted, although with a number of restrictions. The target’s financial adviser will also have to publicly opine that the arrangements are fair and reasonable. The Panel expects management to share equally in the risks and rewards of its equity stake (so, for example, would not permit management to have a guaranteed sale price for its new equity at the bid price). In addition, if management and the bidder collectively own more than 5 percent of a target, the Code requires that target shareholders approve any such arrangements at a shareholders’ meeting.

Information Provided by Bidder to Providers of Financing
The Code obliges a bidder undertaking a management buyout to share all information that the bidder has provided, to debt or equity financing sources, with the independent committee of the target board. This rule is designed to counteract the potential risk that management could have superior information with respect to the target than the independent committee.

Conclusion
U.S. private equity firms and investors should carefully consider the implications of the U.K. takeover rules when weighing the merits of an investment in a publicly traded U.K. target. A number of significant differences between U.S. and U.K. rules may dictate different approaches in strategy, timing, and resource allocation with respect to the planned investment.
## Comparison of U.S. and U.K. Takeover Rules

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<tr>
<th>Regulatory body</th>
<th>United States</th>
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<td>Relevant law</td>
<td>SEC</td>
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<td>Securities Exchange Act of 1934; Regulation 14A - mergers; Regulation 14D - tender offers; State corporate law</td>
<td>City Code on Takeovers and Mergers (including the Substantial Acquisitions Rules); U.K. Companies Act of 1985 and domicile-specific law</td>
</tr>
<tr>
<td>Diligence/Information</td>
<td>Targets have wide discretion to share information on a selective basis and only with bidders that target board determines are credible candidates to make competitive proposal.</td>
<td>Targets must give the same information to all “bona fide potential bidders” (low threshold).</td>
</tr>
<tr>
<td>Exchange</td>
<td>Financing Arrangements at Announcement</td>
<td>On announcement, the bidder’s financing must be on a “certain funds” basis for the duration of the bid; bidder’s financial adviser required to confirm that bidder has available cash necessary to pay for 100% of the shares for which cash is offered.</td>
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<td></td>
<td>Ability to Invoke MAE Conditions</td>
<td>Material adverse effect condition is almost always unavailable as basis for not completing offer. Panel makes determination whether condition may be invoked to avoid completing offer.</td>
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<tr>
<td></td>
<td>Break-up Fees</td>
<td>Break-up fees generally range from 2 to 5 percent</td>
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<td></td>
<td>Lock-up Arrangements</td>
<td>Large shareholders rarely grant any undertaking beyond one to accept the bid if no higher price is offered. Increasingly, institutions are only prepared to give letters of comfort. Target management and directors, however, will normally give irrevocable undertaking to accept offer (or undertaking to vote for transaction in case of amalgamation).</td>
</tr>
<tr>
<td></td>
<td>Purchases During Offer</td>
<td>Bidders are permitted to make market purchases during the period from announcement to closing, subject to certain restrictions, and with certain consequences.</td>
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companies, particularly where the portfolio company is not wholly owned or is jointly owned with another private equity firm in a club arrangement.

Confidentiality Restriction
Many opportunities are made known to private equity firms on a confidential basis, so that the private equity firm is often contractually restricted from sharing the information.

Timing Issues
It may be desirable or necessary for a private equity firm to act quickly in order to pursue an opportunity in a competitive or otherwise time-constrained situation. This may not be compatible with a board’s timing in considering the opportunity.

Proactive Management of Corporate Opportunity Issues
Section 122 of the Delaware General Corporation Law permits companies to include a provision in their certificate of incorporation or otherwise take board action—for example, by approving an agreement to which the company is party or by adoption of a special resolution—renouncing in advance any corporate interest in specified business opportunities or classes or categories of business opportunities. Private equity funds and their portfolio companies can avail themselves of the clarity and protection afforded by Section 122 in a variety of different ways.

Contractual Allocation
Equity investors in privately held companies often enter into contractual arrangements, such as shareholder agreements, partnership agreements, or LLC agreements, governing the rights and obligations of the investors. These agreements frequently contain express provisions detailing what obligations, if any, a private equity investor and its representative(s) on the board or governing body have to present business opportunities to the portfolio company. While these provisions are typically subject to significant negotiation (particularly in club deals), a typical form of starting point for this provision is set forth below.

Section [   ]. Freedom to Pursue Opportunities. The parties expressly acknowledge and agree that: (i) Each Shareholder, Sponsor Director and Affiliated Officer of the Company has the right to, and shall have no duty (contractual or otherwise) not to, directly or indirectly engage in the same or similar business activities or lines of business as the Company, including those deemed to be competing with the Company; and (ii) in the event that a Shareholder, Sponsor Director or Affiliated Officer of the Company acquires knowledge of a potential transaction or matter that may be a corporate opportunity for the Company and such Shareholder or any other person, the Shareholder, Sponsor Director and Affiliated Officer of the Company shall have no duty (contractual or otherwise) to communicate or present such corporate opportunity to the Company and, notwithstanding any provision of this Agreement to the contrary, shall not be liable to the Company or its Affiliates or Shareholders for breach of any duty (contractual or otherwise) by reason of the fact that such Shareholder, Sponsor Director or Affiliated Officer, directly or indirectly, pursues or acquires such opportunity for itself, directs such opportunity to another person, or does not present such opportunity to the Company or its Subsidiaries.

In the case of portfolio companies organized as Delaware limited partnerships or limited liability companies, investors can derive additional comfort from the fact that Delaware law permits the contractual variation of fiduciary
duties in limited partnership and limited liability agreements. Where these arrangements exist (or where a portfolio company is wholly owned by a particular sponsor), private equity investors are able to address questions of opportunities with a significant level of confidence. Joint venturers, which typically enter into agreements to govern the rights and obligations of the parties vis à vis each other and the joint venture, could similarly benefit from this approach.

**Charter Renouncement**

In lieu of a contractual arrangement among all equity holders regarding corporate opportunity, Delaware permits the matter of corporate opportunity to be addressed through a corporation's charter. This approach will be preferable where an investment is structured in a way that does not allow a contractual arrangement among all equity holders, for example, when a portfolio company has public security holders. While used relatively infrequently in the past, some private equity funds are considering this approach as a simple and efficient way to establish clear guidelines for themselves, their co-investors, and their portfolio companies. Charter renouncements are particularly beneficial for private equity firms that focus on and make multiple investments in certain industries.

Charter renouncements typically describe categories of potential opportunities in which the company expressly renounces an interest or expectation, and reaffirm that no director or officer would be liable for any breach of duty in pursuing such an opportunity or failing to present it to the company. Opportunities can be categorized in terms of line of business, geography, identity of the originator of the opportunity, identity of the recipient of the opportunity, or in any other way. For example, a provision may provide that the company renounces its potential interest in all transactions identified by its private equity fund investors (except for any that are presented to them solely in their capacity as directors of the company), which will safeguard their ability to preserve proprietary dealflow and allocate investments among portfolio companies as they see fit. Alternatively, a corporation may renounce opportunities in a particular line of business or geographic area that might otherwise be an extension of its existing business, so as to provide clear boundaries around the types of new opportunities that directors will be obliged to present for consideration.

**Code of Ethics**

Companies could also give guidance to directors by establishing standards for allocating corporate opportunities in their codes of ethics or codes of conduct. In the wake of Sarbanes-Oxley, most public companies have either adopted a new code or revised their existing code, and many private companies have implemented codes as well. Codes that address the subject of corporate opportunities frequently only refer to or restate the applicable law, which, as we have discussed, may offer little certainty or comfort to directors trying to determine what their obligations are. However, there is no reason that a board-approved code of ethics or code of conduct could not be used in the same manner as a contractual provision to set out categories of potential transactions as to which the company disclaims in advance any interest or expectancy.

In any event, portfolio companies that have a code of ethics or code of conduct should take care to ensure that the code's treatment of corporate opportunities is consistent with any related provisions in shareholder agreements, any charter renunciation provisions, or other board actions that may touch on corporate opportunity. As a general matter, actions permitted by a shareholders agreement or a charter renunciation provision should be permissible under the code of ethics without a waiver. A cross-reference to the relevant charter or contractual provision may be helpful.

**Conclusion**

The Delaware law on corporate opportunity can create pitfalls for private equity funds in their dealings with portfolio companies. Both funds and companies can benefit from forethought and proactive management of these issues, which should permit private equity professionals to conduct their core business in harmony with satisfying their fiduciary duties as directors.
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