

By SRS Acquiom

How Private Equity Manages the M&A Post-Closing Process

Abstract

In the past, private equity firms have generally served as their own shareholder representative during the post-closing period in M&A transactions, despite increasing risks and inefficiencies. This white paper explores the various personal and litigation risks and proposes a solution that allows private equity firms to maintain control of the post-closing process while shedding the associated risks and burdens.

Introduction

For decades, buyers of privately held companies have required that the sellers appoint a representative of the former shareholders to speak on their behalf with respect to certain matters that may arise following closing. These issues include the handling of claims the buyer may make for damages resulting from alleged breaches of representations or warranties, working capital adjustments, calculations of earnouts and other similar issues. Where there are multiple selling shareholders, a shareholder representative can ease the post-closing administrative process.

For a number of reasons, many times the lead investor in private equity transactions may elect to assume the role. They are often most familiar with the day-to-day operations and working capital calculations of the selling company. Also, they often own the majority share of the money at risk during the post-closing period and therefore want to maintain control over the post-closing process.

On the other hand, the work can be tedious and is rarely the best use of the investor's time. Serving as the representative can subject the individual or fund to legal and financial risks and distractions. The work is often thankless and without compensation. The optimal solution is one that allows the fund to maintain control of the material issues while shedding the nuisances, risks and burdens.

The Problems with Doing It Yourself

Serving as the representative creates significant risks for the person or entity considering serving in that role. Those risks can come from two directions. First, the representative has duties to the other shareholders and could be sued by them.

Second, the representative has risks related to the transaction and could be sued by the buyer.

Risks Related to Other Shareholders

The representative is an agent of all of the former shareholders and has a fiduciary obligation to ensure their best interests are adequately represented.¹ This agency relationship means that the shareholder representative is a fiduciary of the former shareholders² and, as a result, owes the former shareholders duties of due care, loyalty, good faith and fair dealing.³ In Delaware, the agent's fiduciary duties have been compared to, and described in the context of, those of corporate directors.⁴

This creates a risk of personal liability for the representative if he or she is found to have failed to meet the duty of care or to have been negligent or grossly negligent in the performance of duties. Because the duties of care and good faith generally require the decision maker to make informed business decisions based on "all material information reasonably available to them" and reasonably inform itself of alternative courses of action,⁵ serving as a representative is fraught with risk. This is especially true if the representative has financial interests that may diverge from other shareholders (as a result of liquidation preferences, differing needs for liquidity, the representative's ongoing or strategic relationship with the buyer or for other similar reasons) or if the representative has an acrimonious relationship with other shareholders (such as former founders).

In its decision in the case *In re Trados Inc. Shareholder Litigation*,⁶ the Delaware Chancery Court stated that directors owe fiduciary interests to common shareholders and that the deference given to directors under the "business judgment rule"⁷ might not be available when their economic interests differ. In that case, the defendants were fortunate to prevail because the judge found the transaction to be fair under the "entire fairness standard," but no director wants the risk of falling outside the protection of the business judgment rule normally afforded to them. Because the fiduciary duties of the shareholder representative are analogous to those of directors, a private equity fund may take a substantial risk in serving as the representative if its interests in post-closing economic matters differ from those of any other shareholder. The fund might be walking into an arrangement in which the business judgment rule protections are not

¹ See *Pryor v. IAC/InterActiveCorp*, 2012 Del. Ch. LEXIS 132, at *13 (Del. Ch. 2012).

² *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106, 113 (Del. 2006).

³ *Estate of Eller v. Bartron*, 31 A.3d 895, 898 (Del. 2011).

⁴ *Applebaum v. Avaya, Inc.*, 812 A.2d 880, 889 (Del. 2002); *Lazard Debt Recovery GP, LLC v. Weinstock*, 864 A.2d 955, 966 (Del. Ch. 2004).

⁵ *TVI Corp. v. Gallagher*, 2013 Del. Ch. LEXIS 260, at *40 (Del. Ch. 2013).

⁶ *Klein v. H.I.G. Capital, LLC, et al.*, C.A. No. 2017-0862-AGB (Del. Ch. Dec. 19, 2018) (Delaware has three tiers of review for evaluating director decision-making: the business judgement rule, enhanced scrutiny, and entire fairness. Under the business judgement rule, the court presumes that "the directors acted on an informed basis, in good faith and honest belief that the action taken was in the best interests of the company. On the other end of the spectrum is Delaware's most onerous standard: entire fairness. Here, the court must be satisfied that the transaction was the product of fair dealing and fair price.) [See *In re PLX Tech, Inc. Shareholders Litig.*, C.A. No 9880 - VCL (Del. Ch. Oct. 16, 2018); *In re; Trados Inc. Shareholder Litig.*, 73 A. 3d 17, 44 (Del. Ch. 2013).]

⁷ See *Smith v. Van Gorkom* 488 A.2d 858 (Del. 1985) and related.

available to it. Even if a representative is able to defeat any such claims, the process of defending yourself is often time-consuming and a significant distraction.

Risks Related to the M&A Deal and the Buyer

Serving as a shareholder representative is one of the few roles a person can assume in which there's a material risk of doing nothing wrong but nevertheless becoming personally targeted in litigation. Generally, one can be sued where his actions cause harm to another. In contrast, the buyer can sue the shareholder representative at the fund or personal level if the buyer's indemnification claim, made under the acquisition agreement, is not settled out of court. Being named as a party to a lawsuit can adversely affect the fund or person serving as representative: the obvious distraction and cost of litigation, a potentially negative impact on an ability to get a loan or insurance, and undesired disclosure requirements to limited partners or potential new investors when fundraising. Additionally, most funds would strongly prefer avoiding a public fight with a buyer they may see again on future deals.

This risk can be eliminated by simply not serving as the representative. In a recent case, the buyer in an underlying merger attempted to include both the representative and the selling shareholders as defendants in a class-action suit.⁸ A defendant class would have exposed individual shareholders to burdensome discovery obligations and added expensive complexity to the case. The representative opposed the inclusion of the shareholders, arguing that it was the only proper defendant. The judge assertively agreed, calling *"the common practice of appointing a shareholder representative . . . a helpful mechanism for resolving post-closing disputes efficiently and quickly."*

Forming a New Company to be the Representative is Not a Solution

On some deals, selling shareholders decide to form a new company (typically a limited liability company) to serve as the representative on the theory that any personal liability associated with serving as the representative will be largely eliminated because such liability will be limited to the new entity. There are, however, several pitfalls with this strategy.

First, it is time-consuming and expensive to draft, review, edit, finalize and file with the applicable state agencies all the paperwork that must be completed to form a new entity, appoint its managers, designate its owners, and specify all applicable rights, obligations and privileges of the various parties. Managing this process as the parties work to close an acquisition may be disruptive to the already substantial work and effort required in connection with a deal. After closing, the entity must then file annual reports

⁸ *Mercury Systems, Inc. v. Shareholder Representative Services LLC, et al.*, Action No. 13-11962-RGS, Dkt. #34 (D. Mass., February 14, 2014).

and tax returns and eventually be wound down. The total cost can be tens of thousands of dollars.

Second, it is questionable whether the new entity would actually eliminate personal liability. If the new entity is merely a shell that is not well capitalized and does not follow formal corporate procedures, there is significant risk that a court could “pierce the corporate veil” and find the owners or managers personally liable in the event the new entity is sued.

Third, even if there is incremental mitigation of risk, the individual managing the entity still retains the same administrative burdens that require a commitment of time and effort to properly perform.

Retaining Control Without Serving as the Representative

Given these concerns, there is the question of whether there is a way for a fund to retain desired control over the post-closing process and to protect their investment while eliminating the challenges of taking on the job directly. One solution the shareholders may consider is engaging an independent post-closing representative. This entity assumes the risks inherent in the job, and the *Mercury Systems* case makes clear this solution effectively eliminates those risks for the shareholders.

To solve for the control issues, the shareholders can specifically define in an engagement agreement what the representative must do, what communications it is required to convey to the fund or the shareholders generally, and what consents are required before it takes certain actions. The agreement can specify that the fund or a shareholder committee must be included in certain matters following closing, such as working capital adjustments. The communication requirements can include both monthly updates and immediate notification in the event of a claim or other material matter. The result is that the fund and the other shareholders are able to contractually retain the desired level of control while shedding the burdensome aspects of the job.

This is no longer an unproven concept. This solution has been employed on hundreds of deals and the process has been shown to work effectively. Many fund managers attest that such an engagement works better than assuming the role at the personal or fund level because they are able to utilize both internal resources and the resources and experience of a professional representative. The overall cost of engaging an independent representative is often less than the cost of forming, maintaining and dissolving a new company to serve as such, and having a professional representative provides greater legal protection.

Conclusion

While private equity fund managers have for decades defaulted to the assumption that they can and should serve as the shareholder representative after the sale of a portfolio company, recent developments in case law and the emergence of low-cost solutions should cause them to reconsider whether assuming the role is really their best course of action on each deal. On some transactions, there may be no alternative. But on most, ample evidence demonstrates that it is neither the best use of their time nor a risk worth assuming.

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