To: Private Equity Fund Clients

From: Fund Services Group

Date: March 8, 2004

Re: Protecting Confidential Fund Information

Recently, a great deal of attention has been devoted to the public disclosure of confidential data relating to private equity funds (including venture capital, buy-out and equity-linked debt funds) ("PEFs"). Typically, interest has focused upon the disclosure of financial performance data by limited partners that have been compelled to make such disclosure under a "freedom of information," "public records" or similar law (collectively, "FOIA").

While FOIA risks are very important, they represent only one pathway through which confidential PEF information may be improperly disclosed. This memorandum briefly highlights several of the most significant risks to the confidentiality of PEF information and identifies techniques that PEF managers can apply to mitigate those risks.

Background – The Need for Confidentiality

PEFs obtain confidential information from a variety of sources. For example:

1. Actual and prospective limited partners provide detailed information about themselves through subscription agreements and investor suitability questionnaires;

2. Prospective portfolio companies provide information concerning their finances, business plans, technology, strategy and personnel;

3. Individual PEF managers obtain highly confidential information from portfolio companies when acting as board members, board observers or interim executives; and

4. PEF managers generate proprietary data through their own research and analysis regarding investment and market conditions, trends, risks and opportunities.

In obtaining confidential information from third parties such as limited partners and actual/prospective portfolio companies, PEFs often subject themselves to a variety of legal duties to protect the confidentiality of that information. For example: (i) limited partner information may be regulated under various consumer protection laws such as the Gramm-Leach-Bliley Act;¹ (ii) information provided by prospective portfolio companies may be protected under actual or implicit agreements to use reasonable (or

¹ For additional information, see our memorandum "Continuing Compliance with Consumer Privacy Regulations," dated July 6, 2001.
greater) efforts to maintain confidentiality; and (iii) an individual PEF manager who receives portfolio company information in his or her role as a board member, executive, etc. generally will be subject to strict fiduciary duties to use and disclose such information solely for the benefit of the portfolio company. Breaching any of these legal duties may result in liability for the PEF, its managers, or both.

The improper disclosure of proprietary data generated by PEF managers also may result in financial or other harm to the PEF or third parties.

An example may help illustrate these concerns. Assume that Alice is a member of the General Partner of ABC Ventures Fund, L.P. ("ABC"). ABC has invested in portfolio company "RedChip" and Alice sits on the RedChip board. At a board meeting, Alice learns that RedChip has just lost one of its two key customers. Loss of the second customer in the near term almost certainly would cause RedChip to become non-viable as a business.

Alice returns to her office, where she has been preparing marketing materials for ABC Ventures Fund II, L.P. ("ABC II"). Based on what she just learned at the RedChip board meeting, she sharply revises downward the valuation of RedChip set forth in those materials. She then sends a copy of the marketing materials to John Doe ("Doe"), who is considering an investment in ABC II.

Doe is quite interested in valuation information regarding RedChip because another fund in which he holds a limited partner interest has itself invested in "BlueChip," a close competitor of RedChip. Doe promptly contacts that other fund which, in turn, passes the information to BlueChip. BlueChip sales people spread the word that RedChip can't be trusted to stay in business because its own venture capital backers have lost faith in them, as evidenced by ABC's downward valuation adjustment. Shortly thereafter, RedChip's second key customer shifts its orders to BlueChip. RedChip becomes non-viable, and all of its investors lose their investments.

Alice is distressed. The total write-off of ABC's RedChip investment both reduces the value of her carried interest in ABC and weakens her marketing efforts for ABC II. Her distress soon deepens when she finds that she is being sued by RedChip and its other shareholders for damage to the company. In those suits, it is asserted that she breached her duties as a director by improperly disclosing RedChip's precarious position to Doe via her valuation write-down. To complete her misery, Alice then discovers that ABC limited partners are suing her for breach of fiduciary duty to ABC by improperly disclosing information that she learned in her capacity as a manager of ABC in order to market a different entity (ABC II).

This example doesn't present nearly enough facts to determine whether Alice would be found liable in any of the suits brought against her. It does, however, identify some of the most obvious claims that could be brought against a PEF manager who fails to take appropriate steps to protect the confidentiality of critical information.

Common Problems Regarding Confidentiality

Legends. Many reports and other materials prepared by PEF managers are labeled "confidential" and include other statements to the effect that the recipient must not disclose or otherwise misuse the information contained therein. Unfortunately, there are many circumstances under which a court would refuse to acknowledge a binding legal obligation solely upon the basis of such text. For this reason, it typically is prudent not to rely upon confidentiality legends (e.g., those contained in a private placement memorandum ("PPM")) unless the recipient has actually agreed to treat the relevant information in a confidential manner.
Consent. In general, the owner of confidential information is free to consent to its disclosure. If such consent is granted to a PEF or its managers, the owner of the information typically cannot subsequently make a claim if the information is disclosed. However, obtaining consent can be difficult under certain circumstances, particularly where the owner of the information is a portfolio company and the information was obtained by a PEF manager in his or her capacity as a board member. In such cases, it may be difficult to find a party who has authority to grant such consent on the portfolio company's behalf without a vote of disinterested board members or even the company's shareholders.²

Non-Disclosure Agreements. One way to protect confidential information against improper disclosure or misuse is to obtain a formal, binding agreement (an "NDA") from the recipient of that information. It is important to note, however, that obtaining an NDA will not completely protect a PEF and its managers from liability if they lacked authority to disclose the information to the recipient. For example, if a PEF manager obtains confidential information at a portfolio company board meeting, and improperly discloses that information to a third party who executes an NDA, the PEF manager may be liable to the portfolio company and its other shareholders for any damages that result (notwithstanding the NDA). This is not to suggest that NDAs are without value in such cases. Demanding that the third party recipient execute an NDA may reduce the likelihood that damages will arise (by reducing the likelihood that the recipient will further disclose or misuse the information). Indeed, in cases where proper consent to disclose is not available, obtaining an NDA may be the only protection (albeit limited protection) available to a PEF or its managers if disclosure cannot be avoided.

FOIA. Recently, a number of courts and public agencies have held that limited partners which are governmental or quasi-governmental entities ("FOIA Entities") are required under FOIA to disclose PEF data in their possession notwithstanding that such disclosure clearly is prohibited by NDAs contained in limited partnership agreements executed by those limited partners. In many cases the disclosure was triggered by FOIA requests submitted, not by investors legitimately seeking to protect their interests, but instead by industry participants who wished to use the information for competitive purposes or news organizations that wished to sensationalize the consequences of the Internet "bubble" and its aftermath.

It is very difficult to assess the magnitude of FOIA risks at the present time. First, the law in this area is evolving rapidly as: (i) courts are being asked to determine the scope of FOIA application to PEF data (particularly with regard to individual portfolio company valuations as distinguished from aggregate portfolio performance); and (ii) legislatures are being asked to amend statutes in order to protect the confidentiality of such data. Second, there are a multitude of different FOIA laws at the Federal, state and local levels. A court ruling under California’s Public Records Act will not necessarily shed any light on the scope of FOIA laws in Michigan, Pennsylvania or New York City. Third, FOIA Entities are not ignoring this issue. They are actively exploring investment structures and techniques to make themselves more attractive as limited partners by minimizing their exposure to FOIA obligations.³

² Where PEFs or their managers hold a large percentage of a company's board seats and voting stock, it may be impracticable or even impossible to obtain a truly disinterested vote on such consent.

³ PEF managers should be wary of purported "easy fixes" to FOIA problems. We have heard suggestions, for example, that FOIA problems can be eliminated by delivering information to FOIA Entities via "read only" web pages. Unfortunately, it is not possible to deliver information via a web page in a manner that precludes the recording of such information through "screen capture" software or similar techniques. Similarly, we have heard suggestions that FOIA Entities be permitted access to information only by visiting the PEF managers' premises, and not be permitted to remove
FOIA is not the only basis upon which NDAs can be overridden. The release of information can be demanded by courts and governmental regulators in connection with lawsuits, investigations and other proceedings. While recent FOIA activity has made FOIA Entities less attractive as limited partners to many private equity firms, any limited partner may become legally obligated to disclose confidential information.

**Obligation to Disclose.** The decision to withhold or disclose confidential information often cannot be based solely upon the business judgment of a PEF or its managers. In many cases, there is a legal or contractual obligation to disclose. For example, many PEF limited partnership agreements (especially those drafted before the recent focus on FOIA issues) require that a PEF general partner deliver highly detailed quarterly and annual reports to all limited partners. Moreover, recent changes to GAAP have increased the amount of detail that accounting firms are required to include in their audit reports.

**Funds of Funds.** Over the last decade, funds of funds have become a very important source of capital for many PEFs. However, most funds of funds are structured in the same way as primary PEFs (i.e., as partnerships that accept capital from third party investors in their capacity as limited partners), and many are obligated to provide detailed annual and other reports to those limited partners. This phenomenon greatly increases the pool of parties that might improperly disclose or misuse confidential information delivered by a PEF to its limited partners.

**Electronic Communications.** The explosive growth of e-mail, websites, blogs, PDF scanners and similar communication tools has greatly increased the speed and extent to which sensitive/damaging information can propagate through the business community. Indeed, we are aware of cases in which a PEF's confidential financial statements have been published on a rogue website within days of being distributed to the fund's limited partners. Overall, the likelihood that improperly disclosed confidential information will reach the "wrong" person has increased enormously during just the last few years.

**Standard Analysis**

Whenever a PEF manager is considering the disclosure of information, he or she should address the following questions:

1. **Is the information confidential?** If so, could its disclosure result in harm to the PEF, a portfolio company, or other third party?

2. **Is it possible to obtain consent from the owner to disclose the information?**

3. **Is the proposed recipient subject to an NDA?** If not, could one be obtained? Would such an NDA be enforceable under the circumstances? Would such an NDA adequately limit potential damages resulting from the disclosure?

4. **Is there a contractual obligation to disclose the information?** Could a disclosure waiver be obtained from persons with a right to receive the information (e.g., limited partners) due to its potentially damaging nature?

documents or take notes. Under some FOIA statutes (including California's Public Records Act), such information may be deemed a disclosable public record because it is "used" by a FOIA Entity, even if it is not physically possessed by such entity.
5. Are the potential damages associated with disclosure so great that the manager should withhold the information even in the face of an obligation to disclose?

**Common Situations Relating to Confidential Information**

*Preparation of a Private Placement Memorandum or Other Marketing Materials.* PEF managers are under increasing pressure to supply a wealth of information when raising a new fund. In particular, potential investors often demand very detailed information (including portfolio company information) regarding the investment track records of individual managers.

As noted above, PEF managers should be extremely cautious about relying upon confidentiality legends and similar text in a PPM. Moreover, it is not customary in the private equity industry for PEF managers to demand an NDA from a prospective investor prior to delivering a PPM. For these reasons, PPMs should be carefully drafted to minimize the inclusion of potentially dangerous confidential information. Similar considerations apply to PowerPoint presentations and other supplemental marketing materials (even if prospective investors are not permitted to retain copies of such materials).

To the extent that prospective investors demand additional information in connection with their assessment of, or due diligence regarding, a new PEF, they should be required to execute an NDA prior to receiving such information in the form of a PPM supplement or due diligence response.

*Reports to Limited Partners.* As noted above, many PEF limited partnership agreements require the delivery of detailed quarterly and annual reports to limited partners. PEF managers should: (i) exercise care to negotiate future limited partnership agreements that include appropriate carve-outs for particularly dangerous information; and (ii) consider proposing corresponding amendments to the limited partnership agreements of existing PEFs.

Historically, many PEF managers have provided limited partners with a great deal of portfolio and other information that is not, under the terms of their limited partnership agreements, required to be provided. While this practice can be highly beneficial to the general partner/limited partner relationship, PEF managers should carefully assess all such disclosures to minimize the attendant risks.

*Disclosure of Information to the Adviser of an Actual or Prospective Limited Partner.* Many PEF investors utilize the services of professional advisers to assist with selecting and monitoring PEF investments. While some advisers (e.g., attorneys) are subject to independent duties of confidentiality, many others (e.g., certain types of investment advisers) are not. Before disclosing confidential information to the adviser of an actual or prospective limited partner, PEF managers should determine whether the adviser is subject to an adequate duty of confidentiality and, if not, obtain an NDA.

*Disclosure of Information to the Proposed Transferee of an Outstanding Limited Partner Interest.* In many respects, the proposed transferee of an outstanding limited partner interest is similar to a prospective investor at the time of a PEF's formation. Specifically, the proposed transferee typically will wish to conduct due diligence. However, once a PEF has been in operation for a significant period of time, the amount of confidential information it possesses may be much greater than at or near its formation. For this reason, it is especially important to obtain an NDA from a proposed transferee before disclosing (or authorizing the proposed transferor to disclose) confidential information.
Forms of NDA

The Fund Services Group maintains standard forms of NDA that can be quickly and efficiently tailored to address most common situations. Customized versions of these forms are available to clients upon request.

***

This memorandum is intended only as a general discussion of the information presented and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.