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## The Advisory Board as a Governance Tool in Private Equity Investments

Especially in the context of acquisitions by financial investors, an advisory board may be considered as an additional element of good corporate governance in order to implement the defined goals as effectively as possible. However, an advisory board is not only useful in situations where the interest is held by one single private equity investor. Rather, an advisory board may also add value in scenarios where a large number of investors is involved.

The following article shall give an overview of the potential use of an advisory board as a governance tool and shall provide best practice recommendations for its implementation. In accordance with the practical relevance, the presentation refers to a portfolio company in the legal form of a German limited liability company (Gesellschaft mit beschränkter Haftung – GmbH).

### What are the advantages of an advisory board?

Regarding portfolio companies held by financial investors, the following reasons may in particular drive the establishment of an advisory board:

■ The advisory board (often also referred to as „administrative board“ or „shareholders' committee“, depending on its functions) may be established as an additional corporate body between the shareholder meeting and the management of the portfolio company. On the one hand, this will often accelerate the decision-making process at the shareholder level. On the other hand, the members of the advisory board are involved more deeply in the activities of the portfolio company, by which they can therefore better focus on their tasks and thus increase the quality of their work. Finally, if conflicts arise between the management and

the shareholders, the advisory board will constitute an additional level at which the dispute may be settled before it becomes necessary to discuss the conflicts at the level of the shareholder meeting. This is particularly true in scenarios with several investors; here, an advisory board including a number of independent members, can make a valuable contribution to bridging differences.

■ In addition to taking over control and monitoring tasks, as well as the possibility of exercising management tasks, the advisory board typically acts as a consultant and sparring partner for management in daily private equity practice. For example, an advisory board composed of skilled persons is in a position of bringing external knowledge, experience and contacts to the portfolio company. Furthermore, the involvement of the advisory board may also help to identify potential deficits which may exist at the management level, for example in special situations or crises, but also in scenarios where the management simply lacks experience. This aspect is often emphasized as a particular advantage in discussions with the management in order to justify the installation of an advisory board – even if private equity investors typically also have other intentions for its establishment.

■ Additionally, an advisory board can also provide valuable input into the development and elaboration of the corporate strategic planning of the portfolio company. Experience shows that this aspect is often not particularly prioritized before financial investors enter into a target company. By means of a regular exchange with the advisory board, the management can therefore be disciplined during the term of the participation to constantly focus on strategic considerations as well.

■ Finally, the advisory board is used in certain scenarios to facilitate transitions out of or into the management of the company. For example, in the frequent case of the existing management leaving in the context of the acquisition by a financial investor, but its expertise still being required, the respective persons may be granted a seat on the advisory board rather than relying on the standard consultancy agreement. Vice versa, it is possible to elect a new executive as a member of the advisory board first, in order to facilitate the on-boarding process for a later position as managing director.

## **What is the legal framework for the establishment of an advisory board?**

In contrast to a supervisory board in a stock corporation or in a company subject to employee co-determination, there are no explicit legal provisions for an advisory board. Only if the advisory board holds functions similar to those of a supervisory board (i.e., it is endowed with a minimum of irrevocable control rights), the rules for the supervisory board in a stock corporation will apply accordingly. The specific name of the corporate body is irrelevant in this context. That being said, in many instances it will be possible to exclude the application of such statutory provisions for advisory boards.

As a consequence, the organization, rights and obligations of an advisory board can be tailored and customized in a very flexible way. On the other hand, certain legal uncertainties do exist, such as the of which rights of other corporate bodies can be assigned to the advisory board, or the scope of liability by the advisory board members.

## **How can an advisory board be implemented?**

The legal implementation of an advisory board will essentially depend on the rights and obligations to be assigned to it in detail. As a rule of thumb, the more the company's „normal“ corporate governance structure is modified, the more it is advisable to include detailed stipulations in the company's articles of association.

An advisory board, which exclusively fulfills consultancy tasks, may even be established without any reference in the articles of association (so-called advisory board *ex contractu* – *schuldrechtlicher Beirat*). Instead, it will be sufficient to pass a respective shareholder resolution and to enter into corresponding consultancy agreements with the designated members of the advisory board. On the other hand, if the advisory board shall be endowed with corporate powers exceeding the mere consultancy of the management, the articles of association should at least provide for an opening clause according to which the share-

holder meeting shall be authorized to implement an advisory board by means of a shareholder resolution. If the powers of the advisory board interfere with the statutory rights of the managing directors, or if rights attributable to the shareholder meeting under statutory provisions shall be delegated to the advisory board, it is typically advisable to stipulate this directly and explicitly in the articles of incorporation.

### **What are the rights and obligations which may be assigned to the advisory board?**

The potential powers of the advisory board will mainly depend on the functions it shall exercise. One can roughly distinguish according to whether the advisory board shall serve as a consultant to the management, whether it shall supervise and monitor the managing directors, or whether it shall exercise (limited) management tasks within the company.

An advisory board which shall, according to the intentions of the financial investor, fulfill *advisory functions* exclusively, should in particular have adequate information rights in order to be able to duly exercise its advisory duties. Although it is the general duty of the managing directors to provide the advisory board with all the information that is material for its activities, it is nevertheless advisable to provide an express reporting duty for the managing directors, as well as the obligation to consult the advisory board on specific matters. In addition, a regular reporting mechanism should be installed. On the other hand, as a consequence of the attributed information rights, the members of the advisory boards will have to be bound by a respective confidentiality obligation.

An advisory board, which is, in addition, intended to fulfill *control and monitoring tasks*, may be given a multitude of additional powers like the following:

- the establishment of a catalogue of measures and transactions for which the managing directors must obtain the approval of the advisory board before implementation;
- the definition of comprehensive and detailed reporting requirements;

- the right to issue instructions to the managing directors (in which case it is advisable to determine the interplay with instructions of the shareholder meeting, which may not be entirely excluded or replaced);
- the granting of staffing powers vis-à-vis the managing directors, i.e. the authority to decide on their appointment and dismissal as well as to conclude the related employment contracts;
- the representation of the company vis-à-vis the managing directors.

Finally, it is also possible to delegate to the advisory board *management functions* which would otherwise be the responsibility of the management or the shareholder meeting. That being said, a permanent and complete transfer of all management functions is not admissible, as is the adoption of certain fundamental measures within the responsibility of the shareholder meeting, such as amendments to the articles of association, corporate structural measures or the challenge of shareholder resolutions. As a general rule, the advisory board may, at most, be granted temporary management powers under certain circumstances, e.g. in the context of a management crisis.

In the scenario in which the shares in the portfolio company are held by several investors and an advisory board is established as an additional level for decision-making, it is advisable to shift the aforementioned control and information rights, as well as potential management powers, to the level of the advisory board in order to avoid tensions at the shareholder level. Only if this does not generate the desired result, a decision will have to be taken by the shareholder meeting. In this scenario, particular attention will have to be paid to the organization of the advisory board, e.g. with regard to its rights to appoint its members or majorities required for certain types of resolutions.

### **Which further points should be taken into account when establishing an advisory board?**

Regardless of the specific configuration of the advisory board, the following aspects are often of importance in private equity constellations; they should therefore be taken into account in any event when establishing an advisory board:

- Irrespective of the tasks of the advisory board, it should be made explicit that the shareholders shall have the right to issue instructions to the members of the advisory board. Otherwise, the advisory board members will be legally obliged to the interests of the company exclusively, which do not always necessarily coincide with the interests of the shareholders.
- As the members of the advisory board are frequently dispatched by the financial investors and are therefore expected to report to „their“ investors, an exemption from the confidentiality obligation should be provided for to the extent legally possible.
- Since the statutory provisions for the supervisory board in stock corporations are often inappropriate in private equity situations, their application should be expressly excluded. In the scenario of an advisory board endowed with control and monitoring rights, however, it should be reviewed whether or not the application of the supervisory board provisions of the German Stock Corporation Act (*Aktiengesetz – AktG*) may be acceptable in the individual case.
- With regard to a possible liability of the members of the advisory board, a D&O insurance policy in their favour should be considered. It may also be taken into account to limit the liability of the members of the advisory board to cases of intent and gross negligence.
- Finally, it may be appropriate to have any future members of the advisory board – especially unexperienced candidates – participate in a training course regarding their forthcoming tasks, rights and obligations, something that has already become common practice for members of the supervisory board in stock corporations.

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