Debevoise & Plimpton

The Private Equity Report Quarterly

Spring 2021 | Volume 21, Issue 1

From the Editors

Over the past year, the private equity industry has responded to the upheaval of the COVID-19 pandemic with tremendous resiliency and innovation. Private equity sponsors have acquired new long-term sources of capital through insurance investments, accessed the IPO market through SPACs and protected exit strategies from volatility in the debt financing market through the use of portability provisions. While these strategies were already part of the private equity playbook, the pandemic has intensified their use.

The pandemic has also highlighted the importance of nonfinancial factors in investing—not just climate change, but other environmental issues like biodiversity, and social issues, such as racial justice and economic inequality. The EU's ESG directives are thus one point in an arc tracing the evolving expectations of regulators and investors.

In this issue of the *Debevoise Private Equity Report*, we explore these developments, what they mean for private equity sponsors and the caveats to keep in mind. We hope that you will find this to be a useful guide in developing your own strategies to flourish during times of great change. We look forward to the opportunity to assist you in that journey.

SPOTLIGHT VIDEO INTERVIEW

Celebrating the Private Equity Report

- **Spotlight Interview: KKR's Susanna Berger**

  To mark its twentieth anniversary, we have added a new video section to the ***Debevoise Private Equity Report:*** **Spotlight Interviews**, featuring leading private equity figures from around the world in conversation with Debevoise partners on important industry topics of the day. In our inaugural segment, Susanna Berger, London-based Managing Director and General Counsel for KKR in Europe, speaks with Patricia Volhard, a partner in Debevoise's Frankfurt and London offices. We invite you to: **WATCH HERE** (~15 minutes).

- **SPACs: Key Regulatory Considerations for Private Equity Sponsors**

  SPACs provide sponsors with a permanent capital vehicle, access to different targets than might otherwise be available due to restrictive fund covenants, and greater access to capital through retail investors and liquidity options that are not always available to a traditional private equity portfolio company and private equity funds, allowing for the pursuit of larger targets. Despite these attractions, SPAC sponsors should proceed with some caution.

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- **SPAC Trends in the Europe Market–Are SPACs the New Entrance and Exit?**
  With the popularity of SPACs in the United States reaching fever pitch, we share our thoughts on why the strategy is so attractive for private equity, what sponsors should be wary of and whether they expect a similar uptake in Europe.

- **Locked Boxes in U.S. Practice: An Underused Tool?**
  The locked box in U.S. private M&A is a relatively foreign concept—relegated to special situations and often looked upon with suspicion by wary buyers. Is this reputation justified? Should U.S. practitioners embrace the locked box as a value and efficiency creating mechanism.

- **Insurance Investments: Key Considerations for Investors in the U.S., Europe and Asia**
  Financial sponsors have long been important providers of capital to the insurance industry, but in recent years, private equity acquisitions of insurance businesses have become more common. While this trend has been most noticeable in the United States and Europe, it is beginning to take hold in Asia as well. Private equity sponsors considering insurance investments in Asia and in emerging markets can look to lessons learned from deal experience in the United States and Europe—but need to keep in mind the quirks across different jurisdictions regarding capital, structure and reporting.

- **Portability in Debt Financing Agreements: A Helpful Tool for Private Equity Sponsors**
  Portability provisions, allowing a buyer to step into the shoes of a seller upon a change of control and leave the target's financing intact, have become a useful tool to mitigate the impact of market risk on a potential exit transaction. However, sellers need to think through the required conditions at the time they incur the debt to ensure that closing risks have been appropriately mitigated.

- **The End of Leveraged Buyouts As We Know Them? Hardly.**
  On Dec. 4, 2020, Judge Jed S. Rakoff, of the U.S. District Court for the Southern District of New York, in a decision applying Pennsylvania law, declined to dismiss breach of fiduciary duty claims against the board of directors of the Jones Group Inc. in connection with the April 2014 take-private acquisition of the company by Sycamore Partners. While the decision—*In re Nine West LBO Securities Litigation*—was only a preliminary ruling and not a decision on the merits, it has been described as a potential "game stopper for the private equity business" and a "sobering punctuation mark to a sobering year."

- **ESG Outlook for Private Equity Sponsors**
  While ESG concepts have been gaining momentum for almost two decades, the pandemic, coupled with growing concerns around climate change, has elevated its importance. This article discusses the evolution of ESG investing, provides an overview of the current regulatory landscape in Europe and the United Kingdom, and examines the potential effects of ESG developments on private equity sponsors in the short, medium and long term.

"It's been awhile. I thought I'd stop by and see how you all were doing."

This report is a publication of
Debevoise & Plimpton LLP

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SPACs: Key Regulatory Considerations for Private Equity Sponsors

Private fund SPAC sponsors have particular considerations arising from obligations to their clients.

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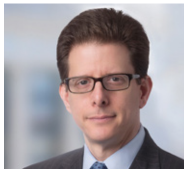
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In 2020, special purpose acquisition companies went from a niche capital markets maneuver to being in the mainstream of popular culture, garnering the attention of the media, retail investors, celebrities and regulators—while raising approximately $75 billion through nearly 250 initial public offerings. The pace has increased rapidly in 2021, with about 300 IPOs raising $90 billion in the first quarter.

Given the benefits they provide to private equity sponsors, there are good reasons for SPACs' sudden popularity. In comparison to traditional IPOs, SPACs offer a more streamlined and faster IPO process, lower financial transaction costs, greater control over deal terms, the management expertise of the sponsors and less uncertainty in pricing due to their simplified price discovery process. SPACs also provide sponsors with a permanent capital vehicle, access to different targets than might otherwise be available due to restrictive fund covenants and greater access to capital through retail investors and liquidity options that are not always available to a traditional private equity portfolio company and private equity funds, allowing for the pursuit of larger targets. Finally, SPACs generally require fewer disclosures to investors at the time of the IPO as compared to the typical disclosure package required in case of a listing of existing operating companies (and pre-commitment disclosure for private equity fund offerings).

Despite these attractions, SPAC sponsors should proceed with some caution. Here is a list of key considerations for any private equity sponsor evaluating a SPAC:

SEC Scrutiny

In the face of the vehicle's proliferation, the SEC has begun to provide formal and informal direction on the potential regulatory risks of SPAC offerings and transactions, some of which raise acute issues for private equity fund managers looking to sponsor a SPAC. The SEC, for example, has: (i) provided educational materials to investors looking to invest in SPACs; (ii) cautioned investors against making investment decisions with respect to SPACs solely based on celebrity involvement; (iii) provided guidance for sponsors relating to disclosure obligations; (iv) hosted meetings and spoken publicly on SPACs, raising awareness of issues and inviting further feedback, especially as to how to further investor protections; (v) questioned whether the statutory safe harbor for forward-looking statements would apply to projections used in proxy statements for de-SPAC transactions; and (vi) explicitly cautioned SPAC sponsors on conflicts of interest and disclosure issues, stating its view that such warrants should be accounted for as liabilities, not equity.

In addition, the SEC has explicitly cautioned SPAC sponsors on conflicts of interest and disclosure issues and, in early April, the SEC brought the SPAC market to a standstill by publicly challenging the accepted accounting treatment for certain types of warrants issued by SPACs. Further slowing the SPAC market, the SEC orally advised SPAC issuers that it will apply its procedural policies rigidly in the registration statement review process. With the recent change in leadership at the SEC, further scrutiny may be ahead.

Conflicts of Interest. SPAC sponsors may have divergent financial incentives from public shareholders of the SPAC. These conflicts can arise in numerous places, including capital and payment structures in the SPAC itself, timing commitments to close a deal within the contractual investment window or repay investors, and competing fiduciary obligations where the sponsor has positions in other financial vehicles or separate business dealings and interests in the target company.

There have been attempts to solve this problem by using a more tailored structure. For example, in July 2020, Pershing Square decided not to take the typical 20 percent sponsor promote and instead to "keep skin in the game" by investing in warrants at market value that included significant transferability and exercise limitations. In addition, many recent acquisitions involve the restructuring of some or all sponsor-promote shares to vest only if the post-closing company's stock performs above certain levels.

Disclosures. The participation by retail investors presents particular risks, as retail investors may not appreciate the implications and the risks of the SPAC structure and sponsor economics. Sponsors therefore should avoid recycling generic SPAC disclosures and instead ensure that disclosures are tailored to their specific SPAC and are consistent with SEC guidance. Another area where tailored disclosure is appropriate is the level of future expense and financing needs that a particular SPAC will incur.

> SPACs provide sponsors with a permanent capital vehicle, access to different targets than might otherwise be available due to restrictive fund covenants, and greater access to capital through retail investors and liquidity options that are not always available to a traditional private equity portfolio company and private equity funds, allowing for the pursuit of larger targets.

For example, SPACs may be subject to different levels of fees and costs, some of which may not be known with precision at the time of the IPO (such as costs relating to potential redemptions and PIPE financing).

In addition to the foregoing concerns, which apply to all SPAC sponsors, private fund SPAC sponsors have particular considerations arising from obligations to private fund clients and any other investment advisory clients:

Allocation. A SPAC target company may be an appropriate investment for a manager's existing funds, creating potential allocation conflicts. For example, a fund's governing documents may require that the manager (who is affiliated with the SPAC sponsor) offer the deal with the target company to its fund as a portfolio company acquisition.

Conflicted transactions. Similarly, conflicted transactions may occur where the SPAC sponsor seeks to have the SPAC acquire a target company in which one of the fund manager's funds has an interest. The precise degree of conflict this poses is determined by the fund's organizing documents, as are the protocols to be followed in instances where conflicted transactions are contemplated.

Successor fund restrictions. A SPAC may be considered a "successor fund" under fund organizational documents, in which case the sponsor may be

restricted in raising capital for the SPAC until after a certain amount of capital from existing funds has been invested or committed.

Key person time and attention requirements. Fund managers must be aware of obligations imposed upon them by fund documents or firm policies regarding the time and attention that must be dedicated to managing a certain fund. This issue is particularly acute where these requirements oblige key persons to devote time to specific funds or strategies, rather than being applicable on a firm-wide or platform-wide basis.

Local offering restrictions. Depending on where a SPAC is set up and offered and how it is organized it may be subject to additional regulatory and marketing restrictions. For example, if offered to investors in Europe, it could in some cases be considered an alternative investment fund within the meaning of the European AIFM Directive triggering a whole set of regulatory requirements.

Developing Litigation Trends

Looming upswing in litigation. Assuming that historic trends continue, the substantial increase in SPAC-related investment activity would indicate a commensurate increase in litigation arising out of alleged SPAC transaction shortcomings, including purported incomplete or misleading disclosures and/or conflicts of interest. The exponential increase in SPAC formations, however, is likely to lead to an even steeper exponential increase in related litigation as some targets will be weaker candidates, more likely to falter after the de-SPAC process concludes, drawing increased scrutiny from both regulators and the plaintiffs' bar.

SPAC-specific litigation vulnerability. Time-limited contractual investment obligations leave SPAC sponsors particularly vulnerable to strike suits in which plaintiffs seek to enjoin the merger, often by way of demanding increased disclosures, in the immediate lead-up to a shareholder vote on the transaction. Sponsors with SPACs nearing the end of their investment windows may be forced to capitulate or face terminating the SPAC and repaying investors.

[*See* "What Do SPAC Federal Securities Lawsuits Look Like So Far?" Above the Law, April 6, 2021 ("Above the Law: Federal Securities Lawsuits"), available here.]

Bi-modal litigation timing trends. SPAC-related litigation to date suggests an emerging trend, that the risk of litigation is not equally likely over the life of the SPAC, but rather increases at two junctures: (i) close to the merger completion date, usually around four months after the merger announcement, often over disclosure or conflicts issues; and (ii) around eight months after the merger's announcement, over stock performance issues only apparent after the merger's completion.

[*See* "SPAC Plaintiffs Are Filing Early—But Not Too Early" BloombergLaw, April 22, 2021 ("Bloomberg: Filing Early"), available here.]

The regulatory and litigation concerns discussed above exist in the context of a market that suddenly feels less friendly to SPACs than it did earlier in 2021. The pace of new SPAC listings has slackened and existing SPACs are finding deals harder to consummate, thanks in part to a drop-off in available PIPE financing. With hundreds of SPACs in the market still pursuing transactions, sponsors have all the more reason to exercise caution.

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SPAC Trends in the Europe Market—Are SPACs the New Entrance and Exit?

> We have not yet seen a proliferation of SPACs listed on European exchanges, although they are expected to gain popularity around the word as demand outstrips the U.S.'s supply.

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This article was originally published in European private equity publication Unquote (link here).

With the popularity of SPACs in the United States reaching a fever pitch, E. Raman Bet-Mansour and James C. Scoville of Debevoise & Plimpton share their thoughts on why the strategy is so attractive for PE, what sponsors should be wary of, and whether they expect a similar uptake in Europe.

Greg Gille: What makes special-purpose acquisition companies (SPACs) relevant to private equity firms?

E. Raman Bet-Mansour: SPACs were the biggest Wall Street story in 2020, and activity in the first quarter of 2021 already exceeded 2020's record pace. Major PE firms have joined the bandwagon on both ends by sponsoring SPACs, acquiring targets via their sponsored SPACs and exiting investments by merging portfolio companies with SPACs (*i.e.*, de-SPAC transactions). By sponsoring SPACs, PE firms are able to diversify their offerings beyond traditional buyout funds, offer shorter exit time horizons and achieve attractive economic returns.

GG: To what extent are SPACs becoming a phenomenon outside of the U.S.?

James C. Scoville: An overwhelming majority of SPACs are listed in the US due to its mature legal and financial infrastructure, and a deep investor base familiar with SPACs. However, many SPACs listed in the US are sponsored by non-US sponsors or looking at non-US targets. We have not yet seen a proliferation of SPACs listed on European exchanges, although they are expected to gain popularity around the world as demand outstrips the US's supply. Regulators in London, Hong Kong, Singapore and other important non-US financial centres are studying the possibility of reforming their regulations to SPACs more easily accommodate SPAC listings.

Notably, the UK sees Brexit as an opportunity to reform its listing rules to make the London Stock Exchange a more attractive listing venue, and on 3 March 2021 new rules were proposed that would reform the current reverse takeover rules that apply to SPAC transactions. Similar regulatory flexibility in Amsterdam is likely to position Amsterdam's Euronext as the core EU listing venue for SPACs on the continent.

GG: What makes SPACs different from traditional PE vehicles?

ERB-M: A SPAC's goal is to unlock value for shareholders in private companies under the guidance of a team of investment professionals, which in essence is the same goal as PE historically, and which may allow PE firms' expertise to shine in a different arena. However, SPACs carry a few important distinctions from traditional PE vehicles.

First, SPACs are publicly listed companies. This status provides SPACs with ready access to public debt and equity capital markets, and no requirement to seek an investment exit within a fixed period of time. Further, as a publicly listed company, a SPAC is able to raise capital from a broader group of investors.

Second, a SPAC is formed with the intention that it seeks to acquire a single operating company (or perhaps a group of related operating companies) rather than a traditional PE vehicle that acquires, owns and ultimately sells a portfolio of operating companies. As a result, a SPAC investment is not diversified across several companies or management teams or geographies, and has increased exposure to the risks of the single underlying business. In addition, a SPAC has a much shorter period to acquire a target (generally up to two years) while a PE fund can have up to a 10-year investment period.

Third, the economic entitlement of SPACs' sponsors is different from a PE structure. In a PE fund, a PE firm usually earns an annual management fee, invests alongside third-party investors to ensure alignment of interests, and receives a carried interest as a share of profits, if certain hurdles are met. However, for a SPAC, the sponsor does not receive a management fee and its invested cash is primarily used for expenses to operate the SPAC until it finds a target. However, if an acquisition is completed, a SPAC sponsor receives a 20% equity interest in the pre-acquisition SPAC, which provides sponsors a strong incentive to find a deal and complete it quickly.

> The market turbulence and historically low interest rate caused by the Covid-19 pandemic are undoubtedly two major factors behind the rise of SPACs, but some of the benefits inherent in the SPAC structure will allow them to stay beyond the current economic and financial cycle, and gain popularity among more PE firms.

GG: What makes de-SPAC transactions different from traditional IPOs?

JCS: First, de-SPAC transactions provide more certainty in target valuation, because parties may determine target valuation through extensive negotiations that are typical in PE buyouts and avoid price fluctuations that may exist in traditional IPOs, which are even more prevalent in the post-Covid equity market.

Second, de-SPAC transactions provide more structural flexibility and allow use of M&A tools (for example, earn-outs, governance, financing) that are not customarily available in traditional IPOs for parties to maximize value and reach compromises on areas they each care the most about.

Third, de-SPAC transactions are more cost-efficient and less time-consuming than traditional IPOs; de-SPAC transactions typically take between four to five months and involve a lower underwriting commission, whereas traditional IPOs typically take six to nine months and involve a higher underwriting commission.

GG: What are key issues for PE firms to consider before sponsoring a SPAC?

ERB-M: PE firms should carefully consider potential conflicts of interests relating to a SPAC business, as well as requirements in its existing fund agreements, and securities law requirements—including dedication of time and attention, allocation of investment opportunities, and conflicts

arising from a SPAC seeking to acquire an existing portfolio company.

PE firms should ensure their key persons are permitted by existing fund documents to dedicate time to the SPAC without triggering a key person event or otherwise adversely affecting existing funds.

In addition, if a target is suitable for both an existing fund and the SPAC, PE firms should consider how to allocate such an investment opportunity. Further, the investment in the SPAC sponsor (and the related incentive economics) is itself an investment opportunity, which may be suitable for one or more existing funds.

Finally, it is possible that PE-sponsored SPACs seek to acquire portfolio companies from existing PE funds. Existing PE firms know their portfolio companies well and are well positioned to evaluate which companies are ready for an IPO. However, these situations do raise potential conflicts of interest and therefore difficult valuation issues, although they can be mitigated through a combination of disclosure, third-party valuations and other techniques.

GG: Conversely, what should PE firms consider before exiting an investment via a de-SPAC transaction?

JCS: One of the appeals to investors of a SPAC is that they can redeem their SPAC shares after they vote in favor of a de-SPAC transaction and retain the ability to enjoy upside by exercising warrants after the closing of such a de-SPAC transaction. Therefore, sponsors should ensure that their SPAC buyers have mechanisms in place to provide backup liquidity in the event that there is a redemption spree.

For example, a SPAC may enter into a forward purchase agreement with its sponsor or anchor investors to obligate such sponsors or investors to provide liquidity in a de-SPAC transaction if needed, or a SPAC may enter into a PIPE transaction to secure liquidity.

In addition, to allow a speedy and efficient de-SPAC process and be attractive to SPAC buyers, PE firms should ensure that their portfolio companies have best practices in place to comply with the rules and regulations governing public companies, have audited financial statements in hand, and can provide adequate public disclosures in a timely manner.

GG: Are SPACs here to stay?

ERB-M: The market turbulence and historically low interest rate caused by the Covid-19 pandemic are undoubtedly two major factors behind the rise of SPACs, but some of the benefits inherent in the SPAC structure will allow them to stay beyond the current economic and financial cycle, and gain popularity among more PE firms.

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Locked Boxes in U.S. Practice: An Underused Tool?

We have seen more discussion this past year of locked box constructs given the difficulties associated with constructing good working capital targets in light of temporary balance sheet disruptions during 2020 due to COVID.

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The locked box in U.S. private M&A is a relatively foreign concept – relegated to special situations and often looked upon with suspicion by wary buyers. Is this reputation justified? Should U.S. practitioners embrace the locked box as a value and efficiency creating mechanism?

A Primer on Closing Accounts vs. Locked Boxes

Prevailing practice in the U.S. private M&A market is a "closing accounts" purchase price construct. Under this construct, the equity consideration due to sellers in a transaction is derived by defining an enterprise value in dollars in the acquisition agreement and then adjusting this amount based upon the cash, indebtedness, net working capital (relative to an agreed target working capital figure or range) and seller transaction expenses as of the closing date. The calculations of these amounts are determined in accordance with definitions and accounting principles negotiated in the acquisition agreement. These figures are "trued up" post-closing through a settlement process, which, for sponsor sellers, is supported by an escrow account. This construct results in the seller benefiting from the earnings, and bearing the burden of losses, of the business through the closing date.

By contrast, in a locked box transaction, the equity value due to sellers is defined in the acquisition agreement in dollars and the only potential adjustment to that amount is for any "leakage" that occurred between a recent balance sheet date (aka the locked box date) and the closing date. Leakage consists of unpermitted payments to or benefiting seller and its affiliated entities and is typically expected to be zero—that is, it is meant to be a protective mechanism but not value-shifting. The dollar equity value is derived from buyer's diligence of the earnings of the business and its balance sheet as of the locked box date. Some locked box structures may include a ticking fee concept, which provides seller incremental compensation the longer it takes to close the transaction. Any leakage is estimated at closing and additional leakage claims may be made for a limited period after closing in a manner similar to the closing accounts construct (including with a supporting escrow in sponsor sales). The locked box construct therefore provides that the upside and risks associated with the target's performance between the locked box date and the closing date inure to the benefit of (or detriment to) the buyer. As a result, seller may seek to negotiate for a higher purchase price to compensate it for running the business between the locked box date and closing.

Although frequently utilized in European transactions, locked box transactions are rare in U.S. transactions. We have seen more discussion this past year of locked box constructs given the difficulties associated with constructing good working capital targets in light of temporary balance sheet disruptions during 2020 due to COVID. However those discussions rarely translated into usage of the locked box construct.

Locked box transactions are often touted as a way to avoid protracted negotiations over the working capital target and closing net working capital inputs. Whether this is true depends on the approach the parties take in arriving at an agreed equity value. There are two basic approaches:

a. Buyer conducts due diligence on the target's net working capital position as of the locked box date (*e.g.*, relative to a trailing 12-month average), but in fixing the enterprise-to-equity value bridge (and resulting purchase price), the parties do not assume a specific normalized level of working capital (*i.e.*, a peg/target) against which a calculation of the NWC position as of the locked box date is compared. Rather, only extraordinary working capital issues would be included in the bridge (as cash- or debt-like items). That is, the deal is priced similar to how a public company deal is priced based upon a fixed equity or per-share value.

b. Alternatively, the enterprise-to-equity value bridge includes the full suite of closing account adjustments, determined as of the historical locked box date. Under this construct, the parties are accelerating the equity value calculation to the pre-signing period (and are keeping it out of the acquisition agreement), but must still engage in a negotiation concerning the basis of the calculation of the target net working capital.

Both approaches avoid the risk of a post-closing dispute relating to the calculations of the closing account purchase price adjustments, while the former approach has the added benefit of meaningfully reducing the time and effort spent negotiating purchase price adjustment terms and the resulting value changes relative to the agreed upon enterprise value.

In the case of either approach described above, the buyer and seller will need to agree upon amounts of excess cash (and the classification of any cash as restricted cash) and indebtedness (including debt-like items such as earn-outs and capital leases) on the locked box date balance sheet, as well as anticipated sell-side transaction expenses. On occasion, incurrences of debt outside the ordinary course or in excess of a certain threshold, or transaction expenses above a specified amount, are defined as leakage.

When Do Locked Box Transactions Make Sense?

The following factors might increase the appeal of utilizing a locked box structure:

- Seasonal business where testing closing date net working capital against a target might lead to a significant equity value swing, which is inconsistent with a going-concern transfer.
- Extraordinary activity in the historical period that makes agreeing on a normalized target net working capital figure more challenging (*e.g.*, due to COVID impacts).
- Businesses with unusually large intra-week or intra-month swings that make agreeing on a target challenging where there is a possibility of closing at any day during a week or month.
- Transactions utilizing a portable debt structure in which the business deal is negotiated on the basis of an equity value / per-share value rather than an enterprise value.

Conversely, the following factors make the usage of a locked box construct more challenging:

- Absence of a recent balance sheet prepared in a manner that gives buyer comfort as to the accuracy and completeness of the balance sheet to be used as the locked box date balance sheet.

- A target company business with affiliate transactions that would make it challenging to cleanly define or police leakage from the target company to the seller or its affiliates (*e.g.*, a corporate carve-out or family run business with numerous day-to-day transactions with family members or affiliated companies).
- Long sign-to-close period with uncertain projections that makes pricing in seller's compensation for operating the business during the interim period challenging.
- Where the seller is a sponsor, buyer's discomfort on relying on a small escrow as the sole recourse for any leakage discovered post-closing (*i.e.*, where a buyer views leakage risks differently from typical closing estimate risks). A fund guaranty or similar support beyond an escrow for leakage claims could be offered by the private equity seller, but most U.S. sponsors are unwilling to offer a fund guaranty in connection with an exit transaction as a matter of policy.

Advantages and Disadvantages of the Locked Box Construct

There are a number of advantages and disadvantages to the locked box construct, both value and process-related. The chart below compares potential value-related pros and cons of the locked box construct from the perspective of each of the buyer and seller.

Pros	
Seller	**Buyer**
Avoids "price chipping" by buyer through NWC peg/target negotiation after competitive tension has been reduced Shifts risks of GAAP-based liabilities that arise between signing and closing to buyer Avoids unexpected purchase price reductions through the closing estimate adjustment process or post-closing true-up Ability to lock in seller compensation for expected profitability between sign and close based on mechanism or value agreed at signing Reduces likelihood of costs associated with post-closing purchase price disputes	Removes potential for purchase price increase through natural differences between closing working capital and the target (*e.g.*, as a result of a growing business) Avoids potential for unexpected purchase price increases through the closing estimate adjustment process Potential to underpay seller for actual profitability between sign and close based on mechanism agreed at signing Reduces likelihood of costs associated with post-closing purchase price disputes

Cons	
Seller	**Buyer**
Loss of potential for purchase price increase through natural differences between closing working capital and the target (*e.g.*, as a result of a growing business) Risk of being undercompensated for actual profitability between sign and close based on mechanism agreed at signing Loss of potential for unexpected (*i.e.*, windfall) purchase price increases through the closing estimate adjustment process	Requirement to commit to equity value purchase price (including any debt-like reductions and NWC adjustment components) at an earlier phase with potentially more competitive tension and/or less access to the management team Risk of overcompensating seller for actual business performance between sign and close based on mechanism agreed at signing Removes potential ability to allocate certain liabilities to seller that may be discovered after signing / after closing Assume risks of GAAP-based liabilities that arise between signing and closing

Whereas economic advantages of the locked box construct to one party generally correspond to disadvantages to the other party, the process-related benefits of the locked box construct accrue to both parties. These include:

- Avoiding protracted negotiation over balance sheet definitions, accounting principles, sample balance sheet and certain other closing account terms.
- In public-company style locked box deals, avoiding the need for protracted negotiation relating to a target net working determination.
- Reducing likelihood of costs and distraction associated with closing estimates and post-closing true-up process.
- Reducing likelihood of distractions and adversarial discussions associated with post-closing purchase price disputes.
- For sellers, there is the potential to simplify the comparison of multiple bids (rather than needing to understand enterprise-to-equity value bridges based upon contract markups).
- For buyers, a willingness to accept or propose a locked box construct can be a distinguishing factor in a competitive process where other bidders are unwilling to do so.

These process-related benefits must be weighed against the following disadvantages of utilizing a locked box structure:

- Accelerates the need for sufficient balance sheet diligence (and potentially full historical NWC analysis) in advance of reaching an agreement on price (or forces bidders to make offers on price that may be difficult to modify in advance of completing due diligence).
- Potential need to negotiate a mechanism for compensating seller for the profitability or operation of the company between signing and closing.
- Lack of familiarity with the construct may create a learning curve for parties and their counsel, and may potentially lead to buyer suspicion in negotiations.
- For sellers, there is additional pressure on the locked box date balance sheet presentation and accuracy early in the process and there is the potential that seeking bids on a locked box basis may complicate comparison of multiple bids if some, but not all, bidders submit proposals accepting the locked box construct.

On balance, locked boxes are often thought of as seller-friendly given the greater value certainty they deliver (although sellers risk losing the benefit of the anticipated growth of the business through closing unless they capture it in the headline price or otherwise). While there is some truth to that idea, the full picture is more complex and use of a locked box construct may be beneficial to both buyer and seller, given the right set of facts and circumstances. U.S. M&A practitioners should add the locked box mechanism to their tool-kit and seriously consider its utilization where warranted based on the nature of the deal.

> There are a number of advantages and disadvantages to the locked box construct, both value and process-related.

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Insurance Investments: Key Considerations for Investors in the United States, Europe and Asia

For private equity firms, acquiring an insurance company brings both the opportunity of reliable returns on investment and ongoing access to capital.

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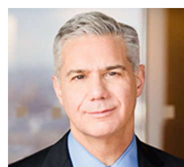
Partner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Financial sponsors have long been important providers of capital to the insurance industry, but in recent years, private equity acquisitions of insurance businesses have become more common. While this trend has been most noticeable in the United States and Europe, it is beginning to take hold in Asia as well. Private equity sponsors considering insurance investments in Asia and in emerging markets can look to lessons learned from deal experience in United States and Europe—but need to keep in mind the quirks across different jurisdictions regarding capital, structure and reporting.

This article reviews recent trends and compares key considerations for private equity players in insurance investments in the United States, Europe and the APAC region. We consider how recent developments may evolve in Asia present opportunities for PE sponsors looking to extend their asset management expertise to insurance investments in these markets.

Insurance Deal Activity and Drivers

United States

Deal activity by private equity sponsors in the United States insurance market has accelerated significantly over the past five years and financial sponsors and pension funds now appear poised to play a permanent role as active M&A participants and controllers in the sector.

Recent examples of growing private equity involvement in the U.S. insurance sector include Blackstone's pending acquisition of Allstate Life Insurance Company for $2.8 billion, KKR's acquisition of Global Atlantic for $4.4 billion, Jackson National's strategic transaction with Athene Holding Ltd to reinsure $27.6 billion of fixed and fixed index annuity liabilities, ThirdPoint Re's $788 million merger with Sirius Group in Bermuda, and Carlyle Group's partnership with T&D Holdings to acquire 76 percent of Fortitude Group Holdings from AIG for $1.8 billion. In addition, we're seeing signs of consolidation in the mutual insurance space with the recently announced sponsored demutualization of Ohio National Mutual Holdings, Inc. by Constellation, an insurance acquisition platform backed by Caisse de dépôt et placement du Québec and Ontario Teachers' Pension Plan Board.

These transactions illustrate how private equity-backed investments and acquisitions in the insurance space can bring experienced investment management capabilities to insurance companies confronted with the challenges of an ongoing low interest rate environment. For private equity investors, these transactions,

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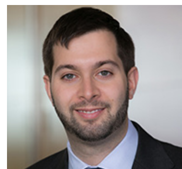
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Associate

particularly in the life insurance space, bring both the opportunity for a reliable return on invested capital and access to the permanent capital provided by an insurance company with a significant base of assets backing reserves.

UK & Europe

Just as in the United States, the UK and Europe have seen a noticeable increase in the involvement of private equity investors in the insurance space in recent years. Any auction process involving an insurance company now typically includes a number of private equity participants as a matter of course.

Private equity sponsors in the UK and Europe often begin their involvement in the sector with investments in insurance service companies and intermediaries; as industry experience, credentials and the relationships with insurance regulators deepen, buyers then expand their reach across the full breadth of the industry—including P&C and life insurers.

Recent deals include GreyCastle's sale to Monument Re (which is backed by Cinven, among others), Bain Capital Credit's deal to invest in Beat Capital and their acquisition of LV=, and Lovell Minnick Partners' take-private of Charles Taylor. Additionally, last year's bumper crop of start-ups looking to take advantage of hardening rates, the "Class of 2020", saw support from private equity players on the equity side and in the form of debt; this year's cohort is expected to continue the trend. Lloyd's of London remains fertile ground for private equity sponsors, and ongoing and planned expense cutting in the market can only increase Lloyd's appeal. Inigo is being backed by JC Flowers, StonePoint, CDPQ and others; Blackstone and Fairfax took part in Ki's capital raise to support its expansion.

Asia

In contrast to the United States, in the UK and Europe, private equity investment in insurers in the Asia Pacific region has been relatively limited to date. Some Asian markets present limited opportunity because the industry is still in its early stages, while other markets are further along but still lack the run-off, consolidation and targets that make for scale possibilities and a vibrant deal environment. Structuring considerations and uncertain regulatory environments can also hamper activity.

However, the area seems ripe for change as new region-wide solvency regimes come into effect, capital-intensive back books become increasingly difficult to service in the low-interest rate environment and insurers continue to seek ways to move risk off their balance sheets. Recent transactions include JC Partners' acquisition of a controlling stake in KDB Life, the strategic co-insurance partnership between Carlyle and Korean Re, and Resolution Life's AU $3 billion acquisition of the Australian and New Zealand wealth protection and mature businesses of AMP Limited.

Expected Regulatory Control and Disclosure Considerations for PE Buyers

United States

Insurance M&A transactions involving the acquisition of control (generally 10 percent or more of an insurance company's voting securities) will be subject to approval from the state insurance regulator of the target's domiciliary state. Because of increased deal activity, state insurance regulators have become increasingly experienced with private equity buyers and the complex structures that they typically present. Regulators are thus examining private equity structures more thoroughly, digging into how control is exercised (including information concerning ultimate controlling persons), proposed affiliate arrangements and their impact on the underlying insurance businesses. To fully understand the proposed deal and the business going forward, regulators now sometimes seek information that private equity sponsors have

traditionally been reluctant to provide, including review of limited partnership agreements and other fund documentation, as well as all aspects of investment management or other affiliate arrangements.

In addition, regulators have placed a priority on ensuring that an acquisition by a private equity sponsor will not negatively affect an insurance company's access to capital sources to back policyholder liabilities. This concern can lead regulators to impose conditions as part of the approval of a change of control, including requirements to maintain a minimum RBC ratio after closing, restrictions on dividends that can be paid by insurance companies without regulatory approval for a certain period of time after closing, and restrictions on affiliate transactions without regard to materiality thresholds that might otherwise exist under insurance law. Given the significant regulatory approval process and the heighted scrutiny of the more complex structures of private equity acquirers, obtaining approval can take between six months to a year. Reinsurance transactions, however, tend to be approved more quickly given the narrower scope of a reinsurance transaction compared to the acquisition of an insurance carrier.

UK & Europe

In the UK and Europe, proposed acquirers of insurance companies, insurance brokers or other intermediaries, as well as certain regulated insurance services firms, will generally need regulatory approval if the transaction involves the direct or indirect acquisition of 10 percent or more of capital or voting rights (20 percent for intermediaries generally). Therefore, unlike in the United States, it is not possible to disclaim control or to use non-voting shares in the transaction to avoid the approval requirement. Additionally, parties which do not individually reach the relevant thresholds can trigger a filing if they reach the threshold on a combined basis and can be shown to have an explicit or implicit agreement to exercise their rights in the same way. Pre-approvals are also required to increase an existing holding above specified thresholds.

Regulators will want to understand any investor's ultimate beneficial owner; for private equity buyers, this can result in some back and forth as the regulator seeks to map the decision-making structure through the fund. Given the prevalence of private equity investors in the industry, regulators in the UK and Europe are sophisticated in dealing with this type of buyer; to ensure a smooth approval process, it is critical to explain the holding structure clearly and the legal analysis identifying which entities require approval.

As in the United States, regulators will want to see transaction-specific documentation along with detailed information and supporting documents for the relevant entities. Regulators will focus on the buyer's plans for the target business, including proposed changes to capital structure and dividend plans, management, systems and governance, as well as the details of the expected integration into the buyer's group. In particular, regulators often require confirmation of the acquirer's commitment and plans to support the target insurer going forward. Reassurance on this point can be usefully provided where the investor has a proven track record in the industry. While regulators may impose conditions on their approval (*e.g.*, additional capital commitments or dividend restrictions), in our experience this usually reflects underlying concerns regarding the target business rather than the buyers.

> Private equity sponsors in the UK and Europe often begin their involvement in the sector with investments in insurance service companies and intermediaries before expanding across the sector.

The regulatory review timeline in the UK and Europe is clearly delineated, regardless of the type of buyer: 60 working days from receipt of a complete filing (subject to "clock-stopping" for an additional 20 or 30 working days, depending on whether it is a European or non-European acquirer). Approval can generally be expected within three to four months of the first filing, even where complex fund structures are involved.

Asia

In Asia, controller thresholds upon which insurance M&A requires regulatory approval varies in each jurisdiction, but can be triggered upon an acquisition of 5% or 10% of the voting securities of an insurer. While the meaning of control varies somewhat by jurisdiction, regulators generally focus on ownership with the ability to exercise, or control the exercise of, voting power.

Regulators will typically require disclosure for all entities "up the chain of control" and information on the general partner including its controlling person, while seeking limited to no information regarding the limited partners. Group structure charts and operating agreements are typically requested, although the depth and level of scrutiny varies by jurisdiction and may also depend on the identity, track record and market reputation of the private equity sponsor.

As part of the approval review and process, regulators will focus on issues around capital adequacy and ongoing support and may impose heightened capital standards, capital support undertakings or dividend restrictions as conditions of approval. To help ensure stable and long-term management, regulators may also subject private equity sponsors to a minimum lock-in period, enhanced operational scrutiny or heightened disclosure requirements.

The views of regulators toward private equity investors vary across the region. While regulators in jurisdictions such as Hong Kong, Singapore, and Korea have experienced successful completion of private equity investment in insurance companies, regulators in jurisdictions in Southeast Asia are still largely untested. As such, the presence of a private equity acquiror will likely extend the timing required for receipt of approvals.

Structuring Considerations in Insurance M&A

United States

The acquisition of insurance companies in the United States can take the traditional form of the purchase of stock or, if the private equity sponsor has already acquired a licensed insurance company, be effected through bulk reinsurance of blocks of business to acquire reserves and a larger pool of assets and cash flows.

Given the lengthy regulatory approval process and additional scrutiny of private equity buyers in the United States, deal negotiations focus on the crafting of covenants and conditions around the obligations to obtain regulatory approval and whether regulatory restrictions imposed on an acquirer by insurance regulators may trigger a right to terminate an acquisition agreement. Buyers and sellers typically negotiate the "burdensome conditions" a regulator could impose that would impede the economic benefits of a transaction for private equity sponsors. These may be developed by the parties following discussions with insurance regulators to better understand the areas of regulatory focus for a particular transaction. These conditions can range from general material adverse effect conditions on one or both parties' expected economic benefits to more specific conditions around dividend restrictions or capital maintenance and support requirements.

In addition to increased focus on regulatory covenants and conditions, there has also been growing use of complex deal financing solutions, including equity commitments, debt financing, and combinations of traditional stock and merger transactions with reinsurance and reserve financing structures. As part of the regulatory approval process, the sources of funding for any acquisition of an insurance company are closely scrutinized by regulators and greater complexity of a sponsor's financing arrangement could increase the time needed for regulatory review.

UK & Europe

Share acquisitions are common in UK and European insurance transactions, with locked box pricing mechanisms more likely to be used than completion accounts. Consistent with the effective transfer of economic risk at signing, pre-closing termination rights, including "burdensome conditions" clauses in purchase agreements, have traditionally been less prevalent than in the United States. However, as both strategic and private equity buyers with familiarity with U.S. insurance transactions have entered the market, termination rights have started to become a point for negotiation, depending on the overall transaction dynamics. A growing trend in private equity deals in the UK and Europe is the

use of W&I insurance; as well as the obvious benefits, a W&I policy can allow the parties to short-circuit negotiations regarding the scope of warranties and specific points of risk allocation. Provided they are brought on board at the right time, W&I insurers can therefore speed up the pre-signing process, which is valuable in an auction process with a limited exclusivity period.

In the UK and Europe, the transfer of a particular book of business, including in a carve-out, can be accomplished through portfolio transfers. This typically occurs through a court process which has the effect of automatically novating policies and reinsurance from the transferor to the transferee without requiring the consent of each individual policyholder. Supporting assets and employees can also be transferred at the same time. Given the number of safeguards to protect policyholders and the administrative steps involved to complete the transfer (which vary from jurisdiction to jurisdiction), this can be a lengthy process taking 12 months or longer. To more quickly achieve the economic effect of transferring the business, it is common for parties to enter into an interim reinsurance arrangement pending completion of the portfolio transfer.

Asia

As in other regions, insurance M&A in Asia can also be structured through a variety of forms, whether through share acquisitions or transfers of particular books of business through portfolio transfers. Both locked box and completion accounts are used in share acquisitions; buyers should expect to encounter similar considerations around the parties' obligations to obtain regulatory approval and what constitutes "unduly burdensome conditions." Depending on the jurisdiction, portfolio transfers can range from a relatively streamlined court process where policies are automatically novated to a more burdensome process requiring regulatory approval and policyholder communications that can be held up due to policyholder objections.

In Asia, as a preliminary matter, buyers also need to consider a variety of other structuring factors, including foreign ownership limitations (FOL), single presence rules and local presence requirements. In certain jurisdictions, foreign private equity funds are prohibited from investing directly in a local insurer and instead must structure the acquisition through a private equity invested financial institution or insurer. FOL rules are often in flux. China removed its 51 percent foreign ownership limitation for insurance companies as of the beginning of 2020, and India recently issued draft guidance raising its FOL from 49 percent to 74 percent. Because of this dynamic regulatory environment, anyone doing insurance deals in countries with FOL rules (other than insurers grandfathered under old regimes) will likely need to partner with a local entity.

With respect to single presence rules, any current holdings must be reviewed to ensure the investor does not run afoul of limitations for being a controller in more than one insurance company or line of business, as applicable. In some jurisdictions, a foreign private equity fund cannot itself be the controller of an insurer, but rather must establish a local presence. In still some other jurisdictions, even where there is no local presence requirement, in practice a local presence may still prove to be quite helpful as part of the regulatory approval process.

Conclusion

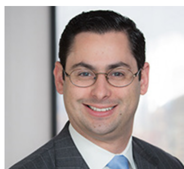
Given the global nature of the insurance business, it is not surprising that there are a number of themes that are common across jurisdictions. As a result, many concepts and regulatory questions will be familiar to investors entering a new region, and deal teams should be able to leverage off much of their expertise when facing familiar issues in unfamiliar markets. However, given the highly regulated nature of these businesses and the diversity of regulatory perspective and sophistication across the world, the devil will continue to be in the details.

To learn more about private equity's involvement in the insurance industry, read our recent piece, *Private Equity and the Insurance Industry: A Close Look at a Natural Partnership*. To hear a discussion of the topics in this article by some of the leaders of our global insurance and private equity teams, an on-demand webinar recording is available here: Global Private Equity Insurance Wave: Recent Trends and Outlook.

Debevoise & Plimpton

Portability in Debt Financing Agreements: A Helpful Tool for Private Equity Sponsors

When an active M&A market occurs alongside a sub-par financing market, a company with portability in its debt financing could become a more attractive target.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Introduction

As disruptive as the COVID-19 pandemic has been to the economy, its effects have not been evenly distributed. Financing markets, for example, continued to flourish. U.S. high-yield bond issuance had a blockbuster year in 2020, with volume increasing 60 percent from 2019 to $435 billion, according to LCD. The M&A market, on the other hand, was slower to rebound. While 2020 deal volumes fell 6 percent to $3.5 trillion, according to Bloomberg, $1.3 trillion of that amount signed in Q4 2020, and Q1 2021's $1.1 trillion in deals represented the best start to a year since at least 1998. This temporary dislocation between the financing and M&A markets had a particular impact on private equity sponsors that had planned to exit portfolio company investments during 2020 and in some cases led to those plans being delayed.

At the same time, however, sponsors and companies took advantage of open financing markets to extend maturity profiles. These financings can serve as a bridge to a future exit while re-levering a business and returning capital to equity holders. Despite those immediate benefits, sponsors and companies need to take care that the new financing does not impede a successful exit once M&A markets have fully returned, such as by incurring debt with expensive call protection. Portability provisions play an important role in mitigating that risk.

The Role of Portability

An acquisition of a target company may constitute a "change of control" under its financing agreements, which usually either triggers an event of default or gives the lenders a put right for the target company to repurchase this debt. In either case, a buyer would need to allocate funds as of signing (whether in the form of committed financing or available working capital) to backstop or replace this existing debt. Instead, portability provisions allow, under certain conditions, for the buyer to step into the seller's shoes in the target's financing agreements, leaving the target company's debt capital structure intact post-closing.

Including portability provisions in debt agreements brings sponsors three main benefits. First, portability features provide a sponsor with the ability to initiate a sale when difficult financing market conditions might impede prospective buyers from raising debt financing. Indeed, when an active M&A market occurs alongside a sub-par financing market, a company that previously obtained debt financing with portability features could become a

more attractive acquisition target, since the buyer will inherit a debt capital structure that is likely better than what the market would provide. Second, portability features allow for a sponsor to pursue debt financing transactions based on strategy and opportunity, without having to worry about how the buyer's ability to replace the debt might affect a future sale. Third, portability provisions can lead to fewer transaction costs overall, since a buyer will not have to pay commitment and other fees for the new debt financing (which are usually more expensive than fees for a best efforts refinancing) and the sponsor seller will not have to "pay" prepayment penalties or other breakage costs to refinance the company's existing debt (which are often allocated as a deduct to the closing purchase price paid to a sponsor seller). Assuming a buyer prices in these lower transaction costs as part of the deal, the sponsor seller can negotiate to receive the benefit of these amounts in the form of additional purchase price.

> As M&A markets return, portability provisions play an important role in mitigating the risk that new financing does not impede a successful exit.

The Five Customary Portability Conditions

Portability provisions customarily include five conditions that must be satisfied so that the buyer can assume the seller's debt in an acquisition. These conditions are designed to provide comfort to the lenders regarding both the company's health and the buyer's reputation as an equity investor.

First, the company must satisfy a leverage ratio requirement. This is often a total leverage ratio test; there may also be a separate leverage ratio test for secured debt. The leverage ratios tend to be set using the leverage levels as of the financing closing date, although sometimes there is a slight cushion added or a rounding upwards. These leverage ratio tests assure lenders that the amount of the company's debt is in-line with lenders' original credit determination.

Second, the buyer must provide sufficient equity financing to meet a pro forma equity-to-capitalization test, typically 30 percent. This demonstrates to the lenders the buyer has sufficient "skin in the game" so that the incentives of the buyer and lenders are aligned. Note if the purchase price paid to the seller is not enough to satisfy the minimum equity requirement, the buyer may need to fund additional equity to the company's balance sheet (which can also be used to prepay a portion of the company's debt, to further increase the equity capitalization percentage).

Third, the buyer must meet certain individual criteria. Financial sponsors typically must have a minimum amount of committed capital or assets under management (usually $1 billion). Similar to the minimum equity test, this provides lenders further comfort that the buyer is a reputable actor with a track record of substantial assets under management which can be provided as future equity capital to the company if necessary. Some debt agreements also allow for a strategic company to be the buyer (including the portfolio company of another sponsor), in which case there may be a requirement for this company to be in the same or related business. Additionally, some debt agreements allow for a SPAC to be the buyer, so long as any controlling shareholder would have been a permitted financial sponsor if acquiring the company directly.

Fourth, the company must provide lenders with the identity of the buyer, and subsequently provide any relevant "KYC" information requested by the lenders within a certain period prior to the closing date.

Finally, the sale transaction must occur within a certain period of time following the financing closing, typically two years. This represents a sufficiently long period for the company's equity owners to arrange a sale process, while also acknowledging that investment considerations (and company performance) may deviate following that time.

Considerations When Negotiating Portability Provisions

There are two considerations sponsors should prioritize in negotiating portability provisions to help minimize risk factors that can occur between closing on the debt and closing on a deal.

First, avoid including conditions that are not fully within the control of a buyer and seller. For example, some debt agreements include a portability condition that rating agencies confirm that the company's credit ratings meet certain agreed levels (often the rating given at the time of the financing). This type of condition introduces incremental risk that the acquisition may not be able to close due to a third party (in this case, a rating agency providing an adverse rating or ratings indication).

Second, make clear that certain conditions can be satisfied at signing using the "limited condition transaction" (LCT) technology already common in debt agreements.[1] In particular for financial conditions, LCT technology provides certainty at signing that the calculations are satisfied based on the agreed debt and equity inputs, and ensures that any potential change in components of the calculation between signing and closing (such as a decrease in EBITDA) would not prevent the condition from being satisfied at closing. A related consideration is the role cash plays in leverage ratio calculations. Given that calculations made at signing will be based on estimated cash on the balance sheet at closing, sponsors should also include a rule that these calculations made at signing can be prepared based on estimated working capital and balance sheet items.

Risk Allocation in Purchase Agreements

Another set of considerations for sponsors is how the risk of failing to satisfy the portability provisions is allocated between the buyer and the seller in the purchase agreement. The following chart summarizes various risks for each of the five portability conditions and how they might be apportioned. Note that the risk allocation may be affected by a buyer's planned capital structure.

Condition	Responsibility	Notes
Leverage Ratio Condition	Typically, Seller. If Buyer is contemplating incurring any additional debt, Buyer may be in a better position to be responsible for the maximum incremental debt input.	Seller may be in a better position to satisfy this condition, since it can provide both the debt and EBITDA inputs at signing. If Buyer is incurring additional debt, Buyer may be in a better position to be responsible for confirming the pro forma debt levels to be used for any ratio calculations. If a debt agreement does not provide for this condition to be satisfied at signing using LCT technology, there is additional risk that this condition may not be satisfied at closing if the company's EBITDA decreases between signing and closing.

1. For further information on limited condition transaction technology, see SunGard 2.0, The Private Equity Report, Winter 2014, Vol. 14, Number 1, https://privateequityreport.debevoise.com/the-private-equity-report-winter-2014-vol-14-number-1/sungard-20.

Condition	Responsibility	Notes
Minimum Equity Capitalization Condition	Seller may be in a better position to be responsible for the debt input. Buyer may be in a better position to be responsible for the minimum equity input, and if Buyer is contemplating incurring any additional debt, the maximum incremental debt input.	Seller may be in a better position to provide the debt component, while Buyer may be in a better position to provide the equity component. If Buyer is incurring additional debt, Buyer may be in a better position to satisfy this condition by confirming both the pro forma debt and equity metrics. If a debt agreement does not provide for this condition to be satisfied at signing using LCT technology, Buyer's equity contribution may be affected if debt levels change between signing and closing. In particular, if debt levels increase between signing and closing (*e.g.*, due to working capital draws under the company's revolver), Buyer may need to put in additional equity beyond what is required in the acquisition to fund the purchase price in order to satisfy this condition.
Buyer Identity Condition (*e.g.*, minimum AUM)	Buyer.	
Sanctions/KYC Condition	Buyer primarily responsible. Seller responsible to the extent within its control. Seller responsible for providing the identity of the buyer.	Buyer should want cooperation from Seller on KYC requests within its control (*e.g.*, new beneficial ownership form is based on Buyer ownership but signed by target). Otherwise, Buyer may be in a better position to satisfy this condition since the sanctions/KYC requirements are specific to Buyer.
Timing Condition	Seller.	

Conclusion

While the turbulence of the past year has lead to a rising number of financings that include portability features, we expect the use of portability to continue even after the pandemic ends. To be sure, portability may not be necessary for sponsors to include in all financing transactions, such as new LBO financings or for investments with longer holding periods. For astute sponsors, however, we anticipate that portability features will be closely considered in connection with future dividend recapitalization or refinancing transactions in advance of the sponsor's eventual exit.

Debevoise & Plimpton

The End of Leveraged Buy Outs As We Know Them? Hardly.

While the decision—*In re Nine West LBO Securities Litigation*—was only a preliminary ruling and not a decision on the merits, it has been described as a potential "game stopper for the private equity business" and a "sobering punctuation mark to a sobering year."

Gregory V. Gooding
Partner

Public company directors decide, but federal judges rule, and a federal court ruling has raised the specter of directors being less willing to sell to private equity firms because of the risk that they would face personal liability for that decision.

On Dec. 4, 2020, Judge Jed S. Rakoff, of the U.S. District Court for the Southern District of New York, in a decision applying Pennsylvania law, declined to dismiss breach of fiduciary duty claims against the board of directors of the Jones Group Inc. in connection with the April 2014 take-private acquisition of the company by Sycamore Partners.

While the decision—*In re Nine West LBO Securities Litigation*—was only a preliminary ruling and not a decision on the merits, it has been described as a potential "game stopper for the private equity business" and a "sobering punctuation mark to a sobering year."

For the reasons noted below, I think that significantly overstates the matter. The sky is not falling and LBOs are not dead.

The Transaction

The *Nine West* transaction involved a leveraged buy-out of Jones Group and the simultaneous spin-out of certain of the company's business lines to an affiliate of Sycamore in 2014. The merger agreement provided that the following actions would take place "substantially concurrently" at closing: (i) the merger and cash out of the Jones Group public shareholders; (ii) a $395 million equity contribution by Sycamore and the borrowing by the surviving company of any additional $200 million of debt (on top of $1 billion of existing debt that would remain outstanding); and (iii) the transfer of a number of key assets by the surviving company to another Sycamore subsidiary for cash (the carve-out).

Between signing and closing, the equity contribution was reduced to $120 million and the new debt was increased to $550 million, apparently without any objection from Jones Group. Although the merger agreement contemplated the new debt and the carve-out, and contained customary provisions requiring Jones Group to assist Sycamore in planning for and effecting those transactions prior to closing, the board's approval of the merger agreement "purported to exclude the additional debt and the carve-out transactions."

The Claims

The entity resulting from the merger and carve-out (now named Nine West) went bankrupt in April 2018, four years following the merger. After the bankruptcy, a litigation trust established for the benefit of certain creditors of Nine West brought breach of fiduciary duty claims against the former Jones Group directors.

The director defendants moved to dismiss these claims on the grounds that their approval of the 2014 transaction was protected by the business judgment rule and that they could not in any case be held liable for damages in light of the exculpatory provisions contained in the Jones Group by-laws.

The Law

Under the Pennsylvania business judgment rule, a decision made in the context of a merger that is approved by a majority of disinterested directors is protected, "unless it is proven that the disinterested directors did not assent to such act in good faith after reasonable investigation."

The court found that the directors were disinterested, but that they couldn't rely on the business judgment rule because they "made no investigation whatsoever" into the additional debt incurrence and the carve-out and, in fact, "expressly disclaimed any evaluation of whether [these] components of the transaction would be fair to the Company."

The directors asserted that they had no obligation to investigate the solvency of the company after giving effect to the additional debt and the carve-out, since these steps were effected after they ceased to be directors (albeit only a moment after and pursuant to the terms of a merger agreement which they had approved). The court disagreed, treating the "substantially concurrent" transactions effected at closing as "a single integrated plan."

As goes the business judgment rule, so goes exculpation, at least in this case. Under Pennsylvania law, a company cannot exculpate directors for "self-dealing, willful misconduct, or recklessness."

The Decision

The District Court declined to dismiss the plaintiff's claim that the directors were reckless, and thus not entitled to exculpation. In doing so, the court emphasized the "conscious disregard" by the directors of whether the additional debt and carve-out would render the company insolvent. The court also noted a variety of red flags that "should have alerted the director defendants [of the need to] investigate the [post-carve-out surviving company's] insolvency."

The Lesson

The directors may ultimately prevail on the merits, if the case isn't settled before then. And certain elements of Judge Rakoff's opinion, including its failure to grapple with the potential conflict between the duties of the directors to the company and to the company's shareholders, can certainly be debated.

But the real takeaway from the decision is the usual one: Process matters. The typical steps that we would advise a target company to take in this situation—including reviewing and understanding the terms of the buyer's financing commitments, obtaining a solvency representation from the buyer in the acquisition agreement, and confirming with management that they expect to be able to deliver any solvency certificates required at closing—would likely have protected the directors here. That is, had the directors not—by taking the position that the debt level and carve-out terms were not their concern—arguably put themselves in a position where they could not claim reliance on these steps.

What didn't protect the directors was taking the position that they need only consider the merger itself, and that they could ignore those elements of the overall transaction that were necessary components to the merger, contemplated by the merger agreement, and facilitated by actions the company was required to take, but that notionally took place a moment after (but substantially concurrent with) the completion of the merger.

Directors can rely only on advice that they seek. The business judgment rule presupposes that directors have in fact made a business judgment. LBOs will survive.

Debevoise & Plimpton

ESG Outlook for Private Equity Sponsors

Despite its limitations in reach, the Non-Financial Reporting Directive successfully introduced ESG reporting requirements to the market.

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I. INTRODUCTION

The COVID-19 pandemic has put a spotlight on the vulnerability of the modern economic system to non-financial risks. The incorporation of environmental, social and governance ("ESG") factors in investment decisions is an important acknowledgment of many of those risks, and in some cases, goes a step further by aiming to achieve certain ESG goals when making investments. While ESG concepts have been gaining momentum for almost two decades, the pandemic, coupled with growing concerns around climate change, has elevated their importance. This article discusses the evolution of ESG investing, provides an overview of the current regulatory landscape in Europe and the UK, and examines the potential effects of ESG developments on private equity sponsors in the short, medium and long term.

The Rise of ESG in Mainstream Private Equity

Increased investor appetite is the clearest indication that ESG has now hit the mainstream. In 2006, the United Nations Principles for Responsible Investment ("UN PRI") was formed, and by the end of 2020, the network had garnered more than 3,000 signatories representing over $110 trillion of assets under management ("AUM"). More UN PRI signatories naturally means more AUM reflecting ESG considerations: the past five years have seen a 30 percent year-on-year increase in ESG assets and ESG selection strategies, representing 45 percent of total European AUM at the end of 2019.

Funds and portfolio companies have embraced ESG as well; Larry Fink, BlackRock's CEO, noted in his 2021 letter that there has been a systemic shift on this issue, given the evidence that companies with strong ESG profiles outperform those without.

In addition to the growing acceptance of ESG by investors and sponsors, the pandemic has broadened the ESG remit beyond primarily climate-related concerns to fully encompass the broader range of environmental, social and governance matters. This shift is underscored by EU-led regulatory developments.

II. THE DEVELOPMENT OF REGULATORY REQUIREMENTS

The European Union

Before 2014, the EU preferred soft-law options for wholesale ESG reporting, such as promoting the UN Global Compact and the UN PRI. That year, however, the EU took a decidedly harder line with the introduction of Directive 2014/95/EU (the Non-Financial Reporting Directive, or "NFRD"), which amended the Accounting Directive 2013/34/EU. The amendments required certain large

undertakings and groups to disclose information on policies, risks and outcomes regarding environmental matters, social responsibility, human rights, anticorruption issues and the diversity of corporate boards. While radical in the scope of the disclosures it required, the NFRD was conservative in reach, affecting only around 6,000 companies across the EU. Despite that limitation, however, the amendments had a significant impact by introducing concrete ESG reporting requirements to the market. The response was positive—not surprising, given that the global financial crisis, still fresh in everyone's mind, had provided a stark reminder of the importance of non-financial considerations in risk management.

ESG momentum was strengthened by the 2015 Paris Agreement and 2030 Sustainable Development Goals, which prompted the announcement of the EU's Action Plan on Sustainable Finance. The Action Plan, which was developed to reorient capital flows toward a more sustainable economy, included three headline regulations: the Low Carbon Benchmark Regulation,[1] the Disclosure Regulation[2] and the Taxonomy Regulation.[3] Importantly, these regulations cast a wide net, applying to (among others) anyone marketing or managing funds in the EU.

The United Kingdom

With the Brexit transition period having ended on January 1, 2021, the United Kingdom has begun to define how its own green finance strategy will depart from the EU's Action Plan. In November 2020, Rishi Sunak, the Chancellor of the Exchequer, laid out the UK's roadmap to developing and implementing environmental disclosure standards that are more robust than the EU's Disclosure Regulation. The UK will require mandatory disclosures in line with the Task Force on Climate related Financial Disclosures ("TCFD") by 2025, going beyond the Disclosure Regulation's "comply or explain" approach. This alignment has already begun its phase in, with premium listed commercial companies now required to provide disclosures in their annual reports consistent with the TCFD. Sunak also stated in the announcement that the UK will review the EU Taxonomy's thresholds and metrics and adapt them as needed for the UK market.

III. WHAT DOES THE FUTURE ESG REGULATORY LANDSCAPE LOOK LIKE?

We expect the ESG regulatory landscape to develop rapidly as we approach the 2030 SDG deadline. Below we set out our expectations for the next twelve months, the next three years and up to the SDG 2030 deadline.

Short term – twelve months

- **The EU Will Progress the Action Plan**

Currently, the Disclosure Regulation is partially in effect, with relevant Level II requirements anticipated on January 1, 2022. It requires financial market participants and financial advisers—including most private equity fund managers in the EU, as well as non-EU managers marketing in the EU under national private placement regimes—to disclose how ESG risks are incorporated into their investment decision-making process and whether (or, for larger firms, how) they consider the principal adverse impacts of investment decisions on sustainability factors. Products that specifically promote environmental or social characteristics and products with sustainable investments as their objective are subject to further special pre-contractual and ongoing disclosures regarding the sustainability indicators used to monitor performance against their objectives.

The Disclosure Regulation will be complemented by the Taxonomy Regulation, which will introduce uniform technical screening criteria to determine whether and to what extent an economic activity qualifies as environmentally sustainable. The Taxonomy Regulation's two climate change objectives are scheduled to become effective on January 1, 2022, with the remaining four environmental objectives taking effect on January 1, 2023.

In addition, existing regulations like the AIFMD will be revised to further incorporate ESG factors. Fund managers will soon be required to introduce procedures to address ESG risks; in

1. Regulation (EU) 2019/2089
2. Regulation (EU) 2019/2088
3. Regulation (EU) 2020/852

particular, sustainability risks will need to be taken into account in the fund manager's risk management policy.

- **The EU Will Introduce Broader Supply Chain Disclosures**

The European Commission has announced its intention to introduce far-reaching supply chain due diligence legislation by this July; in anticipation, the European Parliament recently passed a far-reaching Draft Directive on Corporate Due Diligence and Corporate Accountability ("Draft CDDCA Directive"). The Draft CDDCA Directive covers large undertakings and high-risk small- and medium-sized undertakings, both within and outside the EU, that "operate in the internal market selling goods or providing services." Those companies are required to consider whether their operations and business relationships cause adverse sustainability impacts; wherever adverse impacts are found, companies must address them. Companies must also build such considerations into their contractual relationships, codes of conduct and audits. The Draft CDDCA Directive is at an early stage of development, but its breadth and scope is notable.

- **COP 26 Will Prompt Further Private Sector Regulation**

The 2015 Paris Agreement committed signatory states to limiting global temperature increases to "well below" 2 degrees Celsius. Since then, the policies of individual governments have fallen short of that goal. Given that the pandemic has pushed back the date of the 2021 UN Climate Change Conference (COP 26), and the growing consciousness of stakeholder capitalism, we expect further climate commitments from governments and consequently further climate-related regulations affecting the private sector.

Medium term – three years

- **Addressing the Biodiversity Crisis**

Since the inception of ESG, the "E" has been synonymous with climate-focused investing. However, there is a growing awareness that this approach needs to be broadened. In September 2020, the World Wildlife Federation reported that wildlife populations have fallen by more than two-thirds in less than half a century; further, $44 trillion of economic activity—more than half of global GDP—is at least moderately dependent on nature. The UK Treasury's Dasgupta Report, published in February this year, built on these conclusions, noting that the loss of natural capital lowers crop yields, weakens supply chains and exacerbates natural disasters. The revelatory findings of these reports will likely be discussed at the UN's Biodiversity Conference (CDB COP 15) taking place in Kunming, China, later this year. With the EU and UK both considering biodiversity-related disclosures in the coming years, biodiversity will become an increasingly important aspect of the ESG landscape.

- **Social Considerations to Stay on the Agenda**

The COVID-19 pandemic brought to the fore the problem of economic inequality and elevated its place on the regulatory agenda, with the IMF, World Bank and OECD all noting that the pandemic has deepened the economic divide. With increasing investor acceptance of stakeholder capitalism and disclosure obligations mandating greater corporate transparency, corporates and private equity sponsors alike will be expected to play not just an economic but a social role in the global recovery. Of particular importance to this dialogue is the social taxonomy currently being developed by the European Platform on Sustainable Finance ("EPSF"), which will seek to foster more equitable employment and safe working conditions by promoting investment in education, health and housing. However, the EPSF's social taxonomy may well engender considerable debate and take longer to come to fruition than its environmental counterpart.

- **Public and Private Environmental Litigation**

There are currently 22 cases before courts around the globe invoking obligations under the Paris Agreement, and many more focused on climate change more broadly. The highest-profile decisions so far have been against governments accused of not meeting their international obligations, most notably the Dutch Supreme Court's 2019 decision in *Urgenda Foundation v Netherlands*. In that case, the court held that the Dutch government had acted negligently when setting a CO_2 target which did not align with the Paris Agreement. Such judgments will force governments to address any deficiencies in regulatory regimes that do not align

with increasingly stringent international environmental commitments, affecting private sector targets and allowances.

More ESG regulation will invariably increase the number of claims brought against private companies. An early example arose in January 2020, when 14 French local authorities and five French NGOs brought a claim against Total under the French Vigilance Law, claiming that Total had failed to identify and take appropriate steps to mitigate climate risks and that the company's vigilance plan "does not ensure that the Total group aligns with a trajectory compatible with the objectives of the Paris Agreement."

Long Term – 2030

• The SDG Commitments Become Reality

Many investors are aligning their portfolios with the UN Sustainable Development Goals, comprising 17 goals and 169 targets addressing economic, social and environmental development. Such alignment is a good indicator of the direction of portfolio risk mitigation. However, given the economic and social impact of the pandemic, achieving all of the SDGs by 2030 will prove difficult. Fund managers should be conscious of the wording they use when committing to align their portfolios with the SDGs, being careful not to overcommit to macroeconomic targets which are outside of their control.

• Broader ESG Litigation

ESG litigation is likely to grow on multiple fronts. Alongside the general climate litigation discussed above, courts will also be faced with the question of the extent to which fiduciaries *must* take ESG considerations into account when making investment decisions. As mandatory ESG disclosure obligations increase, so too will alleged breaches of commitments to align with a particular sustainability benchmark. Courts will have to decide questions of compliance with, and perhaps more importantly, the accuracy of, non-financial reporting, whether mandatory or voluntary. Courts must also determine the limit of corporate separateness and the circumstances in which the "corporate veil" can be pierced.

> Governments will be forced to address any deficiencies in regulatory regimes that do not align with increasingly stringent international environmental commitments.

• A Global Reach

While the EU has so far taken the lead in ESG regulation, governments elsewhere are crafting their own approaches. In the United States, the Securities and Exchange Commission has made a number of announcements reflecting the worldview of the new administration. Most notable is the SEC's 2021 Priorities, which set forth a new approach to climate change and other ESG considerations. There is no doubt the SEC's ESG disclosure regime will be influential, but it is unlikely to undermine the EU's current position as the global ESG standard setter.

Similarly, as China becomes an increasingly important player in the global financial markets, more attention will be paid to its still-nascent ESG regulatory environment. However, the World Economic Forum has observed that China is at a tipping point in terms of environmental commitments, noting its ambition to reach peak carbon before 2030 and carbon neutrality by 2060.

IV. CONCLUSION

Regulatory developments and international commitments in Europe, the United States and elsewhere reflect the permanent place ESG has achieved in the economic landscape. Private equity sponsors should keep abreast of this fast-moving regulatory environment.

For more Debevoise insights in the ESG space, visit the firm's ESG Resource Center here.

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