Debevoise & Plimpton

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From the Editors

Identifying and managing risk is an essential concern for private equity funds. Some risks, like the upheaval brought on by the COVID-19 pandemic, are novel and arrive with little warning. Many others, however, can be spotted in advance, through policy pronouncements or developments in case law, giving agile investors an opportunity to revise strategy and, where possible, to take appropriate countermeasures.

In our *2020 Private Equity Report—Year-End Review and Outlook* issue, we noted the uncertainty that came with a new administration in Washington. In the months since then, a clearer picture has emerged of the challenging antitrust environment that dealmakers now face, both in the United States and abroad. Recent developments under Delaware case law have also affected risk assessment by private equity investors. Sponsors can no longer make formerly safe assumptions regarding the redemption of preferred shares or certain M&A litigation risks with respect to minority investments. Other disputes illustrate that a private equity fund's ability to pursue arbitration against a foreign state under investment treaties may be adversely affected by the fund's structure.

We hope that our review of the shifting risk landscape is helpful as you plan your own risk mitigation strategies.

- **Getting Private Equity Deals Done in the Current Antitrust Environment**
  M&A transactions are facing heightened scrutiny from regulators in Washington and around the world. Sponsors are being asked by the FTC to discuss their pipeline and industry track record, "warning letters" are injecting unquantifiable but real risk into deal timelines, and the EU is now examining deals that fall below the Merger Regulation thresholds. Takeaways from a recent Debevoise webinar for private equity leaders highlight the key obstacles to getting deals done.

- **Preferred Equity Redemption Rights: "The Bitter and the Sweet"**
  Private equity investors have relied on preferred equity in deal structures since long before the recent spate of PIPE transactions. But while the redemption rights of preferred equity may seem on the surface to be similar to debt, a recent case before the Delaware Court of Chancery serves as a reminder that the reality is more complex and that those rights are not absolute. Astute investors in preferred securities can strengthen those rights through provisions in the preferred equity's terms.

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Fall 2021 Issue Editors

Paul S. Bird
psbird@debevoise.com

Jin-Hyuk Jang
jhjang@debevoise.com

Editorial Board

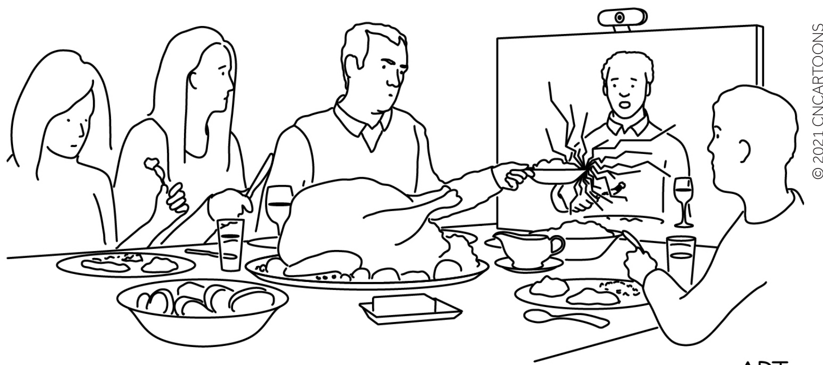
Sally Bergmann
Jennifer L. Chu
Rafael Kariyev
Scott B. Selinger
Patricia Volhard
Jin-Hyuk Jang

Paul S. Bird
Editor-in-Chief

Franci J. Blassberg
Founding Editor

- **Risk of Imputed Control in Delaware Shareholder Litigation**
  Recent cases in Delaware make it clear that significant minority investors in publicly traded companies without voting control can no longer assume that they are free from being labeled a controller in M&A litigation. The procedures outlined in the 2014 *MFW* case provide a roadmap private equity firms can use to mitigate that risk when entering a transaction involving a publicly traded company.

- **Fund Structuring and Investment Treaty Protections**
  All disputes regarding foreign investment are challenging, but those involving a claim against a foreign government raise unique issues for private equity funds. Investment treaties can provide important protections to foreign investors that can be enforced though international arbitration against the government in question. However, the extent to which private equity investors can rely on those protections greatly depends on the fund structure.



"Could you pass the cranberr—"

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Getting Private Equity Deals Done in the Current Antitrust Environment

Around the world, antitrust enforcement agencies are increasingly conducting more rigorous merger control reviews, even for non-strategic transactions that do not raise any immediate and substantive competition issues.

Ted Hassi
Partner

Tim McIver
Partner

Michael Schaper
Partner

Kevin M. Schmidt
Partner

Erica Weisgerber
Partner

Anne-Mette Heemsoth
Associate

Given that deal flow is the lifeblood of private equity firms, the heightened scrutiny toward mergers from regulators is a matter of serious concern. On November 4, Ted Hassi, Timothy McIver, Michael Schaper, Kevin Schmidt, Erica Weisgerber and Anne-Mette Heemsoth from the Debevoise Antitrust and M&A teams hosted a webinar for private equity leaders to assess today's highly dynamic antitrust environment. Highlights included the following:

At the FTC, PE is in the crosshairs. Under the leadership of new Chair Lina Khan, the Federal Trade Commission (FTC) is exercising enhanced scrutiny of PE firms in the M&A space. Recent communications from the FTC's leaders include little if any acknowledgement of the positive role that PE firms can play in providing capital, expertise and synergy; instead, PE firms are seen to "distort ordinary incentives," "strip productive capacity," and "prey on [marginalized] communities."

Second Requests: more common, broader, tougher. The harder line taken by the FTC can be seen in the agency's Second Requests. Observers report that Second Requests (*i.e.*, discovery procedures by which the FTC investigates transactions which may have anticompetitive consequences) are more frequent, probe a wider variety of issues (such as ESG factors and effects on unions and employees) and are more frequently backed up with threated legal action around compliance with the requests.

Investments and strategies are under scrutiny. Importantly for private equity firms, some Second Requests are now reaching beyond the portfolio company involved in the deal to include the sponsor itself. PE firms are being asked about their acquisition pipelines, plans for tuck-ins and add-ons, and industry track record. While this level of scrutiny was previously found in regulated industries, it is now becoming commonplace across the board. In addition, the agency has proposed (but not finalized) a rule requiring buyers to disclose information on their parent companies and subsidiaries, which could increase the burden for private-equity making premerger HSR filings.

The gloves come off for vertical mergers. The FTC recently withdrew its approval of the Vertical Merger Guidelines issued jointly with the Department of Justice in 2020, as well as the agency's commentary to those guidelines, suggesting the agency intends to step up enforcement against vertical mergers.

Warning letters signal no new law, but a big shift in attitude. The FTC has always had the right to challenge transactions after closing. To this end, the agency's new practice of more frequently sending "warning letters" reminding parties of this fact represents nothing new from a statutory perspective. Nonetheless, the warning letters do represent a stark difference from the antitrust agency's typical HSR review process for the past several decades; the letters suggest that parties to reportable transactions should not assume they are in the clear once the 30-day preliminary review period has passed. While it is too early to tell whether the FTC will more aggressively challenge post-close transactions, the agency's pointed reminder of its post-closing reach suggests that parties should be mindful of new transaction risks.

A new point of negotiation between buyers and sellers. Some parties have responded to "warning letter risk" by including provisions in their PSAs tied to the receipt of such a letter. While this has been the exception and not the rule, the provisions used so far have ranged from the ability of the buyer to delay the closing for a short period of time to being able to delay closing indefinitely. Eventually, other methods of risk allocation may emerge as well, such as an adjustment to the purchase price if a divestiture or other constraint is imposed post-closing. Whatever the conditions are, buyers and sellers will want to closely scrutinize antitrust contract provisions that address who leads antitrust strategy, contacts with regulators, and access to communications with regulators.

The return of "prior approval" casts a shadow over divestiture deals for a decade—or longer. The FTC has announced that it will resume its earlier practice of requiring parties to mergers the FTC deems anticompetitive to seek the FTC's approval for a minimum of 10 years for future acquisitions affecting the relevant markets for which a violation was alleged. This prior approval requirement will also require buyers of divestiture assets sold pursuant to a merger consent order to obtain prior approval on any subsequent sale of those assets for a period of *at least* 10 years—essentially giving the FTC veto power over exit strategies. The collateral consequences on the M&A deal space of discouraging private equity firms from acquiring assets that need to be divested for deals to go through remains to be seen. For more detail on this recent change, please see our recent client alert, "Buyer Beware: The FTC's Revived and Expanded Prior Approval Policy."

> It is possible that deals which trigger no merger control filings or issues can still be subject to close regulatory scrutiny and a lengthy sign-to-close timeline under foreign investment regimes.

Antitrust is tougher everywhere. Around the world, antitrust enforcement agencies are increasingly conducting more rigorous merger control reviews, even for non-strategic transactions that do not raise any immediate and substantive competition issues. Another recent trend is the notable creativity in establishing jurisdiction; for example, the EU Commission has now started accepting referrals from national competition authorities to review transactions even if the transaction falls below the EU Merger Regulation thresholds and the referring authority itself does not have jurisdiction to review the case. The EU Commission is also considering revising its merger review thresholds so that more transactions involving early-stage, high-growth tech companies will be covered.

No letup in the EU's strict procedural enforcement. In the current environment, even deals that seem to be following the book can find themselves in regulatory hot water for procedural missteps. The *Altice Europe/PT Portugal* merger provides a cautionary tale: Although the merger got the go-ahead from the EU, the EU Commission later held that conduct of business covenants in the

agreement and the ongoing exchange of information between the parties without “clean team” procedures constituted “gun jumping,” resulting in a fine of €124.5 million.

Global investment is now a national security issue. From the United States to the EU to China, more and more countries are introducing foreign investment regimes, or revising existing ones by widening the scope of application to include sectors not previously considered ‘sensitive.’ Foreign investment regimes are typically triggered by the target’s lines of business, or the nationality or identity of the acquirer or investors. It is therefore possible that deals which trigger no merger control filings or issues can still be subject to close regulatory scrutiny and a lengthy sign-to-close timeline under foreign investment regimes. This development can also create significant compliance complications for PE firms, given the amount and detail of information that can be requested by the relevant authorities, which increasingly also includes information on the limited partners of PE backed deals, including passive, minority and fund-of-funds investors.

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Preferred Equity Redemption Rights: "The Bitter and the Sweet"

> ...preferred equity is not debt (even if considered debt for tax or regulatory capital purposes), and the ability to enforce rights as a preferred equity holder is subject to meaningful legal limitations.

Gregory V. Gooding
Partner

Uri Herzberg
Partner

Kevin M. Schmidt
Partner

Katherine Durnan
Associate

Preferred equity is a long-standing, flexible investment structure for private equity investors. The 2020 Spring issue of the *Debevoise Private Equity Report* reviewed preferred equity terms in the context of the wave of PIPE (private investment in public equity deal) deals that flooded the market in the early days of the pandemic, as pressure on corporate balance sheets and unavailability of traditional financing markets sent many companies on a race for near-term liquidity. While those pressures have eased, we continue to see many preferred equity deals, sometimes used to fill out the capital structure of a large buyout in place of traditional mezzanine debt, and sometimes used by "special situation" groups that target bespoke investment opportunities and are attracted to the degree of customization that preferred equity offers. But, as we have noted previously, preferred equity is not debt (even if considered debt for tax or regulatory capital purposes), and the ability to enforce rights as a preferred equity holder is subject to meaningful legal limitations.

A recent case in Delaware reinforces the potentially bitter aspect of this otherwise sweet form of investment. Our article featured in the 2016 Winter issue of the *Debevoise Private Equity Report* discussed various legal considerations associated with preferred equity. We noted there that the rights of preferred holders are contractual in nature and that an issuer's directors owe no fiduciary duties to the preferred holders in respect of such rights. Although this may not sound so different from the rights of a lender, preferred holders do not benefit from creditor rights or remedies. This is the case even if the preferred equity has certain debt-like features, such as mandatory redemption or cumulative dividend obligations. Under Delaware law, equity cannot be redeemed if it would impair the capital of the issuing company. Courts largely defer to the good faith determination of the issuer's board of directors as to whether redemption of preferred equity would result in impairment of its capital.

In the recent Delaware Court of Chancery decision *Continental Investors Fund LLC v. TradingScreen Inc., et al.*,[1] Vice Chancellor Laster set forth a detailed explanation of the nature of a preferred equity interest and the principles underlying the reasons why preferred holders' rights—and in particular redemption rights—may be difficult to enforce. In that case, the preferred holders were ultimately fully redeemed, but that process took over five years. The Court found that the failure to redeem earlier was not a "default" under the terms of the preferred, and thus the provision of the preferred that required the company to pay interest in the event of a default was not triggered.

1. *Continental Investors Fund, LLC v. TradingScreen, Inc., et al.*, C.A. No. 10164-VCL (Del. Ch. July 23, 2021)

Vice Chancellor Laster explained the court's deference to an issuer's board of directors in determining whether the issuer has sufficient legally available funds to effect a redemption, as long as the board did not act in bad faith or fraudulently, and emphasized that the court's review of such determination does not involve a valuation exercise in the vein of a "mini-appraisal":

> "When bringing a claim for a breach of a mandatory redemption provision, the plaintiff must prove that the corporation had additional funds that it could deploy legally for redemptions (commonly called 'funds legally available'), yet failed to deploy the funds for that purpose . . . . Whether the corporation had funds that could have been deployed legally to redeem more shares is not a valuation exercise that the court decides as if the case were a mini-appraisal. A board's determination as to the amount of funds legally available is a judgment-laden exercise entitled to deference. In the absence of bad faith or fraud on the part of the board, courts will not substitute our concepts of wisdom for that of the directors' as to the amount of funds available for redemptions."

If a preferred holder seeks to establish that an issuer failed to comply with a mandatory redemption right, it must prove that the board (1) acted in bad faith, (2) relied on unreliable methods or data or (3) made determinations so far off the mark as to constitute actual or constructive fraud.

Vice Chancellor Laster distinguished rights in a preferred stock certificate of designation from other contract claims: "Both the [Delaware General Corporation Law] and the common law impose restrictions on redemption rights that other contract claimants do not face . . . . An equity investor is not like other contractual claimants: The equity investor purchased equity, which is presumptively permanent capital."

Issuers have often taken pains to ensure their mandatory redemption provision includes the words "funds legally available" or a similar variant so that it is clear the holder's redemption right applies only in such circumstances. However, Vice Chancellor Laster reminds us that a comparable limitation is implied by law, and thus the presence or absence of such limitation in a mandatory redemption provision does not affect the plaintiff holder's burden of proof to establish that the issuer in fact had sufficient legally available funds to deploy for redemptions.

To put these enforcement limitations in context, Vice Chancellor Laster also pointed out that such limitations confer substantial benefits on both issuers and investors, such as by enabling preferred equity with debt-like features to be classified as equity for tax purposes, which can avoid imputed interest for investors, lower the cost of capital for issuers, and allow regulated issuers to meet capital requirements: "A sophisticated investor that opts to purchase preferred stock … must take the bitter with the sweet."

While enforcement limitations with respect to mandatory redemption rights in preferred equity investments are unavoidable, an investor does have tools to improve its position, given the highly customizable nature of the instrument. For example, a certificate of designation might provide that if the issuer fails to redeem the preferred equity when required to do so, whether due to lack of sufficient funds or otherwise, such failure constitutes a "triggering event" that would result in specific consequences benefitting the investor. These consequences may include an increased dividend rate, additional governance rights, a right to force the issuer to pursue a sale of the company, a decrease of the conversion price or an obligation to establish a sinking fund into which free cash flow would be deposited for use solely to redeem or make dividend payments on the preferred equity.

The "triggering event" concept can improve a preferred investor's position and mitigate its risk with respect to its contractual rights beyond just a mandatory redemption provision, including an issuer's failure to pay dividends or otherwise to take specific actions. At the end of the day, the one right of a preferred equity holder that should be unassailable is the right to derive value at the expense of the common equity in a downside scenario. But cases such as *Trading Screen* reinforce the fact that the drafting of the preferred terms must be done carefully so that even this basic right is not undone due to the disfavored legal status of contractual elements of preferred stock relative to debt or other contractual instruments.

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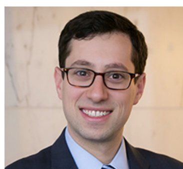
Recognizing and Mitigating the Risk of Imputed Control in Delaware Shareholder Litigation

> This newly expansive view of "actual control" is a troubling development for transactions with significant minority stakeholders, and one that private equity investors and their advisors should keep in mind when engaged in public company transactions that fit plaintiffs' target profile.



Zachary H. Saltzman
Partner

Shannon Rose Selden
Partner

Natascha Born
Associate

David J. Hotelling
Associate

Investors with significant minority stakes in publicly traded companies face an increased risk of deal litigation based on theories of imputed control. Until recently, a non-passive, significant minority investor with limited representation on a company's board of directors could—absent abusive conduct—reasonably expect that it would not be deemed to be a controlling shareholder in M&A litigation as long as it held significantly less than the 50 percent of outstanding stock required for voting control. In the past few years, however, plaintiffs have brought a series of cases challenging that assumption, and have sought to impute control—and with it, a higher standard of review—to transactions involving significant minority stockholders. In these cases, plaintiffs claim that the transaction was conflicted and unduly benefitted the alleged controller, and as a result, the court should subject the deal to Delaware's searching "entire fairness" review rather than deferring to the business judgment of the directors.

While the law continues to evolve, a number of judges on the Chancery bench have credited allegations that a sophisticated financial investor—often a private equity fund—that held only a minority stake in a public company exercised such disproportionate influence as to be practically in control for purposes of a transaction, particularly when that transaction appears to favor the fund. Increasingly, these allegations are surviving motions to dismiss, sending more cases into intensive (and expensive) fact and expert discovery over the key questions of fair price and fair process, and the existence of "actual" control, notwithstanding the minority voting stake.

This trend means that investors who had reasonably concluded they were merely a minority stockholder, able to vote and transact in their own interest, have increasingly found themselves embroiled in long-running litigation that just a few years ago would have been dismissed on the pleadings. The change in Delaware law compels such investors to consider whether they should adopt deal protections typically reserved for transactions with an obvious controller.

This newly expansive view of "actual control" is a troubling development for transactions with significant minority stakeholders, and one that private equity investors and their advisors should keep in mind when engaged in public company transactions that fit plaintiffs' target profile. To that end, we provide below a brief primer on the evolving law and tools for risk mitigation.

Fiduciary Duties and Allegations of Investment Fund Liability

Stockholders are generally free to act in their own interests. However, "controlling" stockholders owe fiduciary duties, which compel the controlling stockholder to act in the interests of the corporation and the other stockholders. Courts assign fiduciary duties to controlling stockholders because a controlling stockholder essentially controls the company and the board's decisions, and the controlling stockholder's decisions may well affect the rights of the unaffiliated stockholders.

Although a stockholder that owns more than 50 percent of the voting shares of a corporation always is a controlling stockholder with the attendant fiduciary duties, a minority stockholder too can be considered a controlling stockholder. For this to happen, the minority stockholder must have either: (1) dominated and controlled the company or its board with respect to the transaction at issue, or (2) exercised considerable voting and managerial power over the company's day-to-day decisions. Under prior case law, an alleged controller with a minority stake usually had to be plausibly abusive or oppressive in order for a court to impute control. For example, courts have looked to actions such as:

- freely removing and replacing board members seemingly not affiliated with the minority stockholder,
- significant influence over or very close relationships with other members of the board,
- threats of a hostile takeover, or
- the exercise of contractual rights to push the company into a "comply or die" situation, in which surrender to the minority stockholder is the only way to avoid placing the company into a dire financial situation, such as bankruptcy.

Recently, however, this behavioral threshold has been lowered, with courts relying on less abusive or explicit conduct to conclude, at least at the motion to dismiss stage, that a minority holder could be a controller. Minority holders with a material voting stake are particularly at risk. Even where judges' opinions cite alleged misconduct in recounting the facts, courts express the legal standard in generic terms indicating that abusive conduct by the stockholder is not necessary.[1] These opinions make clear that at least some judges on the Chancery bench look to the general "gestalt" of control instead of requiring specific allegations of misconduct.[2]

If a court finds that the complaint sufficiently establishes imputed control, the transaction is not protected by the business judgment rule and the mere approval by a majority of independent stockholders will not have a cleansing effect under *Corwin*.[3] Instead, the court will allow the case to proceed to discovery under a presumptive "entire fairness" review, which looks closely at the transaction to determine whether the price and the process were fair. If, after trial, a court is not satisfied in this regard, it has broad powers to fashion an equitable remedy. A court may, for example, determine the price at which the transaction should have happened, and award the difference between that figure and the actual price, which can result in substantial adverse judgments.

Potential Sponsor Liability

Complaints seeking to impute control to an investment fund with a significant minority stake typically do not distinguish between the fund and its sponsor—and neither do the courts' decisions. Especially on the pleadings, Delaware courts have been willing to collapse the distinction between the fund and its manager, and to credit allegations that together they act as the alleged controlling stockholder—even though fund sponsors and management companies are rarely direct investors in public companies. Rather than differentiating between the stock ownership of the sponsor or management company and that of the fund, courts have credited allegations that since the same people sit at the fund and sponsor level, the two entities are indistinguishable for

1. *Calesa Assocs., L.P. v. Am. Capital, Ltd.*, 2016 WL 770251, at *11 (Del. Ch. Feb. 29, 2016).
2. *Reith v. Lichtenstein*, 2019 WL 2714065, at *9 (Del. Ch. June 28, 2019).
3. *See Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015).

the purposes of determining control.[4] This is a disturbing development for sponsors, which increasingly face claims despite their lack of direct investment or representation, and obscures the meaningful differences between the investment vehicle and its contractual investment manager.

Risk Mitigation

To mitigate the risk of being labeled a controlling stockholder, investors should start by recognizing the surprisingly low investment thresholds at which those risks start to accrue, and approach the transaction with an eye toward how those risks might materialize in litigation.

One powerful strategy for investors to follow is implementing the rigid procedure discussed in *MFW* that seeks to insulate the transaction from a controller's influence and, at least in principle, guarantees business judgment review of the transaction.[5] An investor must implement two key conditions to ensure that it is covered by *MFW*'s protections when entering into a transaction. Specifically, prior to the start of economic negotiations, the investor must condition the transaction on approval by both (1) an independent special committee and (2) a majority vote by fully informed minority stockholders. Those charged with constituting such a special committee should identify any connections between the potential controller and the individuals on the special committee in order to avoid allegations that the committee could not sufficiently protect the transaction from the controller. Similarly, the special committee should carefully screen its advisors for any potential conflicts with the minority stockholder that might lead a court to later infer that the special committee did not receive unbiased advice.

If *MFW* is properly followed, any lawsuit challenging the transaction will have a higher chance of being dismissed before discovery. Although implementing the *MFW* procedures may have a cost in terms of the transaction's speed and certainty, those costs must be balanced against litigation risk at a time when courts are more willing to tag a minority stockholder as a controller.

However, it is important to note that putting *MFW* protections in place will not eliminate the risk of a claim surviving a motion to dismiss. That is because the adequacy of the *MFW* procedures requires factual determinations, and plaintiffs can often allege facts—such as those questioning the independence of the special committee or the adequacy of disclosures to the unaffiliated stockholders—that prevent a court from determining at the motion to dismiss stage that the *MFW* conditions were properly implemented. For that reason, an investor should anticipate that plaintiffs will use discovery to explore the underlying facts should *MFW* fail at the motion to dismiss stage.

While there may be countervailing business considerations, an investor can also mitigate the risks of being found a controller in the first place by putting in place contractual arrangements that limit the investor's influence over the company, such as by restricting the number of fund-affiliated directors on the board or expressly requiring independent directors' approval of certain transactions and matters. By the same token, an investor should consider contractual arrangements as a source of risk where they appear to provide the investor with an edge in governance or decision-making.

Although minority investors need to recognize the increased litigation risk they face, that risk can be mitigated and need not prevent desirable transactions. Litigation risk, properly understood and managed, may often be preferable to the deal risk of acting too defensively—particularly while the law regarding minority controlling shareholders remains somewhat uncertain. Sophisticated investors can address these challenges by identifying them at the start of the deal process and adjusting their strategy accordingly.

4. *In re Ezcorp Inc. Consulting Agreement Derivative Litig.*, 2016 WL 301245, at *9 (Del. Ch. Jan. 25, 2016); *In re Primedia Inc. Derivative Litig.*, 910 A.2d 248, 251 (Del. Ch. 2006).

5. *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

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Fund Structuring and Investment Treaty Protections

Because treaty protection typically depends on the nationality of the investor, the nature of its investment in the host State, and the manner in which it owns or controls that investment, the specific fund structure can be dispositive.

Jonathan Adler
Partner

Geoffrey Kittredge
Partner

Ina Popova
Partner

Patrick Taylor
Partner

Cameron Sim
International Counsel

Benjamin Teo
Associate

Lillian Wong
Legal Assistant

Not every dispute relating to a foreign investment is suited to court litigation. This is particularly the case when an investor has claims against a foreign government. Suing a state in its courts is unlikely to be appealing for a host of reasons, especially in high risk jurisdictions. Arbitration is often the only alternative.

Investments can be structured so as to be protected under investment treaties. These treaties offer additional substantive protections under international law and enable the resolution of disputes against states in a neutral forum.

The legal structure of private equity funds can complicate access to such investment treaties, but overcoming such complications is possible and can be worth the effort.

What is an investment treaty?

An investment treaty is an agreement made between two or more states aimed at attracting and promoting foreign investments. Investment treaties contain various incentives for investors, including substantive protections for foreign investments. Usually, they also allow the investor to enforce those protections through international arbitration against the host state, which is a valuable alternative to pursuing claims under local law or in local courts.

There are over 2,600 treaties with investment protections currently in place, with more on the horizon. The rise of investment treaty protections has been one of the most significant developments in cross-border dispute resolution over the past 30 years.

When considering an investment treaty, there are three basic variables to consider: who qualifies for protection, what sort of investments qualify, and what the protections entail.

Who qualifies for protection?

Generally, investment treaties offer protection to investments made by an investor of one contracting state to the treaty (the home state) in the territory of another contracting state (the host state).

Whilst treaties differ, the definition of an investor is normally quite broad. Typically, an investor includes:

a. individuals who are nationals of a home state; and

b. companies with the nationality of the home state.

Many treaties also protect both direct and indirect investors (including minority shareholders), and investors who control, but do not own, the relevant investment.

For a company, treaties may provide that its nationality is determined by its:

a. place of incorporation;

b. principal place of business activities;

c. place of corporate seat; or

d. place of control.

However, some treaties also allow host states to deny the benefits of the treaty to an entity that meets these formal nationality criteria, but is itself owned or controlled by non-qualifying nationals and has insufficient business activities in the state of its putative nationality.

What qualifies for protection?

A qualifying investor also needs to have a qualifying investment to be entitled to protection under an investment treaty.

Again, treaties differ, but most treaties define investments in broad terms as including any kind of asset that an investor owns or controls, directly or indirectly. Some treaties also give examples of covered assets, typically including:

a. shares, stock, and other interests in a company;

b. debt, bonds, and claims to money or performance under a contract;

c. business concessions conferred by law or under contract; and

d. property rights in movable and immovable property.

How are investors and investments protected?

Investment treaties typically include various protections for qualifying investors and investments, such as undertakings by the contracting state:

a. to treat investments fairly and equitably, such as by not frustrating the investors' reasonable and legitimate expectations; by ensuring due process and protecting against denial of justice; or not impairing the investment through arbitrary or discriminatory conduct;

b. not to expropriate the investment without compensation, or take measures tantamount to such expropriation;

c. to respect any undertakings the state has made with respect to investments; and

d. not to discriminate against foreign investors but to treat them no less favorably than other similarly-situated national and third-party investors.

Because treaty protection typically depends on the nationality of the investor, the nature of its investment in the host State, and the manner in which it owns or controls that investment, the specific fund structure can be dispositive. The structure may determine whether the treaty tribunal has jurisdiction over the claims and therefore whether the investor has access to a neutral forum for dispute resolution.

For example, Cayman exempted limited partnerships do not have separate legal personality, which means that the general partner holds the assets of the fund on trust for the limited partners. In contrast, Delaware funds have legal personality, and therefore can also hold assets directly. Other jurisdictions, such as those in the Channel Islands, allow limited partnerships to elect whether or not to have separate legal personality. A key issue for Cayman funds is whether partners could constitute investors under the terms of the treaty on the basis of their beneficial ownership of investments made by the fund. Which entities control an investment for purposes of treaty jurisdiction can also be a highly fact-specific analysis.

> Investments can be structured at the outset to maximize treaty protections, especially in high risk jurisdictions or politically sensitive sectors.

The impact of fund structures: Cases in point

Where a fund structure has been used to make a particular investment, questions may arise as to which entities, and which investors, are protected by an investment treaty and in respect of what kind of interest. Is it the portfolio company, one or more intermediate holding companies, the general partner, the limited partners, the fund itself, or all of them, that has access to investment treaty protections?

Several pending cases illustrate the kinds of issues that can arise when funds and investment vehicles bring claims under investment treaties. For example, in the twin cases of *Mason Capital L.P. and Mason*

Management LLC v. Republic of Korea, PCA Case No. 2018-55 and *Elliott Associates L.P. v. Republic of Korea*, PCA Case No. 2018-51, the claimants are pursuing claims under the South Korea-U.S. free trade agreement. The claims relate to the South Korean government's purported intervention in a 2015 merger between Cheil Industries and Samsung C&T Corporation, in which the claimants were shareholders. Claimants allege that the controlling family of Samsung bribed former Korean President Park Geun-Hye to intervene in the merger via the state-run National Pension Service, causing losses for the Samsung shareholders.

In *Mason*, South Korea objected to the tribunal's jurisdiction under the South Korea-U.S. free trade agreement on grounds relating to the ownership structure of the investment. The claimants in *Mason* are a Cayman exempted limited partnership ("**Mason Fund**") and its general partner, a Delaware limited liability company ("**Mason GP**").

First, South Korea alleged that Mason GP, the Delaware entity, did not either "make" or "own or control" the investment. In dismissing this objection, the tribunal observed that although the investments were registered in Mason Fund's name, as a Cayman exempted limited partnership, Mason Fund lacked legal personality and could not hold property. Instead, the tribunal determined that Mason GP held legal ownership to the investment on trust for Mason Fund.

Second, South Korea argued that Mason GP did not beneficially own the investment. The tribunal also dismissed this objection, and determined that Mason GP's entitlement to carried interest in the investments constituted a beneficial interest in Mason Fund's assets that was protected under the treaty.

In *Elliott*, where the sole claimant is a Delaware limited partnership, South Korea objected that the LP did not itself "make" the investment, because another Elliott entity provided the capital for more than half of the shares.

In *The Carlyle Group L.P. and others v Kingdom of Morocco*, ICSID Case No. ARB/18/29, Carlyle Group L.P. and six of its affiliates (all of which are U.S. entities, including two other Delaware limited partnerships) are pursuing claims against Morocco under the U.S.-Morocco FTA in relation to investments made in a Moroccan oil company, which has since gone into liquidation. Morocco has challenged the jurisdiction of the tribunal on various grounds, including that the claimants lack standing because their investments were made through Cayman special purpose vehicles.

Similarly, in *Gramercy Funds Management LLC and Gramercy Peru Holdings LLC v. Republic of Peru*, ICSID Case No. UNCT/18/2, Debevoise represents two Delaware entities who invested in Peruvian agrarian bonds. Peru has objected to the jurisdiction of the tribunal under the U.S.-Peru FTA on various grounds, including relating to the claimants' ownership and control of the investment.

Decisions on jurisdiction are still pending in *Carlyle*, *Elliott* and *Gramercy*, and will be of special interest to the funds industry.

Structuring for protection from the start

Investments can be structured at the outset to maximize treaty protections, especially in high-risk jurisdictions or politically sensitive sectors. In certain situations, it may also be possible to restructure the investment to create such coverage on a prospective basis. For example, it may be possible to insert a holding company into the chain of ownership below the fund level that would be protected under an investment treaty with the host state of the ultimate portfolio investment.

Any restructuring may, however, affect the availability of treaty protections. For example, in *Elliott*, South Korea has argued that the claims should be dismissed as an abuse of process because the investor allegedly restructured its investment to gain treaty protections at a time when the dispute was foreseeable. In November 2021, it was also reported that the tribunal in *CSP Equity Investment Sàrl v. Spain* (SCC Case No. 094/2013) declined jurisdiction over claims brought by a Luxembourg company on the basis that the dispute was foreseeable at the time of a corporate restructuring.

In light of these risks, any restructuring should be carefully considered with counsel at the earliest opportunity.

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