Debevoise & Plimpton

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From the Editors

In the face of both the current economic environment and regulatory developments, private equity sponsors are exploring new structures and strategies, and reexamining previously existing approaches in a new light. This issue of the *Debevoise Private Equity Report* reviews some of the notable developments our practitioners are observing in the field. We hope that you find this a useful guide during this dynamic time.

In a Choppy Market, Preferred Equity Comes to the Fore

Market conditions have made preferred equity an increasingly popular liquidity and financing alternative to traditional GP-led secondaries, NAV financings and GP financings. Sponsors using this strategy need to navigate several issues including whether the terms more closely resemble equity or debt, obtaining LP consent, and managing conflicts of interest and disclosure requirements.

Structure Options for Addressing the New 1% Excise Tax

The Inflation Reduction Act's 1 percent excise tax doesn't just cover garden-variety stock buybacks—it can also extend to the portion of the purchase price of a U.S. public corporation that is treated as a redemption for U.S. income tax purposes. Affected private equity buyers should consider an alternative financing structure in which the acquisition debt is undertaken by the parent holding company.

Implications of the Inflation Reduction Act for Investors in Life Sciences Companies

The Inflation Reduction Act includes provisions that constitute some of the most significant healthcare reform since the Affordable Care Act—most notably, by requiring HHS to negotiate the price of many of the drugs that account for the highest Medicare spending. Private equity investors in this space will need to factor this and other changes into their investment calculus.

Your Contract Can Only Be Amended in Writing? Not So Fast.

Most agreements contain language requiring amendments to be made in writing. But such clauses aren't the last word on the matter. A Delaware Chancery Court decision in June is only the most recent reminder that—as paradoxical as it may seem—provisions requiring written modification can be undone by oral agreement.

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Avoiding Surprises in Brazilian M&A

Many acquisitions and exits by international sponsors involving Brazilian targets are governed by Brazilian law but use agreements modelled on New York or Delaware forms. However, limited disclosures have made it difficult for sponsors to see how these imported provisions have held up in disputes. Research findings presented at this summer's M&A Conference of the Americas in São Paulo shed light on this question.

Deep Freeze: What PE Funds in Hong Kong Need to Know about the SFC's Asset-Freezing Powers

The Restriction Notices that play an important role in the enforcement arsenal of Hong Kong's Securities and Futures Commission recently survived a constitutional challenge. Private equity sponsors are well advised to understand how Restriction Notices give the SFC a broad basis to freeze an entity's assets—and the assets of the entity's clients—pending an investigation.

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"I hate how the screens get bright so early this time of year."

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In a Choppy Market, Preferred Equity Comes to the Fore

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In fund finance, preferred equity has become an increasingly popular liquidity and financing alternative to traditional GP-led secondaries, NAV financings and GP financings. Although the structure is not new, there is now greater awareness among investors and funds of the advantages that preferred equity offers—especially in periods of a market downturn, where the market for secondary sales may be uncertain and traditional lenders may be more selective and require stricter covenants.

What is preferred equity?

In the fund finance context, preferred equity refers to the issuance of new equity interests in a fund that rank junior to debt but have priority over the common equity of a fund in distributions. Preferred equity may be issued by an existing fund or, more commonly, by a newly formed special purpose vehicle ("SPV") formed by the existing fund and, possibly, related funds. In an SPV structure, the existing and related funds contribute one, some or all of their portfolio investments to the SPV, which then issues common equity to the existing fund and preferred equity to the preferred investors. The SPV structure is favored by preferred investors because the preferred equity is structurally senior to any debt at the existing fund level that is not secured by the fund's assets. The economic terms of preferred equity are typically implemented through the distribution waterfall of the issuing fund or SPV. After the administrative expenses of the issuer have been paid (often subject to a negotiated cap), the preferred investors receive priority in distributions until those investors have received repayment of their capital contributions plus either a minimum rate of return or a multiple on invested capital. In some cases, the preferred investors negotiate for a portion of subsequent distributions once the preferred return has been met, allowing them to share in the upside.

Uses and benefits of preferred equity

Preferred equity is useful in situations where existing fund investors want liquidity but traditional liquidity solutions are limited. In uncertain market conditions, where selling the portfolio company or conducting traditional fund or GP-led secondaries may not be attractive due to depressed activity or valuations, and where GPs see more growth potential and value in retaining portfolio investments for a longer period, preferred equity proceeds can be used for distributions to existing investors, providing them with liquidity

before a full exit while allowing them to remain invested and retain any future upside. Preferred equity deals can often be executed in a few weeks, whereas a continuation fund can take months to close. Further, unlike continuation fund transactions, a preferred equity deal may not require agreement on a valuation of the fund assets, as the economics of the preferred equity provide for a minimum return and downside protection. For the same reason, preferred investors may be satisfied with focusing diligence at the fund level, without undertaking more detailed diligence at the portfolio company level.

> ...preferred equity has become an increasingly popular liquidity and financing alternative to traditional GP-led secondaries, NAV financings and GP financings.

While preferred equity is often used to provide investors with liquidity, proceeds from preferred equity may also be used to fund follow-on investments, support a portfolio company with a capital injection where it cannot get financing on a stand-alone basis, repay existing fund or portfolio company debt, or bridge capital calls from existing investors. Preferred equity thus represents an alternative to NAV financings, which typically have a fixed tenor of two-to-four years and covenants customary for debt investments, and may also require security over the actual assets. NAV financings often also include a provision that triggers an event of default if the loan-to-value ratio exceeds a specified threshold, requiring a sell-down of assets within a specified period. In contrast, preferred equity terms tend to be more bespoke and tailored to the needs of the issuer and the particular deal. The preferred equity may have a longer redemption date or may have no redemption date, with distributions being made as portfolio investments are divested until the end of the fund's term. Preferred equity terms are also lighter on covenants than debt financing, thus offering downside protection to the issuer. As a result, however, preferred equity tends to be more expensive than debt, reflecting the assumption of equity risk and the greater flexibility afforded the issuer.

Preferred equity transactions have also become increasingly common for financing investments in private equity sponsors, with the proceeds often used to fund internal growth initiatives or larger GP commitments to underlying funds as well as to provide liquidity to founders or departing investment professionals. In this context, preferred equity provides a lower cost of capital to founders as compared to traditional equity, which allows founders (and the next generation of investment professionals) to retain future appreciation in the business. At the same time, preferred equity investors typically require fewer minority protections than common equity investors, allowing founders to retain more control over the business.

Key issues in getting the deal done

Debt-like or equity-like?

Whether the terms in a particular deal are more debt-like or equity-like often depends on whether the investor is viewed as a credit provider or an equity investor and on the relative negotiating power of the issuer and its GP. Preferred investors will typically want consent rights above what ordinary LPs in a fund would receive, in order to protect the value of the preferred equity. Common consent rights include restrictions on incurrence of debt and other anti-dilution protections, restrictions on distributions outside of the negotiated waterfall, redemptions and other payments, and affiliate transaction protections. Some preferred investors may also seek consent rights over changes of control of the fund and acquisitions and disposals of portfolio

investments. Preferred investors that are credit funds may negotiate for covenants that are customary in NAV financings, while an issuer may seek lighter covenants on the argument that the preferred investor is receiving higher pricing. The rights of preferred investors, and the degree to which they put constraints on the GP's operation of the fund, are often heavily negotiated.

One issue that is a frequent point of negotiation is whether the preferred investors have a right to remove and replace the GP for bad acts at the SPV level or that relate solely to the preferred equity, without concurrence of the existing LPs. In negotiating preferred equity deals, GPs must often balance the demands of the preferred investors with fulfilling their fiduciary duties to existing LPs, who must be convinced that the deal provides more value than cost.

LP consent

A preferred equity fund financing deal will most likely require consent of the LP advisory committee of the existing fund, a percentage of existing LPs, or both, depending on the structure of the deal and the terms of the fund's partnership agreement. The need for LP consent may be triggered by the amendment to the fund's distribution waterfall, by the establishment of an SPV and transfer of assets to the SPV (which may constitute an affiliate transaction), or by conflicts-of-interest issues. Even if LP consent is not contractually required under the fund's partnership agreement, GPs may choose to seek consent due to potential conflicts of interest, the level of disclosure made to the existing LPs prior to their investment in the existing fund, or simply to maintain goodwill with the LPs. For GP financings, consent is not typically required of the LP advisory committee or a percentage of existing LPs unless the financing would trigger a change of control provision in the sponsor's underlying fund agreements.

Conflicts of interest and disclosure

Direct conflicts of interest may occur if the GP is participating in the preferred equity investment. Even if the GP is not participating, the requirement to provide the preferred investors with a preferred return prior to the existing LPs' receiving their distributions may reduce or delay a GP's receipt of its carried interest, which may in turn incentivize a GP to pursue different, potentially riskier strategies in order to obtain higher returns, such as delaying the realization of portfolio investments in order to obtain potentially higher valuations on exit.

Conflicts of interest may also arise where some, but not all, of existing LPs are participating in the preferred equity investment. These LPs, who hold a different class of senior securities, may be required, or may feel it is prudent, to recuse themselves from approving transactions in which the interests of the preferred equity holders and common equity holders are not aligned.

Disclosure of the terms of the preferred equity deal and conflicts of interest involved are critical considerations prior to closing a deal, whether or not consent is required.

Conclusion

As the markets become more subdued and uncertain, we expect to see a continuing increase in the popularity of preferred equity investments as a flexible alternative to other liquidity and financing solutions as well as an increase in dedicated funds and strategies raised to invest in preferred equity.

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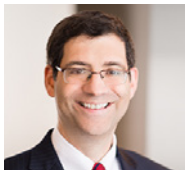
Structuring Options for Addressing the New 1% Excise Tax



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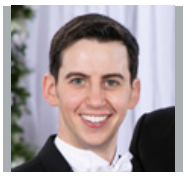


David N. Simpser
Associate

Recently, President Biden signed the Inflation Reduction Act, which imposes a 1% excise tax on the fair market value of stock redemptions made by publicly traded corporations beginning January 1, 2023. While the tax will most commonly apply to ordinary course stock buybacks, it may also apply to any portion of the consideration paid in a leveraged buyout of a public corporation that is treated as a redemption for U.S. federal income tax purposes. However, by carefully structuring the acquisition financing, it may be possible for private equity buyers to avoid the impact of this tax.

The Scope of the New Tax

The Act imposes a nondeductible 1% excise tax on the fair market value of stock repurchased by publicly traded corporations or their specified affiliates. The tax applies to both U.S. public corporations and U.S. affiliates of foreign public corporations that are liable for the tax payment, and to all applicable stock repurchased by those corporations, even if the actual shares redeemed are not publicly traded. The Act includes a netting rule that reduces the excise tax base by the fair market value of stock that is issued during the same taxable year, including stock issued or provided to employees.

Notably, the tax does not apply to any distribution or repurchase treated as a dividend for federal income tax purposes. It also does not apply to repurchases (1) that are part of a tax-free reorganization; (2) if the repurchased stock or an equivalent value of stock is contributed to an employee retirement or stock ownership plan; (3) of less than $1 million annually; (4) by a dealer in securities in the ordinary course of business; or (5) by regulated investment companies or real estate investment trusts.

The Excise Tax and Leveraged Buyouts

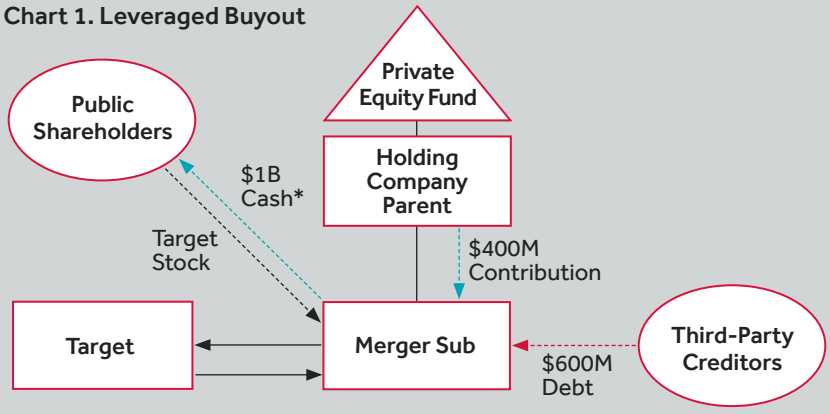
In the classic leveraged buyout structure of a U.S. public company, the acquirer first sets up a corporate merger subsidiary. Immediately prior to the transaction, the merger sub is capitalized with cash equity and borrows to finance the remaining portion of the purchase price. The cash provided to the merger sub through equity and debt is then used to acquire the shares of the target held by the public. The merger sub and public target combine, with the public company "continuing" as a result of the merger and the merger sub ceasing to exist as a separate entity. The private equity fund's holding company then becomes the owner of the continuing company. By operation of law, the

continuing company succeeds to the assets and liabilities of both the former public target and the merger sub—which, importantly, includes the debt incurred by the merger sub to finance part of the acquisition.

Because the merger sub's existence is transitory, it is disregarded for U.S. federal income tax purposes. As a result, the portion of the purchase price paid by the merger sub to the public shareholders that was financed with equity from the acquirer is treated as the purchase price paid by the acquirer. The portion of the purchase price financed with third-party debt that ends up within the continuing company post-merger is treated for tax purposes as a redemption of shares of the public shareholders by the formerly public target corporation. So long as the public shareholders are selling all of their shares in the target in the merger (which usually is the case), they are able to treat the proceeds as capital gains, whether those proceeds are classified as the purchase price paid by the acquirer or as redemption proceeds. However, the post-merger continuing company would be subject to a 1% excise tax on the portion of the purchase price treated as redemption proceeds.

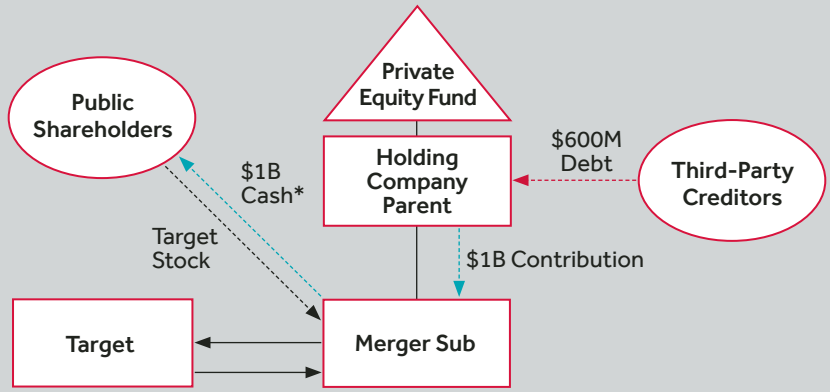
The application of the excise tax on redeemed shares in a classic leveraged buyout structure can be seen in Chart 1. In this example, the public target has a $1 billion enterprise value. To acquire the target, a private equity firm sets up a corporate merger sub. Because the private equity firm believes the target can support a significant debt load going forward, it capitalizes the merger sub with $400 million of equity and causes the merger sub to incur $600 million of third-party debt. In the merger, the shares held by the public are converted into the right to receive $1 billion of cash—$400 million of which is treated as the cash purchase price paid by the acquiring private equity firm and $600 million of which is treated as paid out in redemption of shares by the target. Absent some other exception applying, the post-merger continuing company would incur a nondeductible $6 million excise tax on the $600 million redemption.

Chart 1. Leveraged Buyout



*$400M treated as purchase price paid by parent.
$600M treated as redemption of public shares.

Chart 2. Leveraged Buyout: Alternate Structure



*$1B treated as purchase price paid by parent.

An Alternative Structure

To avoid the application of the excise tax, private equity sponsors should consider financing the acquisition of a public company at the parent level rather than at the merger sub level. In this structure, illustrated in Chart 2, the parent would incur the acquisition debt and then contribute the entirety of the purchase price to the merger sub as equity. The merger would continue as described above, but after the transaction was complete, the

parent, rather than the continuing company, would be directly liable for the debt (though the continuing company would likely become a guarantor). Because of this—subject to the discussion below—all of the purchase price should be treated for U.S. income tax purposes as having been paid by the parent to the public in exchange for the shares, with none of the purchase price treated as having been paid in a redemption by the target.

The tax applies to both U.S. public corporations and U.S. affiliates of foreign public corporations that are liable for the tax payment, and to all applicable stock repurchased by those corporations, even if the actual shares redeemed are not publicly traded.

Other Considerations

As noted above, while the target would not be an actual obligor of the acquisition debt post-merger, it would be a guarantor. Generally, lenders are comfortable from a legal perspective with lending to a holding company so long as the relevant U.S. operating companies, such as the target and its subsidiaries, are guarantors of the debt. However, the structure may lead to additional financing complexity, including the need to move money up from the target to the parent to service the debt.

In considering the use of this alternative structure, buyers should keep in mind the potential for developments in tax regulation and enforcement. Indeed, the Act gives the Internal Revenue Service broad authority to prescribe regulations to prevent avoidance of the tax, including by extending the tax to transactions that are economically similar to a redemption. Future IRS regulations could treat the payment of the debt-financed purchase price in the alternative structure as redemption proceeds for purposes of the excise tax. Further, the IRS could try to tax a transaction that used this alternative structure as a redemption even without changes to regulations, although we believe the transaction should be regarded as a purchase, rather than a redemption, for general income tax purposes.

Because the post-closing parent will own 100% of the equity interests in the continuing company and both parent and the continuing company are U.S. corporations, parent and target can consolidate for U.S. federal income tax purposes. As a result, the interest expense generated by the acquisition debt at the parent can be used to offset income earned by the continuing company for U.S. federal income tax purposes. However, certain states do not allow for consolidation in this manner and instead respect the separate company status of the various entities in the structure. In those states, there may be a benefit to pushing down the parent's acquisition debt to the operating entities, as that allows the interest paid on the debt to be used to offset state income taxes at the operating level. The alternative structure can be adjusted to maximize state tax deductibility of the interest expense by a post-closing restructuring of the financing arrangements or by using a co-borrower arrangement at the merger sub level to incur a portion of the acquisition debt (not to exceed target's historic debt). However, care should be taken to ensure that planning to maximize the state tax deductibility of interest or otherwise simplify the structure post-closing does not adversely impact the tax planning that otherwise drives the alternative structure above.

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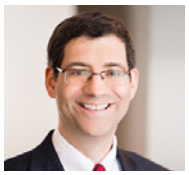
Implications of the Inflation Reduction Act for Investors in Life Sciences Companies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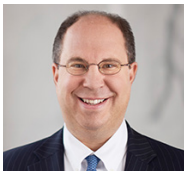
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The Inflation Reduction Act (IRA), signed into law by President Biden on August 16, 2022, is one of the most significant pieces of healthcare reform since the Affordable Care Act. Three of the bill's provisions are of particular importance for private equity investors:

(i) the requirement that the Department of Health and Human Services (HHS) negotiate the maximum price of certain prescription drugs and biologics;

(ii) caps on out-of-pocket spending on prescription drugs for Medicare Part D beneficiaries; and

(iii) the requirement that drug manufacturers pay a Medicare rebate if they raise prices by more than the rate of inflation.

We discuss these provisions and their potential implications for private equity investors, below.

HHS Negotiations for Prescription Drug Prices

Medicare principally covers prescription drugs through Parts B and D. The Part B program provides reimbursement for prescription drugs that are administered on an outpatient basis, such as in physician offices and clinics. HHS currently reimburses Part B drugs at a rate of 106 percent of the drug's average sales price (although, when budget sequestration has been in effect, that rate has dropped to 104.3 percent). Part D covers drugs that senior citizens obtain from pharmacies. Part D plans are operated by private insurers (with government subsidies). Currently, each Part D plan separately negotiates the price of the drugs it purchases for its beneficiaries.

The IRA significantly alters the current framework. Rather than using a formula to determine the reimbursement of Part B drugs and letting private insurers negotiate prices for Plan D drugs, HHS will be required, starting in 2026, to negotiate the price of many of the Part B and Part D drugs that account for the highest Medicare spending. Under the IRA, HHS must negotiate the price of 10 Part D drugs starting in 2026, 15 additional Part D drugs in 2027, 15 additional Part B or Part D drugs in 2028, and 20 additional Part B or Part D drugs in 2029 and beyond. Qualifying products will be chosen from a list of the 50 drugs with the highest total Medicare Part B spending

and/or the 50 drugs with the highest Medicare Part D spending. Products are only subject to negotiations if they are not subject to generic competition and have been on the market for a designated period of time—nine years for small molecules and 13 years for biologics (large molecules).

Any drug selected by HHS for "negotiations" is automatically subject to a statutory maximum price, which is the lesser of (i) the amount at which the drug would have been reimbursed by Part B or Part D under the old regime and (ii) the average non-federal average manufacturer price in 2021 (adjusted for inflation). There is no statutory minimum. When negotiating, HHS is instructed to consider the cost of developing the drug, the cost of manufacturing the drug, and the availability of alternative treatments. The IRA notably seeks to insulate from judicial review HHS's decisions regarding which drugs to select and its maximum price determination, although it remains to be seen if this provision survives judicial scrutiny.

Companies that fail to comply with the negotiation provisions of the IRA may be subject to a punishing excise tax, unless they opt to withdraw their drugs from Medicare and Medicaid coverage—an unrealistic option for most companies. The tax starts at 65 percent of the drug's U.S. sales and may be increased by 10 percent per quarter up to a total of 95 percent of U.S. sales. Further, failure to offer the negotiated price to eligible individuals or their providers may result in a civil monetary penalty of 10 times the product of (i) the number of units dispensed over the relevant period and (ii) the difference between the maximum fair price and the price actually charged.

Investor Considerations

If not altered by Congress before going into effect in 2026, the IRA is likely to have a deleterious effect on the manufacturers of successful drug and biological products that meet the criteria for HHS negotiations. The Congressional Budget Office estimates that this provision will save the Medicare program $100 billion over ten years; the life sciences industry will suffer corresponding losses. Those losses will increase if, as seems likely, commercial insurers attempt to use the HHS negotiation process as a basis for reducing the amount they pay for the subject products. In addition, the IRA creates a new layer of uncertainty for the life sciences industry: HHS's decision about which products to select for negotiations and HHS's determination regarding how far it wishes to deviate from the statutory maximum price may be influenced by the preferences of the HHS Secretary at that time.

Investors should carefully consider whether a target's portfolio includes drugs that are likely to be subject to the IRA negotiations provision. Moreover, investors should ask whether life sciences companies have any plans that may mitigate the impact of the IRA, such as whether companies intend to:

- launch an authorized generic, meaning there would no longer be a single source product on the market;
- launch a redesigned branded product into the market;
- decline to sell the product to any federal healthcare program; or
- agree to pay the excise tax (a theoretical but unlikely possibility).

If a company is considering any of these options, investors should carefully review any associated potential business and legal/regulatory risks.

Investors should also recognize that the IRA may alter the future flow of capital. The shorter nine-year period of immunity from price negotiations for small molecules, as compared to the 13-year period for biologics, could negatively impact funding for trials of new small molecules. This change could ultimately lead to long-term decreases in biopharma R&D and reduced industry innovation.

Capped Out-of-Pocket Spending for Medicare Part D Enrollees

Prior to the IRA, Medicare provided partial coverage for high out-of-pocket drug costs for Part D

Investors should inquire as to whether and how life sciences companies are considering adjusting their drug pricing strategies in light of the IRA (as well as state-law drug pricing measures that have been enacted in recent years).

beneficiaries. Above the catastrophic threshold ($7,050), the government paid 80 percent of the total cost, private insurer Medicare plans paid 15 percent and beneficiaries paid the remaining 5 percent. Beneficiaries typically paid an average of $3,000 to reach the catastrophic threshold and there was no upper limit on the total out-of-pocket expenses that beneficiaries could accrue annually.

The IRA makes two major changes to this framework. First, in 2024, the 5 percent beneficiary share in the catastrophic phase will be eliminated. Second, the law will impose a $2,000 per year out-of-pocket spending cap for Part D enrollees beginning in 2025. Once an enrollee hits this cap, the government's responsibility will decrease to 20 percent, the plan's responsibility will increase to 60 percent and manufacturers will be liable for the remaining 20 percent.

Investor Considerations

This provision could have cross-cutting effects. On the one hand, it may lead to increased purchasing of drugs by certain Part D beneficiaries whose contributions are now capped. Any such increase in manufacturer revenue, however, may be outweighed by added cost sharing to be imposed on manufacturers when patients exceed their out-of-pocket maximum.

Medicare Rebates for Increasing Drug Prices

The IRA provides that starting in 2023, manufacturers that raise the prices of Medicare Part B or Part D drugs in excess of the rate of inflation will be required to pay a rebate to the government. The rebate program will apply to single-source drugs and biologics (including biosimilars) under Medicare Part B and most covered drugs under Part D. If a manufacturer fails to pay the required rebate within 30 days of receiving an invoice, it will be subject to a minimum penalty of 125 percent of the rebate amount.

Investor Considerations

Investors should inquire as to whether and how life sciences companies are considering adjusting their drug pricing strategies in light of the IRA (as well as state-law drug pricing measures that have been enacted in recent years). Since the rebate provision is based on price increases, investors should evaluate the starting price of the drug in question in order to assess the impact of potential constraints on future price increases. In addition, it will be important to verify that companies have developed appropriate processes to make timely rebate payments.

Your Contract Can Only Be Amended in Writing? Not So Fast.

Gregory V. Gooding
Partner

Whether a fund document or an acquisition agreement, most of the contracts your private equity firm has entered into contain a provision such as the following: "No amendment or waiver of any provision of this Agreement shall be valid unless the same shall be in writing and signed by the Parties."

Does that mean a purported oral agreement between you and your counterparty to change or waive the terms of your agreement is ineffective because it is not in writing? Or that your actions following the execution of the agreement cannot effect a change in its terms on the grounds that those actions did not include a writing signed by both parties?

Those are not trick questions! It turns out the answer is less clear than one might think. Subject to certain specific exceptions, oral agreements are generally binding. This includes an oral agreement to change a contractual provision that requires changes to be in writing. Thus, under Delaware law, "contract provisions deeming oral modifications unenforceable can be waived orally or by a course of conduct just like any other contractual provisions." So held the Delaware Court of Chancery in late June of this year, citing a long line of Delaware cases to this effect. *CPC Mikawaya Holdings, LLC v. MyMo Intermediate, Inc., et al.*, (Del. Ch. June 29, 2022).

The same is true under New York law. The principle was stated succinctly more than a century ago by Benjamin Cardozo, when he sat on the New York Court of Appeals: "Those who make a contract may unmake it. The clause which forbids a change may be changed like any other. The prohibition of oral waiver may itself be waived." (*Alfred C. Beatty v. Guggenheim Exploration Co., et al.*, N.Y. Jan. 28, 1919).

Not surprisingly, ultimately succeeding on a claim that the parties have orally agreed to amend a contractual requirement that amendments must be in writing presents difficult burden of proof challenges, and courts are inclined to be skeptical of such assertions. However, defending such a claim can nonetheless be expensive. As the court stated in *CPE Mikawaya Holdings*, in upholding such a claim against a motion to dismiss, "the strenuous evidentiary standard for an oral waiver of a non-oral-modification provision" comes into play only after discovery. A plausible assertion of an oral waiver is likely to survive a motion to dismiss.

The moral remains that of Proverbs: Be careful what you say.

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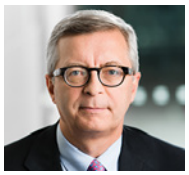
Avoiding Surprises in Brazilian M&A



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Partner

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In recent years, most acquisitions and exits by international sponsors involving Brazilian targets have been routinely governed by Brazilian law. Recently, however, we are noticing New York and Delaware laws making a bit of a comeback in the Brazilian market. What is behind this trend? The comfort that foreign investors developed with transaction agreements governed by Brazilian law has a lot to do with the fact that these agreements are largely modeled on New York or Delaware forms. Indeed, agreements used by international sponsors for Brazilian deals typically contain provisions that are substantially identical to what would be used in a transaction involving a U.S.-based asset. But, do these provisions have the same legal effect when transplanted to a different legal system?

Unfortunately, it is difficult to provide a clear and definitive answer as to whether these provisions work in Brazilian context as they do in the United States. There are two reasons for this. *First*, most high-profile corporate disputes that arise under Brazilian law agreements are resolved in confidential arbitrations, making it difficult for market participants to access legal precedents and determine how provisions were interpreted. *Second*, because Brazilian securities laws do not require public companies' disclosure of the most material agreements in their totality, data regarding market practice is not available, and each Brazilian firm develops its own view of what is market.

Brazilian legal practitioners and researchers have attempted to shed some light on two provisions commonly transplanted from U.S. to Brazilian M&A practice by analyzing a score of recent confidential arbitrations. The findings were presented and discussed at the 2022 M&A Conference of the Americas (MACA) held this summer in São Paulo. The conference was co-organized by New York University School of Law, the Law School of the University of São Paulo and Fundação Getulio Vargas (São Paulo) and was sponsored by Debevoise, PG Law and BTG. The two provisions examined—both central to U.S. deal making—were:

- The provision stipulating that the contractual indemnity is the parties' sole and exclusive remedy for claims relating to or arising in connection with the agreement; and
- The "entire agreement" provision, which provides that the contract contains the entirety of the deal between the parties and limits their ability to bring evidence outside of its "four corners" to interpret it.

Below, we summarize the questions raised with respect to these two provisions.

Sole and Exclusive Remedy. The purpose of this provision is to assure the parties that the agreed-upon contractual indemnity will not be circumvented by recourse to other legal remedies that may be available at law. While it typically preserves the right of a party to pursue fraud claims, it otherwise ring-fences the parties' tail risk, notably affecting the scope of its potential liabilities and related caps and deductibles. This provision is particularly critical in Brazilian M&A because representations and warranties insurance is rarely, if ever, available. Unfortunately, as noted by legal scholars and arbitrators at MACA, a sole and exclusive remedy provision governed by Brazilian law is vulnerable to being challenged in a dispute. Challenges have included "public order" considerations, such as good faith, and the contract's "social function," both contemplated in Brazilian statutory laws. Some challenges invoking the public order doctrine have argued that the sole and exclusive remedy provision could constitute an unenforceable advance waiver of a statutory right. In sum, these precedents suggest that a party relying on a sole and exclusive remedy provision in an agreement governed by Brazilian law may be exposed to risks that would not exist in a New York or Delaware-governed agreement. These considerations are particularly relevant to international investors preparing to exit their Brazilian investments.

Integration Provision. Equally central to the risk allocation embedded in acquisition agreements is the notion that, after signing, the parties are only bound by the "four corners" of the agreement if they have adequately negotiated an entire agreement provision. The goal of this provision in the U.S. is to avoid the admission into evidence of prior or contemporaneous communications between the parties outside of the contract, such disclosed materials, projections, term sheets, emails and so on. This provision ensures the application of the U.S. common law Parol Evidence rule, which bars such extrinsic evidence from being admitted if an agreement has been fully "integrated." By including this provision in the contract, the parties "merge" their discussions into a single document, binding those discussions to its "four corners."

Once again, the words on the page of a Brazilian law-governed agreement appear just as reassuring as those in an agreement governed by New York or Delaware law. However, the reality is more complicated. While it seems established that a party cannot use extrinsic evidence to challenge the agreement's express terms, under Brazilian statutory rules, one could argue that such evidence should be used to construe the parties' intent. Moreover, mandatory statutory provisions may not be subject to integration, and a party may deploy the same "public order" considerations noted above to challenge an integration clause and potentially other bespoke and financially significant provisions.

The cases discussed at MACA do not necessarily imply that United States and other foreign investors should always forgo having agreements governed by Brazilian law. However, it may be worth considering New York or Delaware law for more complex and challenging transactions where the nature of the assets being sold or the context of the negotiation may warrant additional caution and perhaps in exits where sellers are keen to limit tail risk and surprises. If, notwithstanding these cautionary tales, a foreign investor decides to accept the uncertainty of Brazilian law, there are still steps that can be taken, with the assistance of international counsel, to try to limit the potential additional exposure. The inclusion of targeted language in such provisions and strategic changes to the arbitration clause may provide a higher degree of confidence that they would ultimately be enforced.

In recent years, most acquisitions and exits by international sponsors involving Brazilian targets have been routinely governed by Brazilian law. Recently, however, we are noticing New York and Delaware laws making a bit of a comeback in the Brazilian market.

Debevoise & Plimpton

Deep Freeze: What PE Funds in Hong Kong Need to Know about the SFC's Asset-Freezing Powers

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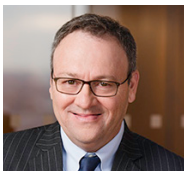

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In recent years, Hong Kong's Securities and Futures Commission (SFC) has adopted a decidedly proactive approach to enforcement, intervening at an early stage when the SFC perceived harm to investors. Restrictions notices (RNs)—an administrative measure that can be used to freeze assets of licensed corporations (LCs) and their clients while an investigation is underway—have become a frequently used tool by the SFC for achieving this objective. The number of licensed corporations receiving restriction notices rose from four in 2017–8 to 38 in 2020–21.

Recently, the High Court of Hong Kong dismissed a constitutional challenge to the SFC's power to issue RNs. Given this backdrop, private equity funds with a presence or operations in Hong Kong need to understand the asset freezing powers of the SFC, know how they might position themselves to minimize their exposure, and be aware of their options if they become affected by such freezing orders or measures.

Section 213 of the Securities and Futures Ordinance (Cap. 571)

To understand the SFC's current use of RNs, it is necessary to step back and examine the tool the SFC traditionally relied upon when it sought to preserve assets pending investigation: Section 213 of the Securities and Futures Ordinance (SFO).

Section 213(1) of the SFO provides that the SFC may apply to the Court for what is in effect a freezing injunction when a person has contravened the SFO or other relevant provisions (or has taken part or been involved in such contravention), or it appears to the SFC that such conduct is occurring or may occur. In deciding whether to grant the injunction, the Court must satisfy itself, so far as it can reasonably do so, that it is desirable that the injunction be granted and that granting the injunction will not unfairly prejudice any person. Section 213(6) further provides that where the Court considers it desirable to do so, it may grant an interim order while it considers an application made by the SFC under section 213(1).

Given the SFC may make an application under section 213(1) based merely on suspicion, and the Court may grant the orders sought if the Court deems such orders to be "desirable," it might appear at first glance that the threshold the SFC must overcome when making an application under section 213 is quite low.

However, the Court has held that before any interlocutory injunction (such as that under section 213) can be granted, a *prima facie* case of contravention of a relevant provision must be established and that there must be an appreciable—not merely fanciful—risk that without the injunction, proper compliance of the relevant statute would be frustrated. The Court has also stated that the traditional equitable principles governing the granting of interlocutory injunctions also apply to govern the granting of such injunctions under section 213. In other words, there must be a serious question to be tried and a risk of dissipation of assets, and the balance of convenience must lie in favor of granting the injunction.

The threshold is thus meaningful—and sufficiently meaningful to prevent the SFC from securing and preserving assets at early stages of its investigations when there is often insufficient evidence to persuade the Court to grant interlocutory injunctions under section 213. As a result, the SFC has resorted to administrative measures—most frequently, the RN.

The Restriction Notice

In February 2021, several individuals brought judicial review proceedings to challenge the legality of the RN regime (*Tam Sze Leung & Others v Secretary for Justice and the Securities and Futures Commission [2022] HKCFI 2330*). In those proceedings, which were ultimately dismissed, the SFC admitted that it sees the RN regime as offering crucial flexibility to the SFC, "particularly at the early stages of any investigation when there is limited available information and evidence which is highly unlikely to be sufficient to pursue [a section 213 application] to Court."

> ...private equity funds with a presence or operations in Hong Kong need to understand the asset freezing powers of the SFC, know how they might position themselves to minimize their exposure and be aware of their options if they become affected by such freezing orders or measures.

The SFC's power to impose RNs stems from sections 204 and 205 of the SFO, which provide that the SFC may by notice in writing prohibit LCs from (amongst other things) disposing of or dealing with, or assisting, counselling or procuring another person to dispose of or deal with, any "relevant property" in a specified manner or other than in a specified manner. LCs are corporations licensed by the SFC to undertake regulated activities such as asset management; whereas "relevant property" is defined as including any property held by the LC on behalf of its clients. Section 207 qualifies sections 204 and 205 by setting out the circumstances where the power may be exercised, including when it appears to the SFC that doing so would be "desirable in the interest of the investing public or in the public interest."

Several points are immediately evident from this. To start, the RN regime is very broad in both its effect and application. The RN regime enables the SFC to freeze not only assets belonging to LCs, but also those belonging to LC clients, and the phrase "desirable in the interest of the investing public or in the public interest" provides the SFC with a very broad basis for intervention. There is no limit to the amount of assets that can be frozen by an RN or to the length of the freezing order. Further, the threshold for invoking this power is very low—only that it appears to the SFC that it is "desirable" in the interest of the investing public or in the public interest for the power to be invoked. There is no requirement for prior scrutiny by the Court or an independent tribunal, and after the RN is issued, there is no legal requirement for periodic review.

Implications for Private Equity Firms

In light of the above, PE funds with operations in Hong Kong may want to consider steps to minimize the risk of its assets being frozen by the SFC. Where possible, PE funds may consider holding funds in bank accounts instead of accounts maintained with LCs. Doing this keeps the funds outside the scope of the RN regime, meaning the SFC must either (i) resort to a section 213 application if it wishes to freeze the funds, which would at least need to be scrutinized by the Court and would give the affected party an opportunity to argue at the first instance against the granting of the injunction, or (ii) use another administrative measure, such as a letter of no consent, to freeze the funds.

If holding assets in accounts maintained with LCs is unavoidable, PE funds may consider segregating the assets into different accounts based on, for example, the asset's purpose, transaction or source, so that in case of freezing, it is less likely that all of the assets would be affected.

> ...the SFC admitted that it sees the RN regime as offering crucial flexibility to the SFC, "particularly at the early stages of any investigation when there is limited available information and evidence which is highly unlikely to be sufficient to pursue [a section 213 application] to Court."

If, unfortunately, an interlocutory injunction under section 213 or an RN is imposed, there are four steps PE funds may be able to take to minimize the impact:

(a) Interlocutory injunction orders made by the Court under section 213 almost always come with a proviso that the injunction may be varied by agreement between the parties or by application to the Court. So if, for instance, there has been a material change in circumstances since the granting of the injunction, or there is a genuine need on the part of the affected PE fund to use some of the frozen money, the PE fund may invite the SFC to agree to a discharge or variation of the injunction, failing which the PE fund may also consider applying to the Court for such relief.

(b) Section 208 allows LCs or individuals affected by RNs to write to the SFC to seek its consent to deal with the frozen assets in a certain specific way or for the withdrawal, substitution or variation of the prohibitions or requirements imposed by the RNs. Should this fail to yield the desired result, the LC or individual may further apply to the Securities and Futures Appeal Tribunal for a full-merits review of the RN on a *de novo* basis.

(c) In some cases, such as where the amount frozen exceeds what is necessary or proportionate under the circumstances, it may be possible to persuade the SFC to vary the freezing order or measure. For instance, where an injunction initially covers all the funds in an account, the SFC can sometimes be persuaded to vary the injunction so that it only prevents the amount of funds in that account from falling below a specific sum (which is usually linked to the amount of damages that the SFC thinks it can recover in legal proceedings).

(d) Where the PE fund has advance notice of the SFC's intention to freeze its assets, the PE fund may attempt to replace the injunction sought by the SFC with voluntary undertakings which better protect the fund's interests. This is more likely to happen in the context of a section 213 application for an interlocutory injunction, where the application may be made *inter partes* in circumstances where there is insufficient urgency or risk of dissipation of assets.

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