Debevoise & Plimpton

The Private Equity Report Quarterly

2023 Midyear Outlook | Volume 23, Issue 2

From the Editors

At the beginning of the year, we noted in our Private Equity Report: 2023 Outlook the considerable macroeconomic and geopolitical challenges facing private equity. As we pass the year's midpoint, those challenges continue to hang over the private equity industry like a stalled weather system, refusing to dissipate, as existing obstacles have solidified and new hurdles have emerged. While the crisis around the collapse of Silicon Valley Bank, First Republic Bank and Signature Bank was not protracted, it nonetheless compounded an already difficult liquidity environment. Fundraising remains highly competitive. The polarization around ESG in the United States has intensified, resulting in a patchwork of wildly different state legislation. The SEC continues to take aim at private fund practices, while in the EU, new regulations stand to complicate both fundraising and the M&A landscape. In this environment, caution rules the day for both sponsors and investors.

And yet, with creativity and persistence, deals are getting done. Lenders are adjusting their balance sheet exposures. Direct lending

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"The language in this contract is wordy and indirect, and it uses unnecessary technical words and phrases. I'm very impressed."

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and co-investments, as well as innovative deal structures, help to fill the financing gaps caused by the pull-back in syndicated debt financings. Brand-name funds are weathering fundraising headwinds by offering incentives and flexibility with terms, while first-time managers are building track records by raising capital deal-by-deal. And through it all, bright spots have begun to appear. The U.S. IPO market is showing early signs of thawing. In Latin America, proactive monetary policy, the move toward nearshoring, and a spate of welcomed governmental reforms give reason for optimism. And while investors continue their caution regarding China, other Asian markets such as Japan, Australia and India are showing healthy levels of activity.

We hope you find the *2023 Private Equity Midyear Review and Outlook* to be a helpful summary of both the various forces shaping the industry and the strategies market participants are using during this dynamic time.

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Investment managers and investors seeking a return to strong private market fundamentals in 2023 have instead been met with a stubbornly persistent inflationary environment, continued pressure on public equities, banking and tech sectors roiled by bank failures and government interventions, rising geopolitical tensions across the globe, and a slew of complex and burdensome new laws and regulatory proposals. These conditions have made the fundraising market as competitive as ever, and sponsors across industries and geographies are battling these headwinds in the search for allocations from investors who are struggling with the denominator effect and a lack of liquidity across their portfolios.

Notwithstanding these conditions, established sponsors with proven track records of delivering strong returns across a variety of market conditions have reason to be optimistic. These sponsors are capturing an outsize share of investor allocations in today's tough fundraising environment, particularly for existing products that may only come to market every two to three years. Banner products remain attractive, and investors are carefully managing their capital to ensure they can participate in these funds when they come to market. But even flagship funds are taking longer to raise and require flexibility and creativity with fund marketing and terms. Emerging managers, on the other hand, face some of the tightest fundraising conditions in the market today. Increasingly, first-time managers are raising capital deal-by-deal in order to build a track record and ride out the current fundraising environment.

In the first half of the year, we have seen sponsors offer economic incentives and other accommodations that were less common over the past several years. For example, loyalty discounts are being offered more broadly and at lower thresholds. Early closing discounts are increasingly likely to continue past the fund's initial closing, often until the date of the fund's first investment or when the management fee commences. Sponsors are also more likely to shorten a fund's investment period, explore stapling a newer product to a more durable established fund, raise smaller "bridge" or "annex" funds, or address more customized requests from anchor investors.

At the same time, more investors are seeking staged commitments in lieu of a large upfront allocation, which can aid their cash planning and provide better visibility into a fund's early performance as it approaches the end of a 12- to 18-month fundraising period. Investors are also looking for more exposure to separately managed accounts or other co-investment opportunities that can reduce the cost of their investment with a manager.

In the midst of this private market slowdown, sponsors are also adjusting to a meaningful uptick in regulatory requirements. The SEC's new Marketing Rule in particular has introduced cost and complexity for sponsors, and the market is still adapting to this new paradigm, as well as a slew of other proposed and recently enacted regulation. International, U.S. and state ESG rules have also continued to develop at a steady pace, but without a uniform approach across borders or common sentiment among investors. Against this backdrop, sponsors and investors alike are struggling to develop effective tools for evaluating the impact of, and implementing procedures to address, these rules and proposals on the private fund industry.

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Fundraising

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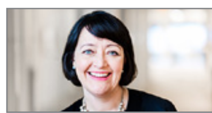
The private market also continues to grapple with the effects of the banking crisis. Liquidity and access to capital were already tight in the beginning of the year, and the failures of multiple regional banks in the spring and the resulting government interventions only exacerbated that tension. Private funds in the venture, growth and tech sectors were particularly exposed to this segment of the banking market, and they now struggle to replace those sources of capital for their own funds and their portfolio companies.

We expect many of these conditions to persist in the second half of 2023 and thus prolong the slow pace of fundraising. Strong performance and creativity will be essential for sponsors to successfully attract capital. The private fund industry continues to be a people business, and we expect relationships between sponsors and investors will be more important than ever as participants continue to grapple with macro factors beyond their control.

Private Funds Transactions



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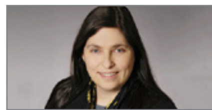

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While markets have stabilized compared to peak 2022 volatility, high interest rates, infrequent distributions and difficult fundraising environments continue to impact the secondaries market.

Single-asset GP-led transaction volume continues to lag due to a material bid-ask spread in pricing between secondary investors and sponsors, as well as challenges in raising the full equity check required to close larger transactions. Many financial intermediaries have advised sponsors to defer single asset transactions with values over $1 billion until the fundraising environment improves. Anecdotal guidance from those intermediaries suggests optimism that the growing need for investor liquidity will eventually outweigh the bid-ask spread, leading to an uptick in GP-led secondaries volume to close the year.

GP-led transactions successfully completed in the first half of 2023 continued to evidence a buyer's market. Outside of the highest performing assets, where there is still competition for allocations, lead buyers frequently negotiated discounts to NAV and comparatively lower management fee rates while exercising more control over continuation fund governance terms. "Super-carry" (i.e., a top-end distribution waterfall tier providing the GP with more than 20% of profit), which was common during the single-asset GP-led transaction boom of 2021, is now increasingly rare. Non-traditional buyers (i.e., investors other than funds of funds) continue to enter this space, accelerating the trend toward the use of more M&A-like features in GP-led transactions—most notably an increased focus on asset-level diligence and seller representations and warranties, including more widespread use of representation-and-warranty insurance.

At the same time, LP portfolio sales have seen a significant uptick, driven by a distribution-light environment, comparative stabilization of PE valuations and pension investors that grappled with the denominator effect at the close of 2022 and start of 2023. Broad investor need for liquidity has precipitated a wide array of portfolios coming to market, even with certain strategies, including venture, growth and energy, continuing to trade at significant

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Private Funds Transactions

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discounts. By comparison, blue-chip portfolios have fared better, with discounts to NAV shrinking over the past year. For larger, diversified portfolios, it is becoming increasingly rare for a seller to engage with a single buyer. As the universe of secondary buyers continues to segment and specialize, financial intermediaries are able to achieve higher, blended portfolio pricing by engaging with multiple, unrelated buyers. Indicative of current fundraising challenges, sponsors have once again started to ask buyers of LP interests to make stapled commitments to their newer funds.

Co-investment appetite remains strong and has adapted to macroeconomic conditions and evolutions in private fund and deal-making technology. As GPs are holding onto portfolio companies for a longer period and seeking to build larger, higher-multiple portfolio companies through add-on acquisitions in pursuit of a more favorable exit at a later date, GPs have increasingly turned to co-investors for follow-on capital. Experienced co-investors have been more willing to undertake bespoke direct investments, such as mid-life investments through direct lending or preferred equity. In some cases, investors are finding mid-life co-investments as attractive alternatives to GP-led secondaries, as they do not require a reset of economics and can allow an investor to negotiate preferred returns and enhanced governance rights in an existing no-fee, no-carry structure. Private credit has thrived, with both sponsors and investors building out lending platforms, driven by the surge in opportunities and the pursuit of portfolio diversification. There has been a rise in captive opportunities where sponsors' equity and credit arms co-exist within one portfolio investment. Such arrangements, however, give rise to concerns over how sponsors will manage conflicts of interest where the two arms are not aligned, along with a push from co-investors to participate in such opportunities to prevent dilution or subordination and maintain alignment with sponsors.

The biggest story for the second half of the year, however, could be new rules under the Advisers Act, which the SEC previewed last year, including a possible prohibition on non-pro rata allocation of broken deal expenses. Such a rule, if implemented across all deals and all participants, is likely to drastically change current market practice (at least in the United States), where allocation is negotiated based on the nuances of a deal, such as whether a co-investor is co-underwriting versus participating in a post-signing syndication.

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The first half of 2023 was, to put it mildly, an interesting time in the fund finance market. The impending failures of Silicon Valley Bank, Signature Bank and First Republic Bank—all notable lenders in the fund finance space—sent fund borrowers scrambling to navigate covenants and restrictions in their credit facilities with these banks, and searching for alternative credit sources. At the same time, investors rightfully expressed concerns about funding contributions into deposit accounts at these banks, putting fund borrowers in the uncomfortable position of choosing compliance with credit facility covenants over the interests of their investors. But the crisis was short-lived, and the credit facilities largely performed with relatively minimal disruption.

Despite—or perhaps because of—the pull back by the regional banks, there continues to be strong demand from funds to fill their liquidity needs (and in the case of newer funds, those demands sometimes go unmet). However, the bank lenders that traditionally have been major players in the fund finance market continue to be buffeted by a series of macroeconomic events—including the increase in interest rates and regulatory changes in capital treatment—and remain more selective with credit extensions. This trend started in the latter half of 2022 and persists today.

We continue to see increased focus on syndication efforts, via assignment or participation. Lenders are also looking to readjust their balance sheet exposures by means of swaps, financial guarantees or other similar transactions. Accordingly, market players have been revisiting the relevant provisions in their facility documents to accommodate such processes.

In addition to subscription facilities, we saw the continued popularity of back-leverage loans and NAV facilities by buyout funds. With the leveraged finance markets disrupted, sponsors increasingly turned to these products to consummate acquisitions, purchase portfolio company debt and make distributions to limited partners in view of delayed exits from portfolio companies. Conditionality for these structures also continues to evolve, with some lenders willing to consider providing these facilities with limited conditions similar to that for opco-level facilities. We also saw more alternative fund finance credit providers offering these facilities.

Sponsors continue to raise capital from insurance companies and similar investors. While 2023 has seen a slowdown in activity in view of market conditions and uncertainty over regulatory developments, we expect rated feeder structures and other structured products such as collateralized fund obligations to continue to evolve and develop. If history is any guide, innovation in the fund finance market will continue so long as sponsors have unmet liquidity needs.

M&A (U.S.)

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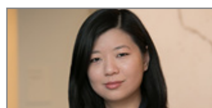

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We continue to wait for a pickup in private equity M&A activity as we pass the midyear point of 2023. The post-COVID hangover of 2022, precipitated by dislocations in the debt financing markets, has endured into 2023. While there have been pockets of activity in certain sectors of the market, total private equity deal volume for the first half 2023 has returned to pre-COVID levels, in line with the global slump in M&A generally, which hit a three-year low in the first half of 2023.

Early hopes for a rebound were also tempered by the regulatory climate, as the Biden administration's FTC and DOJ have not wavered in their scrutiny of private equity deals. Some potential roll-ups and other transformative acquisitions by portfolio companies have been scuttled for fear of a protracted approval process, as sponsors find it difficult to secure committed financing at an acceptable cost when the sign-to-close period has the potential to stretch on for a year or more.

Yet, even in the face of economic and regulatory uncertainty and choppy debt markets, deals are getting done, especially when creative approaches are deployed. In certain sectors, such as healthcare and infrastructure, sponsors have been able to finance acquisitions on acceptable terms, albeit at relatively lower leverage ratios than before 2022. Direct lenders have stepped up as major players, rather than supporting cast members to syndicated lenders. Co-investments are also playing a bigger role in the financing of some deals, as sponsors put less leverage on target companies. Sponsors are also deploying earn-outs and significant rollovers more frequently to bridge valuation mismatches, taking on minority investments and doing co-control deals with incumbent sponsors where existing debt with attractive interest rates can remain in place. Fund-to-fund and continuation fund deals have also remained popular.

However, notwithstanding pockets of activity and innovative structures, the current environment remains one in which buyers are often exercising caution and finding reasons not to do deals rather than racing to signings out of fear of missing out.

Looking to the rest of the year, we are starting to see long-in-the-tooth fund assets being brought to market, perhaps reflecting pressure on sponsors to return money to LPs combined with a recognition that conditions and valuations are not likely to change dramatically in the near future. This development may lead to a more frequent meeting of the minds on price than we have seen in the past 18 months and, together with the continued use of the transaction structures described above, could set the stage for an uptick in deal volume.

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European private equity M&A activity levels continued their downward trajectory during the first half of 2023, with European private equity M&A deal value and deal count declining by 8.7% and 3.8%, respectively, in Q1 2023 from Q4 2022. Many of the hurdles to deal making that emerged in 2022 remain, including continued increases in interest and inflation rates, challenging debt markets, currency volatility and fiscal uncertainty. While the relatively small decline in deal count demonstrated some resiliency, the slowdown is likely to persist until macroeconomic conditions stabilize and investors regain confidence.

Looking more closely at M&A deal values provides additional insight. While M&A transactions valued between €100 million and €500 million accounted for 48% of all deals during the last ten years, they accounted for more than two thirds of the deals done in Q1 2023. The prevalence of smaller deals was partly driven by sponsors continuing to eschew platform buyouts in favor of smaller bolt-on acquisitions, which accounted for 60% of deal count (compared to 22% for platform buyouts). Going forward, however, higher borrowing costs coupled with rising inflation may lead sponsors to focus on unlocking value at the portfolio company level through revenue growth and margin expansion, thus limiting any meaningful increase in deal count through bolt-on acquisitions. To lock in returns and/or avoid expensive re-financings, sponsors may increasingly turn to minority sales and/or GP-led secondaries that do not trigger a change of control under existing finance arrangements.

Since 2018, investors have spent nearly £80 billion buying UK public companies, and we expect take-private transactions to remain popular due to depressed public market valuations, favorable multiples, significant amounts of deployable dry powder and the weakening of the pound. That said, take-privates have not escaped the challenging forces affecting the market as a whole, pushing the average take-private deal value this year much lower. EQT's take-private of Dechra in June for £4.5 billion was a notable outlier; more typical were the take-private of K3 Capital Group by Sun Capital Partners for £270 million in February, and Sureserve's £214 million take-private by Cap10 in April. Globally, Q1 saw more than 80% of private equity deal value being deployed to take-privates, which typically account for 20% of private equity deal value annually.

The energy crisis in Europe as a result of Russia's invasion of Ukraine has generated an increased focus on investing in renewable energy and other cleantech. Looking ahead, we may see increased distressed opportunities in the cleantech sector, if companies undertaking the capital-intensive process of developing these technologies begin to run out of cash. Additionally, European electric vehicle makers face increasing competition from their China-based competitors. This year, for example, we saw British battery-maker Britishvolt collapse into administration before subsequently being bought out, while share prices of European electric-vehicle makers Lucid, Workhorse and Arcimoto have plummeted. Should cleantech market conditions continue to be challenging, private equity funds may find attractive opportunities to acquire companies at a fraction of their peak value, leading to increased M&A activity. Private equity funds will also look favorably on the government subsidies typically on offer in this sector.

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M&A (Europe)

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Conversely, the EU's new Foreign Subsidies Regulation (FSR) stands to make large EU M&A deals more complex by adding a new mandatory notification requirement if parties have received relevant "financial contributions" from foreign (i.e. non-EU) governments. Beginning October 12, 2023, filing is required for qualifying M&A transactions where (i) at least one of the merging parties (in a full merger), the target (in an acquisition), or the joint venture had EU-wide turnover exceeding EUR 500 million in the previous financial year; *and* (ii) the parties (including the target) have received combined foreign "financial contributions" exceeding EUR 50 million in the three years prior to the conclusion of the agreement, announcement of the bid or the acquisition.

What constitutes a "financial contribution" is broadly defined to include all financial contributions directly or indirectly received from non-EU governments and any level of public authorities, as well as from any public or private entity whose actions can be attributed to a third country government. Furthermore, based on the Implementing Regulation for the FSR (published on July 10, 2023), all relevant financial contributions received by the wider acquirer *group* would need to be disclosed. For financial sponsors, that means all portfolio companies under common control as well as all relevant LPs and their investments into the fund managed or controlled by the acquirer making the acquisition. One important change from an earlier draft of the Regulation is that financial contributions received by *other* funds managed by the same sponsor (i.e., via portfolio companies or investors) will not have to be provided if certain requirements are met.

Also at the EU level, the Digital Markets Act (DMA) came into force in May 2023 following a public consultation, with the Commission's decision on which companies will be designated as "gatekeepers" due by 6 September 2023. Equivalent legislation is coming into force in the UK via the Digital Markets, Competition and Consumer Bill (DMCC) which is currently working its way through Parliament. Like the DMA, the main purpose of the DMCC is to give the UK's Competition and Markets Authority the power to tackle the excessive dominance of a small number of technology companies, such as Amazon, Apple and Meta, that are deemed to have "strategic market status" (SMS). Of relevance to private equity firms is the DMCC requirement that companies with SMS notify the CMA of their acquisitions of and investments in "*UK-connected body corporate[s]*" where the value of consideration for their investment is at least £25 million. This increased reporting and scrutiny of acquisitions by the largest players (even of transactions involving very small target companies) may become an important consideration for private firms exiting investments when looking for potential buyers.

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As geopolitical instability, volatile capital markets, supply chain disruptions and regulatory tightening persist, overall M&A activity in the Asia Pacific region remained slow in the first half of 2023. However, APAC's share of global M&A deal value increased slightly, highlighting the region's resilience in the face of the global slowdown.

Following the lifting of COVID-19 restrictions, M&A activity levels have picked up in China, but are nowhere near their peak. Despite a wealth of opportunities, foreign investors are taking a cautious approach to investing in China due to U.S.-China geopolitical tensions and the slower-than-expected recovery of the Chinese economy. Domestic transactions, and particularly transactions driven by state-owned enterprises, continue to be responsible for most of the onshore M&A activity for the year to date.

Among inbound M&A transactions, foreign investors appear to be selective and industry-focused. Electric vehicles continue to draw interest, with China seeing two major deals so far this year: Lotus Technology, valued at around $5.4 billion, is going public through a SPAC founded by L Catterton; and Apollo Future Mobility Group (a Hong Kong-listed firm backed by Hong Kong's Li Ka-shing) acquired WM Motor, a Chinese electric vehicle maker backed by search engine giant Baidu, for $2 billion. There is also ongoing chatter around multi-national companies spinning off their China-related business—Sequoia and AstraZeneca being the latest examples. At the same time, other companies, such as HSBC, have firmly rejected spin-off/separation plans proposed by their shareholders.

Deal activity for the past three years in Japan reached a peak in Q1 2023. Notable transactions include a consortium led by Japan Industrial Partners acquiring Toshiba for $15.2 billion, Bain and GIC investing in WHI Holdings (a Japanese human resources software company) for $2.6 billion, and KKR-backed Global Atlantic's strategic cooperation with Japan Post. In Australia, deal making continues at a healthy pace: A consortium led by Brookfield Asset Management and EIG has agreed to acquire Origin Energy for approximately $18 billion and TPG plans to acquire InvoCare (Australia's largest provider of funeral services) for approximately $1.9 billion.

Outside of the mature markets, interest continues unabated in India as investors continue to seek value outside of China. Mankind Pharma's initial public offering was the biggest in India so far this year and bolstered investors' confidence regarding feasible exit valuations. In another sign of the healthy activity and demand, EQT and ChrysCapital just announced an acquisition of a 90% stake in India-based HDFC's education finance business at a valuation of $1.26 billion, the largest-ever private equity buyout in the country's financial services sector.

As market uncertainty increasingly becomes the norm, deals correspondingly become more highly structured and complex—which leads to increased execution uncertainty. We have observed an uptick in the use of convertible instruments, warrants and options, and generally any mechanisms that allow parties to maximize structuring flexibility and provide downside protection with unlimited upside, while still giving the target company the liquidity it needs on an accelerated or distressed timeline.

As market conditions harden, securing investor interest and commitment becomes more difficult and takes longer. Sponsors and lead investors may use warehouse facilities

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M&A (Asia)

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or advance funds through temporary internal structuring to avoid delays to the deal timeline, and then gradually sell down the warehouse facility to later investors. To manage deal uncertainty and the widening gap between signing and closing, we have also seen increased use of escrow accounts due to concerns of heightened regulatory scrutiny and counterparty creditworthiness or solvency.

We believe both GP- and LP-led secondary transactions will continue to remain an attractive exit option as investors seek additional liquidity. Several sizable continuation fund transactions have already closed in 2023, and all signs indicate that 2023 will set new industry records. While single-asset deals have recently gained traction, well-diversified multi-asset portfolios will likely dominate in the current challenging investment environment.

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While M&A activity in Latin America declined in the first half of 2023 compared to 2022, the prospects for private equity transactions in the region remain positive for the remainder of the year. Several factors inform that outlook:

Macroeconomics and Financing. Latin American economies tightened their monetary policies earlier than their more developed counterparts. Consequently, inflation rates have receded across the region during the first half of 2023. The expectation of more tamed inflation, coupled with sponsors tapping into the private credit market to bridge potential financing gaps, creates positive conditions for the second half of the year.

Geopolitical Dynamics. Geopolitical tensions and trade disputes between the United States and China are encouraging nearshoring of manufacturing to Mexico. This trend presents an opportunity for sponsors seeking to relocate or invest in portfolio companies with manufacturing operations close to the United States, leveraging potential logistical advantages and mitigating geopolitical risks.

Government Reforms. The newly elected left-leaning governments in Brazil and Chile have taken steps to advance significant structural reforms and mitigate initial reservations from the business community. In Brazil, for example, the country's Lower House approved a new fiscal framework and a long-awaited tax reform, substantial reduction in Amazon deforestation and an increased emphasis on renewable energy and sustainability. Similarly, Chile's ongoing Constitutional reform is, by most accounts, expected to result by the end of this year in an outcome that balances social welfare demands and business interests. The recently announced public-private partnership framework for lithium exploration in Chile is also likely to attract the attention of international asset managers and global manufacturers alike, further bolstering the country's investment prospects.

On balance, even though the impact of these measures may not be apparent in the short term, they represent undoubtedly positive signals for the region. The favorable macroeconomic picture, current global geopolitical dynamics, legislative approval of more moderate government reforms, and Latin America's fundamental need to improve its infrastructure and invest more heavily in renewables should result in a pick-up in investment and exit opportunities during the second half of 2023.

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In May, CFIUS issued two new "Frequently Asked Questions" that address issues likely to affect private equity funds and their managers:

- Parties submitting a CFIUS filing may be requested to provide information that identifies all non-U.S. investors "involved, directly or indirectly, in a transaction, including limited partners in a fund," even if a party has a binding contractual obligation to maintain confidentiality regarding a particular non-U.S. investor's interests.

This is not a change in policy or an expansion of existing regulations by CFIUS, but it does serve as a reminder that private agreements regarding investor confidentiality do not constitute a basis for refusing an information request from CFIUS.

- There is a new standard for determining the "completion date" of covered investment transactions that require a mandatory filing with CFIUS under the Foreign Investment Risk Review Modernization Act (FIRRMA). Since FIRRMA's implementing regulations were issued in February 2020, CFIUS has required non-U.S. investors to file a mandatory declaration prior to acquiring certain "trigger rights," including board or board observer seats, in a U.S. business that has or manages sensitive personal data, critical technology or critical infrastructure. This has led some parties to structure transactions so that foreign investors initially acquire their equity interests without the associated trigger rights, with the subsequent issuance of those rights conditioned on receipt of CFIUS approval. This "springing rights" approach was often adopted to facilitate timely capital infusions into distressed businesses.

  The new guidance states that a mandatory declaration must be filed at least 30 days prior to a non-U.S. person's acquisition of any relevant equity interest, essentially nullifying the "springing rights" approach. Accordingly, parties should ensure that they understand and anticipate this pre-closing filing requirement whenever a non-U.S. investor would acquire a trigger right in a covered U.S. business, regardless of when that right is conveyed.

In other developments, U.S. authorities reportedly are formulating a "reverse CFIUS" process that will impose regulatory requirements for U.S. investment in China and several other jurisdictions, at least as it relates to certain transactions involving data or technology considered highly sensitive by U.S. national security authorities. Recent reports indicate that a "reverse CFIUS" regulatory regime may, at least initially, involve only notice to U.S. authorities of certain sensitive investment activities. We continue to follow the developments closely, as any new regulations are likely to affect U.S. investment funds and investment managers engaging in investment activities in or related to China.

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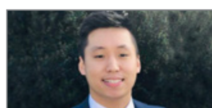

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A spate of successful IPOs and a pair of important legal developments in the first half of 2023 provide important consideration for private equity sponsors if they are contemplating IPOs for their portfolio companies in the near-term.

Recent IPO Market Struggles

To put the recent U.S. IPO slowdown in perspective, consider that there were 1,035 new listings on U.S. stock markets in 2021, largely driven by special purpose acquisition companies ("SPACs") and technology-adjacent issuers. Since that unprecedented year, the market has dwindled significantly, with only 181 IPOs in 2022 and 77 in the first half of 2023. There are many reasons for this decline, including the SEC crackdown on SPACs, higher interest rates and inflation, the war in Ukraine, greater stock market volatility and bank sector uncertainty (including the failures of SVB, Credit Suisse and First Republic). A subdued IPO market in 2022 can also be attributed to the fact that many of the 2021 IPOs underperformed, with stock prices falling 14% on average in the six months following the IPO, compared to the historical average of a 14% gain over that same post-IPO timeframe.

Is the Tide Changing for IPOs?

In recent weeks, the IPO market has shown signs of thawing, with some issuers able to take advantage of market windows. Success stories include CAVA Group, Inc. ("CAVA"), which priced above the range and opened trading up 91%, and Savers Value Village, Inc. ("SVV"), which also priced above the range in its June 2023 IPO and soared over 27% on its first day of trading, providing its private equity sponsors with a successful partial exit. These examples may signal a healthier market to come, as companies representing a diverse range of sectors look to go public. Some recent new issuances still struggled, however. For example, Fidelis Insurance Holding Limited ("FIHL"), a private equity-backed insurance company, priced below the range with the stock performing poorly in the initial day of trading.

Notable Legal Developments Potentially Impacting IPOs

Private equity sponsors should also keep in mind two recent legal developments when considering portfolio company IPOs in the near term:

(1) Investor Scrutiny of Stockholder Consent Rights

In connection with a portfolio company going public, sponsors often look to retain, for a period of time, consent rights over certain major corporate actions, transactions and other events. Because these consent rights can effectively give sponsors veto power over key actions by the company, stockholders have begun to challenge these rights as

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violations of Delaware law. (*West Palm Beach Firefighters Pension Fund et al. v. Moelis & Co.*, case number 2023-0309 (Del. Ch. 2023) is a recent example.) In challenging the legality of controlling shareholder consent rights, named-plaintiff stockholders argue that the rights infringe on the board of directors' ability to manage the business and affairs of the corporation, which the plaintiffs argue is a fundamental principle of the Delaware General Corporation Law. Sponsors considering an IPO may wish to mitigate this risk by incorporating consent rights directly into the corporation's constituent documents rather than in a stockholders agreement.

(2) Supreme Court Limits Potential Section 11 Liability in Direct Listings

The U.S. Supreme Court recently brought new clarity to the potential liability under U.S. securities law for issuers in direct listings. Although uncommon for private equity-backed companies, direct listings provide an alternative pathway to becoming a public company without some of the perceived costs and burdens associated with a traditional IPO. In a June 1, 2023 decision, the Court ruled unanimously in *Slack Technologies v. Pirani* that plaintiffs bringing claims under Section 11 of the Securities Act are required to plead and prove that their shares are traceable to the registered offering. The tracing requirement can be difficult, if not impossible, to prove in direct listings since registered and unregistered shares are typically sold at the same time. Plaintiffs have historically had the same difficulty tracing their shares purchased in the aftermarket once unregistered shares have entered the market and the plaintiff did not purchase directly in the registered offering. Notably, the Court reserved judgment on whether the same Section 11 standing requirement applies to claims brought under Section 12(a)(2) of the Securities Act, creating uncertainty that may invite further litigation. In any event, this ruling provides directly listed companies a strong defense to Section 11 strict liability. However, the ruling does not completely immunize issuers in direct listings from liability, as they may still face claims arising under Section 12(a)(2) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

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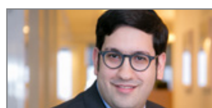

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In the first half of 2023, there were two notable developments in U.S. tax law that are relevant for the private equity sector. First, the U.S. Tax Court found that the receipt of a profits interest in a partnership in exchange for services provided to the partnership's corporate owner does not result in taxable income to the service provider. Second, the Internal Revenue Service released guidance confirming that the publicly traded stock exception to the FIRPTA tax on non-U.S. persons—applicable to non-U.S. persons who hold 5% or less of a publicly traded U.S. real property holding company ("USRPHC") or 10% or less of a publicly traded REIT—is determined at the partnership, rather than at the partner, level. While the guidance discusses the 5% exemption for public USRPHCs, it would have equal application to the 10% exemption for public REITs.

A Broad Reading of Profits Interest Tax Exemption

The U.S. Tax Court provided comfort to taxpayers structuring profits interests in tiered entity arrangements when it held in *ES NPA Holding, LLC v. Commissioner* that a service provider would not be taxed on the receipt of a profits interest in a partnership in exchange for services provided to such partnership's corporate owner. This decision is consistent with the market consensus on the tax exemption of such an arrangement and serves to further validate this position.

The case turned on the meaning of Revenue Procedure 93-27, which exempts from taxation the receipt of "a profits interest for the provision of services to or for the benefit of a partnership." The question for the court to decide was whether services provided by the taxpayer to the *corporate owner* of the underlying partnership constituted services "to or for the benefit of the partnership." The court concluded in the affirmative, and therefore the grant of the profits interest was not taxable.

In confirming that this profit interest grant was not taxable, the decision favors an expansive reading of the rule exempting profits interests from taxation, which is capacious enough to include circumstances where carry recipients provide services to a private equity fund and receive carried interest in a general partner entity of the fund, or where employees of a corporation receive profits interests in a partnership that owns that corporation.

IRS Confirms Market View on FIPRTA Publicly Traded Exception

On May 19, 2023, the IRS released Chief Counsel Memorandum AM 2023-003 (the "Memo"), which discusses two situations concerning the application of the exception from FIRPTA for non-U.S. partners in partnerships that hold public stock of a USRPHC.

In the first situation, a partnership holds over 5% of the stock of a publicly traded USRPHC, which it then sells. The Memo concludes that the stock sale is subject to FIRPTA tax for any non-U.S. partners of the partnership, regardless of their percentage ownership of the partnership. This is because the IRS determined that the publicly traded exception is tested at the partnership level, and not at the partner level.

In the second situation, a partnership holds 4% of the stock of a publicly traded USRPHC and its 25% non-U.S. partner directly holds 4.5% of such stock. The Memo concludes that,

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due to the Code's attribution rules, the non-U.S. holder is treated as holding more than 5% of the USRPHC and therefore gain on the disposition of its entire direct interest is subject to FIRPTA tax. Although not discussed in the Memo, it would appear that a sale by the partnership of its 4% ownership would similarly not qualify for the exemption on account of the attribution of the non-U.S. partner's shares to the partnership.

In light of this guidance, sponsors that are considering a large investment in a publicly traded USRPHC, a publicly traded entity that may become a USRPHC, or a private USRPHC that may one day go public, should carefully consider the holding structure, to leave open the possibility of relying on the publicly traded exception in an eventual exit. In doing so, sponsors should consider the impact of attribution of other direct or indirect ownership interests held by the partners, including the sponsor itself, into the various partnerships.

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The Finance (No. 2) Act 2023 brings several tax changes relevant to investment funds into effect. We discuss four of those changes below.

To begin, the Act **implements key parts of the OECD "Pillar Two" rules** in the UK, introducing new multinational and domestic "top-up" taxes, both of which come into effect for accounting periods commencing on or after December 31, 2023. The Act's implementation of the Pillar Two rules generally follows the "GloBE Rules" issued by the OECD in December 2021 but deviates from those rules in some key ways.

First, under the GloBE Rules, a typical fund partnership may not be an excluded entity (an entity outside the operative provisions of the rules), because the absence of a requirement for the fund to consolidate its accounts with its subsidiaries means that it is not the ultimate parent of a group. Many fund holding companies would therefore not be excluded entities since they would not fulfil the requirement of being owned by other excluded entities. The UK rules, in contrast, provide that funds can be excluded entities if they would be a group parent but are not so only due to the absence of a requirement to consolidate their subsidiaries. Since holding companies will typically be owned by excluded entities, the holding companies themselves will be more likely to fall within the advantageous excluded entity definition.

The Act also amends the definition of "ownership interest" to fit the law on partnerships in the UK. Under the GloBE Rules, the definition of "ownership interest" is tied to the concept of an equity interest resulting in a right to profits. Under UK law (and in a number of jurisdictions), an interest in a partnership is not an equity interest, and partners, not the partnership, have the rights to profits from underlying partnership assets. Accordingly, the UK definition deviates from the GloBE Rules to include interests that "give rise to a share in the profits of the entity" and "would be treated as an equity interest in the accounts of the owner."

Further, the Act has introduced positive changes that should make **Qualifying Asset Holding Companies** ("QAHC") more attractive and easier to operate. Approximately 200 QAHCs have already been established since the regime's introduction in April 2022. First, the

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Tax (UK)

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Act establishes "multi vehicle arrangements," which allow funds with parallel and aggregator entities to be treated as a single fund for the purposes of the QAHC ownership test, assuming certain conditions are met. This is extremely helpful since previously, all entities needed to be separately analysed. Second, the legislation relaxes certain requirements that limited the availability of the "GDO test," one of the tests for "diversity of ownership" that funds are required to meet. The GDO test is the most attractive means to meet the diversity of ownership requirement since it is based on standard marketing during a fundraise and does not require subsequent monitoring. The new rules provide that corporations may qualify to use the GDO test, something that was previously precluded. This helps corporate funds but also benefits Delaware limited partnerships and LLCs, which are regarded as corporations under UK law. To further increase access to the GDO test, HM Revenue and Customs ("HMRC") guidance released in April makes it clear that HMRC is taking a generous approach on compliance with the conditions of the test. All of these changes are welcomed.

Finally, the Act contains provisions allowing for **an acceleration of the UK tax charge on carried interest** to coincide with any U.S. tax charge also due. This follows a change in HMRC practice that had the effect of limiting UK credit for earlier U.S. tax on carry. This resulted in UK resident taxpayers who were U.S. citizens being exposed to potential double taxation since UK tax arising after U.S. tax had been paid was generally ineligible for U.S. credit owing to timing rules. The election for the accelerated charge remedies this by seeking to align the UK charge with the U.S. charge so that U.S. credit can be claimed. However, these rules and the related issues are complex and care should be taken in considering this election.

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The momentum against noncompete agreements got another boost this June, when the New York State Legislature passed a bill broadly prohibiting the use of new post-termination noncompete agreements in the state. The bill, which becomes effective 30 days after Governor Kathy Hochul signs it, would also create a private right of action for workers to bring claims against employers or individuals. Importantly, the bill would only be applicable to contracts entered into or modified on or after the law's effective date and does not invalidate existing noncompetes.

What To Know

The bill would prohibit employers and their officers and agents from requiring or accepting a noncompete agreement from any covered individual after termination of employment.

Covered Individuals. The bill appears to cover noncompetes with most workers. A "covered individual" would include traditional employees, independent contractors, gig workers and others who perform work or services, so long as the worker is in a position of economic dependence on, and under an obligation to perform duties for, the employer or other person.

Covered Noncompetes. A covered noncompete is one that prohibits or restricts a covered individual from obtaining employment after the conclusion of employment. This includes traditional noncompetes and may also include other types of restrictive covenants, although the bill does not specify examples. The bill by its terms does not affect agreements related to (1) trade secret disclosure, (2) disclosure of confidential and proprietary client information or

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(3) solicitation of clients that the worker learned about during employment, in each case so long as the agreements do not otherwise violate the terms of the bill.

The effect of the bill on notice provisions, garden leave and the "employee choice" doctrine (whereby terminated employees can choose to comply with noncompete agreements and receive compensation and benefits or compete and forfeit such compensation and benefits) is unclear and would be determined by the courts.

Private Right of Action. The bill creates a private right of action for covered individuals to bring a claim against an employer or individual who violates the bill's provisions, with a two-year statute of limitations. Remedies would include voiding a prohibited noncompete and ordering all "appropriate relief," including injunctive relief; liquidated damages of up to $10,000; and lost compensation, damages, reasonable attorneys' fees and costs.

Seller Noncompetes. The bill does not address noncompetes entered into in connection with the sale of a business, but the bill would not prohibit noncompetes between buyers and sellers who do not otherwise have an employment or other service relationship. The impact of the bill on individuals who are both service providers and holders of equity interests in their employers, however, is unclear.

Interplay with the FTC's Proposed Rule

Earlier this year, the Federal Trade Commission proposed a federal ban on post-employment noncompetes, although further FTC action on the proposal is not expected until spring 2024. If enacted, the FTC's rule would supersede any state law to the extent that the state law was inconsistent with the FTC's rule; however, a state law will not be preempted if it provides greater worker protections than the FTC's rule.

New York's bill differs from the FTC's proposed rule in two material respects:

- The FTC's rule would require the rescission of existing noncompetes. In contrast, the New York bill would not be retroactive.
- The FTC's rule would permit noncompetes with worker-sellers who owned at least 25% of the business. As discussed above, the New York bill does not have a similar carveout.

What To Do Next

There has been some speculation that New York's bill in its current form might not be signed into law. But even if not, the bill is part of a larger trend at the state and federal level to limit companies' business practices regarding noncompetes. We do not see this trend reversing any time soon.

For this reason, even though New York's bill would not nullify existing noncompetes, we recommend that employers audit their current noncompete programs to understand who is covered, where the workers are located and the nature and terms of the restrictions, and consider appropriate changes to scope and coverage. Employers should also focus on enhancing trade secret protections and customer non-solicitation provisions, which are excluded from New York's prohibition. If the New York bill or the FTC's rule becomes effective, employers may need to consider alternate strategies for retaining key employees, including the implementation of retention incentives and other potential changes to compensation and benefits.

U.S. Funds Regulatory

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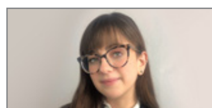

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Spring 2023 Regulatory Agenda

The SEC's recently released Spring 2023 Regulatory Agenda signals there is no letup in the agency's breakneck rulemaking pace. The Spring Agenda's 55 items include 18 items at the proposed rulemaking stage and 37 items at the final rule stage. This continues the momentum of the Fall 2022 Regulatory Agenda, which included 52 items (seven of which have since been adopted). Notably, the preamble to the Spring Agenda states this reflects "only the priorities of the Chair of the U.S. Securities and Exchange Commission, and [does] not necessarily reflect the views and priorities of any individual Commissioner," which suggests that proposal and adoption of any particular rule is not guaranteed.

Proposed rules with a target adoption date of fall 2023 include the following:

- **Private Funds Rule:** As proposed, seeks sweeping changes to the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to regulate substantive contractual terms applicable to private funds and impose certain conduct and disclosure requirements on advisers with respect to their private fund clients.
- **ESG Rule:** As proposed, enhances the disclosure requirements for investment company fund filings and investment advisers' Form ADV regarding ESG strategies.
- **Cybersecurity Rule:** As proposed, requires advisers and funds to adopt and implement written policies and procedures that are reasonably designed to address cybersecurity risks and to provide additional disclosures related to such risks and incidents in investment adviser brochures and fund filings. Although previously expected to be adopted in the spring 2023, the Spring Agenda indicates a fall 2023 adoption date.
- **Safeguarding Rule:** As proposed, significantly broadens the application of existing rule 206(4)-2 (the "Custody Rule") in a new rule, 223-1, to cover a wider range of assets and more closely regulate the relationship between an adviser and its custodian. While the SEC's target for final action on this proposal rule is fall 2023, we anticipate that the final rule is more likely to be adopted in 2024.

The Spring Agenda indicates that the following rules will be proposed in fall 2023:

- **Regulation D Rule:** Would seek to update the accredited investor definition in Rule 501 under the Securities Act of 1933 and Form D to improve protections for investors. However, three bills have recently passed the House that suggest Congress has its own ideas on how the definition of "accredited investor" should be revised: *(i)* the Equal Opportunity for All Investors Act (HR 2797) would update the definition to include individuals certified through an examination established by the SEC and administered by FINRA; *(ii)* the Accredited Investor Definition Review Act (HR 1579) would require the SEC to update the list of certifications (including the "millionaire requirement") that an investor must satisfy to qualify as an accredited investor and *(iii)* the Fair Investment Opportunities for Professional Experts Act (HR 835), would allow investors with certain licenses or educational or professional backgrounds to qualify as "accredited investors."
- **Investment Adviser Covered Technology Rule:** Would seek to regulate investment adviser conflicts when predictive data analytics, artificial intelligence, machine learning, and similar technologies are used in certain investor interactions. Presumably this would involve adopting a new rule under the Advisers Act.

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U.S. Funds Regulatory

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- **Securities Held of Record Rule:** Would amend the "held of record" definition in the Securities Exchange Act of 1934 and recalibrate the way issuers must count shareholders of record under Section 12(g).

Proposed rules in the Spring Agenda's final rule stage, which indicates a target adoption date of spring 2024, include the following:

- **Outsourcing by Investment Advisers:** As proposed, requires investment advisers to: *(i)* conduct due diligence before outsourcing various functions; *(ii)* monitor and reassess service providers' performance; and *(iii)* make and keep books and records related to such due diligence and monitoring. This is a shift in timing from the Fall 2022 Agenda, which listed an adoption date of spring 2023.

Regulation Best Execution: Would amend and enhance the existing best execution framework by requiring detailed policies and procedures for broker dealers engaging in certain conflicted transactions with retail customers.

The Spring Agenda does not reflect many changes since the Fall Agenda, but does add 11 new rule proposals. Among the most relevant to investment advisers is:

- **Registration for Internet Advisers:** Would amend the exemption for internet advisers from the prohibition against registration under the Advisers Act. The rule has an action date of fall 2023.

The Spring Agenda does not include seven rules adopted since the Fall 2022 Agenda, including the share repurchase disclosure modernization amendments, which will require an issuer to provide more timely disclosure on the new Form SR regarding purchases of its equity securities for each day that the issuer, or an affiliated purchaser, makes a share repurchase.

For more information, a comparison chart of the items on the Spring Agenda, marked against the Fall Agenda, can be viewed at this link.

The Marketing Rule

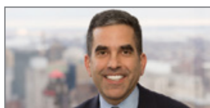
On June 8, 2023, the SEC's Division of Examinations issued a Risk Alert in connection with the amendments to Rule 206(4)-1 under the Advisers Act. The Risk Alert does not provide any new guidance for investment advisers. Instead, the Risk Alert notes that while the SEC staff remains focused on the exam areas outlined in the prior marketing rule risk alert, the staff is also increasing their focus on other areas during examinations, including on testimonials and endorsements, third-party ratings and the amended Form ADV. However, the Risk Alert's lack of any new or specific issues of concern suggests that it is sufficient for investment advisers to continue their existing Marketing Rule compliance efforts and that no additional procedures are needed at the moment.

SEC Enforcement

In addition, as discussed below in the SEC enforcement section, the SEC is also focused on investment adviser excessive management fee cases.

We will continue to monitor updates and provide our insights on further developments.

SEC Enforcement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In 2023 the U.S. Securities and Exchange Commission has continued to bring enforcement actions against entities advising and auditing private funds, signaling its continued focus on cross-trades, valuation practices, and management fee calculations. We review three of the year's most notable actions below.

In April 2023, the SEC brought an action against **Chatham Asset Management** for alleged improper trading in certain fixed income securities related to both its hedge funds and several registered investment companies for which it served as sub-adviser. The firm's clients were heavily invested in illiquid bonds, and in the ordinary course of effecting fund account redemptions, Chatham engaged in allegedly improper dealer-interposed cross-trades in which one Chatham fund purchased the same bonds that another Chatham fund purchased through certain broker-dealers. To make these trades, Chatham allegedly proposed the bond prices to the broker-dealers, and the broker-dealers agreed to the proposed prices with the knowledge that Chatham would repurchase the bonds either directly or indirectly through another broker-dealer. Through this practice, Chatham allegedly charged clients approximately $11 million in additional fees that they would not have paid in the absence of those trades. The SEC noted its concern regarding the pricing of these trades—namely, that Chatham had chosen the inflated prices at which the bonds were cross-traded. The SEC found that Chatham violated Section 206(2) of the Investment Advisers Act of 1940 and Sections 17(a)(1) and (a)(2) of the Investment Company Act of 1940. Chatham's principal, Anthony Melchiorre, was charged with aiding and abetting these violations.

In another spring 2023 action, the SEC brought settled charges against Spicer Jeffries and one of its audit partners for improper professional conduct related to two private fund audits. The SEC alleged that during the audit planning stages, Spicer Jeffries assessed that valuation of investments was a significant fraud risk but did not implement the planned audit approach to respond to the risk. According to the SEC's order, due to these failures and others, Spicer Jeffries did not exercise due care, including professional skepticism related to the adviser's fair value measurements. The order also found that **Spicer Jeffries'** deficient system of quality control led the firm to fail to adhere to professional auditing standards. As part of the settlement, Spicer Jeffries agreed to issue a firm-wide announcement about the case approved by the SEC, and to retain an independent consultant to review and evaluate the firm's audit, review, and quality control policies and procedures, along with several related undertakings. The audit partner also agreed to a one-year suspension from appearing and practicing before the SEC. This action highlights the SEC's continued focus on gatekeepers in the private fund context.

The SEC has continued to prioritize reviews of private fund advisers' calculation of post-commitment management fees, and in June 2023 announced an action against **Insight Venture Management LLC** in which the firm agreed to pay a $1.5 million penalty to settle charges that the firm had calculated management fees in a manner not in conformance with the fund documents. Specifically, the order found that Insight inaccurately calculated management fees based on aggregated invested capital at the portfolio company level instead of at the individual portfolio investment security level, as required by the

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SEC Enforcement

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applicable limited partnership agreements. In addition, the SEC found that the firm failed to disclose a conflict of interest relating to the firm's discretion in determining whether an asset would be considered permanently impaired so as to reduce the basis used to calculate management fees. Notably, the case started as a referral by the Division of Examinations to Enforcement—thus serving as a reminder to private fund managers that fee calculations remain in the crosshairs during SEC examinations and that the firm's fee calculations must be aligned with fee disclosures in the relevant fund documents.

Looking ahead, we expect to see continued robust enforcement against private fund advisers, especially in instances where there is a perceived conflict of interest or an issue with the calculation of management fees.

ESG

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ESG continues to be top of mind for private equity firms in 2023. The first half of the year brought an array of new laws and regulations taking effect or under development, as well as the launch of new reporting frameworks. In addition, ESG is becoming increasingly contentious in the United States, creating a challenging landscape in which to operate. We anticipate an even more eventful second half of 2023, with the finalization of the U.S. Securities and Exchange Commission's climate and ESG-disclosure rules among a number of significant events.

We highlight below some recent ESG developments of particular interest to private equity firms. (Additional analysis of ESG developments can be found by visiting Debevoise's ESG Resource Center and subscribing to our ESG Weekly Update.)

United States

State-Level Developments

Nearly every state has now introduced legislation related to ESG. The state-level ESG landscape has become increasingly polarized, as some states pass "pro-ESG" and others pass "anti-ESG" laws and regulations.

Notably, in May, Florida passed a sweeping anti-ESG law, with restrictions that include a prohibition on the issuance of green bonds by state entities. The law also requires the Florida State Board of Administration and fiduciaries to consider only "pecuniary factors" when investing public monies (such as retirement system assets) and when exercising shareholder rights like proxy voting that go along with those investments. The Florida law includes an anti-boycott provision requiring state funds to be deposited only into financial institutions that "do[] not engage in the unsafe and unsound practice of denying or canceling its services" to a person on the basis of the person's failure to meet ESG standards, among other factors.

Texas likewise introduced several anti-ESG bills—some that passed last year and others pending legislative approval—directed at insurers, financial institutions, state pension funds, and government bodies. One bill would require Texas's attorney general to review

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ESG

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the constitutionality of federal executive orders and actions concerning ESG-related financial regulation. Another bill would prohibit insurance companies from boycotting businesses on ESG grounds.

At the other end of the spectrum, California legislators proposed a number of significant pro-ESG bills that would require companies to conduct climate risk assessments, disclose greenhouse gas emissions, and prohibit investments in fossil fuel companies, among others.

To complicate matters further, while some states have staked out adamant positions for or against ESG, others are taking more tempered views or staying on the sidelines. Indiana and Kansas, for example, have softened their positions on anti-ESG actions due to concerns regarding possible negative financial impacts on the state and state's retirement plans. Wyoming and North Dakota have refrained altogether from passing certain anti-ESG bills because of concerns regarding possible unintended consequences.

Additional details can be found on the Debevoise State-Level ESG Developments tracker.

SEC Proposed Rules on ESG-Related Disclosure

Last year, the SEC announced three long-awaited proposed rules relating to ESG disclosure. In March, it issued the proposed "Enhancement and Standardization of Climate-Related Disclosures for Investors" (the "Issuer Rule"), which would add for SEC registrants climate-related disclosure requirements to Regulation S-K and Regulation S-X. In May, it issued the "Funds Rule," requiring covered entities offering ESG-related financial products to disclose in fund prospectuses, annual reports, and adviser brochures the ESG factors considered in the fund's investment decisions.

Concurrently with the Funds Rule, the SEC released a third proposed rule, the "Names Rule," that would require funds using ESG terminology (e.g., "sustainable," "responsible," "climate," "low-carbon," "green," etc.) in their name to make 80% of their investments reflecting the investment focus suggested by the name.

While these rules were initially expected to be finalized by the end of 2022, the final versions are now scheduled to be issued in the fourth quarter of 2023. Although the Issuer Rule may be revised after having been the subject of Congressional inquiries and almost 15,000 comment letters, the Funds Rule and Names Rule are expected to remain largely in their current forms.

Department of Labor ERISA Rule

On January 30, 2023, the U.S. Department of Labor (DOL) rule permitting fiduciaries to consider climate change and other ESG factors when selecting investments for retirement plans became effective. Days before, Republican attorneys general representing 25 states sued the DOL in Texas federal court alleging, among other things, that the rule exceeds the DOL's statutory authority and "undermines key protections for retirement savings" by promoting ESG factors in investing. On June 2, 2023, the U.S. Department of Justice filed a motion for summary judgment against the lawsuit.

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ESG

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In parallel, the Senate passed a joint resolution to nullify the rule, which was supported by almost all Republican and two Democratic senators. President Biden used his first veto against this resolution. A two-thirds vote in both the House of Representatives and Senate is required to override a presidential veto, which currently appears unlikely.

Global

ESG Frameworks

Net Zero Alliances

Recent anti-ESG developments in the United States have had a chilling effect on ESG alliances, most notably the Net Zero Insurance Alliance (NZIA). The NZIA saw roughly half of its 28 members (including some founding members) resign after the attorneys general of 23 states published a letter stating their "concern[] with the legality" of the organization—in particular, possible violations of antitrust laws. The UN Environment Programme responded by issuing a public statement citing "recent discussions within the United States" as the reason why members with "significant US business and exposure" have withdrawn from the NZIA, which recently adjusted its membership requirements.

A similar letter was sent to 53 of the largest U.S. asset managers, claiming that they are disregarding their fiduciary duties to maximize financial returns by joining groups seeking to reduce emissions, such as the Net Zero Asset Managers Initiative and Climate Action 100+.

ISSB

On June 26, 2023, the International Sustainability Standards Board (ISSB) published its long-awaited General Requirements for Disclosure of Sustainability-related Financial Information (IFRS S1) and Requirements for Climate-Related Disclosures (IFRS S2). These standards require companies to disclose information on how they address risks and opportunities regarding sustainability and climate, respectively.

The ISSB disclosures are meant to accompany a company's financial statements and are built on the same concepts as IFRS Accounting Standards.

ESG Laws

German Law on Supply Chain Due Diligence

On January 1, 2023, the German Act on Corporate Due Diligence Obligations in Supply Chains (*Lieferkettensorgfaltspflichtengesetz*) entered into force. Under the Act, companies must conduct due diligence on human rights and environment-related risks within their supply chain. This includes all stages of producing a company's products or services carried out in Germany or abroad. The obligations cover the company's own business and its direct and indirect suppliers.

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ESG

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Net Zero Laws and ESG Regulations

Switzerland and Taiwan are among the latest countries legally enshrining net zero targets, committing to cut greenhouse gas emissions by 2050.

On January 3, 2023, the Philippines' Securities and Exchange Commission published rules requiring Sustainable and Responsible Investment funds to adopt sustainability principles or ESG factors as their key investment focus. Funds in scope are also required to invest at least two-thirds of their net asset value in investments aligned with their sustainable investment objectives.

Climate Transition

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The U.S. Supreme Court's May 25, 2023 end-of-term decision in *Sackett v. Environmental Protection Agency* is the latest to dramatically narrow federal regulatory authority in a way that creates substantial uncertainty for investors. By limiting the EPA's authority to regulate wetlands, the Court devolved that federal authority to the states, exposing companies—and their investors—to a patchwork of highly variable state regulatory schemes in lieu of a unifying federal structure. Decision-makers who would have looked to EPA regulations to guide their business decisions must now wade through any number of interlocking, and highly differentiated, state law regimes. While the various state laws are too many and too varied to fully address here, we briefly summarize the issue and its potential implications.

The landmark decision in *Sackett* substantially narrowed the Environmental Protection Agency's jurisdiction under the Clean Water Act. The majority held that for a wetland to qualify as a water of the United States ("WOTUS")—subjecting it to federal regulation—the wetland must have a "continuous surface connection" to a traditional navigable water. This stringent approach supplanted prior, and broader, Supreme Court interpretations of the Act, which allowed the EPA to protect not only wetlands that adjoin traditional navigable waters, but wetlands with a "significant nexus" to such waters.

Sackett places on individual states the burden of regulating more than 18 million acres of previously federally regulated wetlands. This will lead to further inconsistency and variability across regions, as states already employ highly disparate regulatory schemes. Broadly speaking, state approaches to wetland regulation fall into one of three categories:

- **Rely on the federal interpretation:** Half of the states rely on federal interpretations of WOTUS, and will thus now apply the "continuous surface connection" test in regulating intrastate wetlands. These states include Alabama, Alaska, Arkansas, Colorado, Delaware, Georgia, Hawaii, Idaho, Iowa, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, South Carolina, South Dakota, Texas, and Utah.
- **Supplement the federal protection:** Seven states and the District of Columbia have developed some supplemental protections for non-WOTUS wetlands. While the regulatory schemes among this group vary, these states have generally taken a "gap-filling" approach. For example, North Carolina has in place a permitting mechanism

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for discharges to isolated intrastate waters, and more recently has attempted to regulate "federally non-jurisdictional wetlands" and "classified surface waters." States in this group include Arizona, the District of Columbia, Illinois, Indiana, North Carolina, Ohio, West Virginia, and Wyoming.

- **Develop their own extensive regimes:** Eighteen states comprehensively regulate non-WOTUS wetlands. These states have developed permitting programs for all nontidal wetlands, isolated wetlands, and freshwater resources. They will continue to protect wetlands that have lost federal protection under *Sackett*. The states with comprehensive wetland regulations include California, Connecticut, Florida, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, Washington, and Wisconsin.

The *Sackett* ruling—and the heightened judicial scrutiny of federal regulation it represents—poses challenges for sponsors seeking to invest in companies that may be subject to relevant environmental regulations. Post-*Sackett*, states are likely to reexamine their existing wetland regulation policies. While some states may respond to the decision by filling the regulatory void imposed by *Sackett*, others may choose to remove existing protections. Complicating matters further, the decision called into question the federal permitting process, and the Army Corps of Engineers has since suspended its approval of jurisdictional determinations until regulators finalize updated guidance.

Finally, regardless of how individual states decide to regulate their wetlands, any business that operates in multiple states may be subject to mismatched regulatory schemes. This increasingly varied and unpredictable regulatory environment warrants careful due diligence attention for future investments as well as a close review of the existing environmental compliance policies of current portfolio companies. In any event, it is unlikely the Clean Water Act will be the last federal environmental regulation to be significantly narrowed, and we are actively monitoring this space to keep abreast of further developments.

Real Estate

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Market conditions so far in 2023 have been dominated by uncertainty and volatility stemming from high inflation and interest rate hikes. In March, downward pressure on the real estate market further intensified as regional banks and other lending institutions tightened their lending standards in response to the failures of Silicon Valley Bank, Signature Bank and First Republic Bank. These more difficult lending conditions drove the cost of borrowing up and the volume of debt originations down, draining investment and constraining deal activity. As a result, by the end of Q1 2023, investment in commercial real estate was down 55% year-over-year. The multifamily and office sectors were hit hardest, with investment down approximately 65%, while retail investment declined by approximately 32%.

While certain sectors were adversely affected by the economic headwinds of 2023, others exhibited resilience. The **hospitality** sector experienced increases in hotel

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Real Estate

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occupancy, average daily rates and revenue per available room in the first half of the year. As domestic business travel returns and global tourism and leisure travel continues to grow, investors purchasing stabilized hospitality assets will be well-positioned to capitalize on strong demand. And while the first quarter saw a marked contraction in **retail** overall, there has been an ongoing demand for high-quality, well-located retail assets as consumers return to in-person shopping. Retailers with adequate capital are likely to continue abandoning poorly-located, outdated or obsolete spaces for higher-quality locations, while owners of assets now less desirable for retail continue to look to reposition these spaces for different uses.

In some sectors that were hard hit in the first half of the year, positive fundamentals have begun to solidify. In the **multifamily** sector, strengthening labor markets, cooling single-family housing markets and growing construction activities may lead to an increase in demand and pave the way for greater investor confidence by year-end. Although the **industrial/logistics** sector has experienced slower rent growth of late, vacancy rates remained low. Fundamentals in the sector continued to thrive, largely as a result of demand for warehouse space driven by the boom in e-commerce.

The **office** sector, however, continues to face challenges. The shift from in-person to remote/hybrid work drove demand down, increased market dislocation, constrained liquidity and stagnated the issuance of office building loans. Moreover, record lease expirations, combined with a surge in sublease space available on the market (caused by the switch to remote/hybrid work and layoffs in the technology sector), added to mounting office space surplus. In this flight to quality, best-in-class, well-located assets will continue to perform well, but outdated, poorly-located Class B and C properties will continue to suffer.

With an estimated $92 billion in office debt due (or coming due) by year-end 2023, and an estimated $58 billion coming due by year-end 2024, discussions about office-to-residential conversions (“OTRCs”) have emerged front and center on the national stage. Some U.S. markets offered tax incentives tied to affordable housing metrics, while others issued revitalization plans to encourage OTRCs; so far, however, tax incentives, relaxed zoning restrictions and increasingly favorable land use regulations have simply not been enough for OTRCs to gain any real traction from a business perspective.

By pausing interest rate hikes while simultaneously hinting at further rate increases before year-end, the Federal Reserve has provided investors with a mix of hope and dread, resulting in a cautiously optimistic investor outlook for 2024. If rate hikes continue, however, uncertainty and volatility will likely resume.

Restructuring

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After a relatively quiet 2021-2022, restructuring activity has increased dramatically in 2023 due to the convergence of several factors. Continued interest rate increases from the Federal Reserve, the tightening credit market, inflation's impact on consumer spending, and supply chain disruptions have all adversely affected companies across a variety of industries. Consider that the first four months of 2023 saw more corporate bankruptcy filings than the first four months of any year since 2010. With interest rates expected to remain high, we anticipate this substantial restructuring activity to continue.

As we discussed in the Private Equity Report: 2023 Outlook, the downturn in the credit cycle has made it more difficult for highly levered companies to secure new capital or refinance debt. These conditions have brought a predictable uptick in out-of-court liability management transactions. Because these transactions often involve different treatment for majority and minority lenders (such as so-called "uptier" and "dropdown" financings), these transactions have been the subject of recent noteworthy litigation. Most recently, a Texas bankruptcy court in *Serta Simmons* issued a highly publicized ruling rejecting the nonparticipating lenders' claims that Serta's 2020 uptier transaction breached its Credit Agreement or violated the implied duty of good faith and fair dealing. In the court's view, the competitive process run by Serta to solicit a potential transaction from competing groups of existing lenders resulted in an "open market purchase" permitted under the Credit Agreement. Several other companies that have undergone similar liability management transactions have also recently filed for bankruptcy, including Revlon, Wesco/Incora and Envision Healthcare, raising the possibility that the propriety of these transactions will continue to be litigated in bankruptcy courts. Regardless of how these cases ultimately unfold, they illustrate that while liability management transactions can provide critical short-term liquidity and additional runway, they may leave companies in need of a more comprehensive restructuring.

This year has also seen a number of key developments altering the landscape for addressing mass tort liabilities through bankruptcy. In May, the Second Circuit issued its long-awaited decision in *Purdue Pharma*, reaffirming that nonconsensual third-party releases are permitted under the Bankruptcy Code in appropriate circumstances. In vacating the district court's decision, the Second Circuit allowed Purdue to proceed with its Chapter 11 plan, supported by over 95% of voting creditors, which would use the bankruptcy process to insulate shareholders and others from litigation. Mass tort bankruptcies almost invariably involve significant claims against non-debtor third parties, making third-party releases a key issue in these cases. The *Purdue* decision leaves the Second Circuit aligned with the majority of other circuits, including the Third Circuit, although specific standards deviate in each circuit.

In another development on the mass torts front, an Indianapolis bankruptcy judge recently rejected an attempt by Aearo Technologies, a 3M subsidiary, to use Chapter 11 to resolve nearly 260,000 lawsuits against it and its solvent parent related to allegedly defective earplugs. The court found that the bankruptcy filing lacked a valid reorganization purpose and that an "otherwise financially healthy debtor" should not stay in bankruptcy, especially when most of its liabilities are guaranteed by its solvent parent. The Aearo ruling comes on the heels of the Third Circuit's dismissal of the

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Restructuring

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bankruptcy case of *LTL Management*, a subsidiary of Johnson & Johnson that was tasked with resolving J&J's talc-related mass tort litigation. Among other things, the Third Circuit found that LTL was not in sufficient financial distress when it filed for Chapter 11 because of a funding agreement in which parent J&J agreed to backstop LTL's tort liabilities "without any disruption to its business or threat to its financial viability." That said, the Third Circuit noted that it did not intend "to discourage lawyers from being inventive and management from experimenting with novel solutions." Perhaps taking a cue from that comment, LTL filed a second bankruptcy case after revising the J&J funding agreement. Most recently, the Fourth Circuit has weighed in with a ruling supporting the Chapter 11 case of Bestwall, a subsidiary of Georgia Pacific, seeking to resolve its asbestos liability. We expect litigation on these issues to continue in multiple circuits going forward.

For the second half of 2023, we may see more surprises, like the recent failures of Silicon Valley Bank and other regional banks, which could lead to additional volatility and instability.

International Arbitration

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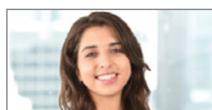

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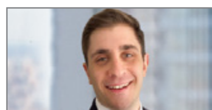

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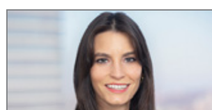

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When private equity firms are structuring funds or conducting due diligence on transactions involving portfolio companies, investment treaty protections are often regarded as irrelevant considerations. For funds involved in cross-border investment, this can be a mistake that exposes the fund to considerable risk. To see how this is so, consider a fund whose last remaining investment is a valuable portfolio company in a regulated sector in an African jurisdiction. The shares in the portfolio company are owned through a special purpose vehicle ("SPV") domiciled in a Gulf State. The founders of the portfolio company, prominent business executives in the African State and who retain a minority stake in the portfolio company, become embroiled in a political dispute with the host government, which retaliates against the founders by freezing the portfolio company's assets.

Litigating against the African State in its own courts is obviously unappealing and not likely to be productive. Fortunately for the fund, there is a comprehensive bilateral investment treaty (BIT) between the African State and the Gulf State. BITs provide investors from one party's country with protections when investing in the other party's country—an important tool for fostering cross-border investment. While the specifics of BITs vary, they typically include provisions ensuring that the other country's investors will receive fair and equitable treatment, that investment property won't be nationalized, and—most importantly for this scenario—that disputes between one state and the other country's investors are subject to arbitration before an international tribunal convened under the rules of a body such as the International Centre for Settlement of Investment Disputes (ICSID), an arm of the World Bank.

The portfolio company thus writes to the African State, asking it to cease its actions against the portfolio company and raising the possibility that the matter will go to arbitration if the actions continue. This is often a highly effective threat, as the arbitration process is public—bringing the very real possibility that the African State will be perceived by the global business community as unfriendly to foreign investment.

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International Arbitration

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And, of course, in addition to the considerable reputational risk, the State also faces the substantial damages claims that will be at the center of the arbitration.

BIT protections thus have a prophylactic effect and serve as a remedy of last resort in the event a dispute escalates—a remedy that would not exist had the SPV not been domiciled in a jurisdiction that had a BIT with the African State. Should a host state decide to target foreign investors in a particular sector—because, for example, that sector is doing particularly well and the government wants to keep the profits for itself—it will likely target investors without BIT protection instead of investors with such protections.

Unfortunately, the scenario described above is not hypothetical. After Poland forced Abris Capital Partners to sell its stake in a Polish bank, Abris turned to a Stockholm Chamber of Commerce tribunal, which awarded Abris more than $171 million in damages. When Lone Star Funds set out to sell its stake in Korea Equity Bank, it turned to an ICSID tribunal after Korean authorities allegedly attempted to delay the sale through regulatory and tax roadblocks. Last year, the tribunal awarded the fund $216.5 million, plus interest.

Obtaining BIT Protection

Investors do not have to elect to have BIT protection; the protection is a consequence of there being a BIT in place between the two countries and the investors and investment meeting the definitions and requirements outlined in the BIT.

It is straightforward to find BITs that are in force and that cover the investment contemplated; from there, a holding company can be established in a state that is a counterparty to the state where the investment will be located. However, it can be challenging to structure the investment so other structuring considerations are not undermined. Because fund structures are often complex, tying together entities domiciled in a variety of jurisdictions, it is usually best to structure lower down the corporate chain through the holding companies that own the shares in the portfolio companies.

Further key considerations include the following:

- **Timing.** It is important to structure the investment so that it is covered by a relevant BIT before any dispute arises with the host state regarding a particular investment. Doing so after a dispute has crystallized risks denial of the protections of the BIT.
- **Nature of the holding company vehicle.** Different BITs have different requirements relating to the status of the holding company incorporated in the investor's home state. For example, a BIT may require that the holding company undertake genuine economic activity in the home state or that the investment decisions are taken by the holding company in the home state.
- **Nature of the investment.** It is also necessary to assess whether a particular type of investment is specifically identified as being protected under the applicable investment treaty and whether direct as well as indirect investment holdings are protected. This last point will influence the amount of freedom the PE fund will have in determining what the optimized investment holding structure will be.

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International Arbitration

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Structuring to take advantage of investment treaty protections is a valuable tool that provides assets with a layer of protection beyond what is provided by contracts with, and laws of, the host state. This is particularly relevant for private equity firms with assets in jurisdictions that may be risky from a legislative or regulatory perspective. If government action adversely impacts those assets, dispute settlement under investment treaties can offer a neutral forum where the parties have a level playing field before experienced arbitrators.

Products Liability

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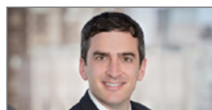

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Investors in chemical and consumer product manufacturers should carefully monitor litigation risks arising out of per- and polyfluoroalkyl substances commonly referred to as PFAS or "forever chemicals." Although this class of more than 10,000 chemicals has been in use since the 1940s, PFAS have emerged as a source of mass tort litigation that has resulted in recent nine- and ten-figure settlements. Such costly litigation is likely to continue for the foreseeable future.

PFAS are a complex group of manufactured chemicals that are ubiquitous in today's society because of their resistance to water, oil, temperature, and fire. They are used across a wide variety of products and applications, including non-stick cookware, firefighting foam, fast food containers, and waterproof clothing. Plaintiffs allege that PFAS are especially dangerous "forever chemicals" because they do not naturally break down. Plaintiffs further allege that PFAS cause a variety of adverse health effects, such as certain cancers, kidney disease, altered immune and thyroid function, and reproductive harms—although these claims are hotly contested by defendants.

Since the start of 2023, there have been several major settlements in the world of PFAS litigation:

- In June 2023, 3M Company reached a $10.3 billion deal to settle claims of polluted groundwater brought by various public water systems.
- Also in June 2023, three chemical companies—Chemours Co., DuPont de Nemours, and Corteva—announced that they would pay $1.185 billion to settle thousands of claims alleging that PFAS manufactured by these companies polluted public water systems.
- In March 2023, a federal judge approved a $54 million settlement agreement for class members in an action against 3M and Wolverine World Wide, a footwear manufacturer that used a PFAS manufactured by 3M to waterproof its shoes. The class members alleged that Wolverine's manufacturing site polluted their groundwater with PFAS, harming their health and decreasing property values.

These settlements, however, are by no means the end of these companies' PFAS exposure, as they remain defendants in numerous additional lawsuits, and as new PFAS-related lawsuits continue to be filed. For example, the Kentucky Attorney General recently filed a new lawsuit against 3M, DuPont, Chemours, and several other defendants alleging environmental contamination caused by PFAS.

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Products Liability

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But large chemical manufacturers are not the only companies at risk of PFAS liability. As PFAS litigation has led to large recoveries, plaintiffs' counsel has expanded their focus from PFAS manufacturers to companies throughout the supply chain. Plaintiffs have targeted new defendants across a diverse range of industries, including fashion, cosmetics, fast food, and national defense. The causes of action in these matters include not only environmental contamination and personal injury claims, but also false advertising, requests for injunctive relief for data collection, breach of warranty claims arising from a failure to disclose material information, and more. PFAS litigation has also triggered follow-on coverage litigation with insurers regarding whether PFAS claims are covered under existing insurance policies.

In light of these risks, investors and private equity funds should assess their potential exposure to PFAS-related liability and consider the following measures:

- Identifying in diligence a target's potential PFAS exposure, history of liability or past claims, and whether the target has historical insurance policies covering PFAS or environmental contamination, as well as assessing the robustness of the target's compliance programs.
- Conducting audits to assess potential PFAS-related exposure stemming from portfolio company products and product supply chains;
- Assessing whether advertisements or marketing claims are consistent with the presence of PFAS in any products;
- Reviewing PFAS-data collection procedures for compliance with applicable federal and state environmental laws;
- Consulting counsel to discuss appropriate measures in the event a company becomes aware of any material PFAS use or exposure that could result in adverse actions; and
- Cooperating as appropriate with ongoing investigations by government agencies.

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Law 360

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Law 360

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