Debevoise & Plimpton

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From the Editors

The increasing interest rates of the past year and a half have placed constraints on accessing the traditional sources of capital that are private equity's lifeblood. The *Fall 2023 Private Equity Report* explores strategies that are available to sponsors and companies in need of capital. We also examine the evergreen topic of how to prepare for the sale of a portfolio company, as well as a matter of growing importance: AI governance.

Asset Management M&A: Current Trends and Key Legal Considerations

Attracted by greater access to capital, private equity firms continue to play a role in the ongoing consolidation taking place in the Asset Management industry. We explore a range of structuring and legal considerations in these deals, including valuation and consideration, consent by clients and limited partners, regulatory approvals, and post-closing commercial arrangements and business integration.

Ready, Set, Sell: 10 Things to Consider Before Starting a Sale Process

In a follow-up to our detailed examination of carve out transactions in the *Spring 2023 Private Equity Report*, we outline ten things sponsors need to do in order to execute a successful portfolio company sale.

What Real Estate Equity Investors Considering Debt Investing Need to Know

The rise in interest rates and the macro environment have pushed many fundamentally sound real estate properties toward distress—a development that has some real estate investors who typically take equity positions eyeing becoming lenders as well. Equity investors considering such a move should not let their familiarity with the sector obscure the fact that the lender role brings different market relationships, rights and responsibilities.

Capital Structure Options for a Higher Interest Rate Environment

Both private equity firms and their portfolio companies are adapting to the end of the era of inexpensive and readily available debt financing. In this new reality, companies in need of financing can employ various techniques to optimize their capital structure, including liability management transactions and different types of financial instruments.

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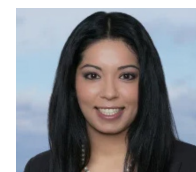

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Loans for Buyout Funds: A Newly Popular Tool in Fund Finance

As fund sponsors face both heightened liquidity needs and a slowdown in exits, net asset value (NAV) financing has become increasingly common. Establishing these credit facilities requires extensive diligence by lenders at both the upper-tier and portfolio company level and requires sponsors and lenders to come to terms on numerous issues that are explored in this article.

Giving AI Governance a Risk-Based Approach

With the advent of generative AI, private equity firms are grappling with the twin tasks of encouraging and supporting portfolio companies' use of this wapproached in a responsible, defensible, and controlled manner. Establishing a risk-based AI governance program is a critical step in doing so.

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"It's almost Thanksgiving, then it's the holidays, then it's dark, then it's muddy, then it's vacation… Can we pencil something in for next September?"

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Asset Management M&A: Current Trends and Key Legal Considerations

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M&A activity and consolidation in the Asset Management ("AM") arena continue apace, fueled by the rewards of scale in a still-fragmented industry. Those rewards are particularly attractive now, given a challenging global macroeconomic outlook, growing regulatory burdens and, for all but the most differentiated strategies, fee pressure.

Current Trends Driving AM M&A

M&A activity in the AM space, while falling below 2022 levels, nonetheless remained healthy in the first half of 2023, with more than 30 transactions with a value of at least $100 million occurring across a varied array of AM targets and purchasers, including retail managers, insurers, fintech firms and private fund managers.

The sustained activity has been driven by a number of trends, including:

Consolidation – The AM sector has been consolidating for years, so as to better withstand the macro economic headwinds of inflation, geopolitical fragmentation and rising interest rates, all of which make it more difficult to raise funds, successfully navigate the public markets, and exit private investments at desired valuations.

Participation in the AM industry's consolidation has allowed PE firms to pursue four objectives: (i) achieve greater access to capital for their primary fundraises through a strengthened IR function and by leaning into the trend that sees limited partners increasingly commit more capital to fewer managers; (ii) achieve economies of scale; (iii) compete with larger players; and (iv) induce investors (including LPs) to invest by providing lower fees and greater value.

Increasing Regulatory Burdens – Both U.S. and non-U.S. regulators continue to focus on the private fund industry, increasing compliance and reporting burdens for managers. Managers have thus needed, and will continue to need, increased resources devoted to compliance personnel and systems to meet these requirements. Greater scale allows managers to spread these costs over a larger fee base.

Tech-driven Acquisitions – Technology, and in particular AI, has the potential to change the face of the AM industry as firms move, at least in part, to automate their investment processes. To keep up with competition, many AM firms without proprietary technology are looking to acquire fintech start-ups and/or technology-driven asset managers.

Product and Geographic Diversification – Diversifying product lines and geographic exposure is a strategic priority for many AM firms, leading them to pursue acquisition of niche AM firms, such as fund managers specializing in secondaries, infrastructure or emerging markets.

Sell-side Commercial Considerations – Being acquired can be an attractive way for founders/management of AM firms to manage generational change, secure the capital and backing needed for their firm's next phase of growth, and achieve at least partial liquidity to reap the benefit of the growth of their business to date.

Buy-side Commercial Considerations – Purchasers, including PE funds and pension funds, often acquire AM assets to gain exposure to that manager's human capital and investment opportunities by, for example, having the ability to seed new funds or obtain co-investment opportunities.

Deal Types

While there is no one-size-fits-all AM M&A transaction, the deals we see generally fall into one of—or a combination of—the following five categories: (i) a stock sale, asset sale or merger; (ii) a majority or control acquisition; (iii) a minority investment (sometimes with a future option to take a controlling stake); (iv) a spin-out of a portion of the business to management; or (v) a sale of a product line or portion of the overall business. These transactions can entail different types of securities, including common, preferred or structured equity and debt.

The asset being acquired also varies from deal to deal. For example, certain purchasers will acquire an entire AM entity, whereas others will acquire economic interests in the funded GP commitments and/or carry entitlements of specific managed funds or future funds.

Many AM M&A transactions couple an equity interest in the target with preferential commercial arrangements to invest in the target's future funds, to obtain co-investment opportunities or both. Conversely, such transactions may obligate the purchaser to commit to future funds to be established and managed by the target, thus giving the target greater certainty in its future capital raises.

Some Structuring and Key Legal Considerations

As with any transaction, structuring and legal considerations are crucial for the success of an AM M&A deal. These may include:

Consideration Structure – Valuing AM targets is often complicated, with the valuation of illiquid and contingent assets leading to gaps between sell-side and buy-side expectations. To bridge these gaps, parties often use structures that include earn-outs and other forms of contingent consideration or exclude from the transaction certain assets, such as existing carry entitlements, especially where the valuation gap is large.

Client and LPs Consent/Amendment of Documents – Depending on the applicable regulatory regime and existing contractual terms, clients of the AM firm being acquired may need to consent to the deal. The purchaser and seller will need to negotiate how that process will occur (including the form of consent, timing and disclosure) and the purchaser will want the ability to consent to any amendments to the agreements between the AM firm and its clients, particularly when those amendments touch on economic matters. Typically, where client consent is required, closing of the transaction will be conditioned on receipt of consents by a specified minimum percentage of clients (usually measured by AUM or revenue run-rate); the agreement may provide for a purchase price adjustment if consenting clients fall below a specified threshold.

Management and Rollover Incentives – In most AM M&A transactions, an important part of the deal is retaining and incentivizing management, usually through a combination of "carrots" and "sticks." Potential carrots include carry allocation, bonuses and equity awards. Sticks may include restrictive covenants aiming to limit managers' ability to work in competing AM players and equity forfeiture provisions if they do so. Where the target is becoming part of a larger AM group, the purchaser may consider whether to harmonize the arrangements reached with the acquired firm and those in force for the larger group.

Regulatory Approvals – Depending on the nature of the target business and the jurisdictions in which it operates, approvals and clearances from financial services regulators (such as the Financial Conduct Authority or the Prudential Regulation Authority in the UK) may be required for the deal to close. These approvals could be required at the level of the target AM firm as well as at the level of any portfolio

companies it owns or controls. The transaction may also be subject to various antitrust or other foreign direct investment reviews. Although substantive antitrust problems at the firm level are uncommon given the fragmented nature of the AM industry, it is still important to conduct thorough due diligence of the target, including regulatory, antitrust and freedom of information analyses.

Interim Covenants – The purchaser will need to negotiate appropriate interim covenants to (i) protect itself from a reduction in the value of the target between signing and closing and (ii) ensure the company continues to operate in the ordinary course and does not take on additional commitments without the consent of the purchaser. However, antitrust and regulatory considerations, as well as commercial considerations, will limit the ability of the purchaser to control the business prior to closing.

Representations and warranties and Indemnities – Purchasers typically seek a complete package of representations and warranties providing post-closing protection (either through a rep and warranty insurance policy or an indemnity), while sellers seek to minimize post-closing risk. A purchaser-favorable set of reps and warranties will cover all main areas of the target, including, in particular, compliance with laws and regulations—a key risk area in the AM space. Depending on the due diligence findings, the purchaser might also seek indemnity protection for known exposures. On the other hand, where management is also a seller, purchasers will want to avoid the need to sue management. This consideration—as well as the seller's own desire to avoid post-closing claims—may lead the parties to rely on a rep and warranty insurance policy.

Tax Structuring – Depending on the type of transaction, the nature of the target and the jurisdictions involved, the proper tax structure may be crucial to maximize value for the parties, reduce tax leakage, allocate tax assets and liabilities and optimize exit. Given the types of legal entities involved, the various types of assets at issue, including carried interest, and the need to efficiently incentivize management, the tax structuring for an AM M&A deal may be more complex than for transactions in other sectors.

M&A activity and consolidation in the Asset Management ("AM") arena continue apace, fueled by the rewards of scale in a still-fragmented industry.

Post-Closing Governance – Depending on the type of transaction and the target, a key area of negotiation will be post-closing governance. Specifically, parties will need to agree on governance structures (*e.g.*, board and investment committee mandates and composition) and how day-to-day and strategic decisions will be made. Topics to be covered include entry into strategic transactions, launch of new funds/products, incurrence of debt, management of liabilities and hiring/firing decisions and carry allocations.

Post-Closing Commercial Arrangements – As mentioned above, many AM M&A transactions include commercial arrangements between the parties relating to future investment opportunities and fundraises. The most common arrangements include target commitments to provide investment opportunities to the purchaser and its affiliates, whether through primary fund raises, co-investment opportunities, or both, and purchaser commitments to invest a minimum amount in future fundraises. One potential downside of these preferential arrangements is that they may affect the client consent process and may ultimately limit the target's ability to fundraise from third-party LPs post-close.

Post-Closing Business Integration – Purchasers should consider how best to integrate the target, including from a cultural perspective. Parties will also need to pay special attention to: (i) whether and how the purchaser and the target will be consolidated from an accounting perspective, as well as the consequences of any such consolidation; and (ii) due diligence as to whether the use of control-based affiliate definitions in their contracts will trigger unintended consequences (*e.g.*, restrictive covenants applying to the purchaser's affiliates, including portfolio companies).

The AM sector's M&A landscape offers exciting opportunities but market participants need to be well prepared and fully informed to capitalize on them.

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Ready, Set, Sell: 10 Things to Consider Before Starting a Sale Process

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In the “circle of life” of private equity investing, the acquisition of a portfolio company eventually leads to the exit from the portfolio company. There may be twists in the ownership journey along the way—a transfer to a successor or continuation vehicle, a minority sale to a new investor, one or more “add on” acquisitions, the sale of a division or a business unit, or an IPO (leading to liquidity over an extended period)—but, at some point, a full exit will occur.

Often, the timing of the exit does not fully align with the sponsor’s original investment horizon. Financing conditions, management transitions, competitive disruptions, and a myriad of other events may lead a sponsor to accelerate exit and kick-start a sale process. Sale processes can move quickly. Without proper preparation and organization, a selling sponsor may fail to find the best buyer for its portfolio company, face delays in deal execution and may need to compromise on key deal terms. Although many factors affecting the sale process are outside a sponsor’s control, it pays to be prepared. A sponsor will therefore want to take stock of key sell-side issues prior to beginning a sale process. (These considerations assume the sale of an entire portfolio company in a single transaction; for sell-side issues associated with carve outs, such as the sale of a division or business unit, see the Spring 2023 issue of the *Private Equity Report*). Keep in mind that several of the items on this list take significant time and resources to pull together, so plan to get started sooner rather than later.

1. Structure/Optimizing Tax Planning

Whether a portfolio company is a partnership or a corporation for tax purposes will have material tax implications for both the selling sponsor and buyer, so the selling sponsor should be clear from the start about expectations regarding the entity or entities being sold and allocation of tax-driven value. A buyer typically is able to amortize purchase price attributable to an interest in a partnership for U.S. federal income tax purposes, which creates additional tax shield and value. Sponsors will want to ensure that potential buyers factor this benefit into their price when marketing the portfolio company. However, a partnership may also present pitfalls, as sponsors will often have investors at several levels, including investors participating via blocker corporations, and may have either agreed to or otherwise want to exit in part through a sale of those blockers. It’s best to make this intention clear at the start of the process, so that a buyer is not led to believe it is acquiring entirely partnership interests, only to be later asked to buy at a different level.

If the portfolio company is a corporation, the sponsor should consider whether there are tax attributes, including net operating losses or deductions attributable to compensation and transaction expenses, that the portfolio company will be able to access after closing. If there are, the sponsor should seek to have the existence of such attributes factored into the purchase price, or otherwise seek payment for the benefit of such attributes when they are realized by the portfolio company post-closing.

2. Equity Arrangements. Over the lifetime of an investment, the equity structure of a portfolio company may evolve—whether through an issuance of stock to a new primary investor, as consideration for one or more "add on" acquisitions, to implement a management incentive plan or for other reasons. A buyer will want to verify that any such issuances were validly authorized and documented at the time, and that the capital structure presented by the seller is accurate and complete. Ensuring the portfolio company's corporate books and records are readily accessible, accurate and up-to-date will save time and headache down the line.

3. Employee Entitlements/ Retention Considerations. There are generally two key employee-related considerations for selling sponsors and buyers in connection with a sale transaction, early attention to which will lead to a smoother transaction. First, the sponsor will need to understand what management and other key employees will be paid as part of the transaction, (*e.g.*, as a result of equity incentives of transaction bonuses). Second, the parties will need to determine the portfolio company's liabilities to all employees after the transaction closes, including pensions, deferred compensation and retention bonuses.

A buyer will be keenly interested in the amounts to which the management team is entitled in a deal, because that will inform the management team's incentives to get the transaction done and will help the buyer determine what types of additional long-term incentives will be needed to keep the executive team properly motivated going forward. Will there be a substantial payout for a chief executive who is near retirement age, meaning the buyer will need to begin a leadership search sooner rather than later? Will the selling sponsor's incentive plan fully vest and be cashed out in the transaction, or will awards remain outstanding, thereby providing some built-in retention value for the buyer? For a private equity buyer, the answers to these questions will also determine the amount of skin in the game the management team will be asked to keep in the business via an equity rollover or reinvestment of proceeds, and understanding the structure will allow the buyer to determine if a tax-deferred rollover of equity interests can be offered to the management team in order to make their commitment as efficiently as possible. Specificity around these payment details is difficult to obtain earlier in a sale process where equity value is not locked down, but even rough estimates are helpful for purposes of framing a buyer's discussions with management.

The seller should also be ready for the buyer to scrutinize the potential economic effects of the employment agreements and employee benefit plans that the portfolio company will retain following the closing. A buyer may wish to negotiate new employment agreements with some or all of the senior management team, reflecting new economics regarding cash compensation or severance benefits, new restrictive covenants or other changes to the status quo. A buyer often looks to treat unfunded pension and other deferred compensation liabilities as indebtedness of the portfolio company, which reduces the equity value ultimately paid by the buyer.

Lastly, treatment of annual bonuses, long-term performance cash incentives and retention bonuses that will become payable after closing are often the subject of negotiation in terms of which party to the transaction will bear those costs and whether some of them should be allocated between buyer and seller.

> Many factors affecting sale process are outside a sponsor's control; it pays to be prepared.

4. Debt Review. The portfolio company's existing debt financing arrangements will receive considerable attention from both sides. Sellers and buyers alike will be keen to understand how a proposed transaction may affect a portfolio company's existing financing arrangements, including whether these financing arrangements can remain in place post-transaction. The possibility of investing in a company with existing financing arrangements at low interest rates, whether through portability provisions in those debt agreements or by structuring the percentage of equity sold in a transaction to avoid triggering a change of control provision, is particularly relevant for buyers in the current high interest rate environment. In recent years, some sponsors, looking ahead to a future sale, added portability provisions to portfolio company debt agreements in connection with a refinancing transaction. In most cases, though, that option does not exist, so a private equity buyer must obtain new debt financing to consummate the transaction and repay the company's existing financing arrangements at closing. In that case, prior to commencing a sale process, a seller should confirm whether any prepayment penalties or other breakage costs may be required to refinance the company's existing debt, and plan to account for these amounts to reduce the consideration received at closing. The seller may wish to investigate whether a slight delay in transaction timing could lead to a lower prepayment penalty being required.

> Whether a portfolio company is a partnership or a corporation for tax purposes will have material tax implications for both the selling sponsor and buyer, so the selling sponsor should be clear from the start about expectations regarding the entity or entities being sold and allocation of tax-driven value.

5. Diligence Process. Prior to conducting comprehensive due diligence, potential bidders typically receive a teaser and a confidential information memorandum providing a high-level overview of a portfolio company's business. Any potential buyers moving forward after reviewing that preliminary information can be expected to conduct detailed due diligence on the portfolio company. Thorough preparation for the diligence process by the seller will greatly affect how time- and energy-intensive this process is for both sides, and make the seller better prepared to negotiate any issues that may arise from the diligence process.

As a first step, selling sponsors should ask their advisors to provide sample due diligence request lists of the documents and information buyers can be expected to request. Identifying and organizing that information is often a time-consuming exercise, so it is advisable to get started as early on in the sale process as possible. Two areas warrant particular attention:

- *Data Room Set Up / Staging.* Sponsors will need to arrange for due diligence materials to be posted in a virtual data room, and should consult with legal counsel to determine the scope and timing of information being provided. For example, if any bidders are competitors of the portfolio company, certain information may need to be redacted, held back, or disclosed only to a "clean team" of that bidder. It may also be advisable to hold back certain information for strategic reasons. For example, if the portfolio company has engaged in any add-on transactions, the sponsor may want to hold back the underlying purchase agreements for those transactions to avoid a scenario where buyers attempt to leverage those agreements when negotiating the definitive documentation for the portfolio company sale.
- *Preparation of Disclosure Schedules.* An early start on sell-side diligence also facilitates preparation of the disclosure schedules to the purchase agreement. Initial population of the disclosure schedules can begin based on the selling sponsor's auction draft purchase agreement, even before the agreement is provided to or negotiated with potential buyers.

6. Significant Contingent Liabilities – Environmental. Portfolio companies that own real property or conduct chemically intensive operations should assess whether there are actual or potential environmental issues related to their properties or operations ahead of a sale process.

Environmental issues may bring regulatory, litigation and reputational risks, reduce the value of the property to the business, or affect the property's future usability or saleability. Identifying whether any environmental studies or reports (*e.g.*, Phase I assessments) have been prepared in the past, and/or whether any such studies or reports may be required by a buyer, will help a selling sponsor determine whether to commission or update such studies or reports as well as help frame any investigative or remedial actions that may need to be taken, any potential costs and the timing implications on the transaction itself.

7. Significant Contingent Liabilities – Litigation/Disputes. Sellers need to have a firm grasp on any pending litigation matters and outstanding litigation liabilities, which will be closely scrutinized by any potential buyer. Buyers will expect a summary of any pending and historical matters (typically within a five-year look-back period), and will endeavor to understand whether the matters are ordinary course (and non-material) or whether they could lead to material liability in the future. Sellers should be prepared to explain the current status of any litigation, the merit of the underlying claims, an estimated amount of any potential or outstanding liability, and whether the matters are covered by the portfolio company's existing insurance plans. Likewise, buyers will be interested in ongoing disputes (particularly with key customers or suppliers) that may result in legal proceedings. In certain cases where the post-closing liabilities are either particularly significant or uncertain, a buyer may request a special indemnity. Having a handle on the details of the underlying matters will be helpful in defending against—or at least effectively negotiating—any such requests.

8. Third-Party Consents. In addition to identifying material contracts as part of the diligence process as outlined in Item 5 above, sellers will need to review those contracts to determine whether the transaction would trigger any notice or consent requirements. If any third-party consents are required, sellers will be expected to have a view on the likelihood of receiving those consents, the potential cost of obtaining consent, and alternatives if consent cannot be obtained.

9. Governmental / Regulatory Approvals. Regulatory approvals and other regulatory filing and notice requirements often drive the timing of the deal's consummation, so it is essential to determine what regimes and requirements may apply to the proposed transaction, as well as what information is needed to finalize that determination and is to be provided in connection with any applicable approvals or filings. The existence or extent of certain requirements will hinge on the particular buyer, but there is a lot the selling sponsor and portfolio company can do to make meaningful headway even before a buyer is identified.

- *Regulated Industries.* If the portfolio company operates in a regulated industry, parties will need to determine whether the transaction will require notice and/or consent from the applicable regulator. Having a head start on this analysis will increase a seller's credibility with those regulators and allow both buyer and seller to have better-informed expectations regarding potential roadblocks, and the anticipated timeframe, for completing the proposed sale.
- *Antitrust.* Transactions exceeding a certain deal value ($111.4 million for 2023) are generally reportable under the Hart-Scott-Rodino (HSR) Act unless an exemption applies (*e.g.*, due to the structure of the buyer or limited U.S. nexus of the portfolio company). Whether antitrust filings will be required in any non-U.S. jurisdictions will ultimately depend on the identity of the buyer, but sellers should work with antitrust counsel in advance to ensure that the portfolio company's revenue and other required data is segmented as appropriate to allow potential buyers to determine if antitrust filings are required in any non-U.S. jurisdictions. Sellers should also work with antitrust counsel to determine whether there is potential antitrust risk with any of the likely bidders due to competitive overlap with the seller.
- *CFIUS/Foreign Direct Investment Filings.* If the potential buyer could be a foreign company (or a U.S. company controlled by a foreign person), then the sponsor will want to conduct advance diligence to determine whether the transaction would be within the jurisdiction

of the Committee on Foreign Investment in the United States (CFIUS). If the buyer might be foreign, then the seller will want to determine whether the transaction might be subject to a mandatory CFIUS filing, which may be the case if the business deals in "critical technology" or if the buyer is foreign government controlled. Even if a CFIUS filing is not mandatory, however, if the business is one that would be categorized under CFIUS regulations as a "T[echnology] I[nfrastructure]D[data] U.S. business," or if the acquisition might otherwise plausibly implicate national security concerns, a foreign buyer may wish to make a voluntary CFIUS filing and then have CFIUS approval be a closing condition. The seller should remember that the CFIUS process can be time consuming and could delay closing unless there are other, longer post-signing regulatory processes that need to be completed. Apart from CFIUS, if the business has operations outside of the United States, the seller and buyer will need to determine whether foreign direct investment filings are required in any non-U.S. jurisdictions.

> Regulatory approvals and other regulatory filing and notice requirements often drive the timing of the deal's consummation, so it is essential to determine what regimes and requirements may apply to the proposed transaction, as well as what information is needed to finalize that determination and is to be provided in connection with any applicable approvals or filings.

10. Outside Advisers/Other Third Parties. Investment banks and legal counsel are often the first advisors that a sponsor hires in connection with a portfolio company sale, but getting ahead on identifying other potential advisors and third parties that may require engagement will help to ensure a smoother process.

- *Local Counsel.* If the portfolio company has operations outside of the United States, it is likely that the sponsor will need to engage local counsel in those jurisdictions. Non-U.S. jurisdictions often have more onerous notice and consent requirements for sale transactions and the seller should have a firm grasp on those requirements—and how they may impact timing of the transaction—before buyers begin diligence in earnest. For example, companies in certain jurisdictions have government-mandated works councils dedicated to protecting employee rights; requirements relating to and negotiations with a works council can be time consuming and directly affect the transaction structure and definitive agreements.
- *Accountants/Tax Advisors.* Bringing on board accountants and tax advisers early will enable sellers to identify any potential financial and/or structural issues that may need to be addressed as part of the transaction, as well as any vendor-side due diligence issues that may need to be disclosed during the buyer's due diligence.
- *Consent Parties.* Once a seller has identified any required third-party consents (see Item 8 above), it should consider the appropriate time for notifying those parties of the transactions. Given confidentiality concerns, sellers typically try to limit the number of third parties that are made aware of a transaction before signing, but depending on the materiality of the consent required, it may be advisable to gauge the counterparty's likelihood of cooperation earlier on in the process.

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What Real Estate Equity Investors Considering Debt Investing Need to Know

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The real estate market is facing material distress on a number of fronts. A rapid rise in interest rates has led to an increase in financing costs and made refinancing more challenging for property owners, while geopolitical events, uncertainty in the banking sector, inflation and high treasury yields have constrained lending activity. Changes in work habits post-COVID and the "flight to quality" have left many office spaces vacant and retail and service businesses without a steady flow of customers. A general slowdown in real estate transactions has created difficulties for investors in valuing commercial properties and debt investments.

Not all distressed real estate is created equal. While many older office buildings are simply obsolete given current demand and may need to be repurposed, many cash-flowing, viable properties across asset classes face capital markets distress due principally to the recent rise in interest rates and subsequent increase in financing costs. In response, institutional investors have begun to marshal capital in order to take advantage of the opportunities created by such distress.

In particular, many investors who have historically focused on equity investments are now considering opportunistic debt investments, either through new loan origination or debt acquisition in secondary markets. These investors are often attracted to distressed debt because of its priority of repayment within the capital stack, fixed payment stream with the potential for equity-like returns in a higher interest rate environment and—in secondary markets—favorable cost basis. Operating as a lender, however, presents different challenges than equity ownership. This article focuses on the key questions that traditional real estate equity investors and others should consider before investing in distressed real estate debt, with a particular focus on non-CMBS debt opportunities.

Capital Position

For parties who typically invest on the equity side, debt investments present new relationships to negotiate. While equity investors may already be fluent in the various types of control and liquidity rights that can exist between equity partners, as debtholders they must consider additional dynamics, including the rights among lenders and the various agreements between the lenders and the borrower.

For example, if an investor seeks to acquire debt and join a bank group as a senior lender, it should have a clear handle on the lender syndicate and how the property's capital stack operates, including any mezzanine loans or preferred equity holders. What rights and obligations does the agent or lead bank have with regard to the syndicate? Do the non-lead co-lenders have generally equal

rights and/or any transfer rights? A lead lender will typically make most decisions among a group of *pari passu* co-lenders except for certain critical items, such as changing the maturity date, which could require a majority, a super-majority or all of the co-lenders to agree. Furthermore, if there are mezzanine or preferred equity positions in place, a debt investor should be mindful of any additional control and approval rights those lenders may have.

Oftentimes a potential debt investor in search of higher returns for greater risk will consider entering the fray as a subordinated lender, whether in a mezzanine, B-Note, preferred equity or other subordinated role. It is critical for these investors to review the relevant intercreditor, participation and/or co-lender agreements to understand the rights and remedies of all lenders in the capital stack. Certain lenders may have approval rights that could impede a workout or loan restructuring, the right to cure senior loan defaults or the right to buy out senior positions either at par or at a premium. Subordinated debt investors must be especially focused on protecting their investment from being de-valued by the rights held by other lenders—particularly preferred equity investors, who often have minimal protections—and should be prepared to spend significant time and resources in diligence upfront.

Equity investors pursuing mezzanine debt opportunities should be aware that their collateral is not the property itself, but rather a security interest in the property-owning entity. A foreclosing mezzanine lender thus steps into the shoes of the borrower and must contend with the senior loan on the property, including a possible mortgage foreclosure, but will lack standing in any bankruptcy of the property owner. Senior or non-mezzanine subordinated debt holders should be cognizant of this right, as a mezzanine lender could become an owner of the property by curing a default and thus become responsible for servicing its debt.

Regardless of the investment strategy a prospective lender intends to pursue, it should evaluate the quality and experience of the property's sponsorship and ownership structure and the potential for liquidity events and/or changes in control among its co-lenders and borrower. With several parties involved, interests and objectives can often diverge. Debt investors should also be prepared to consider the conditions under which they would allow a change in the ownership of the property and a modification of the debt.

Diligence Challenges

While equity investors may be accustomed to having substantial access to a property's financial information and physical access to the property itself, prospective debt investors—particularly those in secondary markets—will likely have to perform due diligence on the property and its sponsor with less information than usual, and thus rely on informed estimates of prior performance. Particularly for properties experiencing distress, information gaps for diligence could be substantial, and debt investors should take a cautious approach to underwriting—especially since comparable data points may be sparse in the current market.

Unlike debt originations, where a borrower generally will pay its lender's third-party costs, debt investors in secondary markets are likely to have to pay their own diligence and transaction costs. Additionally, secondary market investors are unlikely to benefit from current property-level representations and warranties from a borrower and will have to rely on their own due diligence and general representations and warranties from the selling lender regarding the loan file, which are unlikely to bridge the diligence gap completely. It is also critical that secondary market debt investors understand what prior discussions may have occurred between the selling lender and the borrower or other lenders, as they may be stuck with statements made by the selling lender or precluded from certain recovery efforts by a selling lender's prior actions (such as under New York's "one action rule").

The Ultimate Plan

Debtholders have a different set of options available to them which can help to lower the risk profile of a debt investment. Prospective debt investors should consider these scenarios and develop an understanding of which options in their toolbox may prove the most efficient for their investment.

Note sales and payoffs: While an equity investor will most likely look to a sale or recapitalization of a property for an exit, debt investors will commonly either sell their debt to a third party or accept repayment via a refinancing or property recapitalization. Debt investors should understand their rights to sell their

note and whether doing so will require the consent of the borrower or any other lenders, or whether there are net worth or liquidity requirements for a permitted transferee under any applicable loan documents.

A sponsor looking to refinance its debt could present a welcomed opportunity, especially if the property is struggling and the loans are backed by meaningful guarantees. Lenders should recognize, however, that a borrower may seek to repay its debt at any time, potentially before a debtholder has held the loan long enough to achieve its target returns. Potential debt investors should be prepared to leverage prepayment premiums, yield maintenance provisions or defeasance to ensure that, in the event of an early prepayment, their debt investments are worth the risk, time and effort.

Foreclosure: A debt investor should be well-versed in the mortgage foreclosure process within the property's jurisdiction if it contemplates a "loan-to-own" strategy or decides to exercise its right to take over a struggling property from a defaulting borrower. The mortgage foreclosure process can vary widely in cost and complexity across localities, and differences could be especially stark for portfolios of assets distributed across different states. A deed-in-lieu of foreclosure could offer advantages in speed, cost and discretion. A mezzanine debtholder could have an easier time foreclosing more quickly and, in some jurisdictions, avoid transfer taxes.

In evaluating any foreclosure or deed-in-lieu, a debtholder should consider the potential for transfer tax liability, particularly in certain jurisdictions such as New York where transfer taxes are so high as to effectively prohibit foreclosures or deeds-in-lieu. Defaulting borrowers likely do not have the resources to cover transfer taxes even if there may be a contractual responsibility to do so, so debtholders may need to look to guarantees to cover borrower liabilities (though a guarantee from a sophisticated sponsor covering transfer taxes is rare). A foreclosing debtholder desiring to sell the property should pay close attention to the prescribed local foreclosure sale process to avoid any potential post-sale liability to the former borrower (which can also raise concerns about the conduct of a prior lender).

Guarantees: In addition to relying on the property itself for repayment—as with a foreclosure—debt investors should understand what other types of credit support might be available to them. Many real estate loans include repayment, carry and completion guarantees (for construction loans or development projects) which could provide avenues to recovery. So-called "bad boy" guarantees typically function as deterrents for bad acts from the borrower without which the borrower could easily file bankruptcy or impede the exercise of lender remedies. Guarantors and their financial resources should be evaluated as part of the sponsor diligence process both for investors originating new loans and those acquiring existing debt.

Other concerns

Regardless of where they enter the capital stack, debt investors should be cognizant of any applicable regulatory requirements for lenders. For example, certain states may require a lender to be licensed in their jurisdiction, or there could be Committee on Foreign Investment in the United States (CFIUS) restrictions for non-U.S. entities investing in certain types of U.S. real estate. There may also be tax issues depending on a debt investor's capital sources or the other parties involved in the transaction.

Debtholders should always be mindful of potential lender liability issues to the extent they may be found to have harmed the property owner's business and/or pushed it into bankruptcy. Lender liability is especially a risk if a debt investor has a participating mortgage or other equity component, which gives it some control over operations at the property and marks a key point of distinction between debt and equity investments.

Conclusion

This article has provided an overview of key considerations and differences for traditional equity investors considering investing in real estate debt, particularly distressed debt. A myriad of other issues could arise during the course of such investments, though, from reputational risks to environmental problems. Equity investors looking to enter the debt market should be strategic in looking for opportunities to do so and enlist the support of experienced advisors to help assess pitfalls and risks that may be hidden in their business plans.

Debevoise & Plimpton

Capital Structure Options for a Higher Interest Rate Environment

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With the federal funds target rate above 5% for the first time since 2006 and interest rates on various financing options increasing accordingly, private equity firms and portfolio companies are slowly adapting to higher interest rates. These rate increases mark the end of a generation of inexpensive and readily accessible debt financing and the return of tighter capital and financing markets, with higher coupons and more onerous terms. Companies in need of financing, however, are still able to take advantage of various financing techniques to optimize their capital structure. We discuss five of those options below.

Liability Management: As interest rates rise, the prices of lower interest rate instruments that a company may have outstanding are likely to decrease. Companies with excess cash thus have an opportunity to do a cash tender offer for their outstanding securities, or repurchase their securities or term loans on the open market, at a discount to par value. For companies funding the repurchase with new debt, purchasing outstanding debt at a discount may mean that less new—and likely more expensive—debt needs to be issued. These options allow a company to de-lever and to manage upcoming maturities at attractive, opportunistic prices.

Amend and Extend: In an "amend and extend" transaction, the borrower seeks to extend the maturity date on its existing credit facility rather than refinance it at then-current interest rates. The extended maturity can be anywhere from two to five years, and is sometimes accompanied by other changes, such as tighter or additional covenants, additional security or collateral and an amendment fee for the extending lenders. These amend and extend transactions can help a borrower buy time before it needs to refinance or repay its outstanding credit facility and can be accomplished more quickly than a full refinancing, provided that lenders are willing to consent to the transaction. One downside, however, is that an amend and extend transaction may require *all* lenders to consent to the extension of the maturity date, potentially making the transaction more difficult and expensive to complete. In that case, and if unanimous consent is not forthcoming, a portion of the loan may need to be repaid, or one or more replacement lenders—who are willing to consent—may need to join the facility.

Utilize Both Fixed and Floating Rate Debt: In a high or increasing rate environment, companies should consider the optimal mix of fixed and floating rate debt. While fixed rates can act as a hedge against future increases in interest rates, they also carry the risk of locking in high rates if issued at or

near the peak of an interest rate cycle. On the other hand, floating rate instruments become more expensive as interest rates rise, but also confer costs savings when rates begin to decrease. Companies should take into consideration how rates are expected to change over the life of their outstanding debt, and utilize both fixed and floating rate instruments, including synthetically through interest rate swaps, to optimize their cost of capital and exposure to interest rate changes. For example, for floating rate instruments issued when reference rates were near zero and that have a periodic reset every five or more years, the current interest rate environment offers an opportunity to refinance with a fixed rate instrument that may reduce the cost of financing and act as a hedge against future increases in interest rates. Redemption premiums or "no-call" features should also be considered when determining whether to issue fixed or floating rate debt, as they can effectively limit future refinancings if and when interest rates drop.

Deferred Payment Terms: Certain financing structures may allow a borrower the flexibility to defer interest payments on their debt. These include "payment-in-kind" or PIK instruments and "hybrid" instruments. PIK instruments allow the borrower to pay interest in kind (*i.e.*, through the issuance of additional debt) rather than in cash. The interest that is paid in kind is capitalized and added to the principal balance of the loan or bonds. PIK instruments can be structured to meet the borrower's needs, with true PIK instruments requiring payment in kind until maturity and PIK-toggle instruments allowing the borrower to elect to pay in kind, subject to the satisfaction of any applicable conditions. Hybrid instruments, popular with financial institutions, typically allow for the deferral of interest payments for some period of time, which can provide a company with significant flexibility. In the event that the company is not making interest payments, the company would be subject to a dividend stopper and the missed interest payments must be made in the future.

Equity Financing: While potentially dilutive and more expensive from a weighted average cost of capital perspective, equity financing can allow a company to raise capital without ongoing cash costs, *e.g.*, in the case of common stock or non-cumulative preferred stock, and with no maturity date. Similarly, convertible securities may provide companies with a low interest rate (particularly as compared to the interest rate on other debt) and with the possibility of future dilution (which can be managed with derivatives or share repurchases). The proceeds from any equity financing could be used to repay higher interest rate debt. For public companies with shelf registration statements, these transactions can be done quickly, allowing the company to hit market windows when the opportunity presents itself.

> Companies in need of financing, however, are still able to take advantage of various financing techniques to optimize their capital structure.

Debevoise & Plimpton

NAV Loans for Buyout Funds: An Increasingly Popular Tool in Fund Finance

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During the past several years, turbulence in financial markets—stemming first from COVID-19 and then from the changing interest cycle—has caused fund sponsors to face both heightened liquidity needs and a slowdown in private equity exits. In response to these conditions, we are seeing considerable growth in the use of net asset value (NAV) financing by fund sponsors as a means of meeting additional liquidity needs and as an alternative to traditional exits. Below are some of the key considerations when putting in place NAV credit facilities.

LPA/Fund considerations

Given that NAV financing is a relatively new tool in private equity, determining whether a NAV credit facility is permitted under the fund's limited partnership agreement (LPA) is often an important first step—particularly for later-stage funds with legacy form LPAs. However, we are now seeing a newer vintage of LPAs that specifically anticipate and build in mechanics for the use of NAV financing. With this development, we are seeing sponsors turn their focus toward providing investors disclosures and discussions regarding anticipated leverage at an earlier stage in the fundraising process.

Structuring

In the United States, the borrowers under NAV credit facilities typically consist of one or more bankruptcy-remote special purposes vehicles (SPVs) that are joint and severally liable. Those SPV borrowers will usually hold 100% of the equity interests in investment vehicles that in turn will hold the portfolio companies of the fund. If tax or other considerations restrict transfer to the SPVs, the NAV financing may be structured by having the borrowers hold a preferred interest in the cash streams from the relevant portfolio assets instead of holding the portfolio assets themselves. However, such "off to the side" structures are mainly prevalent in Europe rather than in the United States.

Diligence

Diligence is always an important focus for lenders and spans both the upper-tier and asset levels. At the upper-tier level, diligence typically focuses on the structures for how investment vehicles are held, how lenders will in practice have recourse in the event they need to take enforcement action and ensuring that borrowers are sufficiently remote and limited in the scope of actions they can take (that is, that the SPVs are in fact, truly bankruptcy remote). At the asset level, diligence review can be broad ranging and take some time to complete. Typically, diligence will cover everything from the composition of the portfolio

(which will feed into concentration limits included in eligibility criteria) to ensuring that appropriate steps have been taken to allow lenders to enforce against assets (*e.g.*, obtaining any third-party consents required for transfer or assignment of assets).

Security/Collateral

Unlike the "all assets" pledge that is common in more traditional areas of secured lending, collateral packages in the NAV financing space often vary. For example, lenders typically do not have direct recourse to the portfolio assets of the underlying funds. Instead, it is more common for lenders to only have recourse to the assets of the SPV borrower (which typically consist of bank accounts and the SPV's right to receive cash distributions from the portfolio assets). In such cases, lenders may also seek a pledge of the SPV's and/or the investment vehicle's equity interests. However, this is typically subject to diligence (as to, for example, whether such equity pledges are restricted by the entities' constitutional documents). Depending on the structure, "bad acts" guarantees are commonly provided by parent funds to provide lenders with additional protection. Unlike a full parent guarantee, such guarantees will typically only protect against a limited range of more serious acts (*e.g.*, against borrowers transferring assets to entities not subject to the collateral package or putting in place a pledge over assets in favor of other creditors) and bankruptcy events.

Valuations

While the fund's quarterly report is the starting point of the valuation, the right to challenge such valuations and receive third-party appraisals is often an important focus for lenders under NAV facilities. Negotiation here typically centers on the scope of appraisal rights and how often those rights can be exercised (including whether the occurrence of certain key events should trigger additional rights). Depending on the complexity of the appraisal rights, which party will bear the cost of such appraisal can also be an important factor. In some cases, parties will set out criteria for making that determination, such as whether an event of default is ongoing or how many lender-initiated appraisals have already occurred in the calendar year.

Eligibility Criteria

Consistent with other areas of asset-based lending, eligibility criteria are used under NAV facilities in determining which assets will qualify for inclusion in the borrowing base and ultimately serve as an important mechanism for lenders to mitigate their exposure to the risk of performance associated with the underlying assets. While it is common for portfolio assets subject to bankruptcy or payment events of default to be excluded from eligibility, other terms may be more heavily negotiated. For example, borrowers may try to limit certain other exclusions to only those resulting in a specified decline in the applicable asset price.

Cash Sweep

Cash sweep mechanisms in NAV facilities vary broadly and are usually heavily negotiated, given that lenders primarily only have recourse to cash distributions from the portfolio companies. The agreed-to mechanism will typically net out a limited number of items, such as tax distributions, before funds are applied as per the cash sweep. Often the cash sweep is limited in the earlier years of the facility so long as loan-to-value is below agreed thresholds. Over time, depending on the performance of the fund and the number of assets in the portfolio, all netted proceeds may need to be swept to pay down the loans.

Lenders' Remedies

Depending on the nature of the collateral provided, options for enforcement may take different forms. Typically, lenders will have a right to require that the borrower commence a sale process in the event of certain material defaults, such as when a borrower fails to make a mandatory prepayment and concurrently fails to comply with an LTV maintenance covenant. In such cases, the sponsor will usually retain control over the sale process, provided that the sponsor parties keep lenders informed and comply with timelines and procedures set out in the NAV facility. If the sponsor fails to meet such requirements or in the case of certain negotiated events of default, the lenders may have the ability to direct the sale process.

As more alternate lenders enter this market, in the current interest rate environment, we expect NAV financings to continue to rise in popularity and become a standard component of the fund finance toolkit.

Giving AI Governance a Risk-Based Approach

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Approximately a year after the release of ChatGPT, the promise and peril of generative AI continue to dominate media headlines, corporate roadmaps, boardroom presentations and regulatory agendas. Yet many businesses are still in the early stages of adopting or testing generative AI, as well as more traditional AI solutions. While a number of early adopters are actively promoting the benefits they have obtained from these technologies, others have reported mixed results and even some regrets.

At the same time, the legal and regulatory landscape for AI continues to evolve quickly and unpredictably worldwide. In recent months, several international, state and local jurisdictions and regulatory bodies have introduced measures aimed at regulating AI. There are no signs that this regulatory scrutiny will abate.

As stewards of investor capital, private equity sponsors are faced with a dual challenge of encouraging and supporting their portfolio companies' use of these potentially transformative technologies, while also ensuring that those companies approach AI initiatives in a responsible, defensible and controlled manner—in other words, in a manner that is most likely to produce value without generating unnecessary or unacceptable risk. These challenges also apply to private equity firms themselves, which are exploring the potential upside of using AI technologies to support their own investment operations while remaining sensitive to the increased demands for risk management. In the *Spring 2023 Private Equity Report*, we outlined considerations for private equity when managing risks associated with the use of generative AI technologies. As the generative AI risk management programs of private equity firms and their portfolio companies begin to take shape, a key lesson that emerges is the importance of effective AI governance. This article discusses some evolving expectations and strategies for effective AI governance and the role of an AI governance program in both supporting responsible value creation and mitigating the risks associated with AI technologies.

Taking a Risk-Based Approach

The approach to AI governance should be risk-based and allow reasonable flexibility to adapt, based on the benefits and risk of the particular use. An effective, risk-based AI governance program allows companies to safely adopt and oversee the use of new AI technologies as they become available. It also allows companies to triage elevated-risk AI technologies already in use and apply appropriate guardrails to manage those risks.

Different uses of AI pose different levels of risk. For example, using AI to schedule and plan meetings poses very different risks from a use of AI that involves proprietary portfolio company data.

> In the recent months, several international, state and local jurisdictions and regulatory bodies have introduced measures aimed at regulating AI, and there are no signs this trend will abate.

There are four principal factors that should be evaluated in assessing the specific risks associated with any particular AI use case: the AI system being used; the purpose for which the AI system is being used; the relevant data accessed by that AI system; and the expected users.

Establishing a Cross-Functional Governance Committee

Because AI risks span a range of substantive areas, private equity firms and any of their portfolio companies that may meaningfully use AI should consider establishing a cross-functional governance committee that either oversees the AI program or establishes other means for establishing accountability. Committee members may include representatives from the business, legal, information security and data analytics.

AI governance committees may be tasked with a range of responsibilities, such as helping set the company's AI strategy; maintaining the firm's AI policies and procedures; supporting appropriate training for employees on uses of AI; conducting oversight of the use of AI; and otherwise ensuring that the company's use of AI is productive, responsible and consistent with applicable legal, regulatory and compliance requirements.

These responsibilities are typically documented in a committee charter, which may also detail requirements and expectations for committee work and meetings and reporting channels to senior management and the board.

Creating a Governance Framework

Effective AI governance programs are supported by a framework of policies, protocols and programs, including:

AI Policies. AI policies outline expectations and any prohibitions or limitations on employees' use of AI. These policies may also address other specific AI risks, including vendor management concerns, ongoing monitoring for quality control, AI-related incident response and data governance.

Training. Appropriate training should be conducted with respect to policies and expectations for individuals involved in developing, monitoring, overseeing, testing, or using elevated-risk AI applications on the associated risks.

Inventory. To exercise risk-based oversight of AI, companies should consider collecting an inventory of information about existing and proposed AI use cases that includes sufficient details about the AI system, its purpose, the relevant data and the expected users to assess the relevant risks.

Elevated Risk Factors. Companies should also consider identifying a list of elevated risk factors that, when presented by a particular AI use case, may trigger enhanced review and assessment processes.

Mitigation Options. Companies may also wish to identify measures that can be implemented, including bias assessments, model testing and validation, enhanced transparency, or additional human oversight, as appropriate, to reduce the risks associated with certain uses of AI. We have previously identified specific mitigation measures for generative AI in the *Spring 2023 Private Equity Report*.

Documentation. Companies should also consider maintaining documentation about the program, including any reporting to senior management and the board.

The scope and complexity of each of these component policies, protocols and programs may vary, depending on the maturity of a company's AI program.

Reviewing and Assessing AI Use Cases

After establishing a governance framework, the AI governance committee's next task is typically to review and assess existing AI use cases and put in place a process for identifying and evaluating new use cases as they emerge. The level of review should be based on a company's view regarding potential risks associated with the particular AI use case. Those involving elevated-risk factors, for example, may require enhanced review and assessment processes, including additional consultation with other company employees, outside experts, or other individuals as appropriate.

The review should result in a determination that the risks associated with the AI use case being evaluated are either: (1) acceptable; (2) acceptable, but only if certain risk mitigation measures are implemented; or (3) not acceptable, in which case the proposed use case is not approved to move forward.

The process and outcome of the review should be documented and communicated to all relevant stakeholders for the AI use case.

AI has the potential to create significant business opportunities for private equity firms and their portfolio companies. Designing and implementing an effective AI governance program can support companies in fully realizing these opportunities without unintentional pitfalls that arise because certain risks associated with AI were not properly considered or addressed.

> As the generative AI risk management programs of private equity firms and their portfolio companies begin to take shape, a key lesson that emerges is the importance of effective AI governance.

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