Debevoise & Plimpton

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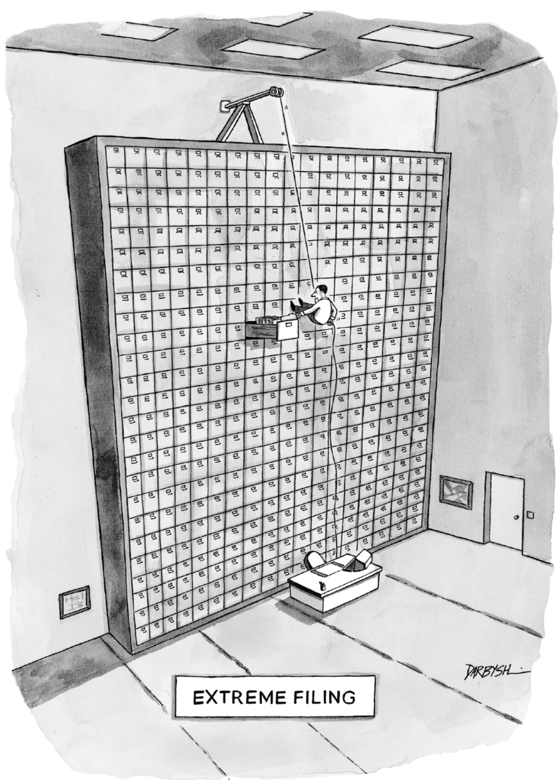
THE PRIVATE EQUITY REPORT

From the Editors

The environment for private equity is particularly dynamic at the moment. Geopolitical developments are impacting market access and conditions, while regulatory and policy changes bring new—and sometimes more favorable — compliance requirements. And new vehicles and opportunities emerge to allow capital to be put to use under a range of investment strategies.

This issue of the *Private Equity Report* explores several recent developments, changes and opportunities relevant to private equity sponsors, investors, partners and managers:

Private Equity and the Insurance Industry: A Close Look at a Natural Partnership. The business model and asset bases of insurance companies make them attractive acquisitions for PE sponsors. Acquiring an insurance company requires attention to



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regulatory requirements at both the federal and state levels along with tax and fund investment considerations.

European Commission Incentivizes Insurance Companies to Invest in European Companies. Proposed changes to the Solvency II regulations would significantly cut the prudential capital requirements for EU-regulated insurance companies holding long-term investments in European companies—including in certain European private equity and venture capital funds.

PE Investing After FIRRMA: Considerations for Sponsors and Investors. Congress has significantly broadened the scope of potential review by the Committee on Foreign Investment in the United States of foreign equity investments, with implications for both sponsors and their foreign investors.

Delaware M&A Appraisal: Where We Stand After DFC, Dell and Aruba. A trio of decisions by the Delaware Supreme Court is likely to reduce appraisal risk in the acquisition of public companies domiciled in that state.

SEC Pares Back Required Content for Exhibit Filings: Takeaways for PE. New amendments to Regulation S-K allow reporting companies to exclude immaterial schedules and attachments from all exhibit filings. In addition, confidential information can be omitted from the filing of certain contracts and agreements without a formal Confidential Treatment Request.

Brexit: The European Union Prepares for the Day When the UK Leaves. The UK's exit date has been pushed back to October 31, and uncertainties abound. Nonetheless, both the EU- and UK-based private equity firms are preparing for the day when the UK becomes a "third country."

Key NAV Takeaways from the Global Fund Finance Symposium. NAV and hybrid facilities provide popular financing vehicles for many fund types. Debevoise participated in a panel at the March 2019 Global Fund Finance Symposium in Miami addressing the current fundraising climate, asset valuations and other topics of interest to PE investors.

We hope you find these articles helpful in navigating the many legal and market considerations that inform private equity investing today.

The Editors

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Private Equity and the Insurance Industry: A Close Look at a Natural Partnership

"Because insurance companies hold large pools of assets to fund often long-dated future liabilities, they need capital-efficient ways to manage and invest those assets. Insurance companies thus often make natural investors in alternative asset strategies, such as the purchase of limited partner interests or other bespoke solutions offered by private equity sponsors."

1. State of the Market

Private equity sponsors are playing an increasingly important role as managers of insurance company assets, which has implications for both the insurance M&A market and the private equity fund investment space.

The reason for this development can be traced to the insurance company business model in which premiums are received from policyholders and invested for a period of time before eventually paying out much of the premium amount in claims and expenses. In the case of an insurer that pays out roughly the same amount in claims and expenses as it receives in premium revenue, the premium revenue represents, on an aggregated basis, a zero coupon loan for the average duration between the receipt of the premium and the payout of claims. For life and annuity insurers especially, the average time period between the receipt of premiums and the payouts of claims can be many years, meaning that an insurer's profitability will be driven in large measure by its success investing the premiums it collects.

A. Insurance M&A

Private equity sponsors are natural acquirers of insurance businesses. Insurance companies are required by state insurance regulators to hold significant amounts of assets on their balance sheets in order to fund future liabilities that may arise under the insurance policies they have issued. Particularly in the case of life and annuity insurers, these future liabilities are long dated and can be backed with less liquid asset strategies. An acquisition by a private equity sponsor of an insurance business creates the opportunity for the sponsor to increase the insurance business' return on investment which, as noted above, is a key driver of profitability.

B. Fund Investments

Because insurance companies hold large pools of assets in order to fund often long-dated future liabilities, they need capital-efficient ways to manage and invest those assets. As a result, insurance companies often make natural investors in alternative asset strategies such as the purchase of limited partner interests as well as other bespoke solutions offered by private equity sponsors. The specifics of how any particular investment is structured, of course, can have significant implications under the capital regimes to which insurers are subject.

2. M&A Developments

Private equity sponsors—including Apollo Global Management LLC, The Blackstone Group ("Blackstone") and The Carlyle Group ("Carlyle")—have been involved in a significant number of public company deals involving life and annuity companies. As with the investing synergies described above, this reflects the intersection of interests between private equity and insurance: Insurance companies seek profitable growth through enhancing their investment management capabilities, while private equity sponsors need access to the "permanent" investment management opportunities that can be provided by an insurer with an ongoing stream of new premium revenue.

A recent example is provided by the acquisition in late November 2017 by CF Corporation (an acquisition vehicle backed in part by private funds affiliated with Blackstone) of Fidelity & Guaranty Life for $1.8 billion. In connection with this transaction, Blackstone entered into an arrangement with Fidelity & Guaranty Life to manage its approximately $25 billion investment portfolio.

Another recent example is the announcement on August 1, 2018 by American International Group, Inc. ("AIG") and Carlyle of a strategic partnership in which Carlyle acquired 19.9 percent of DSA Re (a reinsurer established by AIG that reinsured legacy insurance business issued by AIG) and entered into a strategic asset management relationship with the reinsurer. Similar to the acquisition of Fidelity & Guaranty Life, this transaction gave Carlyle access to a large pool of assets that will benefit from Carlyle's asset management expertise as well as a possible platform for the acquisition of other insurance business.

3. Fund Investments

With the assets that insurers have on hand to invest at an all-time high, sponsors have been hard at work developing scalable products and structures to cater to the regulatory, tax and other requirements of their existing and prospective insurance company clients. U.S. insurers, for example, are particularly concerned about the effect an investment will have under the risk-based capital (RBC) regime to which the insurer is subject. Under these regimes, U.S. insurers typically face substantially higher capital charges when investing in limited partner or other common equity interests than when investing in rated debt or rated preferred equity interests.

One product available to address insurance company RBC charges is a feeder or parallel vehicle that issues "rated" debt (as well as some equity) to insurers, with the debt portion of the investment producing substantially lower RBC charges than limited partner interests, particularly where the underlying investments are in credit products. The debt issuer may be a dedicated feeder for a particular fund or may be part of a "collateralized fund obligation" structure that invests in a variety of products. Another scalable approach to reducing RBC charges is for insurers to use their general accounts to take out life insurance policies with other insurance writers, which in turn invest the premiums in insurance dedicated funds ("IDFs") comprised only of insurance company investors. In this case, the insurer holding the insurance company-owned life insurance ("ICOLI") policy ultimately benefits from the investment performance of the IDF, and the writer of the policy receives premium income for its part in the arrangement.

Of course, while sponsors are increasingly focused on scalability, they nonetheless continue to provide tailored solutions to address insurers' RBC concerns, such as co-investment accounts that provide for the client to hold debt instruments directly in lieu of limited partner interests.

Even when primarily driven by RBC considerations, insurance investment structures often pose a variety of tax issues that sponsors must navigate. For rated debt arrangements, parties will want to ensure that the issuer does not pay entity-level tax. New limitations on deductions for interest expense under recent tax reform legislation also pose complications for issuers, although proposed regulations provide some welcome clarifications. ICOLI arrangements must satisfy a variety of technical tax rules to ensure that the policy delivers the favorable treatment U.S. tax law affords life insurance. For example, the investments backing the policy must meet a diversification requirement (which "looks through" an IDF to its underlying investments, but only if certain requirements are satisfied). Moreover, the insurance company buying the policy must not have formal or informal control over investments by the ICOLI writer (*e.g.*, the ICOLI investor generally cannot communicate with the fund sponsor).

As these products and structures are refined and continue to gain prominence, sponsors will be able to offer a more sophisticated set of options to insurers that are increasingly willing to invest in less liquid assets in exchange for the potentially higher yields sought by core private equity strategies.

4. Regulatory Considerations

A. Insurance M&A

Insurance M&A typically takes one of two forms: (1) acquisition of an insurance company or (2) reinsurance of insurance liabilities to an existing insurance platform (which a sponsor can only do if it already has access to a licensed reinsurance company).

If the transaction involves the acquisition of a U.S. insurance company, the transaction will be subject to approval from the state insurance regulator of the target's domiciliary state. While many state insurance regulators have become more comfortable with private equity buyers in recent years, they still draw heightened scrutiny relative to other financial institution buyers. As part of the state insurance regulator approval process, sponsors will be required to provide information about their controlling persons as well as share a business plan detailing how the sponsor plans to run the business after closing of the transaction. In connection with the approval, regulators may impose certain conditions on the sponsors such as (a) maintaining a minimum RBC ratio at the target company after closing of the transaction (potentially including a requirement that some amount of assets be held in trust in order to maintain that minimum RBC ratio) or (b) a restriction on dividends that can be issued by the target company without regulatory approval for a certain period of time after closing of the transaction. As in any M&A transaction, non-insurance approvals or non-disapprovals or expiration of waiting periods may be required such as expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, or approval by the Committee on Foreign Investment in the United States.

If the transaction takes the form of reinsurance, whether regulatory approval is required prior to the transaction becoming effective depends on the laws of the domiciliary states of the target company and the acquiring company. If required, the approval process typically takes less time than the approval process in connection with an acquisition of an insurance company, and approval is less likely to have conditions associated with it.

B. Fund Investments

Unlike insurance M&A deals, insurance regulators do not typically have the right of prior approval over fund investments. One important exception is in the case of a material investment by an insurer into a fund or strategy managed by an affiliated fund sponsor, in which case prior insurance regulatory review will typically be required. Of course, in all cases, such investments need to comply with applicable law, which, for insurance companies, contains both qualitative and quantitative limits on permissible investments.

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AMERICAN INVESTMENT COUNCIL

European Commission Incentivises Insurance Companies to Invest in European Companies

"In 2016, unlisted equity investments only represented 3% of insurance companies' total investments, due in part to the method used to calculate the prudential capital required by the Solvency II Regulation to cover the market risk inherent in those investments."

On 8 March 2019, the European Commission published a draft amendment to the Solvency II Regulation that will establish revised prudential capital requirements for EU-regulated insurance companies holding long-term investments in European companies—including holdings in certain European private equity and venture capital funds. Insurance companies taking advantage of the newly introduced capital charge for long-term equity investments could, under certain circumstances, slice their capital requirements in half: the Regulation will introduce a stress factor of 22% for long term investments, which could apply instead of either 39% or 49% that would normally apply to private funds under the standard formula at present. This is a very welcome step and an important victory for the European private equity industry associations after a lengthy campaign. The change should herald a boost to private equity and venture capital funding.

Prudential Capital under Solvency II

In 2016, unlisted equity investments only represented 3% of insurance companies' total investments. That is in part because investing in private equity or venture capital comes with a hefty capital charge for insurance companies as a result of the calculation method for the prudential capital required to cover the market risk inherent in those investments as set out in the Solvency II Regulation. To protect insurance companies from insolvency, they are required to hold enough prudential capital to absorb potential losses from their business activities. This includes the insurance company's investments and the market risks they are exposed to. Solvency II provides a standard formula to calculate the required prudential capital to reduce the likelihood of insolvency over the next year to 0.5% or below. To cover the market risk in the insurance company's investment portfolio, the market value of each asset is taken as the starting point and multiplied by a stress factor set out in the Solvency II Regulation to simulate potential losses. When the Solvency II Regulation was drawn up, equities listed on a regulated market (type-1 equity) were given a stress factor of 39%. Unlisted equity investments (type-2 equity) drew the short straw: they were allocated a stress factor of 49% along with any other investments that could not be allocated to any other risk module set out in the standard formula. On the other hand, a considerably better stress factor of 22% was allocated to the insurance company's "strategic" equity investments. To capture the actual economic risk, Solvency II follows a "substance over form" principle exemplified by the "look-through" approach. This means that insurance companies are generally required to treat investment funds as transparent and to calculate their prudential capital by looking through the funds they are invested in and treating the underlying portfolio assets as if they were direct investments.

Funding the European Real Economy

Since the original rules were formulated, European legislators have made several changes to mitigate this harsh treatment of unlisted equity investments. Those changes followed studies that showed that there is less volatility for certain sub-sets of investments, justifying preferred treatment. The changes were also motivated by policy objectives: it is the declared goal of the European Commission, set out in the Action Plan on building a Capital Markets Union and reaffirmed in the Mid-term Review '17, to channel funds from institutional investors to projects that will boost the European real economy, including the funding of small- and medium-sized enterprises (SMEs). A first step towards that goal was the establishment, in 2013, of two new European fund products, EuVECA and EuSEF, focused on venture capital and social entrepreneurship funds respectively, lowering the bar of entry to the European marketing passport for private equity managers.

Preferential treatment was subsequently offered to insurance companies investing in those fund products and, following discussions with the European private equity industry, also to those investing in closed-ended, unleveraged alternative investment funds domiciled in the European Economic Area (EEA). As a consequence of those discussions, an exemption was introduced pursuant to which equity investments held by those funds are reclassified as type-1 equity and receive a 39% shock factor under the standard formula. Investments by insurers in non-EU investment funds are, however, not yet eligible for this reduced capital charge and may only become eligible in the future if they avail themselves of the Alternative Investment Fund Managers Directive's (AIFMD) third-country passport when it is introduced. Any such third-country passport will require the fund manager to opt in to full compliance with the AIFMD and is unlikely to be widely adopted. This reduced capital charge therefore creates an incentive for EU-regulated insurance companies to invest in European private equity funds, rather than those established elsewhere.

Now, the forthcoming changes to the Solvency II Regulation envisage a further reduction in the capital charge for two sub-sets of equity investments in European companies. This will further incentivise investment in venture capital and private equity funds by this potentially huge source of capital, but will also increase the incentive for fund managers to use EU structures.

Long-Term Equity Investments

Under the proposed change, a portfolio of long-term equity investments will be able to benefit from a stress factor of 22%, similar to that already now applicable for strategic holdings.

Although the policy intent was uncontroversial, the approach taken in the original draft rules that were published by the Commission was widely criticised. These drafts would have established conditions that would have been onerous for direct investments held by an insurance company and virtually impossible for investments made through private equity and venture capital funds. After intense lobbying by the European private equity industry associations, the provisions were amended so that the 22% stress factor can be applied to a portfolio of equity investments that meet the following requirements:

- the equity investments in the portfolio and their holding period must be clearly identified;
- the portfolio must be ring-fenced, separately managed, assigned to the obligations arising from a subset of the insurance company's activities and remain assigned for the life of those obligations;
- the insurance company's solvency and liquidity position and asset-liability management ensures that there will be no forced sales of the portfolio's equity investments for at least 10 years;
- the equity investments are listed in the EEA or are unlisted equities in EEA headquartered companies; and
- the average holding period of the equity investments exceeds five years.

Helpfully, if the equity investments are held in a portfolio of a qualifying EU investment fund, as described above, the underlying investments do not have to meet these criteria themselves as long as they are met at the level of the fund. This last-minute addition to the rules took account of criticism that applying the criteria asset by asset was almost impossible if the insurance company was investing in a third-party-managed private equity fund. There remains the question if and to what extent the underlying portfolio companies would also have to meet at least some of the requirements (*e.g.* being headquartered in the EEA). The wording does not suggest so.

An additional improvement is the reclassification of diversified EEA-based private equity portfolio

> "The forthcoming changes to the Solvency II Regulation will further incentivize investment in venture capital and private equity funds by insurance companies, but will also increase the incentive for fund managers to use EU structures."

In addition to the introduction of a new stress factor for long term investments, the Commission has also introduced an option to reclassify a diversified portfolio of common shares of unlisted companies with their headquarters and the majority of their workforce in the EEA as type-1 equity with a stress factor of 39%. To qualify, the portfolio's *beta* must not exceed a certain threshold, and the companies must meet the following requirements:

- they must have a majority of revenue denominated in EEA or OECD currencies, and
- they must meet either of the following two requirements for the last three years:
  - (i) the annual turnover or balance sheet total of the companies must exceed EUR 10 million, or
  - (ii) they must have had more than 50 employees.

For European fund sponsors, this may be of limited relevance, as assets held by closed-ended unleveraged EEA private equity funds are already treated as type-1 equity. However, insurance companies investing in some non-EU funds, or those employing leverage may find this new capital charge helpful.

This draft amendment is still subject to review by the European Council and the European Parliament. However, it is not expected that there will be significant changes.

With trillions of assets under management, and relatively low levels of unlisted equity investments, the European insurance sector remains a large untapped source of funding. The revised stress factor of 22% is more aligned with the risk profile of longer-term equity investments and an important step in encouraging insurance companies to invest more in European private equity funds.

Any incentive to make EEA investments or to use EEA structures has particular significance for UK fund sponsors ahead of the UK's (potentially) imminent departure from the EU. From the date of departure (or, if there is a transitional period, from the end of any such period), it would seem likely that UK companies or structures will not qualify (unless, for example, the UK pivots towards a Norway-style long-term relationship with the EU). That could be a particular issue for any UK funds which have traditionally sought capital from EU-based insurers. Subject to the reservations set out above, they may be able to avail themselves of the preferential treatment later on if and when the AIFMD's third-country regime is introduced.

On the other hand, if the UK proceeds to "onshore" European law in the way it currently intends, it is quite possible that UK-based insurance companies will only get a 22% preferential capital weighting if they invest in UK funds or those with a UK-investment focus.

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PE Investing After FIRRMA: Considerations for Sponsors and Investors

"Sponsors and LPs will now need to pay attention to non-controlling equity investments in certain types of U.S. businesses because FIRRMA expands the scope of CFIUS's jurisdiction to 'other investments'—of any size—by a foreign person in three categories of U.S. businesses."

With President Trump's signing of the Foreign Investment Risk Review Modernization Act ("FIRRMA") on August 13, 2018, private equity sponsors and investors will need to pay closer attention to review by the Committee of Foreign Investment in the United States ("CFIUS") of foreign equity investment in the United States.

- FIRRMA meaningfully broadens the scope of potential CFIUS review to include certain noncontrolling equity investments involving foreign (*i.e.*, non-U.S.) persons but also provides for important limitations on that expanded scope, all of which will come into effect by no later than February 2020.
- CFIUS has launched a Pilot Program so that GPs with funds that invest in "critical technologies" used in certain key industries should consider whether they now must file mandatory declarations with CFIUS prior to closing.
- Sponsors will also want to consider the effect of an ongoing Department of Commerce proceeding that eventually will result in expanding the scope of "critical technologies" to include "emerging technologies," as well as a future proceeding that will further expand the scope to encompass "foundational technologies."

Given these developments, whether investments are made directly, or indirectly through a general fund, separate account or co-invest vehicle, sponsors that are themselves foreign—or have foreign LPs—should consider whether a CFIUS filing should—or must—be made.

CFIUS and Controlling Investments

When a foreign person's acquisition of control of a U.S. business might raise national security concerns, parties to the transaction have often chosen to file a notice with CFIUS to obtain U.S. Government review and approval of the transaction. Among the many factors that may raise such concerns are U.S. businesses that have government contracts, are the sole or a dominant source or supply of an important product, operate critical infrastructure, develop or manufacture critical technology, collect sensitive personal information, or are proximate to U.S. ports or military installations.

Historically, an equity investment would only be considered a "covered transaction"—in part *and, therefore, within CFIUS's jurisdiction—if the foreign person acquired "control" of a "U.S. business."* "Control" means the power to determine important matters affecting an entity, including by having voting control, positive or negative control of a board decision, or influence afforded by a dominant economic stake—and is not limited to holding a majority of the voting equity.

FIRRMA changes none of that. In three circumstances, the sponsor should continue to consider whether a notice should be filed with CFIUS if a general partner ("GP") or a fund acquires control of a U.S. business that raises national security implications:

- the GP is itself a foreign person,
- the GP is a U.S. entity controlled by a foreign person, which, potentially could include a foreign limited partner ("LP"), or
- the fund itself is a foreign entity (*e.g.*, based in the Cayman Islands), and is not ultimately controlled exclusively by U.S. persons.

Until FIRRMA, in a typical PE structure, a U.S. or offshore fund with a U.S. GP that U.S. persons ultimately control, notwithstanding one or more foreign LPs, seldom triggered CFIUS issues. That is because no foreign LP "controlled" the U.S. business directly or indirectly. Even where the U.S. fund acquires a controlling interest in the business, an individual LP usually does not have any direct or indirect control over the portfolio company. Nor does it usually have any means of exercising control over the GP absent special governance rights (*e.g.*, the unilateral right to terminate the GP). Nonetheless, both prior to FIRRMA and now, economic leverage—where a foreign LP has a dominant equity position in a fund—could be considered as providing that LP with the means of exercising control over a U.S. GP.

FIRRMA's Expansion to Non-Controlling "Other Investments"

Sponsors and LPs will now need to pay attention to noncontrolling equity investments in certain types of U.S. businesses because FIRRMA expands the scope of CFIUS's jurisdiction to "other investments"—of any size—by a foreign person in three categories of U.S. businesses:

1. A business that owns, operates, manufactures, supplies or services "critical infrastructure"—that is, systems or assets whose incapacity or destruction would have debilitating impact on national security.
2. A business operating in an area of "critical technology."
3. A business that maintains or collects sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security.

Importantly, however, an "other investment" will be a "covered transaction" *if and only if the foreign person acquires at least one of the following "trigger rights" in connection with its investment:*

1. Access to material nonpublic technical information in the possession of the U.S. business.
2. A seat on the board of the U.S. business, including as an observer, or the right to nominate a director.
3. Substantive decision-making authority (other than through voting of shares) with respect to the critical infrastructure, critical technologies or sensitive personal data aspects of the U.S. business.

This expansion of FIRRMA to "other investments" comes into effect on the earlier of 18 months after the date of enactment of FIRRMA (*i.e.*, February 2020) or CFIUS's issuance of implementing regulations (the "FIRRMA-delayed effective date"). For PE sponsors, that a noncontrolling investment by a foreign person in one of the three categories of business may be a "covered transaction" *only if* one of these "trigger rights" is present has important implications both for direct investments and for indirect foreign investments by an LP through a fund. These are described further below.

Separately, FIRRMA also expands the definition of "covered transaction" to include the acquisition by foreign persons of private or public U.S. real estate, by purchase or lease, that is or is located within an airport or maritime port, is in close proximity to a U.S. military installation or is otherwise sensitive to national security or that would facilitate intelligence gathering by the foreign person or expose national security activities to foreign surveillance. This expansion to real estate investments, which includes a statutorily based exception for real estate in urbanized areas, also will come into effect on the FIRRMA-delayed effective date. The expansion has been of interest to REITs and developers of nearby projects, who may be focused on the nationality of their tenants.

Notably, with respect to the expansion of "covered transaction" to "other investments" and certain real estate transactions, one provision of FIRRMA contemplates that the implementing regulations will further define the term "foreign person." Ultimately, therefore, the expansion may be limited to "certain categories" of foreign persons, taking into account how the foreign person is connected to a foreign country or a foreign government and whether that connection may affect U.S. national security. The regulations could provide that foreign persons from certain countries that are close U.S. allies might not be subject to the full range of FIRRMA's expansion of "covered transaction."

Broadened Scope of Critical Technologies and the Mandatory Declaration

For sponsors of funds that target technology businesses, FIRRMA and its implementing regulations may be of concern because they substantially expand the scope of what is considered to be a "critical technology." Before FIRRMA, the definition of a "critical technology" has been limited, principally to a defense article subject to weapons control, a technology that was export controlled pursuant to multilateral regimes (due to national security or an anti-proliferation regime) or for reasons of regional stability or surreptitious listening, nuclear equipment or technology, or a select agent or toxin.

> "For sponsors of funds that target technology businesses, FIRRMA and its implementing regulations may be of concern because they substantially expand the scope of what is considered to be a "critical technology."

FIRRMA considerably expands "critical technology" to include "emerging or foundational technologies," which are to be identified through U.S. inter-governmental agency processes. The Department of Commerce has now launched such a process to identify potential "emerging technologies." In November, the Department issued an Advance Notice of Proposed Rulemaking ("ANPRM") that identifies 14 proposed categories of such technologies, including biotechnology, artificial intelligence, advanced computing, additive manufacturing, quantum information, logistics technology and robotics, each of which has numerous subcategories. The public comments filed in response to the ANPRM address the definition of "emerging technologies," the criteria for determining whether an emerging technology is important to U.S. national security, and how applying export controls to emerging technologies might affect U.S. technological leadership. Many of the commentating parties advocated for a narrower definition of "emerging technology." The next step is for the Department to develop rules that would propose to classify particular technologies as "emerging" (*i.e.*, "critical") for CFIUS purposes.

For sponsors making investments that are "covered transactions," FIRRMA also effected some important changes in the CFIUS review process. Until FIRRMA, CFIUS's review of a "covered transaction" began with the seller and buyer jointly filing a voluntary notice. A section of FIRRMA establishes an additional, shorter-form declaration process for commencing CFIUS review; however, except for the Pilot Program (addressed below), that provision only comes into effect on the FIRRMA-delayed effective date.

In some cases, the filing of declarations will be voluntary, but, in other cases, it is now or will be mandatory.

CFIUS launched a Pilot Program on November 10, 2018 that requires the filing of a declaration with CFIUS if the foreign person is making either a controlling investment or an "other investment" in a "pilot program U.S. business," which is a business that produces, designs, tests, manufactures, fabricates or develops a "critical technology" that is used or is designed for use in a set of 27 identified industries; once the ANPRM process runs its course, and emerging technologies are defined, declarations will need to be filed for foreign investments in businesses that engage in those activities involving such technologies if they are used in those industries. The identified industries include research and development in biotechnology, nanotechnology, semiconductor and related device manufacturing and electronic computer manufacturing.

Sponsors with LPs in which foreign governments have an interest, including state-owned entities or sovereign wealth funds, also will want to pay heed to CFIUS's implementing regulations. *When issued, the regulations will make declarations mandatory for any "other investment" (described above) by which the foreign investor will acquire a direct or indirect "substantial interest" in the U.S. business, where a foreign government entity itself has a "substantial interest" in that foreign person.* The regulations defining "substantial interest" have yet to be promulgated, but they are expected to include means by which a foreign government could influence the actions of the foreign person. Voting interests of less than 10 percent will not be considered a "substantial interest."

Affected fund sponsors need to know when to make filings with CFIUS and how to reconcile deal and CFIUS review timetables. FIRRMA prescribes a period of up to 90 days—and, potentially, longer—for CFIUS's review of notices. The new declaration process contemplates that the declarations themselves will be shorter and are subject to shorter, fixed timelines. *Sponsors should note that if a declaration is to be filed, whether on a mandatory basis, under the Pilot Program, or eventually on a voluntary basis, the parties to the transaction must file it no later than 45 days before the closing of the investment.* CFIUS must respond to the declaration within 30 days of filing. Fund sponsors should keep in mind, however, that CFIUS may not necessarily approve the transaction subject to the declaration. CFIUS could conclude that it cannot take any no action on the basis of the declaration, request that the parties file a full-blown notice or initiate a review of the transaction. Even as short as these deadlines are, they may present challenges to sellers or buyers to "covered transactions" that, for competitive or other reasons, needs to proceed swiftly.

Implications of FIRRMA for Direct Investing

For a fund sponsor, the key takeaway of FIRRMA's expansion is that a foreign person's minority equity investment (whether by the GP, a partner or investment professional of the GP or one of the fund's LPs) in certain categories of U.S. businesses may, depending both on the business and whether one of the trigger rights is present, qualify as a "covered transaction." With respect to the three categories of U.S. business described above, the foreign person may be either (i) a foreign LP investing in a fund through a co-invest arrangement, (ii) a GP that itself is foreign or is a U.S. entity but is controlled by a foreign person or (iii) a foreign individual (such as one of the sponsor's investment professionals) who is investing through the GP. The trigger right may be present if the foreign investor (including an otherwise passive foreign LP) has rights of access to material nonpublic technical information. That may be the case if the U.S. business is not public, and the foreign person receives sensitive technical information about the manufacturing or development of a critical technology. A trigger right may also be present if an investment professional of the sponsor who invests through the GP or a fund sits on the board of a portfolio company that is within one of the three categories. In such cases, a voluntary filing with CFIUS may be warranted once the implementing regulations are issued; alternatively, if the U.S. business is subject to the Pilot Program, the filing of a declaration, depending on the nature and use of the critical technology by the business, may be mandatory.

Implications of FIRRMA for Fund Investing

Importantly, for PE sponsors with foreign LPs, the effect of the expansion of CFIUS review described above can be substantially mitigated as to those LPs by a new, FIRRMA-provided "investment fund safe harbor:" the safe harbor entirely excludes from the definition of a "covered transaction"—and, therefore, from the purview of CFIUS—a passive investment made by a foreign LP through a qualifying investment fund. (The safe harbor is in effect for the Pilot Program and will be more generally in effect for other "other investments" by the FIRRMA delayed effective date.) To qualify for this safe harbor:

1. The fund must be under the control of a GP who is not a foreign person.
2. If the foreign LP sits on an LP advisory committee, the committee must not have the ability to approve, disapprove or control the fund's investment decisions; decisions made by the general partner regarding the fund's portfolio companies; or the hiring, firing, selection or compensation of the GP. (The committee may, however, opine on a waiver of a conflict of interest or allocation limitations.)
3. The LP may not have access to material nonpublic technical information as a result of participating on the LP advisory committee.

FIRRMA does not have much effect on funds that operate through U.S. GPs that are ultimately controlled by U.S. persons and where the persons investing through the GP are not foreign. As was the case before FIRRMA, that an individual LP is a foreign person should not warrant a filing with CFIUS because the LP ordinarily is passive—it does not have control over the GP or the portfolio company—assuming that the LP does not have any trigger rights. (CFIUS looks at whether an individual foreign person has control. Thus, even if a fund has multiple foreign LPs or if those foreign LPs in the aggregate hold the lion's share of the equity, this does not change this conclusion unless the LPs are acting in concert.)

If a GP of a fund has a foreign LP with a dominant economic stake (even if not a majority of the total equity of the fund LPs), or if a foreign LP invests through a single managed account, however, the sponsor may want to consider more carefully whether to make a CFIUS filing. In such cases, that LP might be seen as having economic leverage and, hence, some measure of control over the U.S. GP—possibly rendering that U.S. GP a "foreign person."

Fund sponsors should note that a foreign LP's noncontrolling, indirect investment in a U.S. business through the fund will not necessarily mean that the transaction is an "other investment." That is so because, under the usual investment fund structure, an LP typically does not acquire one of the three trigger rights described above. That would be true with respect to the Pilot Program businesses or, more broadly, any other business that is developing an "emerging technology" (as will be specified by the Department of Commerce) or as to any of the categories of U.S. business discussed above.

In addition, many investments made by a foreign LP through a general investment fund will presumably fall within the investment fund safe harbor. *To ensure that safe harbor treatment is both available and not jeopardized, the fund sponsor may wish to tailor the rights of an LP advisory committee and foreign LPs to the statutory terms of the safe harbor.* Those more circumscribed rights are likely to be consistent with common practice and LPs' expectations. Both to preserve safe harbor eligibility and to preclude a foreign LP's interest in the fund from being considered an "other investment," the sponsor will want to retain the right to limit the flow of any portfolio company's sensitive information to any foreign LP. The sponsor also may wish to preserve for itself the right to take such steps over the life of the fund as may be necessary to minimize the risk that foreign LPs' indirect investments in portfolio companies may trigger CFIUS review.

That an investment is made by a foreign fund-of-fund investor typically would not constitute a "covered transaction." The top-tier fund generally would not acquire one of the three trigger rights that would make its investment an "other investment." Moreover, if the underlying fund is managed by a U.S. GP, the statutory investment fund safe harbor, subject to implementing regulations, should ordinarily be available.

Key Conclusions

- Sponsors will want to structure their fund documents, where possible, either to (i) take advantage of the statutory investment fund safe harbor or (ii) ensure that foreign LPs will not have one of the trigger rights that would cause their indirect noncontrolling investments to be subject to CFIUS review.
- Sponsors should be aware that, after the FIRRMA-delayed effective date, they may be required to file a mandatory declaration for an "other investment" by a foreign entity in which a foreign government has a substantial interest.
- If the fund's GP is a non-U.S. person or is U.S. but is controlled by a foreign person, or if foreign persons investing through the GP or foreign LPs will have trigger rights, such as access to nonpublic technical information or governance rights with respect to important decisions of the GP or a portfolio company, present or future CFIUS implications should be considered. In those cases, understanding the ownership of these foreign persons or entities, as well as the nature of the U.S. business, will be important.
- If the U.S. business operates in an industry included on the Pilot Program list or is, more broadly, involved in "emerging" or other "critical" technologies, or if other national security considerations are present (such as the collection and maintenance of sensitive personal data or the operation of critical infrastructure), the sponsor may want to consider whether a CFIUS filing should—or, in the case of mandatory declarations, must—be made.

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Delaware M&A Appraisal: Where We Stand After DFC, Dell and Aruba

"The overall thrust of these cases is to make deal price the starting (and in many cases the ending) point for appraisal analysis in transactions between unaffiliated parties where the target company has a robust trading market and the deal results from an unconflicted and reasonable sale process."

With its April 16, 2019 opinion in *Verition Partners Master Fund Ltd. v Aruba Networks, Inc.*,[1] and following its late 2017 decisions in *DFC Global*[2] and *Dell*,[3] the Delaware Supreme Court has completed a trio of decisions that are likely to reshape the law and practice of public company merger appraisal in Delaware. In each case, the Delaware Supreme Court overturned an appraisal award of the Court of Chancery for failing to give sufficient weight to the parties' negotiated merger price. While the Supreme Court made clear that deal price is not the exclusive—or even presumptive—measure of fair value for appraisal purposes and that the appraisal statue obligates the Court of Chancery to "take into account all relevant factors,"[4] the overall thrust of these cases is to make deal price the starting (and in many cases the ending) point for appraisal analysis in transactions between unaffiliated parties where the target company has a robust trading market and the deal results from an unconflicted and reasonable sale process. Private equity sponsors should understand how these decisions are likely to reduce appraisal risk in acquisitions of public companies.

The deals giving rise to the appraisal actions underlying this trio of Supreme Court decisions—and the appraisal analyses undertaken by the Court of Chancery—were each decidedly different:

- DFC Global was acquired by a private equity firm following a two-year sale process, initiated by the company, which included a broad range of potential private equity and strategic buyers. The Court of Chancery appraised the fair value of the company at $10.30 per share—nearly 10% more than the $9.50 deal price agreed to by the parties and approved by DFC Global's stockholders—in a decision that gave equal one-third weighting to the deal price, a customary comparable company analysis and a discounted cash flow (DFC) analysis.
- Dell also involved a private equity acquisition, albeit one that also included the Company's eponymous founder, CEO and 16% stockholder. Despite having a highly active trading market and broad analyst coverage, a post-

1. C.A. No. 11-448-VCL (Del. 2019).
2. *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3 346 (Del. 2017).
3. *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017).
4. Del. Gen. Corp. L. §262(h).

signing go-shop and unusually target-favorable deal protections, the Court of Chancery gave no weight to the $13.75 per-share deal price and instead relied exclusively on a DFC analysis to value the company at $17.62 per share, nearly 30% higher than the deal price.

- The acquisition of Aruba by Hewlett-Packard was a strategic merger expected to give rise to significant synergies that, like all elements of value arising from the merger, are required to be ignored for purposes of appraisal.[5] Taking into account both the Supreme Court's endorsement in the *Dell* decision of market price as an indicator of the fair value of a widely traded company and the inherent difficulty of measuring synergies, the Court of Chancery appraised Aruba-based exclusively on the company's 30-day pre-announcement trading price of $17.13 per share, more than 30% less than the $24.67 per-share deal price.

In each instance, the Delaware Supreme Court reversed on the ground that the lower court gave the parties' deal price insufficient weight. In *DFC Global*, the Court held that "economic principles" indicate that the best evidence of fair value was a deal price resulting from an "open process, informed by robust information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid." In *Dell*, the Court held that where there is "compelling" evidence of "market efficiency, fair play, low barriers to entry, outreach to all logical buyers" and a well-designed sales process, the lower court abused its discretion by failing to give the deal price "heavy weight." In last week's *Aruba* decision, the Court directed the lower court to enter a final judgment at a price ($19.10 per share) that reflected the deal price less the respondent's estimate of deal synergies.

The Delaware Supreme Court emphasized the probative value of the agreed deal price and de-emphasized the value of alternative valuation methodologies such as discounted cash flow models. For example, in *Dell*, the Court noted that while a DFC may be "the best tool for valuing companies when there is no credible market information and no market check," in a transaction involving an efficient trading market and a "robust sale process involving willing buyers with thorough information and the time to make a bid," it is hazardous for a judge to ignore such market evidence in favor of its own evaluation of "widely divergent partisan expert testimony."[6] In *Aruba*, the Court noted the circularity inherent in such substitutes for a market-based deal price, as those tools themselves "often depend on market data and the efficiency of the markets from which that data is derived."[7]

When is deal price less probative? Certainly in the case of an acquisition by a controlling stockholder but also if there is insufficient evidence of an efficient pre-deal trading market in the target's stock, which inevitably serves to anchor the price in a sales process. In *Dell*, the Supreme Court emphasized the Company's "vast and diffuse base of public stockholders, its extensive analyst coverage, and the absence of a controlling stockholder," all of which the court characterized as "hallmarks of an efficient market."

A flawed sales process or evidence of pre-deal market manipulation will likely also lead the court to discount deal price. For example, management might "purposefully temper[] investors' expectations for the Company so that it could eventually take over the Company at a fire-sale price."[8] A weak market check prior to signing a transaction coupled with highly restrictive deal protections may undermine confidence in the agreed deal price, as may an unwillingness of key management to work with alternative buyers.[9]

5. Del. Gen. Corp. L. §262(h).
6. *Dell*, pp. 61-65.
7. *Aruba*, p. 15.
8. *Dell*, p. 42.
9. *See Dell* pp. 52-59. The Delaware Supreme Court specifically noted that none of these factors was present in the Dell transaction.

Even where deal value is ignored or discounted, appraisal petitioners still face the risk that appraised value will be less than they would have gotten in the merger, at least in the case of a strategic transaction giving rise to synergies. For example, in the 2018 appraisal of AOL following its $50 per-share acquisition by Verizon, the Court of Chancery determined that the combination of relative strong deal protections (including a 3.5% break-up fee and unlimited three-day matching rights) and "unusually preclusive" statements by AOL's CEO as to his intention to close the deal with Verizon undermined the reliability of the deal price in determining fair value. As a result, the Court of Chancery apprised AOL exclusively on the basis of a DFC analysis, which resulted in a below-deal-price award of $48.70.[10] Not surprisingly, the number of appraisal actions filed in Delaware has declined significantly following the *Dell* and *DFC Global* decisions. In 2018, a total of 26 appraisal petitions were filed in Delaware, a 56% decline from the 60 such petitions filed in 2017 and barely one-third of the 76 appraisal actions filed in 2016.[11] The results of recent appraisal actions that have reached an ultimate award are even more striking. A survey of Delaware appraisals involving public company mergers shows that over the 14-year period ending in December 2016, 68% of appraisal awards were above the deal price, with 10.5% of awards being below the deal price and 21.5% being at the deal price. In contrast, of the seven public company appraisal awards in 2017 and 2018, five were below the deal price, one was at the deal price, and one was a modest 2.8% above the deal price.[12]

Going forward, it seems likely that appraisal actions in strategic mergers—in which synergies must be factored out of the fair value determination—will be increasingly rare. While private equity-led going-private transactions are not generally considered to give rise to synergies, and thus may be viewed as more inviting targets for appraisal litigation, the Delaware Supreme Court's *Aruba* decision left open the door to an argument that the elimination of public company agency costs is itself a synergistic benefit that should be subtracted from deal price in determining fair value.[13] As a result, we expect future appraisal cases to be largely limited to acquisitions of private and small-cap companies, controlling stockholder transactions (including transactions where a controlling stockholder partners with a private equity firm to take the company private) and deals with significant process flaws.

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10. *In re Appraisal of AOL Inc.*, C.A. No. 11204-VCG (Del. Ch. Feb. 23, 2018).

11. Cornerstone Research, *Appraisal Litigation in Delaware: Trends in Petitions and Opinions 2006 – 2018*, p.4.

12. L. Hamermesh and M. Wachter, *Finding the Right Balance In Appraisal Litigation: Deal Price, Deal Process, and Synergies* (2018), PennLaw: Legal Scholarship Repository. Note that the pre-2016 above-deal price awards include the subsequently reduced *DFC Global* and *Dell* awards. The data in the above text also includes two appraisal awards in 2018 that post-dated the Hamermesh and Wachter article.

13. "Synergies do not just involve the benefits when, for example, two symbiotic product lines can be sold together. They also classically involve cost reductions ... Private equity firms often expect to improve performance and squeeze costs too, including by reducing 'agency costs.'" *Aruba*, pp. 10-11.

SEC Pares Back Required Content for Exhibit Filings: Takeaways for PE

"This amendment provides welcome relief to reporting companies, including post-IPO portfolio companies, some of which had already been omitting such immaterial schedules and attachments from material contracts."

On March 20, 2019, the SEC announced the adoption of amendments to Regulation S-K intended to modernize and simplify disclosure requirements applicable to SEC reporting companies. Two of those amendments have significant implications for private equity sponsors seeking to exit investments, whether through IPO or sale of a portfolio company.

Omission of Schedules to Exhibits

When publicly filing a merger, acquisition or similar agreement—for example, in connection with a public company's purchase of a portfolio company—reporting companies customarily exclude from the filing the disclosure schedules and other immaterial attachments to the agreement. Prior to the recent amendments, these omissions were permitted only for material merger, acquisition and similar agreements. Under the new rules, immaterial schedules and similar attachments may be omitted from *all* exhibit filings, including material contracts such as credit agreements and services agreements. This provides welcome relief to reporting companies, including post-IPO portfolio companies, some of which had already been omitting such immaterial schedules and attachments from material contracts—in some cases, resulting in an SEC comment requesting that the company refile the exhibits in full.

To benefit from the new rules, the information in the omitted schedules and attachments must be (i) not material and (ii) not otherwise disclosed in the body of the exhibit or in the base disclosure document to which the exhibit is attached. Reporting companies must file with the applicable exhibit a list briefly identifying the contents of the omitted schedules and attachments, unless that information is already included in the exhibit (for example, in the table of contents). In addition, reporting companies should be prepared to furnish omitted materials to the SEC upon request.

Elimination of Formal Process for Confidential Treatment Requests

Reporting and soon-to-be reporting companies—for example, a portfolio company preparing the S-1 registration statement for its IPO—often must publicly file material contracts and agreements that contain sensitive information. In these instances, the company typically submits to the SEC a confidential treatment request ("CTR") to omit this information from the public filing, on the basis that its public disclosure would cause it substantial competitive harm. Following review of the application, which can take several weeks, the SEC issues a confidential treatment order granting or denying the CTR. This process is time-consuming and potentially disruptive to a reporting company's business. For example, the SEC will not declare a pending registration statement effective while a CTR is being reviewed.

The new rules permit reporting companies to omit confidential information from (i) material merger, acquisition and similar agreements and (ii) material contracts not made in the ordinary course of business *without* filing a formal CTR. Instead, companies need only make appropriate markings to the exhibit and exhibit index indicating the existence of information that was omitted because it is both immaterial and would likely cause competitive harm to the company if publicly disclosed. Exhibits that do not fall under one of the two categories noted above (*e.g.*, underwriting agreements and debt indentures) do not benefit from these new rules governing CTRs.

While the new rules eliminate the formality of the CTR process, the substantive requirements related to assertions of confidentiality remain intact. On April 1, 2019, the SEC announced the establishment of a task force and procedures for reviewing registrant filings to assess whether redactions to exhibits appear to comply with the relevant rules for redacting confidential information. Reporting companies should be prepared, upon request from the SEC, to promptly provide supplemental materials similar to those currently required in a CTR, including an unredacted copy of the exhibit and an analysis supporting confidential treatment of the redacted information. If the supplemental materials do not support a company's redactions, the SEC may request that the company file an amendment to its public filing that includes some, or all, of the previously redacted information.

Other Changes and Effective Dates

The new rules also include amendments to various other disclosure requirements applicable to current and periodic reports (*e.g.*, Forms 8-K, 10-K and 10-Q) and offering documents, including with respect to executive officer disclosure, Section 16 "insider" filings (*i.e.*, Forms 3, 4 and 5), and the rules governing incorporation by reference. We summarize these and other selected changes in our recent client update, accessible here.

The rules governing redaction of confidential information became effective on April 2, 2019. Companies with pending CTRs may, but are not required to, withdraw the requests. Most of the remaining final rules, including the rules governing the omission of schedules to exhibits, became effective on May 2, 2019.

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Brexit: The European Union Prepares for the Day When the UK Leaves

"The third-country passport is now even more political than it once was: giving UK private fund managers full, passported access to professional investors in the EU would be hard to push through the EU's legislative process right now."

On March 29, 2017, the United Kingdom gave the European Union two years' notice of its intention to leave the EU. However, as the world knows, that is not how events unfolded. Instead, the UK requested an extension to its notice period and, at the time of writing, remains a full member of the EU, with a revised notional exit date of 31 October 2019. That date, though, is far from certain: the exit could happen sooner, if the terms of withdrawal are agreed before the end of October; or it could be postponed again; or even cancelled altogether, if advocates for a second referendum ultimately win the day. But, for the moment, firms are focused on the end of October as the most likely date for Brexit—and they must be ready for that to be a disorderly ("no-deal") Brexit.

All sides are hoping that this extra time will enable a "no-deal" outcome to be avoided and a Withdrawal Agreement to be signed that includes a "transitional period" lasting until at least December 2020. If so, it should be (more or less) business as usual until then for UK-based firms. But if there is no deal, and no further extension, UK-based firms must be ready to lose access to the EU's single market this Halloween.

Meanwhile, the EU continues to quietly prepare for the day when the UK becomes a "third-country" (EU-speak for "not one of us")—whenever that might happen. The final shape of the UK's future relationship with the EU is as uncertain as when it will happen but, at the moment—at least so far as financial services is concerned—the UK is on course to rely on the EU's partial and unsatisfactory "equivalence" rules to establish the terms of its access to EU-based investors. That is the path the UK government opted for in the non-binding Political Declaration that sits alongside the draft Withdrawal Agreement, and it has been the working assumption of lawmakers and regulators ever since. Not surprisingly, that assumption has had an effect on the regulations relating to third country access that have been in process.

Most obviously for the private funds sector, the assumption that the UK will one day be a third country has scuppered any immediate hopes of the EU activating the "third-country passport" ordained by the Alternative Investment Fund Managers Directive (AIFMD). That would have given non-EU firms full access to the single market in exchange for non-EU managers agreeing to full compliance with AIFMD rules (including being supervised by an EU regulator). But the third-country passport is now even more political than it once was: giving UK private fund managers full, passported access to professional investors in the

EU would be hard to push through the EU's legislative process right now. Furthermore, forthcoming changes to the rules on fund cross-border marketing applicable to EU managers could have a negative, knock-on effect for non-EU (including UK) managers (as we recently reported here). So access to the EU market will certainly get tougher.

Many UK-based firms also need to consider the right of access for third-country firms contemplated by the EU's Markets in Financial Instruments Directive (MiFID), which covers placement agents and some private equity firms that operate in the UK as "adviser-arrangers"—including many established by U.S. sponsors. It is somewhat unclear if and under what circumstances the marketing of funds is a regulated MIFID activity in the EU. The question has not been given much attention in the past, as UK firms had the required license in the UK and with that a passport to undertake MIFID activities in the EU. By losing that passport, these firms now face a fair amount of legal uncertainty. The third-country passport written into the MiFID rule book could help those firms when they lose the EU passport currently available to UK firms, even though this right of access for non-EU firms has also not yet been activated by the European Commission. But the rules for that passport, when it comes, are also being tightened.

In what seems to be a response to Brexit, provisions added to the revised EU prudential rules for investment firms (published earlier this year) will require the European Commission, when it considers whether to make a positive equivalence decision for a given country, to take into account the risks posed by the services and activities that firms from that third country could carry out in the EU. When the services and activities performed by third-country firms are likely to be of "systemic importance for the EU," that country's regulatory regime can only be considered equivalent after a "detailed and granular" assessment. In addition, the Commission may attach specific conditions to an equivalence decision to ensure that ESMA (the pan-EU regulator) and its national counterparts "have the necessary tools to prevent regulatory arbitrage and monitor the activities of third-country investment firms." There will also be an annual reporting requirement on the scale and scope of services provided in the EU, the geographical distribution of the firm's clients and investor protection arrangements. There are also proposals to tighten the reverse solicitation exemption.

Given the scale of access potentially required by UK firms to EU professional investors, the requirements imposed on firms accessing any future MiFID third-country passport have been significantly extended beyond the original model of a one-off registration with ESMA. Furthermore, whether the EU grants equivalence will be both a political and a technical exercise, depending in part of the state of relations between the UK and the EU at the time. Even if the UK follows EU rules, there is no guarantee that equivalence status will be granted and, even if it is, it may come with conditions or time limits. So although there is good reason to hope that a close long-term relationship between the UK and the EU can ultimately be achieved, it remains sensible to plan for a less-positive outcome—especially since the ultimate resolution of these questions may be some years away, and with the potential for significant disruption in the meantime.

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Key NAV Takeaways from the Global Fund Finance Symposium

"Any sponsor wanting to raise a NAV facility should consider a lender's potential security package when setting up its fund investment structure. Lenders may ask to take security as close to the assets as possible, although ultimately this is a negotiation point."

Staying abreast of financing developments is of ongoing importance to private equity funds. On March 26, 2019, Thomas Smith of the firm's London office participated in the NAV and Hybrid Facilities Panel at the Global Fund Finance Symposium, along with Steve Colombo (Goldman Sachs Asset Management), Vicky Du (Standard Chartered Bank), Brian Goodwin (J.P. Morgan Asset Management), Katie McMenamin (Travers Smith) and Adam Summers (Fried, Frank, Harris, Shriver & Jacobson). Below are the key highlights of the discussion.

NAV facilities mean different things to different people. There really is no "one size fits all." To cite just a few common uses of NAV facilities:

- A credit fund may employ a levered investment strategy from its inception.
- A secondaries fund may effect a dividend recap using a NAV facility.
- A private equity fund may re-lever a concentrated pool of its investments.
- An open-ended infrastructure fund may rely on its NAV facility rather than its limited uncalled capital in light of its open-ended strategy.

The fundraising climate remains generally positive. There remains an abundance of liquidity in the market for sponsors to invest. This material liquidity is one cause for the increase in asset prices. In this pricing environment, leverage can help funds maximize returns from their investments.

The liquidity of underlying investments is key to NAV facilities. Lenders generally prefer to lend against liquid assets. As a result, the relatively liquid assets held by credit funds and secondaries funds facilitate a NAV lender's credit analysis. In contrast, private equity investments are much less liquid and therefore find fewer willing lenders, although that lender market is growing.

The availability of financing may require third-party consents. The specific requirements will depend on the fund structure, the security package and the nature of underlying investments. For example, a secondaries fund effecting a dividend recap will need to consider whether it must obtain GP consents to transfer underlying investments under a new SPV, to give security over that SPV and to authorize the lender to ultimately enforce security. Expect lenders to conduct diligence on the underlying assets to understand the applicable consent requirements.

Lender security requirements will inform NAV facility structuring. Any sponsor wanting to raise a NAV facility should consider a lender's potential security package when setting up its fund investment structure. Lenders may ask to take security as close to the assets as possible, although ultimately this is a negotiation point to be informed by a cost-benefit analysis and the required consents discussed above. Lenders may require at least a share pledge over holdco SPVs below fund level which hold the assets. Lender requirements will vary across lenders, structures and investment strategies.

Asset valuations are crucial to any NAV facility. Many types of assets, including private equity investments, secondaries investments and infrastructure investments, are difficult to value other than by the sponsor. In many NAV facilities, lenders will therefore accept the sponsor valuation of underlying assets by reference to sponsor financial statements prepared for their limited partners, provided the sponsor includes an appropriate valuation methodology. The valuation of credit fund assets, which is heavily negotiated between sponsor and lender, are an exception, however. Credit fund sponsors may be prepared to accept that broadly traded loans can be valued by reference to quotes of dealers in the market. However, those sponsors will prefer to use their own valuation method for any loan asset which is not valued by reference to an objective mark.

NAV facility amortization matters to both sponsors and lenders. A balance must be struck between the strategy of the sponsor, on the one hand, and the need for the lender to de-risk and ensure repayment of the loan at maturity, on the other hand. Certain NAV facilities will amortize sharply, while others will not amortize at all. For example, a credit fund using a levered fund strategy from its inception may not find it acceptable for its NAV facility to amortize before the end of the investment period because any earlier amortization would impact its levered investment strategy. In contrast, a secondaries fund seeking to return capital to its investors by levering its existing portfolio towards the end of its investment period may be more willing to accept amortization of its NAV facility in parallel with its investment sell-down strategy.

NAV facilities may seek to borrow against all or a specified subset of fund assets. Some sponsors may wish to borrow against the NAV of all investments in the fund. Other sponsors may wish to lever specific assets. This question is most keenly negotiated by credit funds, who will prefer that assets acquired after the NAV facility is put in place be automatically included in the facility borrowing base (subject to meeting pre-agreed eligibility criteria). Certain lenders are comfortable with this approach, whereas others will require a veto right over inclusion of future assets in the borrowing base.

Hybrid facilities combine NAV and subscription line elements. In offering a NAV facility, lenders look to the underlying assets of the sponsor for their credit support, while subscription-line lenders look to the uncalled capital of the fund's limited partners. A hybrid facility combines the two types, allowing a sponsor to put in place a single facility with both a subscription-line element and a NAV element.

Credit funds have the option to raise a hybrid facility or split NAV and capital call facilities. Credit funds may be presented with the option either to put in place a hybrid facility or raise split NAV and capital call facilities. There are reasons for pursuing each option. Sponsors preferring to split their facilities may find a wider group of willing lenders and may gain cheaper pricing overall. They may also gain the benefit of less fund-level regulation, as only the subscription line covenants will apply to the main fund entity. On the other hand, sponsors preferring a hybrid facility only have to deal with one lender and one facility (although there may be multiple points of contact at that one lender, insofar as putting in place a hybrid facility may require collaboration between different sections of a lender). Importantly, sponsors of hybrid facilities may also be able to ramp up their levered investments at the start of the life of the fund by relying on the uncalled capital credit at the time when the fund holds no or very few underlying investments.

These are only a few of the numerous aspects of NAV and hybrid facilities addressed during the panel discussion. Please contact us to further discuss these facilities.

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About the Debevoise Private Equity Group

Debevoise has been recognized as a market leader in the Private Equity industry for over 35 years. With more than 200 lawyers around the globe dedicated to the industry, our Private Equity Industry Group brings a collaborative, multidisciplinary approach to our work. As reflected consistently in quotes from clients in our rankings in *Chambers Global*, *Chambers USA*, *The Legal 500*, and *PEI* year after year, our unique "close knit partnership" brings a "breadth of resources to solve complex problems" enabling us to be a seamless presence globally at every stage of the private equity life cycle.

Debevoise & Plimpton LLP is a premier law firm with market-leading practices, a global perspective and strong New York roots. We deliver effective solutions to our clients' most important legal challenges, applying clear commercial judgment and a distinctively collaborative approach.