

2019/2020 Private Equity Year-End Review and Outlook

Introduction

Private equity is posting a strong finish to the decade, continuing the trend of the past several years. Fundraising remains healthy, and both terms and interest rates remain favorable to borrowers for leveraged deals. And while some Brexit-related uncertainty remains, the recent Conservative victory seems to be bringing that long-running drama to an end.

To be sure, there are challenges as well: valuation multiples remain high and there is growing concern that we may be nearing the top of the economic cycle. Notably, the market has responded not by downshifting, but by creating new types of opportunities structured to meet evolving investor priorities. Neither ongoing trade wars nor the political tensions in the United States and the UK have dampened the market's fundamental outlook. The tax and regulatory situation for private equity is generally stable as well, although there are several areas that will undergo increased regulatory and enforcement scrutiny.

Our 2019/2020 Private Equity Review and Outlook offers our perspective on the year behind us and highlights some of the trends and developments to watch for in the year ahead.

Fundraising



Jonathan Adler
Partner—New York
jadler@debevoise.com



Lorna Bowen
Partner—New York
lbowen@debevoise.com



Andrew Ford
Partner—New York
aford@debevoise.com



John W. Rife III
Partner—London
jrife@debevoise.com

Global fundraising activity in 2019 has remained steady after the record-breaking levels achieved in recent years. With nearly \$200 billion of capital raised through the third quarter, we expect this year's total to match, if not exceed, the amount raised in 2018. While changing economic, political and regulatory landscapes may affect the private equity fundraising markets as we head into 2020, investor appetite generally remains strong, and so we anticipate this long-running fundraising strength to continue.

One of the most notable trends in the private equity fundraising space is the growing desire of investors to diversify their portfolios. LPs are expanding their mandates to include more jurisdictions and strategies. Sponsors are responding by diversifying their businesses both geographically and across asset classes, increasing the number of product lines they offer and pursuing new types of strategies. Over the past year, we saw multiple firms that historically focused on raising traditional buyout funds expand their businesses to include more specialized strategies, including infrastructure, emerging markets and growth equity. With many of the view that we are at or close to a market peak, we expect to see further diversification next year with firms increasingly pursuing distressed debt, special situations and credit strategies.

Another trend we are seeing is a notable increase in the role of private equity sponsors as managers of insurance company assets, including both significant acquisitions by private equity sponsors and funds of insurance businesses as well as fund, managed account and other specialized investment arrangements such as “collateralized fund obligation,” ICOLI and rated note structures. As these products and structures are refined and continue to gain prominence, we expect sponsors to be able to offer an increasingly sophisticated set of options to insurers that are seeking less liquid assets in exchange for the potentially higher yields sought by core private equity strategies.

Finally, we are also seeing a growing desire by investors to participate in co-investment opportunities and invest in alternative fund structures, including permanent capital vehicles and other long-dated funds. These types of investment activities provide LPs with several benefits. For example, investing in longer-term and permanent capital vehicles offers a stable and low-risk investment opportunity with regular cash flows and a lower fee burden. Investors also are attracted to long-dated asset classes because of the flexibility they provide to invest in companies that may require a longer time horizon to deliver returns. As more investors begin to recognize the benefits of these new structures, we expect demand for them will increase, with sponsors in return providing more such opportunities in the upcoming year.

Fund Financing



Pierre Maugüé
Partner—London
pmaugue@debevoise.com



Thomas Smith
Partner—London
tsmith@debevoise.com



Felix Paterson
Associate—London
fpaterson@debevoise.com

Collateralized Fund Obligations

The groundbreaking development in fund financing for 2019 was the growing use of collateralized fund obligations (CFOs) to help sponsors raise capital for their private funds. These structures are particularly appealing to insurance companies investing in funds on a risk-based capital-efficient basis. CFOs can be structured as investments in a diversified portfolio of funds or used in a single commingled fund. During 2019, we advised on several of these transactions, as sponsors and investors sought to find innovative and effective ways to structure investments in funds.

ESG

While environmental, social and governance (ESG) criteria have been part of the investing landscape for some time, in the past year we have begun to see sponsors increase their prioritizing of ESG in fund finance transactions. One novel and interesting approach has been to vary the margin on fund-level subscription facilities by referencing the fund's ESG performance. The parties to a financing agree to set the margin at an initial level and, on each anniversary of the facility, adjust the margin to reflect the fund's ESG performance against certain key performance indicators.

NAV

We previously highlighted the growing popularity of net asset value facilities and hybrid facilities (where the borrowing base is a combination of uncalled investor commitments and fund investments). This trend continues, with NAV facilities increasingly no longer raised only by credit and secondaries funds (which have liquid assets), but also by private equity funds (with less liquid underlying assets).

M&A and Leveraged Finance (U.S./Europe)



Christopher Anthony
Partner—New York
canthony@debevoise.com



William Y. Chua
Partner—Hong Kong
wychua@debevoise.com



Alan J. Davies
Partner—London
ajdavies@debevoise.com



Scott B. Selinger
Partner—New York
sbselinger@debevoise.com



Dominic Blaxill
Associate—London
dblaxill@debevoise.com



Michelle Gilmore
Associate—London
mgilmore@debevoise.com



Ryan T. Rafferty
Associate—New York
rtraffer@debevoise.com

U.S. M&A

After a slow start to 2019 following equity market turbulence at the end of 2018, private equity deal volume picked up considerably in the second quarter and has stayed strong through the end of the year.

In the face of continuing high valuation multiples, we have seen sponsors continue to look beyond traditional leveraged buy-outs to deploy capital, pursuing growth equity investments, joint ventures and minority investments.

This past year saw a robust number of sponsor sale auction processes, perhaps driven by valuation multiples and perceptions regarding where we sit in the economic cycle, and we expect sponsor sale processes to continue to come online as we enter 2020.

For now, deal volume shows no signs of slowing. To be sure, uncertainty around the 2020 U.S. presidential election looms large, though we expect any effect to be most pronounced in industries such as healthcare, which have the potential to be directly affected by a change in government policy. Concerns regarding the U.S./China trade dispute also persist, though, to date, we have not seen a direct impact on overall deal activity.

U.S. Leveraged Finance

The leveraged finance market experienced a credit quality bifurcation in 2019 of the type that we have not seen in a number of years. Significant outflows of retail investors from leveraged loans funds, together with trade issues, increased pressure on yield and concerns over the possibility that we are reaching the peak of the current economic cycle all precipitated a flight to quality, with high-quality credits able to obtain syndicated financing on peak terms. On the other hand, credits with any hint of blemishes or question marks (especially involving EBITDA adjustments) struggled to obtain commitments and in syndication, with most such deals being fully flexed, some even pricing beyond the flex.

These factors led to a record year for the private debt markets, with sponsors looking for transaction financing, ranging from large-cap deals to lower-middle market deals, an area where private capital has been an important source of capital for many years. This development reflects the maturation of the private debt market, which has experienced record fundraising almost every year during the last half of the decade. That growth has allowed funds to provide ever-increasing commitments, which in 2019 facilitated several \$1 billion-plus unitranche deals for companies with EBITDA in excess of \$100 million. Sponsors have benefited from the availability of this capital, which provides certainty of term, the absence of flex and the ability to execute quickly with no marketing or ratings requirements.

As we look forward to 2020, we expect that sponsors, particularly in the middle market, will continue to test the bounds of investor appetite for aggressive syndicated loan terms. They will also continue to explore the availability of alternative sources of capital in the private debt markets as traditional financing markets continue to fluctuate in the face of investor uncertainty regarding the longer-term economic outlook.

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M&A and Leveraged Finance (U.S./Europe)

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Europe M&A

As in the United States, creative deployment of capital in Europe is likely to remain decisive for strong returns in the context of an oversubscribed European buyout market. Take-privates are increasingly popular in spite of high premiums, as public targets become comparatively more affordable relative to the high multiples seen in private M&A transactions.

Traditional buyout specialists are also turning their attention to minority stakes in an attempt to create diversified portfolios that address investors' concerns over Brexit and recessionary signals. In light of the current industry-wide stabilization trend, risk-distributing acquisition structures such as partnerships with strategic buyers, co-investments and joint ventures have also become more attractive in the face of market volatility and macroeconomic uncertainty.

Europe Leveraged Finance

We are continuing to see loan documents that are very friendly to sponsors and borrowers, with "cov-lite" now the norm. Sponsors continue to push for and obtain increased covenant flexibility with additional add-backs to EBITDA (including cost savings and synergies, often in unlimited amounts). Sponsors are also obtaining restrictions on loan transferability, which inhibits the lender's ability to transfer to the secondary market without obtaining borrower consent. There continues to be a downward pressure on interest rates. New alternative lenders are appearing on the growing non-bank direct lending market, with direct lenders increasingly able to move beyond small to mid-market deals to fund larger transactions.

UK Tax



Richard Ward
Partner—London
rward@debevoise.com



Paul Eastham
Associate—London
peastham@debevoise.com

Last week's UK election handed the Conservative party a decisive mandate to form a majority government to "Get Brexit Done." While that vote provided a sense of direction, plenty of uncertainties remain. For example, the Conservative election manifesto was curiously silent on changes to UK tax policy that might be needed to help cover funding gaps and improve the UK's post-Brexit global competitiveness. In any event, private equity firms whose investment structures include UK companies should plan for the fact that they will soon no longer benefit from the EU Directives that currently remove withholding taxes on interest and withholding taxes and income tax on dividends, in each case paid between a UK company and a group company in an EU member state. In addition, the EU Directive that facilitates the tax-neutral treatment of cross-border mergers between a UK company and a group company in an EU member state will no longer apply. However, it appears that there will be no material changes (other than administrative) to the UK's VAT regime, even though this is an EU-mandated tax. We've [previously commented](#), in some depth, on these tax aspects of Brexit.

Brexit-related tax questions aside, the new Conservative government's intention appears to be to keep much of UK taxation the same as it is, although there will be changes in some areas. For private equity firms holding UK businesses in their portfolio, the following three points in particular should be kept in mind:

- The UK's corporation tax rate will remain at 19 percent (rather than be reduced to 17 percent, as previously proposed).

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UK Tax

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- Entrepreneur's relief, which can lower a UK seller's effective UK capital gains tax rate on disposal of an interest in a trading business from 20 percent to 10 percent, will be reviewed.
- Tackling tax avoidance and evasion will be the subject of renewed focus, in part by implementing the controversial digital services tax, which is most likely to affect UK-inbound multinational enterprises with material UK sales.

Early 2020 should also bring long-awaited final guidance from HM Revenue & Customs regarding the rules covering carried interest and disguised investment management fees. The extent to which the final guidance deviates from prior draft guidance remains to be seen. Once the final guidance has been published, private equity firms may wish to review their UK principals' remuneration with their advisers.

Separately from the new UK tax developments described above, private equity firms that invest in Europe may find themselves directing significant resources in 2020 toward dealing with a number of tax initiatives that had surfaced previously.

Despite what appears now to be its departure from the EU, the UK has committed to implementing "DAC6," an EU disclosure regime that will require taxpayers and their advisers to report to EU tax authorities cross-border transactions that touch the EU and include certain "hallmarks." Because some of these hallmarks are not tax-related, they may expand the universe of reportable transactions in unexpected ways. As we've [discussed previously](#), the UK's draft regulations implementing the regime, published in July, suggest that these reporting obligations could be very onerous for private equity firms, their portfolio companies and their advisers. In particular, there is some uncertainty as to whether common fund transactions involving tax-exempt investors or hybrid entities may become routinely reportable. However these issues are resolved, firms should prepare well in advance of the first reporting deadline in August 2020, which will cover all reportable arrangements implemented since 25 June 2018. The final UK regulations are expected in early 2020.

Over the past few years, the UK and EU have sent increasingly clear signals that UK and European tax authorities will no longer tolerate private equity investment holding structures that lack sufficient substance in their jurisdiction of establishment. One such signal came in February, with the judgment handed down by the senior court of the EU in the so-called "Danish cases." The court's ruling indicated that a Luxembourg company, which held a European investment that was ultimately owned by a non-EU private equity fund, had to be the "beneficial owner" of investment proceeds in a broad sense (*i.e.*, not bound to pass on all such proceeds to its owners) in order to benefit from a reduced rate of withholding tax on interest under an EU Directive.

This scrutiny of holding structures is also reflected in the recent ratification by the UK and many other jurisdictions (including Luxembourg) of the BEPS multilateral instrument ("MLI"). Under the MLI, starting in 2020, certain of the UK tax treaties most commonly used in the private equity context will no longer allow the granting of treaty benefits to an arrangement in which obtaining those benefits was "one of the principal purposes" of that arrangement. Private equity firms should carefully assess the integrity of their European

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UK Tax

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investment structures so that they do not fall foul of these changes. For further background, see [our notes](#) on the MLI and the introduction of the BEPS Action 6 “principal purpose” test.

Finally, private equity firms with UK real estate investments should note an important deadline, in April 2020, in the rollout of the UK’s “NRCGT” capital gains tax charge for non-UK resident investors on direct and indirect disposals of UK real estate. One of the major NRCGT structuring tools available to widely held funds is an “exemption election,” which can exempt certain gains from taxation provided that the election is made within 12 months following its effective date. Given that the NRCGT rules came into effect in April 2019 (as previewed in the [2018-2019 YERO](#)), firms that are planning on using the exemption election should aim to make the election, or at least discuss their plans with their advisers and HMRC, by April 2020 (with an effective date of April 2019) in order to reduce the risk of investors bearing preventable tax costs and a reduction in firms’ carried interest returns.

European Regulatory



Patricia Volhard
Partner—London / Frankfurt
pvolhard@debevoise.com



Simon Witney
Special Counsel—London
switney@debevoise.com



Jin-Hyuk Jang
International Counsel—Frankfurt
jhjang@debevoise.com



John Young
International Counsel—London
jyoung@debevoise.com

Although 2019 saw successive extensions to the date on which the United Kingdom will leave the European Union, it is now almost certain that it will do so by the end of January. However, as it turns out, preparations for the possibility of a “no-deal” Brexit may still prove to be useful. The transition period – which seems likely to end on 31 December 2020 – may lead to a cliff-edge Brexit, if a new free trade agreement cannot be agreed in time. Furthermore, it is very unlikely that any such trade agreement will deal extensively with financial services, meaning that “passporting” will probably be lost when the transition ends. Most firms are now familiar with the risks that a hard Brexit entails, and are as prepared as it is possible to be, but 2020 will see them looking at their contingency plans once again.

In the private equity sphere, Brexit risk has focused on any restriction that Brexit will impose on a UK firm’s ability to approach EU investors during fund-raising. Working on the general assumption that UK-managed funds will no longer have the benefit of the EU AIFMD marketing “passport” (which would depend on extension of the “third country” passport to the UK – not likely in the short term), Luxembourg and (to a lesser extent) Ireland are now firmly established as the EU hubs for private equity fund management. Many managers intend to continue their portfolio management and fund-raising activities from a UK office, often with authority delegated by a manager in Luxembourg or Ireland. However, such an arrangement will need to satisfy regulators scrutinizing the “substance” of the EU office and its ability to supervise the UK team’s activities.

Brexit aside, many fund managers are finding the regulatory aspects of EU fund-raising more and more complex, having to navigate a complex set of “hard” and “soft” preferences of EU investors. Faced with these challenges, an increasing number of managers outside the EU are giving serious consideration to an EU structure, either in parallel with or even in place of their traditional non-EU structure. In addition, while

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European Regulatory

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the European Commission's forthcoming changes to AIFMD under the Cross-Border Marketing Directive are intended to harmonize the definition of "pre-marketing" across jurisdictions, the market widely regards a tightening of the conditions for "reverse solicitation" as the regulatory quid pro quo, bringing the possibility of increased enforcement activity to an area that has attracted little such attention to date.

In the UK, the FCA continues to place a very modest focus on the private equity industry, having little desire to interfere with arrangements negotiated between investors and funds or to question the sufficiency of managers' fiduciary duties. All FCA-authorized private equity firms implemented the Senior Managers Regime by 9 December 2019, with the new accountability requirements putting internal governance arrangements on a clearer and more formal footing. In addition, the FCA initiative to improve cost reporting to investors across the asset management industry led to the publication of template reports in 2019, which were largely adopted by the industry.

The European Commission, meanwhile, is re-doubling its efforts on environmental, social and governance (ESG) matters. The forthcoming European Disclosure Regulation will require most private equity managers to disclose how they have considered sustainability issues that affect the value of an investment and to state whether they have taken account of societal impacts more broadly. But, since many private equity firms have become further engaged with ESG issues in recent years, the Disclosure Regulation seems unlikely to impose unworkable new burdens on the industry, and is largely moving in sync with increasing investor requirements.

U.S. Regulatory



Kenneth J. Berman
Partner—Washington, D.C.
kjberman@debevoise.com



Gregory T. Larkin
Counsel—Washington, D.C.
gtlarkin@debevoise.com

The Securities and Exchange Commission (SEC) is likely to continue its focus on retail investors. Consistent with recent years, the priorities of the Office of Compliance and Examinations (OCIE) in 2019 were primarily directed toward protecting retail investors. However, private fund sponsors continue to receive attention as well, with disclosures concerning conflicts of interest and fees and expenses being of particular concern. We expect these trends to continue in 2020.

The SEC adopted an interpretation of the fiduciary duty applicable to investment advisers—including private fund managers—under the Advisers Act. The final interpretative release includes several notable clarifications made in response to comments to the interpretation that the SEC initially proposed in April 2018. Among other things, it emphasizes the differences between retail and institutional clients and provides guidance on disclosures regarding conflicts, including on the allocation of investment opportunities. We expect that this interpretive guidance will inform future SEC regulatory initiatives and OCIE examination findings. Investment advisers should continue to review their disclosures, particularly with respect to conflicts of interest, to determine whether they need to be supplemented or clarified to keep pace with this guidance.

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U.S. Regulatory

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The SEC has proposed significant amendments to modernize the Advertising Rule under the Advisers Act. The proposed amendments to the Advisers Act Advertising Rule (Rule 206(4)-1) would expand the definition of “advertisement” to capture more modern communications and expand the Rule’s general prohibitions while removing some of its more specific prohibitions. In addition, the proposed amendments would impose new requirements regarding performance presentations. The SEC also proposed amendments to the Cash Solicitation Rule (Rule 206(4)-3) that would extend the application of the Rule to persons who solicit investors for private funds. Finally, reflecting its focus on retail investors, the SEC recently re-proposed a rule governing mutual fund investments in derivatives.

The SEC is expected to propose amendments to the Custody Rule in 2020. In March 2019, the SEC Division of Investment of Management (DIM) solicited feedback on the Custody Rule (Rule 206(4)-2) regarding non-delivery-versus-payment settlements and digital assets. However, the proposed amendments are expected to go beyond these two issues.

Federal agencies approved certain amendments to the Volcker regulation addressing the proprietary trading prohibition, with more changes expected. The agencies adopted certain existing guidance regarding covered funds provisions; however, the bulk of the issues pertaining to covered funds will be the subject of a future proposed rulemaking.

The legislative environment remains uncertain. Several pieces of congressional legislation have been recently proposed that could affect the private equity industry. While none of this legislation appears close to being adopted, the U.S. House of Representatives did hold a hearing focused on the private equity industry on November 19.

SEC Enforcement



Andrew J. Ceresney
Partner—New York
aceresney@debevoise.com



Robert B. Kaplan
Partner—Washington, D.C.
rbkaplan@debevoise.com



Julie M. Riewe
Partner—Washington, D.C.
jriewe@debevoise.com



Ryan M. Kusmin
Associate—Washington, D.C.
rmkusmin@debevoise.com

Upcoming action by both the U.S. Supreme Court and Congress may impact the SEC's ability to seek disgorgement in federal district court. In early November, the Supreme Court agreed to hear an appeal challenging whether courts possess the authority to order disgorgement in SEC enforcement proceedings. The case, *Liu v. S.E.C.*, follows on the heels of the Supreme Court's 2017 decision in *Kokesh v. S.E.C.*, which found that disgorgement is a penalty and therefore subject to a five-year statute of limitations. In *Kokesh*, the Court expressly declined to address the same issue—judicial authority to order disgorgement in SEC proceedings—that *Liu* will now directly address.

Meanwhile, the U.S. House of Representatives in November passed with bipartisan support H.R. 4344, a so-called “*Kokesh fix*” that would amend the Securities Exchange Act of 1934 to allow the SEC to seek disgorgement of ill-gotten gains for a period of 14 years. Although similar legislation has been introduced in the U.S. Senate and referred to the Senate Banking Committee, no further action has been taken. Such a “fix,” were it to pass, would moot the potential significance of the *Liu* appeal.

The SEC's Division of Enforcement Annual Report for 2019 showed a continued focus on asset managers. In addition, the Report showed overall enforcement numbers (both monetary remedies and total cases brought) increasing modestly from FY 2018. In FY 2019, the SEC brought 181 cases related to investment advisers and investment companies, the most of any category reported, and a 77 percent increase in the same category from the prior year. That said, the majority of those cases stemmed from SEC's retail-focused Share Class Selection Disclosure Initiative. But even with its ongoing focus on retail advisers, the SEC continued to scrutinize private equity firms in 2019 and brought several enforcement actions against them involving conflicts of interest, valuation, and compliance with the Custody Rule. Asset managers should expect the SEC to bring cases on similar issues in the coming year, as well on the continuing hot-button matters of virtual currencies and cybersecurity.

UK Business Integrity



Samantha Rowe
Partner—London, Paris
sjrowe@debevoise.com



Simon Witney
Special Counsel—London
switney@debevoise.com



Conway Blake
Associate—London
cblake@debevoise.com



Tom Cornell
Associate—London
tcornell@debevoise.com

Recent Developments in the Law on Parent Company Liability in the UK

Environmental, social and governance (ESG) issues have become increasingly pressing for private equity and venture capital firms, with responsible investors taking care to ensure that their portfolio companies comply with applicable legal rules and adopt relevant best practices. However, recent developments in UK domestic law have brought into focus the risks associated with greater involvement by parent companies (and, by extension, investors) in the policies and operations of their subsidiaries or underlying investee companies.

Although the parent-subsidiary relationship cannot in itself give rise to a duty of care for parent companies as a matter of UK law, several cases have explored the circumstances in which a parent company can nevertheless assume responsibility for the wrongdoing of subsidiaries. For example, a number of significant UK Court of Appeal cases in 2018 appeared to confirm that parent companies could not assume responsibility merely through the imposition of mandatory group-wide policies. In those cases, the relevant test was said to be one of “control”: Did the parent company exercise a sufficient level of control over the business operations of the subsidiary? The Court of Appeal generally took the view that group-wide policies by themselves did not meet this criterion.

The test was revisited this year by the UK Supreme Court in *Vedanta Resources PLC v. Lungowe*, a case which involved a claim brought by a large number of individuals in Zambia against a Zambian copper mining company and its UK-based parent company. The Supreme Court confirmed that the key question is the level of control or intervention exercised by the parent company in the management of the subsidiary’s operations. By way of illustration, the Supreme Court drew a distinction between passive investors and vertically integrated corporate groups whose business is carried on “as if they were a single commercial undertaking, with boundaries of legal personality and ownership within the group becoming irrelevant, until the onset of insolvency, as happened with the Lehman Brothers group.”

In this respect, the Supreme Court merely reiterated the test that had been applied by the Court of Appeal. However, the Supreme Court then went further and opined that group-wide policies may also give rise to a duty of care in certain situations. Lord Briggs gave the following examples of situations where group-wide policies might result in liability for a parent company:

- Where the group-wide policies concern the environmental impact of inherently dangerous activities and are shown to contain systemic errors which, when implemented by a particular subsidiary, then cause harm to third parties.
- Where the parent company does more than merely proclaim the group-wide policies by, for example, taking active steps such as training, supervision and enforcement in order to ensure that they are implemented by subsidiaries.
- Where the parent company holds itself out in published materials as exercising a degree of supervision and control over its subsidiaries, even if it does not in fact do so.

UK Business Integrity

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Although this new guidance appears to introduce the possibility of far-reaching liability based on high-level statements, it is important to bear in mind that it was given in the context of the overriding test, which remains one of control or intervention. In other words, the examples set out above still relate to the degree of control exercised by a parent company over its subsidiaries. Moreover, the Supreme Court did not technically decide the duty of care question on the merits, and so the precise scope of parent company responsibility remains to be determined.

This state of affairs may be of little comfort to investors who want clarity on exactly where the “control threshold” lies. However, while that clarity will have to wait for future cases, the key takeaway is that the criterion used in determining liability remains the parent’s degree of control over the subsidiary’s operations. Further, the Supreme Court took the view that “passive” investors in separate businesses (*i.e.* separate to their own) are unlikely to cross the requisite control threshold. This category of investors would appear to include investment funds and even, possibly, private equity portfolios—in other words, equity investors that do not form part of an overarching, vertically integrated corporate group.

So private equity fund managers and the funds that they manage are not in exactly the same position as parent companies. Nevertheless, managers should exercise some degree of caution in relation to their public statements regarding the actual level of control they exercise over portfolio companies, since the underlying legal principles are the same as for parent companies—and those principles are not yet settled.

That could change next year: There are a number of cases on the horizon that should provide the Supreme Court and the lower courts with an opportunity to throw further light on the issue of parent company liability. In 2020, the Supreme Court will hear the appeal from the Court of Appeal decision in the *Okpabi* case, involving Royal Dutch Shell and the Shell group of companies. In any event, there are similar cases waiting in the wings and the UK courts will have to grapple with parent company liability again before long.

Debevoise & Plimpton represented Royal Dutch Shell in the case His Royal Highness Okpabi v Royal Dutch Shell Plc referred to above.

About the Debevoise Private Equity Group

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The *Debevoise & Plimpton Private Equity Report*, comprised of our global private equity team's market knowledge, is published quarterly and is approaching its 20th year of publication.

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