Debevoise & Plimpton

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THE PRIVATE EQUITY REPORT

From the Editors

A highly competitive environment places a premium on finding creative ways to get deals done. Once those deals have consummated, there is often a need to secure additional financing for add-on acquisitions through the proper structuring of incremental debt. Strategies for debt (re)structuring are also relevant for companies grappling with a liquidity crunch. And aside from the nuts and bolts of transactions and financing, funds and companies must also contend with ongoing regulatory emphasis on disclosure regarding a range of topics.

This issue of the Private Equity Report explores several recent developments in dealmaking, financing and disclosure pertinent to the private equity community:

MINI-SERIES SPOTLIGHT
Sponsor Innovation in Dealmaking

***

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

The Editors

"We'll find the money for that. My guy is on it right now."

This report is a publication of
Debevoise & Plimpton LLP

Debevoise & Plimpton

MINI-SERIES SPOTLIGHT
Sponsor Innovation in Dealmaking

Private equity sponsors continue to operate in a highly competitive environment with record levels of dry powder globally. As a result, many auction processes are concluding with sky high valuations, leaving disciplined investors on the outside looking in. Current market dynamics have forced many sponsors to be creative in order to deploy capital outside of the typical auction context. This miniseries highlights deal techniques that sponsors are utilizing to gain an edge on the competition and create opportunities that present an attractive risk-return profile.


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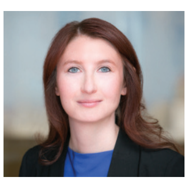
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Unlocking Value through the Use of Sponsor-Strategic Partnerships

Much ink has been spilled on the increasing number of private equity sponsors and cash-rich strategics chasing after the same limited pool of quality targets. Much less attention has been paid to what we see as a growing and important trend: transactions involving private equity sponsors "teaming up" with strategics in innovative ways that unlock value for both sides. Recent transactions illustrate the various forms these partnerships can take:

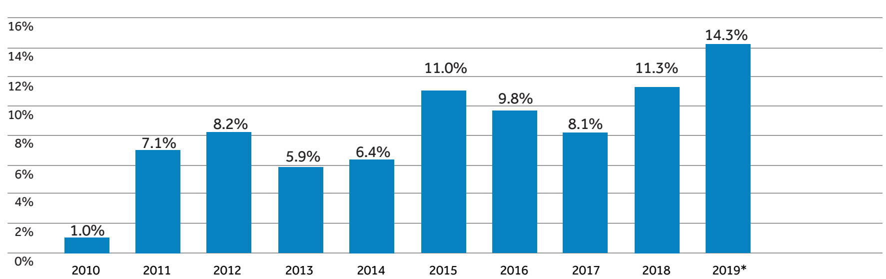
1. **The sponsor and the strategic team up to acquire a business**, as when OptumHealth and Summit Partners joined forces to acquire Sound Physicians or when KKR teamed with HCA to acquire Envision Healthcare.
2. **A strategic sells a stake in an existing business to a sponsor**, such as Thomson Reuters' sale of its majority stake in its Financial & Risk unit to Blackstone.
3. **A strategic buys a stake in a sponsor-owned portfolio company**, such as Tenet Healthcare's acquisition of United Surgical Partners, a portfolio company of Welsh, Carson, Anderson & Stowe (WCAS).

Data from Capital IQ indicates that there were 13 transactions involving some form of sponsor-strategic partnership out of 43 private equity buyouts with deal values in excess of $500 million that were announced between January 2017 and September 2019.[1] According to PitchBook, over 10% of private equity buyouts in 2018 with deal values in excess of $1 billion involved sponsor-strategic partnerships (in 2019 (through the beginning of October), that figure is closer to 15%).[2]

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019*	
1.01%	7.08%	8.21%	5.93%	6.38%	11.04%	9.79%	8.15%	11.30%	14.29%	% of buyout count

*as of 10/10/19

% of Joint PE-Corporate Buyouts Valued at $1B



1. Based on Capital IQ report with the following criteria: 1) Investment Style Managed (Buyers/Investors): Private Equity/Buyouts; 2) Company Type (Buyers/Investors): Public Investment Firm OR Public and Private Companies; 3) M&A Announced Date: 1/1/2017-9/27/2019; 4) Total Transaction Value ($USDmm, Historical Rate): is greater than 500; 5) Geographic Locations (Target/Issuer): United States of America (Primary); 6) Industry Classifications (Target/Issuer): NOT (Real Estate (Primary) OR Government-Related Services (Primary)).
2. Data and chart provided by PitchBook as of October 10, 2019.

A number of sponsor-strategic partnership transactions have been concentrated in the healthcare sector, where we have seen sponsors leverage partnerships with corporate buyers to navigate regulatory requirements and exploit commercial opportunities. Indeed, according to the 2019 Bain Global Healthcare Private Equity Report, in 2018, there were 18 sponsor-strategic partnership deals in the healthcare sector that accounted for $7.9 billion, or 12.5% of disclosed value. Further, KKR/HCA's acquisition of Envision Healthcare and OptumHealth/Summit's acquisition of Sound Physicians mentioned above were among the 10 largest healthcare deals of 2018.

Advantages of Sponsor-Strategic Partnerships

From the sponsor's perspective, partnering with a strategic to acquire a business offers a number of important advantages:

- The partnership may distinguish the sponsor in a competitive process and allow it to tap into synergies and additional sources of capital to afford higher valuation multiples and participate in larger deals
- The strategic partner may give the acquired business access to more markets, distribution networks, commercial opportunities and economies of scale than a sponsor alone could offer
- A strategic partner can help mitigate concerns that shareholders and regulators may have regarding a private equity buyer, particularly in regulated sectors such as healthcare and insurance
- Alternatively, if a stand-alone acquisition by a strategic presents antitrust or other regulatory issues, a sponsor-strategic partnership might allow the partners to "split" the business to avoid such hurdles and create a transaction that could not be completed by either partner acting alone
- A strategic partner may provide an opportunity for a sponsor to buy a target company and "split" the business based on the assets that are more attractive to each of the sponsor or the strategic partner in order to maximize overall value
- If the strategic partner has a strong credit rating, a sponsor can often access cheaper debt financing
- A strategic partner may provide a built-in exit opportunity for the sponsor

Recent sponsor-strategic partnership transactions illustrate some of these points. Take, for example, the ability to have a clear exit for the sponsor. In 2017, TPG and WCAS teamed with Humana to acquire the hospice business of Kindred. The following year, the consortium acquired Curo Health Services for $1.4 billion, which it then combined with Kindred to create the largest hospice provider in the United States. The parties hardwired a path to exit by agreeing to a series of put/call mechanics that enable TPG and WCAS to put their shares in Kindred (after reflecting the addition of Curo) to Humana after a period of three years, with an exercise price multiple determined by certain agreed-upon valuation metrics. Similarly, in 2015, Tenet Healthcare paid $425 million to buy a controlling stake in United Surgical Partners, a portfolio company of WCAS, and negotiated a put/call structure that gave Tenet a path to full ownership over five years. In 2018, Tenet announced it had completed the purchase of WCAS's remaining stake.

The OptumHealth/Summit acquisition of a controlling interest in Sound Physicians, a physician staffing company, showcased both the commercial advantages of a strategic partner and the effect on the target's credit ratings. According to a ratings report by Moody's, the B1 Corporate Family rating they gave Sound Physicians is supported by its "leading position" as a hospitalist provider and Moody's opinion that the company is "better aligned with hospitals and payers than many other physician staffing companies" in light of OptumHealth's ownership stake in the company.

Benefits of sponsor-strategic partnerships accrue to the strategic as well. These include deal sourcing for potential add-on acquisitions, better management rollover packages to help retain and motivate management and key employees, and expertise in rationalizing the target's business and improving its efficiency. More importantly, a partnership with a private equity firm provides the strategic with the opportunity to learn a new business over an extended period of time with less economic exposure.

In deals where a strategic sells a piece of an existing business to a sponsor but continues to maintain a sizable position in the investment, the strategic may partner with the sponsor to avoid a lengthy auction process, deconsolidate a (typically underperforming) business, refocus its resources and management attention to its core business and record a gain on sale, while continuing to participate in the upside of the business under the stewardship of the sponsor until an ultimate exit. Examples of such transactions include the 2018 sale by AmTrust of 51% of its U.S.-based fee business to Madison Dearborn and the 2017 sale by FIS of 60% of its management consulting business to Clayton, Dubilier & Rice.

> "These partnerships may provide sponsors with a leg up in competitive bidding, a clear exit plan and access to more markets, while strategics may get access to increased deal flow, better packages to retain and motivate management and expertise in improving the efficiency of the new business."

Challenges of Structuring Sponsor-Strategic Partnerships

Although sponsor-strategic partnerships can offer clear advantages, realizing these benefits requires time, effort and commitment. For one thing, incentives may not always be aligned: a sponsor may have a three-to-five-year horizon, whereas a strategic may have a longer-term focus. A sponsor and a strategic may also have differing views about the optimal exit scenario. For example, a strategic may want restrictions on the ability of the sponsor to sell to the strategic's competitors. A strategic buyer may be sensitive to certain issues that are of less concern to sponsors, such as regulatory matters and other aspects of the target that may affect the strategic buyer's ongoing business.

Moreover, the key terms of these partnerships – which are often complex and critical to a successful outcome – may have to be negotiated in the midst of a fast-moving auction process, and sponsors are often better positioned to make decisions and act quickly than a large strategic buyer. It may be difficult to agree on the terms of a partnership in time to win a bid, or alternatively, parties may decide to work out specifics after a deal has signed, only to find that they lack a clear understanding of each other's interests and goals. In deals where the sponsor-strategic value proposition includes entry into long-term commercial relationships between the acquired business and the strategic, these issues can be particularly acute, as negotiating those arrangements often requires the input of target management, access to whom can be difficult outside of a proprietary process.

Overall, it is critical for the partners to develop a good working relationship, if one doesn't already exist, and establish trust early on in the transaction in order to set themselves up to be successful.

Best Practices for Sponsor-Strategic Partnerships

While every sponsor-strategic partnership is different, there are a number of best practices that sponsors should keep in mind when considering these combinations:

1. **Define the partnership at the outset.** Discuss the goals of each party up front. Agree to the greatest extent possible on key issues with respect to partnership governance and go-forward arrangements, including post-acquisition board composition and veto rights.

2. **Have the exit in sight.** Formulate a common understanding of when and how the sponsor will exit the deal and discuss potential exit mechanisms, including a right of offer/first refusal, put/call rights (including pricing mechanism for a put/call, although it may be difficult to agree on a put or call price in advance) and drag-along rights.

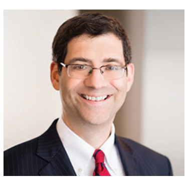
> "It can take work to align the interests of sponsors and strategics, with possible sticking points, including different investment horizons, sensitivity to potential regulatory issues and restrictions on selling the new company to competitors."

3. **Consider the implications.** Anticipate the projected impact the partnership will have on the contemplated transaction, including the partnership's effect on substantive antitrust analysis and possible additional regulatory requirements. In the case of a publicly traded target, consider whether the combined holdings of a sponsor and a strategic partner make them subject to early-warning disclosures and, in some jurisdictions, formal tender offer and bid requirements.
4. **Focus on the presentation to the seller.** Consider how best to present an attractive and unified message regarding the partnership to a seller throughout the bid process. Predict seller concerns with the sponsor-strategic partnership bid and proactively offer solutions to avoid a seller discounting the partnership bid as too complicated or conditional to get done.
5. **Be flexible and creative.** These transactions generally require solution-oriented and creative dealmakers to work through issues efficiently and commercially to keep the deal on track. Consider establishing "rules of the road" up front to be able to move quickly to respond to changing auction dynamics and other deal issues that will inevitably arise throughout the bidding, negotiation and even implementation phases.

Armed with an understanding of what issues have the greatest potential to create problems down the line, deal teams can prioritize resolving those issues earlier in the process, enabling the parties to focus on working together to bring a transaction over the finish line, and ultimately maximize the value of their partnership to achieve a successful investment outcome for both the sponsor and strategic partner.

Royalty Financing: An Appealing Alternative to Traditional Life Sciences Financing

Life sciences firms are seeking new ways to raise capital for biologics and other R&D-intensive therapies. Royalty financing is meeting that need while providing a structure that offers private equity and venture capital investors several advantages over traditional debt financing.



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Royalty financing has emerged over the past decade as an attractive investment vehicle in the life sciences space. It offers private equity and venture capital investors several advantages over traditional debt financing, and it provides life sciences firms with new ways to raise capital and fund investment for biologics and other complex therapies that require extensive R&D and increased time to market. Below, we discuss some of the various factors driving the growth of royalty financing transactions as well as certain unique commercial factors.

In the healthcare context, the term "royalty financing" is typically applied to two quite different types of transactions: 1) "royalty monetization," where investors purchase the rights to some or all of a royalty stream for a lump sum; and 2) "development financing," which refers to investor funding for development of a product in exchange for a percent of future product sales. Universities, hospitals and other nonprofits are the most common recipients of royalty monetization, while biotechnology companies are the most common recipients of development financing. The royalty financing market has been estimated to provide $14 billion per year in deal flow.

Advantages for Investors

Faster Return on Investment

Royalty financing is appealing to investors looking for a faster return on investment than equity typically provides. Equity investors must typically wait for the occurrence of an IPO, exit event or leveraged recapitalization to recoup some or all of their investment. By contrast, royalty monetization provides immediate access to an existing cash flow through the acquired royalty stream. Likewise, in development financing deals, investors typically receive returns as a percentage of future net product sales, which can often be expected to occur before the opportunity for an equity exit.

Increased Certainty

Increased certainty is another benefit of royalty financing. With traditional equity, the investment value is a function of many disparate factors, including the target's entire product portfolio (and the accompanying uncertainty as to which products will be blockbusters and which will be busts). Royalty financing transactions permit investors to cherry-pick products with proven track records or that, in the eyes of the investor, have a high likelihood of success.

Mitigation of Market Volatility

Royalty financing is also attractive to investors looking to minimize the risk of market volatility. By investing in a particular product's royalty or revenue stream, the investment is directly tied to the underlying economics of the product. While an investor certainly takes on the risk of such product's commercial failure, the investor is less susceptible to general market volatility (including, for example, the market over or undervaluing a particular piece of news or fluctuations from current political conditions) that can directly affect the value of an equity investment.

Unique Commercial Aspects

Flexibility

Royalty financing offers investors the flexibility to structure agreements in ways that are tailored to their investment goals. Development financing deals, in particular, have fairly bespoke contracts and provide the opportunity for creative structuring.

For example, royalty payments in these types of transactions may be treated as consideration for entering into debt financing. Recently, Mannkind Corporation executed a development financing agreement and related debt facility with Deerfield Private Design Fund II, L.P. ("Deerfield") and Horizon Sante FLML SARL. The debt financing was broken down into four tranches and provided Deerfield with the option as to whether it would fund later tranches if certain conditions were not met (including, for example, conditions relating to drug trial results and FDA approval). In exchange for this flexibility, Mannkind's royalty payments to Deerfield would decrease if Deerfield elected not to fund a debt tranche. This type of mechanism allows the parties to adjust the economic terms and risk profile of a deal over time as development progresses and more information regarding the product and its likelihood of success becomes available.

Development financing agreements may also include other arrangements designed to protect investors. For example, PDL BioPharma's financing of Ariad Pharmaceuticals's Iclusig drug provided PDL BioPharma with a put option obligating Ariad Pharmacuetical to repurchase the royalty payments upon exercise of the option if certain conditions were met (including the company's bankruptcy, a change of control or the company's failure to make royalty payments within a specified time frame). Ariad Pharmaceutical also granted PDL BioPharma a security interest in the royalty payments and certain patent rights, among other collateral. These types of backstops allow investors to hedge the risk of relying solely on a product's uncertain future revenues (particularly when the royalty supplier has weak growth or is pre-revenue).

Although royalty monetization agreements are far more uniform in terms than development financing agreements, there is flexibility here as well. In most royalty monetization agreements, the purchaser obtains the entire royalty stream, but the agreement can be structured for the royalty supplier to retain a certain percentage of the royalty payments and/or the milestone payments. In a recent deal between Agenus Royalty Fund LLC, Agenus Inc. and Xoma (US) LLC, for example, Agenus purchased only 33% of the royalty payments and 10% of future milestone payments.

A Middle Ground for Risk and Reward

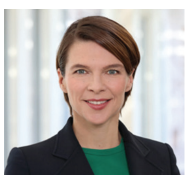
Royalty financing transactions typically do not include guaranteed minimum payments. In this sense, royalty financing is riskier than debt financing, which (assuming no default by the borrower) guarantees repayment plus interest. Because of this risk, royalty financing can ultimately be more expensive for the royalty seller than traditional debt financing. On the other hand, royalty financing agreements do not typically include a payment cap on the total amount of royalties payable to the investor. This type of transaction thus provides the potential for significantly higher returns than those provided by traditional debt instruments. That said, because the return is still based off a fixed percentage of sale, one would not expect a royalty financing transaction to generate the outsized returns sometimes seen from early-stage investment, particularly if the target ultimately undergoes an IPO. As such, royalty financing can frequently be thought of as a middle ground between the two traditional financing poles of guaranteed return on investment of debt and the potential for very high returns from early-stage equity.

Tax Considerations

Royalty financing transactions also raise a number of tax considerations, depending on the terms of the transaction. Because royalty financing transactions may contain elements of both a sale and of a financing transaction or a license, careful analysis is necessary to determine the tax treatment of payments. These issues are particularly acute in cross-border royalty financing transactions, where withholding taxes can apply and diminish the returns to investors. If the business terms allow for it, tax practitioners sometimes try to classify royalty financings as loans, where the rules governing issues such as cost recovery and withholding taxes are more predictable.

ESG Developments in Europe

The European Commission's Disclosure Regulation will require funds to disclose the methods they use for incorporating sustainability risks into their investment decision-making. Importantly for non-EU private equity funds, the Regulation will affect many European-based private equity investors, such as occupational pension schemes.



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Prospective investors now routinely ask searching questions about a private equity firm's approach to environmental, social and governance (ESG) issues, and many firms have developed detailed policies that address these investor requests. However, in Europe at least, policy-makers are catching up. Since the launch of the European Commission's Action Plan on financing sustainable growth in 2018, European regulators have taken steps to put responsible investment principles on a legislative footing. This year we have seen significant progress towards the adoption of specific legislation and the first concrete changes are likely to be effective in 2021.

From a private equity perspective, the Disclosure Regulation – now agreed to by the EU's various law-making institutions – will have the most immediate impact. This will require all fund managers to publish the methods they use for incorporating sustainability risks on their websites. The Regulation makes a distinction between sustainability "risks," which could impact the value of an investment, and sustainability "impacts," those factors with wider societal consequences which may reach beyond specific investments to affect society at large. All managers are required to disclose their approach to value items, while smaller fund managers will have the option to say that they do not take account of wider societal consequences (and clearly explain their reasons for not doing so). The requirement to make these disclosures will, inevitably, catalyze a behavioral change for some.

Private equity fund managers – including those outside of Europe who may not be directly affected by this change – will also be indirectly affected because of the regulations that affect their investors. Many significant European investors in private equity funds, such as EU-based occupational pension schemes, are covered by the Disclosure Regulation. This will increase the attractiveness of private funds that themselves comply with these disclosure rules, or are at least those that are able to satisfy the investors' enhanced due diligence requirements. EU-based insurers, also significant investors in private equity, are subject to a separate initiative that will mandate consideration of sustainability risks in their investment processes. Changes to the Solvency II Directive will clarify that the "prudent person" principle that underlies insurers' investment decisions can take into account sustainability risks such as climate change.

Under the Disclosure Regulation, firms that launch "sustainable" products – broadly, products that explicitly aim to have a positive impact on ESG issues as part of their objective – will be required to make enhanced disclosures. In particular, where firms designate an index as a suitable benchmark for the product's objectives, the firm will need to justify the choice of index, while firms that do not use a benchmark index will need to explain why they do not. Products that aim to reduce carbon emissions must benchmark themselves to the Paris Climate Agreement's global warming targets.

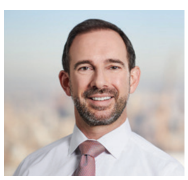
> "Recent work on the Taxonomy Regulation revealed significant differences of opinion between EU countries regarding which activities should be considered environmentally sustainable, with nuclear energy being particularly contentious."

This year also saw work on the Taxonomy Regulation, another initiative of the Action Plan. The Taxonomy Regulation is an ambitious attempt to establish a classification system and common language for describing economic activities that are considered environmentally sustainable for investment purposes. However, a recent publication by the Council of the European Union, which represents the member states, revealed interesting political differences regarding which of the activities should be considered to be environmentally sustainable, with some member states strongly arguing against the inclusion of nuclear energy. It is now unclear when the Taxonomy Regulation will be finalized, since the Council has pushed the target date back to 2022. However, if ultimately adopted, the EU's taxonomy could become the basis for investor mandates and may be used as a global reference point.

The European Commission says that its Action Plan is aiming to refocus the financial services industry on financing the European and global economy "for the benefit of the planet and our society." With their focus on disclosure, these reforms may not lead to wholesale changes in investor or manager behavior, but are likely to focus the minds of many market participants focused on the ESG issues that arise from their investment activity, and will at least ensure that investors consider these issues when making investment decisions.

The Return of Regulation FD Enforcement: Implications for Private Equity

The recent settlement of the SEC against pharmaceutical company TherapeuticsMD for violations of Regulation FD serves as a reminder of the importance of compliance programs, monitoring and training for this regulation at a time when the SEC had placed a priority on protecting Main Street investors.



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On August 20, 2019, the U.S. Securities and Exchange Commission ("SEC") announced that it had settled charges against TherapeuticsMD, Inc., a Florida-based pharmaceutical company, for violations of Regulation Fair Disclosure ("Regulation FD") following the company's sharing of material, non-public information with sell-side research analysts without also disclosing the same information to the public.

This action offers important takeaways for public portfolio companies and their officers and directors subject to Regulation FD. Private equity firms that control or invest in public companies will also benefit from these observations.

TherapeuticsMD's Violations of Regulation FD

Adopted by the SEC in 2000, Regulation FD prohibits the selective disclosure by a public company and persons acting on its behalf (e.g., directors, executive officers and investor relations professionals) of material, non-public information about the company or its securities to certain persons (in general, securities market professionals and holders of the company's securities who are likely to trade on the basis of the information), without concurrently making widespread public disclosure. An intentional selective disclosure must be accompanied by a simultaneous public disclosure, while an unintentional selective disclosure must be followed "promptly" by a public disclosure.

The SEC found that TherapeuticsMD made selective disclosures concerning TX-004HR, a hormone drug therapy, on two separate occasions while the therapy's new drug application was under review by the Food and Drug Administration ("FDA").

The first selective disclosure occurred in June 2017. Following initial indications of deficiencies with the drug application, TherapeuticsMD publicly announced that it would meet with the FDA on June 14, 2017, to discuss advancing the review process. The next day, a TherapeuticsMD executive sent a series of emails to sell-side research analysts that described the meeting as "very positive and productive," without a simultaneous disclosure by the company of this information to the public. After the publication of research reports reflecting this information, the company's stock price closed up 19.4% on June 16.

The second selective disclosure occurred a month later. Early in the morning of July 17, 2017, TherapeuticsMD issued a press release and filed a Form 8-K which disclosed that the FDA meeting had enabled the company to present "new information" to address the FDA's concerns, but which did not provide any details of the new information. In response to this disclosure, the company's stock price fell 16% in pre-market and early trading. That same morning, during a pre-scheduled call with sell-side analysts, TherapeuticsMD executives discussed the new information submitted to the FDA in support of the application and its relevance to the overall safety of TX-004HR. Each of the analysts then published research notes that included the detailed information submitted to the FDA that had been discussed on the call, in several cases repeating the company's positive conclusions about the studies' safety implications for TX-004HR. The company's stock rebounded, finishing down only 6.6% by market close. TherapeuticsMD did not publicly disclose the information it revealed to analysts for another two weeks, during its August 2017 earnings call.

The SEC found that on both occasions TherapeuticsMD failed to simultaneously publicly disseminate the material information in accordance with Regulation FD, thus placing the investing public at a disadvantage relative to the analysts and their subscribers who were privy to the selective disclosures. The SEC charged the company with violations of Section 13(a) of the Exchange Act and of Regulation FD, and imposed a monetary penalty of $200,000.

> "The TherapeuticsMD action represents the SEC's first case focused solely on Regulation FD in nearly six years and could well signal a renewed interest by the agency in combating selective disclosure."

Takeaways for Public Portfolio Companies and Their Officers and Directors

The SEC's action against TherapeuticsMD holds three key lessons for the leaders of, and investors in, public portfolio companies.

Prepare for continued interest by the SEC in Regulation FD enforcement. While the TherapeuticsMD action represents the SEC's first case focused solely on Regulation FD in nearly six years, it could well signal a renewed interest in combating selective disclosure, particularly given the ongoing priority the agency has placed on protecting retail investors.

Implement and maintain effective policies, procedures and training. TherapeuticsMD's violation of Regulation FD was compounded by the SEC's finding that the company did not have compliance policies or procedures for Regulation FD in place prior to the violation. In contrast, note that in 2013, the SEC chose not to bring a Regulation FD enforcement action against First Solar Inc. (but instead only against the company officer who had violated Regulation FD) in part due to the company's "environment of compliance" prior to the violation.

Public portfolio companies should implement, periodically review and, if necessary, update their Regulation FD policies, procedures and training for officers, directors and employees authorized to communicate with the financial community and investors. Senior management, directors (including private equity professionals sitting on the boards of public portfolio companies), in-house counsel and other key personnel should be informed of company policies, procedures and limits on communicating material, non-public information. While intentional or negligent violations of a company's policies and procedures may still occur, substantive compliance policies and procedures can protect a company from civil and administrative SEC proceedings as well as the attendant reputational harm.

Develop a response plan and consider cooperation.

Regulation FD covers both intentional and unintentional disclosures of material, non-public information. In the event of an unintentional selective disclosure, Regulation FD requires the company to make a public disclosure as soon as reasonably practicable, but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange (regardless of where or whether the company's stock is traded), in each case after a senior company official learns of the disclosure.

If an unintentional selective disclosure occurs, time is thus of the essence. Public portfolio companies should have a plan ready to implement that provides for prompt corrective measures. A company may wish to designate the general counsel or another key employee as the point person for receiving notifications of inadvertent disclosures. Directors, officers and other company spokespersons should be encouraged to contact that person immediately in the event of an unintentional selective disclosure.

> "If faced with an SEC investigation, public portfolio companies should consider cooperating with the SEC to reduce or avoid penalties. First Solar, for example, avoided being charged due to its self-reporting and 'extraordinary cooperation' with the subsequent investigation."

If faced with an SEC investigation, public portfolio companies also should consider cooperating with the SEC to reduce or avoid penalties. In issuing a penalty against TherapeuticsMD, the SEC credited the company for its subsequent remedial action, including its implementation of policies and procedures for compliance with Regulation FD and its establishment of review protocols for external communications. Similarly, First Solar avoided charges by the SEC due to its decision to self-report the company officer's misconduct to the SEC and its "extraordinary cooperation" with the investigation.

Debevoise & Plimpton

Debt Tender and Exchange Offers: The Basics

Restructuring debt through tender or exchange offers can be an attractive option for companies in financial distress. Even if the offer is unregistered, however, there are numerous legal, strategic and logistical factors to be navigated if the offer is to be a success.

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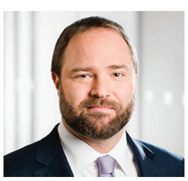

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Introduction

A company experiencing financial distress or seeking to rationalize, refinance or simplify its debt capital structure may utilize various transactional approaches to restructure its existing indebtedness. Liability management transactions, typically involving a cash tender offer or exchange offer, are commonly employed in support of such restructuring efforts. Companies considering such a restructuring, however, need to keep in mind a range of legal, strategic and logistical considerations directly relevant to the conduct and execution of a cash tender offer or exchange offer.

In its simplest form, a debt tender offer is an offer, typically by the issuer, to purchase all or a portion of its outstanding debt securities for cash at a price specified by the offeror. Similarly, an exchange offer (which is also technically a tender offer) is an offer, typically by the issuer, to exchange a holder's existing debt securities for new equity or debt securities of the offeror or other consideration (or a combination thereof). The legal rules governing, and the mechanical processes underlying, cash tender offers and exchange offers are substantially similar, with certain differences highlighted below. This article focuses only on debt tender offers, and does not discuss equity tender offers to which a different set of rules apply.

Tender Offer Defined

The securities laws do not define the term "tender offer," and the Securities and Exchange Commission ("SEC") and courts must look to the specific facts and circumstances to determine if one exists. The SEC has advised, and courts have adopted, the following eight factors as relevant in determining the existence of a tender offer: (i) the active and widespread solicitation of public security holders, (ii) the solicitation to purchase a substantial percentage of the securities, (iii) the offer to purchase the securities at a premium over the prevailing market price, (iv) the terms of the offer are firm rather than negotiable, (v) the offer is contingent on the tender of a fixed minimum number of securities, (vi) the offer is open for only a limited period of time, (vii) the offerees are pressured to sell and (viii) the public announcement of the purchasing program precedes or accompanies a rapid accumulation of securities.[1]

These factors provide companies, as well as the SEC and courts, with guidelines to determine whether the rules governing tender offers should be, or should have been, followed with respect to a particular transaction or series of transactions. While no single factor is determinative, it is unclear how many factors must be

1. *See Wellman v. Dickinson*, 475 F. Supp. 783, 818-26 (S.D.N.Y. 1979); and *see, e.g., SEC v. Carter-Hawley Hale Stores, Inc.*, 760 F.2d 945, 950-53 (9th Cir. 1985); *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); and *DeBartolo Group, L.P. v. Jacobs Group, Inc.*, 186 F.3d 157 (2d Cir. 1999).

present for a particular transaction (or series of transactions) to constitute a tender offer.

Complying with Securities Laws

An examination of the regulation of cash debt tenders or exchange offers begins with Section 14(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which includes the general anti-fraud provision applicable to tender and exchange offers and grants the SEC power to create rules applicable to tender offers. While most of the rules promulgated by the SEC in this area apply to *equity* tender offers, one rule, Rule 14e-1, provides the basic framework for conducting and completing a cash tender offer or exchange offer for debt securities, with many specific practices developed under an extensive regulatory mosaic, including formal and informal guidance issued by the SEC and its Staff, as well as commonly utilized and agreed market structures and approaches.

Securities Act Registration. The registration requirements of the Securities Act of 1933, as amended (the "Securities Act") are inapplicable to cash tender offers. However, to the extent that securities form any or all of the consideration offered by an issuer to outstanding holders in connection with an exchange offer, the offer of such securities must be registered under the Securities Act absent an applicable exemption. Companies commonly utilize available exemptions from Securities Act registration under Regulation D, Section 4(a)(2) and Regulation S of the Securities Act. Section 3(a)(9) of the Securities Act may also provide an exemption from registration for use in connection with an exchange offer, but is often not of practical use because it requires that no commission or fee is paid for the solicitation, a requirement that cannot be met if, as typical, a dealer manager is utilized.[2]

Unregistered exchange offers typically can be completed more quickly and at less expense than an SEC-registered exchange offer, as they avoid SEC review and, while subject to the general anti-fraud provisions of the Exchange Act, are not subject to line item disclosure requirements. In order to qualify for an exemption, the offer typically is limited to accredited investors or institutional accredited investors, qualified institutional buyers ("QIBs") and/or non-U.S. persons. In particular, since a company generally may not engage in any "general solicitation," the offering document cannot simply be broadly disseminated or sent to all holders if retail investors hold the securities. Rather, the company may need to pre-qualify holders through the use of eligibility questionnaires or by having investors provide representations (including in any support agreement) that they are accredited investors, QIBs or non-U.S. persons, as applicable, prior to sending materials that could constitute an offer.

> "The company should carefully consider what types of material non-public information will be shared with investors in pre-offer negotiations since those investors will require all such information to eventually be made public."

Timing Considerations. Rule 14e-1 includes basic requirements regarding the length of time that a tender or exchange offer must be held open (and potentially extended) that must be factored into the execution planning for any restructuring plan. Broadly speaking, tender offers must be held open for a minimum of 20 business days to allow investors holding the tendered-for securities to consider the offer and decide whether they will participate.[3] For purposes of Rule 14e-1, a tender offer is deemed to have commenced on a particular day so long as the tender offer materials are sent to holders by 11:59 p.m. and must expire no earlier than at midnight on the 20th business day.[4]

2. Section 3(a)(9) has a number of requirements, including that the new securities are issued by the same issuer as the old securities, security holders are not asked for any consideration other than the old securities, the offer is made exclusively to the issuer's existing holders and no commission or fee is paid for the solicitation.

3. *See* 17 C.F.R. §240.14e-1(a) (2015).

4. *See* 17 C.F.R. §240.13e-4(a)(3) and (4) (2015).

Once the offer period commences, however, any changes to the terms of the offer may result in an extension of the 20-business-day period. For example, if there is an increase or decrease in the amount of securities being sought (in the case of an increase, if the additional amount of securities sought exceeds 2% of the subject securities outstanding) or in the consideration offered, the tender offer must remain open for at least 10 business days following the change.[5] Other material changes may require that the offer remain open for at least five business days from the date of the change.[6] Note that any time remaining in the original offer period counts toward these duration requirements. For example, a change in price made on Day 9 would not require an extension of the original expiration date because, for a tender offer not being conducted as an abbreviated 5-Day Tender Offer (as defined below), the expiration of such tender offer will occur at least 11 business days later under the terms of the offer satisfying the rule.

A narrow exception to Rule 14e-1's 20-business-day timing requirement was created by a 2015 SEC no-action letter.[7] The letter set the minimum offer period for a tender offer in respect of certain non-convertible debt securities, regardless of rating, at five business days. This exception to the basic 20-business-day rule, however, is subject to a number of limitations that may be challenging for a financially distressed company to meet, including that the offer may not be made: (i) in connection with a consent solicitation, (ii) if a default or event of default exists under the indenture or (iii) if the company's directors have authorized discussions with creditors regarding a consensual restructuring. Unlike an equity tender offer, withdrawal rights in a debt tender or exchange offer are not required by Rule 14e-1, although the SEC noted that in a 5-Day Tender Offer withdrawal rights are required for a specified period.

Additional timing complexity may be present to the extent that the company plans to conduct an exchange offer and the company's financial statements will go stale during the pendency of the offer. Even if such an exchange offer is conducted as a private placement, a dealer manager may require delivery of a "comfort letter" by the company's auditors and/or delivery of a negative assurance letter by outside counsel and delivery of such letters will be inhibited to the extent that the company's financial statements go stale prior to the expiration of the offer. Further, even in the absence of such delivery requirements, basic disclosure liability principles may necessitate that the stale financial statements be updated prior to the expiry of the offer.

Liability and Duties. Section 14(e) of the Exchange Act and the rules promulgated thereunder also establish liability for fraud or manipulative acts in connection with an offer.[8] Tender offers are also subject to the general anti-fraud provisions of the Securities Act, including Section 10(b) and Rule 10b-5 promulgated thereunder, which prohibit the use of materially misleading statements or omissions in connection with the purchase or sale of a security.[9] In addition, if the debt securities that are subject to the tender offer were registered with the SEC, the Trust Indenture Act of 1939, as amended, also provides important protections for the holders of such debt

5. 17 C.F.R. §240.14e-1(b) (2015).

6. *See* Regulation of Takeovers and Security Holder Communications, Exchange Act Release No. 34-42055 (Oct. 22, 1999), available at http://www.sec.gov/rules/final/33-7760.htm.

7. SEC No-Action Letter, "Abbreviated Tender or Exchange Offers for Non-Convertible Debt Securities" (available Jan. 23, 2015), available at http://www.sec.gov/divisions/corpfin/cf-noaction/2015/abbreviated-offers-debt-securities012315-sec14.pdf. A tender offer conducted pursuant to such no-action letter, an abbreviated "5-Day Tender Offer".

8. Section 14(e) prohibits an offeror from making any untrue statement of a material fact, or omitting to state any material fact necessary to make the statements made, in light of the circumstances in which they were made, not misleading. Section 14(e) also prohibits any fraudulent, deceptive or manipulative acts in connection with a tender offer. To state a claim under Section 14(e), which has been interpreted to include a private right of action, the plaintiff must prove that he or she relied on the statement, that the fraud proximately caused his or her loss and that the defendant acted willfully or recklessly.

9. Rule 10b-5 also prohibits the use of deceptive devices to buy or sell a security. Investors have a private right of action under Rule 10b-5, and such suits are common in the world of securities litigation. The scope of Rule 10b-5 liability also covers a wide range of participants, including companies and their employees. If successful, plaintiffs may obtain remedies including compensatory damages and rescission.

– namely against the impairment of rights to the principal of, and interest on, the debt.

The Offer – Mechanics

There are also numerous mechanical aspects to consummating a tender or exchange offer. It is generally recommended to retain a dealer manager to manage the exchange, including the pre-screening and solicitation of holders. In an exchange offer, dealer managers, who play a role similar to underwriters in a registered transaction, commonly undertake due diligence and require delivery of comfort letters and negative assurance letters. In certain circumstances, such as when the securities are held in physical form, when the securities are sufficiently concentrated among a known group or the exchange will be privately negotiated with, and only open to, a limited subset of holders, it may be possible to proceed without a dealer manager. In these situations, the company and their counsel (often with the assistance of a financial advisor) may prefer to manage the exchange themselves, including the mechanics required by the trustee. If the existing securities, the new securities, or both are or will be DTC eligible, however, engaging a dealer manager to assist in coordinating the DTC process can be beneficial. In fact, it is likely necessary to use a DTC participant to qualify the new securities to trade through DTC.

It is also customary to retain an information and exchange agent who will provide information to noteholders, answer questions and assist noteholders with tendering securities. If existing securities are certificated, holders will be required to tender the physical certificates. More typically, securities will be held through DTC, in which case tenders may be completed electronically via DTC's Automated Tender Offer Program ("ATOP"). In each case, a dealer manager and information agent will provide assistance to an investor's personnel tasked with completing the mechanics necessary to consummate a tender or exchange. In our experience, engaging experts to facilitate this process can be more efficient than leaving it to the company or counsel to manage.

> "Directors and officers of a corporation in financial distress should consider the impact of actions on all stakeholders and exercise their judgment in an informed, good-faith effort to maximize the corporation's long-term wealth-creating capacity."

In handling execution mechanics, companies need to take into account the tendency of holders to wait to tender securities until the final days of the offer period. This occurs for a number of reasons, not least of which is administrative, as the individuals responsible for completing the tender mechanics at the holder are most likely different from the people who made the original investment or with whom the company negotiated the transaction. Where ATOP is used, DTC creates a "contra-CUSIP" for each option an investor may choose when responding to the offer. Once tendered, securities are shifted into the appropriate contra-CUSIP, temporarily suspending the transferability of the securities. Due to the length of time an offer must be held open, holders are unlikely to accept the market risk inherent in tendering their securities, and limiting their transferability, until the last possible moment.

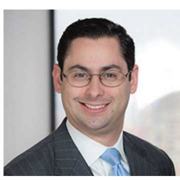
Conclusion

Liability management is an essential part of a company's financial toolbox and many restructuring and refinancing options exist. Anticipating liquidity shortfalls or other financial distress and actively managing the capital structure can provide a company with sufficient time to avoid a bankruptcy and restructure their capital structure through a consensual transaction.

The Devil in the Details: MFN Provisions and the Financing of Add-On Acquisitions

> "A borrower faced with the possibility that the financing of an add-on acquisition may result in a repricing of existing debt may be able to avoid that outcome by structuring the transaction to fall under an exception or limitation to the MFN provisions."

Jeffrey E. Ross
Partner



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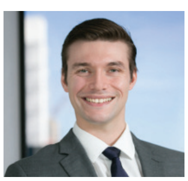

Nathan T. Frost
Law Clerk

When a private equity shop acquires a new business, it rarely stops there. Instead, the firm builds momentum around its new portfolio company like a snowball rolling downhill, expanding and growing the business through add-on acquisitions of complementary enterprises. Doing so, however, requires capital. Fortunately, credit facilities typically contain incremental (or "accordion") provisions that allow borrowers to finance add-on acquisitions under existing financing agreements. While many borrowers take advantage of this opportunity, there are numerous factors to consider before doing so – particularly regarding the so-called Most Favored Nation ("MFN") provisions applicable to incremental credit facilities.

Incremental Debt Capacity and MFN Provisions

When financing an add-on acquisition through an incremental credit facility, the additional indebtedness may take the form of additional term debt or increased revolving commitments. While there are several nuances to incremental debt capacity and variations in market practice, many modern credit facilities contain three primary incremental baskets:

- **A cash-capped basket** that permits the borrower to incur incremental indebtedness of up to the greater of either *(i)* a set dollar-threshold or *(ii)* a percentage of trailing twelve months ("TTM") EBITDA;
- **A ratio-based basket** that permits the borrower to incur unlimited indebtedness, so long as the borrower is in pro forma compliance with a pre-determined leverage ratio; and
- **A voluntary-prepayment basket** that recaptures borrowing capacity by permitting the borrower to incur incremental indebtedness in an amount equal to the amount of voluntary prepayments made on or prior to the date of such incurrence (in the case of voluntary prepayments of revolving loans, such prepayments must be accompanied by a corresponding permanent reduction in the revolving commitments).

Modern credit facilities for syndicated loans give borrowers the option to document the terms of any indebtedness incurred under the incremental provisions as either *(i)* an increase in the size of an existing tranche of indebtedness, *(ii)* a new stand-alone tranche of indebtedness under the existing credit facility or *(iii)* a new tranche of indebtedness documented under a separate credit facility. If incremental indebtedness will be documented under a separate credit facility, many credit facilities provide borrowers with additional flexibility and may permit such debt in the form of notes or loans.

In exchange for the increased flexibility to incur additional indebtedness, borrowers are commonly asked to provide lenders with MFN pricing protection. This gives lenders the comfort that if the all-in yield of the incremental indebtedness exceeds the all-in yield of the existing loans by a pre-determined spread, the interest rate margin of the existing loans will be increased to ensure that the all-in yield of the existing loans remains within that spread. The all-in yield often includes margin, interest rate floors, upfront or similar fees or original issue discount shared with all financing providers, but excludes the effect of any arrangement, commitment, underwriting, structuring, syndication or other fees payable in connection with the incremental financing that are not shared with all such providers.

The application of MFN provisions vary from agreement to agreement in terms of scope, duration and types of indebtedness to which they apply. A savvy borrower will fully understand the circumstances in which the financing of an add-on acquisition could trigger the MFN protections of its credit facility and potentially result in a repricing of the existing indebtedness. Indeed, the specter of such a repricing should give pause to any borrower considering this financing approach. The cost associated with a repricing could even alter the expected return on investment from the add-on acquisition to the point that the investment is no longer justified. Further, the additional burden of determining in real time the implications of MFN provisions can put a potential acquirer at a disadvantage in a fast-moving acquisition scenario. Borrowers should therefore ensure that they have carefully thought through the potential impact that MFN provisions may have on the cost of capital associated with the financing of add-on acquisitions.

> "In exchange for the increased flexibility to incur additional indebtedness, borrowers are now commonly asked to provide lenders with MFN pricing protection that keeps the all-in yield of the original indebtedness in line with that of subsequent financing."

Possible Variations in MFN Provisions

Perhaps not surprisingly, the terms of the MFN provisions are often one of the most heavily negotiated components of a credit facility, with lenders seeking to have the MFN apply to all incremental indebtedness and borrowers seeking to limit its application as much as possible. While it is generally the case that the MFN provisions will be triggered if the all-in yield of the newly issued tranche of *pari passu* indebtedness exceeds the all-in yield of the existing indebtedness, there can be exceptions and limitations. Some of the most common include:

- **MFN Cushion Size:** Typically, MFN provisions are only triggered if the all-in yield of the newly issued tranche of indebtedness exceeds the all-in yield of the existing indebtedness by more than 50 basis points. In recent deals, some sponsors have increased the cushion from 50 basis points to 75 basis points.
- **Interest Margin Only:** Here, the MFN is based on interest rate spread alone rather than the all-in yield. This approach allows issuers to structure financings so that the interest rate spread will not trigger the MFN, even if the all-in yield of the newly issued indebtedness greatly exceeds the all-in yield of the existing indebtedness (*e.g.*, when issuing debt with high levels of original-issue discount).
- **MFN Sunsets:** With this provision, MFN only applies to indebtedness issued within a certain time period – often from 6 to 24 months – following the issuance of the existing indebtedness.
- **Maturity Date Limitations:** This clause limits the MFN only to incremental that matures within a specific period outside of the existing indebtedness.
- **Currency Limitations:** Here, the MFN applies only to indebtedness denominated in the same currency.
- **Interest Rate Limitations:** Many MFN provisions include exceptions for indebtedness that accrues interest at a fixed rate.
- **Incurrence Limitations:** This clause restricts MFN provisions only to indebtedness that is incurred under certain baskets. For example, a common formulation is for indebtedness incurred under a ratio-based incremental basket to be subject

to the MFN, while indebtedness incurred under the cash-capped incremental basket is not.

- **Use of Proceeds Limitation:** Some credit agreements do not apply the MFN if the use of proceeds is to finance a "Permitted Acquisition."
- **Basket Exceptions:** Recently, we have seen credit agreements include an exception that permits the borrower to incur an agreed amount of additional indebtedness without triggering the MFN, regardless of the all-in yield of that indebtedness. These baskets can be sized at up to 100% of TTM EBTIDA.
- **Syndication Limitation:** Many MFN provisions apply only to indebtedness that is syndicated, thus creating an exception for indebtedness that is privately placed or provided by "buy and hold" investors.
- **Security Limitation:** A near-universal exception provides that the MFN applies only to indebtedness that is secured on a *pari passu* basis with the existing indebtedness.
- **Documentation Limitations:** Some MFN provisions include exceptions for indebtedness documented either under a separate credit agreement or as a note or security.

In most cases, a given credit agreement will only include some of these exceptions. For committed financings, the MFN exceptions are often subject to "market flex," which allows the arrangers to modify or remove the exceptions to the MFN in order to help facilitate syndication of the underlying indebtedness.

How Borrowers Can Manage MFN Provisions

A borrower faced with the possibility that the financing of an add-on acquisition may result in a repricing of existing debt may be able to avoid that outcome by structuring the transaction to fall under an exception or limitation to the MFN provisions.

For example, some borrowers with a security limitation in their MFN have issued 1.5 lien debt. In this debt structure, the add-on lenders' position is senior to any junior lien or unsecured indebtedness, but junior to the pre-existing indebtedness. While this strategy carries an economic cost, as 1.5 lien debt is more expensive than first lien debt, the cost savings associated with avoiding triggering the MFN may make the greater expense of the debt acceptable.

We have also seen borrowers structure loans so that a portion of the fees payable in connection with the debt issuance takes the form of structuring or arranging fees – thus excluding the fees from the calculation of all-in yield. This structure is primarily available if the financing is provided by "buy-and-hold" investors, but is unlikely to be successful in the case of a syndicated debt issuance.

A more common method of sidestepping MFN provisions is to either structure the indebtedness as a security or have the indebtedness incur interest at a fixed rate. By issuing a secured bond, the borrower will be able to issue indebtedness that is secured on a *pari passu* basis with the existing indebtedness but may be able to avoid the MFN if the MFN then applies only to indebtedness issued in the form of term loans. The same logic applies to the issuance of indebtedness that accrues interest at a fixed rate of interest. However, prior to pursuing a bond issuance as part of one's acquisition financing, the issuer should ensure that both it and the target company have prepared any necessary historical financial data. Without ready access to this information, it may not be feasible to launch a bond offering in the 144A market.

The MFN provisions contained in a borrower's existing credit documentation can significantly affect the viability of accessing an incremental credit facility to finance add-on acquisitions. As outlined above, savvy borrowers may be able to structure a financing to avoid an MFN provision, if proper forethought is given in the initial drafting and negotiation of the MFN provision. However, many lenders have come to view MFN protection as a sacred right and, therefore, borrowers should consider the impact that any transaction structured around an MFN provision might have on its ongoing relationship with its debt investors, including in connection with future refinancings or incremental financings. In addition to the strictly contractual considerations, a sophisticated borrower should also consider how the borrower's existing creditors would view such a structure and how that might impact execution of the current or future syndication.

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