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From the Editors

At the end of 2020, many regarded the extraordinary resiliency shown by both the economy in general and private equity in particular and wondered if the momentum would last. As we pass the midpoint of 2021, the answer so far has been clearly in the affirmative. To be sure, the recovery is uneven across sectors, the COVID-19 threat is far from extinguished, and there may well be a cooling of the economy on the horizon as we witnessed by the volatility in the stock market this past week. But broadly speaking, fundraising, M&A and the secondaries market are all strong.

Indeed, the greatest source of uncertainty for private equity today comes not from market conditions but from the regulatory changes being discussed or enacted in Washington, Westminster and Brussels. The Biden administration has revived the debate on the tax treatment of carried interest, encouraged a tougher line on non-competes, strengthened CFIUS' enforcement capabilities and is promising heightened antitrust scrutiny. In the UK, a public consultation on the tax treatment of asset holding companies is underway. In Europe, the Sustainable Financial Disclosure Regulation has been enacted, and the Mandatory Human Rights Due Diligence law is moving through the pipeline. Staying ahead of this level of regulatory flux will require both stamina and agility for private equity firms.

We hope that you find this edition of the Private Equity Report Mid-Year Review and Outlook to be a useful summary of the current state of the market and of the notable developments in the regulatory landscape.

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Buoyed by the initial vaccine rollout and increased confidence that the end of the pandemic was in sight, private equity fundraising had a strong finish to 2020. That solid foundation set the stage for further investor interest and confidence in private equity in 2021, fueled by a combination of strong returns, innovative investments, low interest rates and elevated valuations in the public markets. In fact, the first half of 2021 saw a record number of funds in the market. Much of that activity was led by a few mega-funds and successor funds—including CD&R Fund XI, Silver Lake Partners, Apax Partners, New Mountain Capital and Genstar—that have soaked up a significant share of this year's fund commitments. But emerging managers and managers raising smaller funds are enjoying success as well, as travel restrictions are lifted and the fundraising ecosystem adapts to virtual due diligence and relationship building—providing multiple channels through which fundraising can take place. These trends are expected to continue throughout the year.

While generalist funds dominate the market, private equity firms—including the larger generalist firms—are also raising significant specialist funds, driven by heightened competition to seek top returns with sector- and subsector-specific offerings. For example, growth sectors like technology and healthcare were popular during the first half of the year. These trends are expected to continue, as more firms begin offering specialist and high-growth products. There has also been continued focus on private credit funds, with both increased interest from sponsors and investors, as well as growing differentiation within credit funds in terms of investment strategies by underlying sectors, asset classes, level of the capital structure and risk-reward profile, among other variables.

Private equity firms continue to focus on tapping into insurance company capital. Private equity sponsors are investing in insurance and reinsurance companies as well as attracting significant insurance company investors. Private equity and insurance companies are recognizing their overlapping interests, and several strategic private equity acquisitions of insurance companies have recently taken place.

After a turbulent year, many private equity sponsors are also focusing on ESG-driven strategies (for additional information regarding recent ESG-related trends please see the last issue of the *Private Equity Report* published in May 2021). Sponsors are also adapting to new ESG regulatory and disclosure regimes—particularly in Europe—and contending with increased focus on these matters by the SEC. With a historic and global concern for environmental, climate, social, and governance issues, private equity firms committed to these practices are seeing success responding to investor demands for corporate responsibility.

Finally, venture capital fundraising is also having a robust year and is on pace to have a record year. Like private equity, venture capital dry powder continues to expand as firms look to make investments in more developed companies.

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Secondaries get a full-throated embrace

The secondaries market activity during the first half of 2021 largely continued the themes that marked the second half of 2020: an unusually high prominence of GP-led transactions as a proportion of the overall private fund secondaries market, a surge in single asset transactions, and economic volatility continuing to complicate deal execution.

While market expectations and recent data signal a likely resurgence in traditional LP portfolio transactions, the past 12 months have demonstrated a full-throated embrace by sponsors of GP-led secondary transactions. In particular, the market share of single asset GP-led transactions has surged; this strategy is increasingly pursued as an alternative to a traditional third-party sale or IPO exit, and this trend is expected to continue. The decreased availability of traditional LP portfolio transactions has created intense jockeying among buyers for allocations in GP-led transactions, particularly in processes run by top-quartile managers. In addition, there has been a trend towards syndication among secondary investors on the buy-side of GP-led transactions, where many secondary buyers cannot, or will not, underwrite an entire transaction. The combination of these developments has led to an erosion of buyer leverage in many transactions, particularly at the top end of the market and in large and concentrated, or single asset, transactions. A seller-friendly private M&A market over the last several years—where "no indemnity" transactions have become commonplace—has similarly tilted GP-led transaction terms in favor of the sell-side.

Some differentiation, however, is beginning to appear between the top-quartile managers and those in the third and fourth quartile (and less concentrated, multi-asset continuation fund transactions), where buyers often can exercise more leverage.

Throughout the market, however, speed is critical. The pandemic highlighted how a long transaction timetable makes asset pricing based on historical figures extremely difficult during periods of high economic volatility. While a historical approach to pricing is the norm in both traditional and GP-led secondaries, GP-led transactions are more complex and rarely can be executed on accelerated timelines, increasing the risk of a stale and unattractive liquidity option being presented to current LPs. Competition with traditional M&A exits also highlights the need for speed, as a long transaction timetable heightens the possibility of third-party interlopers and broken-deal risk. With the trend towards single asset transactions in the GP-led space now well established, we expect to see more deal protection technology borrowed from traditional M&A, including post-signing exclusivity agreements, "no shop" and/or "go shop" provisions and broken-deal fees.

Though traditional primary LPs have become increasingly open to GP-led transactions as a source of liquidity, there are lingering concerns over fairness of process and transaction terms. True status quo options for existing LPs are becoming less common, with many transactions now being structured as "reinvestment" opportunities rather than real continuations of investment. Many LPs also experience difficulties with internal resource allocation because evaluation of the sell/hold decision in a complex GP-led transaction on a 20 business day election timeframe can prove challenging. We advise sponsors pursuing a GP-led transaction to proceed with caution and consult early in the process with their LPACs and key LPs lest they jeopardize larger and longer-term LP relationships.

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Building off the momentum generated during the last two quarters of 2020, 2021 saw record levels of financing activity through the first six months of the year. These activity levels have been driven by strong investor demand for debt instruments and increased deal making activity. We anticipate financing activity to remain robust for the remainder of the year.

Despite the ongoing COVID-19 pandemic, historically low interest rates and improving credit default rates have combined to continue to drive institutional investors into the credit markets. Through June 2021, investments in US CLOs are up by nearly 150 percent compared to the same period in 2020, helping to push high-yield bond and loan margins lower. Investor appetite and competition for allocations of levered loans has also contributed to the rise in issuer-friendly covenant packages—particularly for private equity sponsored credit agreements. Covenant terms that just a short time ago were reserved for only the largest and most aggressive credits now appear in the transaction documents of more ordinary course transactions.

This year has also brought a focus on ESG-linked financings from both corporate and private equity issuers—a trend that holds in both the North American and European finance markets. We expect ESG features to continue to become more common as issuers and investors continue to seek to obtain economic benefits, including margin step-downs, tied to achieving ESG-related performance indicators.

Fund finance activity has also been robust, most notably in the continued growth and evolution of products that complement or expand the traditional capital call facility. Specifically, there has been a marked increase in NAV loan activity, as private equity sponsors seek to expand their ability to apply leverage. At the same time, we are seeing an increase in the number of private equity sponsors that are using back-levered facilities to help finance investments that are not candidates for traditional LBO financing—including investments in joint ventures. These facilities often have features that are akin to a classic margin loan, but which have been reinvented to support investments in privately held companies

Looking beyond 2021, the high-yield bond markets may cool a bit due to inflationary concerns and increased speculation around the timing of any move the Fed might make to taper quantitative easing and raise interest rates. In that case, investors may be driven to the leveraged loan market and the attractive yields offered by floating rate loans. The end of 2021 will also bring with it the culmination of LIBOR as the benchmark rate, with 2022 ushering in financing's post-LIBOR era.

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The momentum that emerged in private equity dealmaking during the second half of 2020 has continued through the first half of 2021. To be sure, there are some headwinds, including increased inflationary pressures, a rising number of cyber attacks on both corporations and government agencies, and recent disruption in SPAC formation activity. Nonetheless we expect the deal market will remain hot for the balance of the year.

Looking to the remainder of 2021, we anticipate that sponsor exits will constitute a significant driver of M&A activity. Exiting sponsors have a range of alternatives, including a white-hot market for sales to other sponsors, strategic buyers looking to diversify product offerings, growing use of continuation fund structures, and IPOs or deSPAC sales. While IPOs and deSPACs don't allow for immediate monetization due to lock ups and other market considerations, they remain very viable options. Indeed, sponsor portfolio companies may get even more SPAC inbound attention as some entrepreneurs become increasingly wary of SPACs and choose to build their businesses through private financing rather than facing the immediate glare of the public markets.

Late in the first quarter, the pace of new SPAC launches slowed significantly as a result of SEC accounting queries, some bumpy market performance by deSPACed companies, and the resulting brake tapping by PIPE investors. But there are still more than 400 SPACs in the market hungry for deals, and SPAC sponsors may get increasingly creative to find them, as evidenced by the proposed Tontine/Universal Music transaction.

A development worth watching is the return of the mega LBO, as we saw in the highly competitive, $30 billion Medline transaction. The ability of a group of sponsors to unite their firepower to pursue large targets is further turbo-charged by the significant amount of capital available for deployment by sovereign wealth funds and other alternative capital providers, who have demonstrated their willingness to underwrite opportunities on very aggressive timeframes. At the other end of the target life cycle, we also see sponsors increasingly pursuing early-stage venture and growth investments, hoping to identify opportunities earlier in a company's trajectory rather than wait and fight it out in the very competitive market for established businesses.

While the market is generally hot all over, some sectors are hotter than others. Unsurprisingly, software/tech and healthcare/life sciences have dominated the first half of 2021, and post-pandemic supply chain disruptions may create deal opportunities in logistics and logistics tech support. Although final infrastructure legislation has not yet been enacted, we still believe this is a sector to watch for deal activity in coming months. In addition, the notable deals in real estate that took place during the first half of the year fueled by the powerful disruptions in that industry should continue, even as the larger economy recovers from the pandemic. Longer term, dealmakers will be watching how the FTC and DOJ implement President Biden's recent executive order regarding antitrust enforcement; more aggressive positions from the agencies in response to M&A deals with strategic acquirers could ultimately work to the advantage of private equity buyers, though could also make sponsor sales to strategic buyers more difficult.

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The combination of the COVID-19 pandemic and the start of Brexit on January 1, 2021 unleashed a wave of economic challenges and uncertainty. For private equity, however, challenges and uncertainty represent opportunity—and all the more so when there is a copious amount of dry powder at hand. So it is unsurprising that deal activity in Europe has been strong since the second half of 2020.

This has been particularly the case in the United Kingdom, where the continued depression of listed company valuations—especially when compared to private targets—has led to a proliferation of take-private transactions backed by private equity sponsors. Indeed, deals of this type represent around half of all announced public takeovers in the United Kingdom during the first half of 2021. Notable examples include KKR's recently announced recommended offer for global infrastructure company John Laing Group and Blackstone's proposed acquisition of St. Modwen Properties. We expect this trend to continue.

Uncertainty in the market has also resulted in GPs looking to utilize continuation funds as an exit option and to provide liquidity to existing investors who may also elect to roll over all or a portion of their interests into the continuation fund for exposure to future upside. Such GP-led restructurings have been used for both multi-asset and single-asset funds. Continuation funds have allowed sponsors to hold on to hard-hit investments in sectors such as hospitality, retail and travel, in the hope of a better return when the pandemic subsides. At the same time, continuation funds present an opportunity for GPs to obtain additional value from well performing investments.

There have also been a number of proposed changes to the European regulatory landscape that have had or will have an impact on deal-making. For instance, in the United Kingdom, the Financial Conduct Authority is consulting on proposed changes to the listing rules in an attempt to make London a more attractive listing venue for special purpose acquisition companies ("SPACs") following the large number of listings of such vehicles in the United States over the last 18 months. Under the new regime, SPACs would no longer be subject to suspension of trading upon the identification of an acquisition target, and investors would also have redemption rights similar to those available in the United States. Time will tell if these proposed changes have come soon enough for the United Kingdom to truly compete with the United States in this regard and to catch the "SPAC wave."

Finally, as we reported last year, European governments and regulators continue to be granted greater powers to scrutinize, and potentially block, M&A transactions on national security grounds. The latest example is the United Kingdom's National Security and Investment Act, which will introduce, when it comes into force later this year, both mandatory and voluntary notifications for transactions in sensitive sectors, ranging from military or dual-use items to digital infrastructure and artificial intelligence. Similar developments are playing out in jurisdictions across Europe, and dealmakers in this space should seek early advice, be prepared to submit national security assessments and factor the timetable for review into their overall process timelines.

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Spurred by increased vaccine availability and the continuing low interest rate environment, the Asian M&A market has regained its confidence, with the upward trajectory in deal making that began in late 2020 continuing into the first half of 2021. While the pandemic's effects on the global economy have by no means subsided, the APAC region is an attractive M&A market for superior returns and growth opportunities.

Within the region, China was the first major global economy to recover from the pandemic and continues to play a leading role economically and commercially. Certain sectors fared better during the second year of the pandemic, including industrials and chemicals, technology, healthcare and financial services. The largest deal announced thus far in the region is the $15.2 billion acquisition by Shenzhen-listed Tianshan Cement of controlling stakes in four affiliated Chinese cement companies, which resulted in Tianshan Cement becoming the largest publicly listed cement business in China.

Historically, founders of Asian companies have been more reluctant to cede control than their counterparts in the United States and Europe. As a result, non-control transactions such as significant minority stake sales, as well as growth equity-style transactions and joint ventures, continue to feature prominently in the Asia deal market. However, as these companies mature, many have started considering succession and management issues, and private equity is increasingly being seen as a preferred partner and a key path to exit—particularly in Japan, where family-owned businesses with aging founders are prevalent. Just among Tokyo Stock Exchange-listed companies, over 300 companies have significant family ownership and a chief executive officer, president and/or controlling shareholder over the age of 60. Across the region, the trend toward private-equity driven exits has been accelerated by the pandemic, as Asian founders, especially those with mid-sized businesses, come to appreciate the value of scale and the need for investment in technology in light of rapidly changing market conditions. The required additional funding and other operational resources could be readily provided by private equity firms, which are sitting on significant amounts of dry powder globally. These deals are taking a range of forms, from change-of-control to carve-out transactions.

SPACs are much less common in Asia than elsewhere, and most Asian stock exchanges have not yet allowed listings of blank-check companies. Nonetheless, mergers involving U.S.-listed SPACs may play an important role in the Asian M&A market by offering easier access to the U.S. capital markets, particularly for high-growth tech unicorns in Southeast Asia and other parts of Asia. A record-breaking recent example was the $40 billion merger of Singapore-based Grab Holdings, the ride-hailing, food-delivery and digital wallet group, with a NASDAQ-listed SPAC sponsored by Altimeter Capital. This de-SPAC transaction, the largest to date, also included PIPE funding of more than $4 billion.

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Latin America's GDP declined seven percent during 2020, and the double whammy of persistent challenges in controlling the pandemic and the region's rising political temperature is making it difficult to reverse that contraction. Despite these conditions, there has been a steady rebound in M&A activity during the first half of 2021. In Brazil, the region's M&A powerhouse, 517 M&A transactions valued at 234.7 billion Reais were completed in the first four months of the year. Those figures represent a 97 percent increase in transaction volume and a 181 percent increase in deal value compared to the same period last year. While strategic and domestic players still represent a healthy majority of deployed equity capital, local and international private equity sponsors are gradually resuming activity.

A combination of low interest rates, devalued currencies, and large amounts of dry powder raised in 2020 is encouraging sponsors to pursue deals in the hot sectors of tech, healthcare, education and banking. Deal activity in these areas is increasingly driven by a wave of industry consolidations and appetite from international investors for promising digital assets. The blurring of the lines between private equity and venture capital in the tech sector is another trend worth watching. In addition, U.S.-listed SPACs focused on Latin American assets could become significant buyers and offer additional exit opportunities for sponsors seeking liquidity in the upcoming months. These factors, combined with the region's long-lasting infrastructure gap, new investor-friendly legislation, and the expectation that vaccinations might eventually catch up across the region will offer support to the M&A market during the second half of 2021.

As in the United States and Europe, there is growing attention in Latin America to environmental, social and governance (ESG) factors. Although ESG reporting for public companies remains voluntary in most Latin American jurisdictions, regulators and local stock exchanges are focused on the topic. In 2020, for instance, stock exchanges in Mexico and Brazil partnered with Standard & Poor's to launch ESG indexes. Earlier this year, the Brazilian Securities and Exchange Commission began a public consultation to amend the ESG reporting requirements for public companies. As these trends evolve in Latin America, ESG may become part of the expanding suite of investment considerations, just as data privacy and compliance have in recent years.

We expect private equity M&A in Latin America to continue to recover during the second half of this year. However, while the IMF projects 4.6 percent GDP growth for the region in 2021, the social and economic challenges posed by the slow pace of vaccination and the rise of political risk (particularly in Brazil, Colombia and Peru) remain significant. Because upcoming elections make 2022 a politically charged year, we expect sponsors to look to complete their investments and exits during the balance of 2021.

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NYSE Amends Related-Party Transaction Approval Requirements

In April, the NYSE amended Section 314.00 of the NYSE Listed Company Manual regarding the approval requirements for related-party transactions. The changes curtail in two important ways the flexibility NYSE-listed companies previously enjoyed regarding how they approved these transactions. First the definition of "related-party transactions" no longer includes a qualifier with respect to transaction value materiality. *All* related-party transactions must now be approved, even if below the $120,000 disclosure threshold under Item 404 of Regulation S-K. Second, related-party transactions must now be reviewed in advance by a company's audit committee or another independent body of the board of directors; it is no longer permitted to ratify related-party transactions after the fact. NYSE-listed companies should review and update their related-party transaction policies and the charters of the board committees that review related-party transactions to ensure ongoing compliance with the amended rules.

SEC Chairman Gensler Announces Review of Rules Governing Trading Plans by Insiders

In June, the Chairman of the SEC announced that the SEC will be undertaking a rulemaking process relating to Rule 10b5-1 plans in an attempt to curb perceived abuses of these plans by insiders. Any new rules are likely to impose additional compliance burdens and limitations on the use of Rule 10b5-1 plans, such as a "cooling-off" period prior to the first trade under the plan, restrictions on the use of sequential Rule 10b5-1 plans, and advance disclosure of the adoption of Rule 10b5-1 plans (including potentially stricter enforcement of late Form 4 filings). Given the popularity of Rule 10b5-1 plans in the investment community and their utility as a planning tool for company insiders, it will be important to watch for the effective date of any rule changes and the extent of any available grandfathering of plans in effect before that date.

UK Tax

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A number of key tax developments have occurred in the United Kingdom during the first half of 2021. While significant legislative changes have been few, consultations relevant to funds are gathering pace. We offer some observations on these, as well as case law and international developments, below.

Finance Act 2021

The Finance Act and the related consultations and calls for evidence released on March 23, 2021, the United Kingdom's inaugural "Tax Day," were less dramatic than the fund industry had anticipated. However, the increase in the headline corporation tax rate from 19% to 25% in 2023, new provisions on business rates and the new financial institution notices are all worth noting, given their potential impact on structuring decisions and portfolio companies. There have also been welcome changes to the UK hybrid mismatch rules, which broadly reflect draft legislation of November 2020 and address anomalies in the rules raised by the fund industry.

Crucially, neither the Finance Act nor the Tax Day publications addressed the future of capital gains tax, as many expected they would, following the release of the Office of Tax Simplification late last year. Like the Finance Act, the Tax Day consultations were generally benign from a funds perspective.

Funds Consultations

There have been several consultations recently regarding proposed legislative changes directed at the asset management industry. The most notable of these was a consultation aimed at rendering the United Kingdom an attractive asset holding company jurisdiction, which concluded its second stage in February 2021. This was followed by draft legislation published for further consultation on July 20, 2021, with a view to inclusion in the Finance Bill 2022. While the draft legislation is incomplete and gives rise to a number of questions, it is promising and does address certain key areas which have caused the UK to be an undesirable asset holding jurisdiction, such as a limited participation exemption on gains and the imposition of withholding tax on interest.

In addition, a call for input on investment funds generally, released in January 2021, contains some tax elements and refers to a consultation later in the year on VAT and management fees—an area in which funds may have diverging preferences, depending on their structures.

International

With the end of the Brexit transition, UK entities can no longer rely on a number of key EU tax directives and regulations. However, the tax cost for investment funds should be largely mitigated by the United Kingdom's excellent double tax treaty network and, in the case of social security contributions, the replacement of EU rules with a new regime

Continued on page 11

UK Tax

Continued from page 10

very similar to the previous one. With the United Kingdom having effectively repealed most of DAC6, it is possible that some UK-based investment funds may view the tax consequences of Brexit as positive overall.

After their June meeting in London, the G7 finance ministers endorsed current OECD initiatives to introduce a global minimum tax and to make changes to tax allocation rules among jurisdictions in the light of the digitalisation of the economy. The G7 specified a rate of at least 15% for the global minimum but are silent on exemptions to the suggested OECD provisions—an important issue for funds. These ambitious projects are worth watching.

Case Law

A number of first-instance case law decisions regarding partnership-based incentive arrangements have been released this year that have the potential to affect investment funds, including Odey Asset Management LLP v HMRC [2021] UKFTT 31 (TC) and HFFX LLP v HMRC [2021] UKFTT 36 (TC)), and more such cases are likely to be forthcoming. These cases involved HMRC successfully invoking bespoke partnership tax provisions to combat arguably abusive situations. While the arrangements in question would fall foul of current anti-abuse law not in place at the time of the facts, the decisions are nonetheless notable for their detailed consideration of investment partnership agreements and partnership law. HMRC have clearly acquired deeper experience and knowledge of the investment funds industry and have grown more comfortable with taking an aggressive stance toward fund partnerships. Funds should be mindful of this and the corresponding greater likelihood of scrutiny; more cases are likely to be forthcoming.

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The Carried Interest Debate Returns

With President Biden's recent proposals on tax reform, the debate over carried interest is front and center again. Currently, carried interest is taxed on a flow-through basis—and often at the more favorable capital gains rates, which currently top out at 20 percent, instead of as ordinary income, which carries a top rate of 37 percent. However, for more than a decade, many have argued that carried interest should be taxed as compensation, and therefore subject to ordinary income rates. The Tax Cuts and Jobs Act of 2017 represented something of a compromise on this score, by requiring carried interest recipients to hold a capital asset for over three years to qualify for the preferential, long-term capital gains rate, rather than the one-year holding period that usually applies.

While some hoped that the Tax Cuts and Jobs Act would resolve the debate over carried interest for the foreseeable future, Biden's tax proposal has shown that hope to be short lived. Under the proposal, taxpayers with income exceeding $400,000 would have to pay ordinary income tax rates on carried interest—and the top ordinary income rate would increase to 39.6%. Taxpayers below the $400,000 threshold could still pay the lower capital gains rates on carried interest, provided that the three-year holding requirement was met. These changes would begin in 2022.

In addition to the changes to carried interest, the Biden proposal also targets capital gains more generally. The current proposal would tax long-term capital gains and qualified dividends at ordinary rates for taxpayers with an adjusted gross income of more than $1 million. However, it is possible that any final law may end up with a capital gains rate lower than ordinary rates (28% has been speculated, which would be consistent with top capital gains rates in the recent past and also mirror the proposed corporate tax rate). As proposed, the rate change would apply retroactively to April of this year.

The impact of the change to carried interest taxation will depend on the rate differential between capital gains and ordinary income, if any. Even if the rate changes are implemented exactly as proposed, carry reform will still be relevant for taxpayers with incomes between $400,000 and $1 million.

Carried interest holders and their tax advisors are in a difficult position when it comes to tax planning, since it remains unclear whether or in what form Biden's proposals will go forward. Private equity funds in the process of selling investments in 2022 may consider accelerating the timeline to bring the sale into 2021. This acceleration may benefit taxable investors of the fund by enabling them to take advantage of current-law capital gains rates, assuming any change to the capital gains rate is not retroactive. This may also have a benefit to carried interest recipients, assuming the investment has been held for more than three years. Similarly, the uncertainty around effective dates may complicate planning for private equity sponsors contemplating a GP stakes deal. However, as the ultimate fate of tax reform remains unknown, private equity investors, sponsors and their advisors will need to keep a close eye on legislative developments.

Continued on page 13

U.S. Tax

Continued from page 12

Private equity owners of management company interests also need to note the tax proposal's Medicare provisions. Under current law, business income earned through an S corporation or a limited partner interest generally is not subject to the 3.8% Medicare tax. This would change under President Biden's proposal. As a result, private equity participants could see a significant increase to their taxes on both carried interest (from 23.8% to 43.4%) and management revenue shares (from 37% to 43.4%).

Taxpayers with AGI up to $400,000	• Carried interest taxed at capital gains rate if asset held for over three years • Other capital gains taxed at preferential capital gains rate if asset held for over one year
Taxpayers with AGI between $400,001 and $1,000,000	• Carried interest taxed as ordinary income • Other capital gains taxed at preferential capital gains rate if asset held for over one year
Taxpayers with AGI over $1,000,000	• Carried interest taxed as ordinary income • Other capital gains taxed as ordinary income to the extent income exceeds $1,000,000

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Continued Legislative Efforts to Restrict Employee Non-Competes

During his presidential campaign last fall, Joe Biden vowed to "work with Congress to eliminate all non-compete agreements, except the very few that are absolutely necessary to protect a narrowly defined category of trade secrets." Little time was wasted in trying to fulfill that promise. On July 9, 2021, President Biden signed an executive order urging the Federal Trade Commission to ban or limit non-compete agreements. The proposed crack down on non-competes is one of many initiatives covered by the executive order, and it remains unclear how broad sweeping any action by the FTC in this area may be.

Congress has also signaled an appetite to regulate non-competes. In February, a bipartisan group of legislators introduced the Federal Workforce Mobility Act in both the House and Senate, which would be the first legislation of its kind at the federal level. The proposed bill would prohibit the enforcement of non-compete agreements entered into after the legislation is enacted, with the exception of those necessary to protect trade secrets or that relate to the sale of goodwill or ownership interests or to partnership dissolution or disassociation. Although the Senate has yet to take action on its bill, the House has sent its version to its Committee on Energy and Commerce and its Committee on Education and Labor. Unlike non-compete legislation enacted at the state level, the Federal Workforce Mobility Act is written broadly: it is not limited to low-wage workers, it applies to employees that were fired for cause, and it does not carve out non-solicit or garden-leave agreements from the definition of a non-compete agreement. It is unclear whether Congress is likely to pass the bill in its current state, and in light of President Biden's July 9 executive order, it seems more likely that the Federal Trade Commission will attempt to regulate non-compete agreements under its current authority. One potentially "positive" aspect of the executive order is its focus on "unfair" non-compete agreements, which may steer the FTC away from more aggressive approaches such as an outright ban and towards more rational limitations.

Whatever the limitations of federal-level legislation or rulemaking may be, however, there continues to be important developments on at the state level. At least 15 states and the District of Columbia have adopted legislation aimed at curtailing the use of non-compete agreements since Barack Obama issued an executive order in 2016 urging them to do so. At the end of May, for example, the Illinois legislature passed a comprehensive bipartisan bill amending the Illinois Freedom to Work Act that limits the use of both non-compete and non-solicit agreements with employees currently earning less than $75,000 and $45,000 per year, respectively. Other states, including New York, New Jersey, Iowa and Connecticut are currently considering bills that would narrow the use of non-competes in those jurisdictions.

Employers should remain alert to legislative developments in this area, particularly in those states where their employees work. **Given the increased scrutiny and skepticism of non-competes, in crafting such agreements, employers should not overreach and should instead ensure that non-competes are narrowly tailored and utilized only where there is a legitimate basis.** Employers should also ensure that they have other forms of trade secret protection in place that can be relied on where non-compete agreements cannot be enforced, including non-disclosure agreements, confidentiality agreements and invention assignment agreements.

CFIUS Reform

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Following FIRRMA, CFIUS expands its reach

Since the final regulations implementing the Foreign Investment Risk Review Modernization Act ("FIRRMA") were promulgated in February 2020, the Committee on Foreign Investment in the United States ("CFIUS") has been operating under significantly expanded jurisdiction. (Our *2020/2021 Private Equity Year-End Review and Outlook* includes a discussion of the new regulations and filing requirements.) As a result, private equity fund sponsors have had to pay closer attention to CFIUS considerations at various points in the investment life cycle, from ensuring that investments by foreign limited partners fit within available CFIUS safe harbors to managing sales processes of portfolio companies involving foreign bidders. The following developments are of particular importance for fund sponsors:

- CFIUS continues to expand its staff, including establishing the new Office of Investment Security Monitoring & Enforcement to beef up CFIUS's enforcement function. Parties that have elected not to voluntarily notify CFIUS of transactions that are within its jurisdiction and that raise significant national security concerns may receive an inquiring knock on the door well after closing. Although CFIUS' current focus appears to be on Russian and Chinese buyers, others may attract attention depending on the acquired business. For some buyers, in closer cases, and depending on the buyer, this new enforcement focus may change the risk calculus of deciding not to make a voluntary filing.
- Short-form declarations provide the potential for shortening CFIUS review of a transaction to 30 days, allowing in some circumstances for shorter periods to closing. In response to a declaration, CFIUS can approve the transaction, reject it or request that a notice be filed. In addition, it often provides a "shrug its shoulders" response, meaning that it neither approves nor rejects the transaction, nor does it request that a notice be filed. This response leaves the parties to decide whether to seek a safe harbor approval through a full-blown notice filing. In certain cases, however, a shoulder shrug may be good enough for the buyer, under the assumption that if CFIUS had identified serious national security concerns, it would have requested that a notice be filed.
- CFIUS has a keen interest in knowing who is swimming in the LP pool and from whom PE sponsors are obtaining capital. Even though CFIUS regulations do not generally require disclosure of otherwise passive LPs in the context of a notice filing, one should be prepared for staff requests to disclose LPs with an ownership interest of five percent or more.
- Despite the changes that have taken place, there are still a number of expansions to CFIUS's jurisdiction included in FIRRMA that have yet to be implemented, such as adding "emerging" and "foundational" technologies to the list of "critical technologies." FIRRMA may not be the last word in expanding CFIUS's mandate to meet perceived national security issues. Sens. Rubio (R-FL) and Cornyn (R-TX), for example, have recently proposed S. 1745, which would expand CFIUS's jurisdiction to U.S. businesses working with certain genetic information. General partners should thus be prepared for future changes to CFIUS's reach and requirements and the possibility that some additional transactions might be the subject of filings, whether mandatory or voluntary.

U.S. Regulatory

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The Biden administration's appointment of Gary Gensler ushered in a new direction at the Securities and Exchange Commission. The SEC's 2021 Regulatory Agenda and the Department of Examinations' 2021 Examination Priorities, both recently released, provide important insight into what private equity firms can expect in the second half of the year.

2021 Regulatory Agenda

The SEC's Regulatory Agenda catalogues a number of short-term and long-term goals furthering Chair Gensler's focus on strengthening markets, increasing transparency and safeguarding investors. Several new rules and rule amendments that could affect investment advisers are currently in the "proposed rule" stage. We anticipate that the SEC will release a number of these proposals (or begin discussions regarding those proposals) in the coming months that will include:

- *ESG:* Potential new requirements for investment advisers and investment companies relating to ESG factors, including ESG claims in marketing and disclosures.
- *The Custody Rule:* Potential amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 regarding the custody of funds or investments of investment adviser clients. In March 2019, the SEC staff solicited comments on custody issues relating to digital assets and to transactions that are not processed or settled on a delivery-versus-payment (DVP) basis.
- *SPACs:* Potential amendments to rules that could affect SPAC offerings.
- *Form PF:* Potential amendments to Form PF, which may result in additional disclosures, particularly relating to counterparties and counterparty risk.
- *Incentive-Based Compensation:* The SEC (along with a number of other regulatory agencies) may re-propose regulations and guidelines covering incentive-based compensation practices (as required by Section 956 of the Dodd Frank Act), which may have an effect on private fund carried interest.

In addition, the Regulatory Agenda refers to a number of "pre-rules," suggesting that the staff of the SEC will recommend that the SEC request public comment on certain issues in preparation for possible rule proposals. Examples of topics in this "pre-rule" stage that are relevant to investment advisers pursuing a private equity strategy include:

- *Exempt Offerings.*
  - *Accredited Investor Definition:* When the SEC adopted amendments to the Accredited Investor Definition in August 2020, the agency declined to increase the definition's financial thresholds. It now appears that the SEC may increase those thresholds.
  - *Regulation D Information:* The SEC may consider requiring private issuers to provide more information to potential investors and the SEC (in Form D or other filings), particularly for Rule 506(c) offerings.
  - *Integration of Offerings:* The SEC may reconsider the "principles-based" integration framework it had previously adopted.

Continued on page 17

U.S. Regulatory

Continued from page 16

- *Third-Party Service Providers*. The SEC staff may recommend that the SEC formally consider whether and how fund service providers—including index providers and model providers—might be regulated in the future. This appears to be the continuation of an SEC staff initiative from 2018, when the staff suggested that index providers may need to be treated as "investment advisers."

2021 Examination Priorities

While the Regulatory Agenda highlights the SEC's upcoming regulatory priorities, the Division of Examinations' 2021 Examination Priorities reveal areas of focus that investment advisers can expect in SEC examinations, including protections for retail investors, the fiduciary duty of market participants and the implementation of Regulation Best Interest procedures. The Examination Priorities also specifically focus on (i) information security and operational resiliency as part of a broader focus on risks arising from emerging market events, such as the global COVID-19 pandemic and cyber events; (ii) financial technology (fintech) and digital assets; and (iii) ESG related matters.

The Division will also prioritize registered investment advisers that have not been examined since their inception or for a number of years, in order to assess compliance in light of investment advisers' growth or other changes in their business. For registered investment advisers that advise private funds, the Division will continue to focus on three key issues:

1. internal firm compliance, especially with respect to new services and products that may create heightened regulatory risk, and the design, implementation, and maintenance of compliance programs;
2. whether RIAs have satisfied their duties of care and loyalty, with a particular emphasis on risks associated with fees and expenses, complex products, undisclosed or inadequately disclosed conflicts of interests, and compensation arrangements; and
3. valuation risks, especially in sectors that have been affected by the global COVID-19 pandemic, such as energy and real estate.

The Examination Priorities also suggest that the Division will be continuing its growing interest in ESG-specific strategies and funds that incorporate ESG considerations in their investment process. This development aligns with increasing interest in the topic by the SEC, investment advisers and investors. For example, in June 2021, the SEC requested public comment on the potential regulation of climate change disclosures. The request generated significant feedback from a variety of market participants, but with no clear consensus regarding whether, or how, the SEC should regulate climate disclosure.

Private equity firms, particularly those that disclose the use of ESG metrics in their strategies, should review the Division's ESG Risk Alert for the Division's views on ESG regulatory risks as well as ESG best practices. The ESG Risk Alert represents the clearest and most granular articulation of the SEC's concerns about the marketing of ESG-related investment products, including the sufficiency of those practices, related

Continued on page 18

U.S. Regulatory

Continued from page 17

documentation, and the policies and procedures of the asset managers that sell these products. (Our detailed commentary on the Risk Alert is available here.)

In March 2021, shortly before the Division issued its ESG Risk Alert, the Division announced the creation of a Climate and ESG Task Force. The ESG Task Force will develop initiatives to proactively identify ESG-related misconduct, and will initially focus on identifying any material omissions or misstatements in issuers' disclosures concerning climate risks under existing rules. The ESG Task Force will also analyze disclosure issues and compliance shortfalls in investment advisers' and funds' ESG strategies.

Most recently, in July 2021, the SEC's Asset Management Advisory Committee (AMAC), composed of industry experts representing the views of various market participants, recommended to the SEC that it suggest best practices to the asset management industry regarding ESG disclosure. According to the AMAC, those practices should incorporate a clear description of each product's strategy and investment priorities, including, for example, a description of non-financial objectives, such as environmental impact or adherence to religious requirements. In addition, the AMAC suggested that the SEC encourage issuers to adopt a framework for disclosing material ESG matters and to provide an explanation if no disclosure framework is adopted. Notably, the AMAC did not recommend that the SEC adopt prescriptive requirements or requirements relating to ESG disclosure.

In his remarks to the AMAC, Chair Gensler highlighted his view that there is a need for greater ESG transparency from funds, focusing on the use of ESG-signaling language in marketing (including in fund names) and likening the issue to "truth in advertising." By contrast, Commissioner Pierce, a Republican appointee, noted that ESG standard setting could be "unworkable and imprudent."

The focus by both the Commission and staff on ESG highlights the increasing importance of this issue in the regulatory landscape that applies to investment advisers. We will continue to monitor how this evolving issue will affect our private equity clients and their broader businesses.

Investment Adviser Marketing

In addition to the issues highlighted by the Regulatory Agenda and the Examination Priorities, private equity firms will also need to plan their transition to the new Marketing Rule, which the SEC adopted in December 2020. The Marketing Rule replaces the existing Advertising Rule (old Rule 206(4)-1) and the existing Cash Solicitation Rule (old Rule 206(4)-3), with a new Rule 206(4)-1). Our summary of the Marketing Rule is available here.

While the Marketing Rule became effective in May 2021, advisers are not required to comply until November 4, 2022. Some investment advisers have found it beneficial to begin complying with the Marketing Rule sooner, which is permissible so long as the firm does not cherry pick requirements across the old and new formulations of the rule.

Continued on page 19

U.S. Regulatory

Continued from page 18

Thus, an adviser complying with the Marketing Rule before the official compliance date should seek to comply with the rule fully. We continue to work with investment advisers to private funds as they transition to complying with the Marketing Rule.

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Every new SEC administration brings a new tone to the agency and has the potential to shift the direction of enforcement and regulation. The SEC under Chair Gensler signals a pendulum swing away from the previous administration. As a result, we expect the remainder of 2021 and the coming years to be a time of more intense regulatory activity, including rulemakings, interpretations, and potentially enforcement, applicable to private equity advisers and the broader investment management industry.

European Regulatory

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What You Need to Know about the EU's New Pre-Marketing Rules

Beginning 2 August 2021, the new EU pre-marketing rules will apply in EU member states, as part of the EU Cross-Border Distribution of Funds Directive (Directive (EU) 2019/1160, "CBDF Directive").[1] Below we address some common questions regarding the ability of EU and non-EU alternative investment fund managers (AIFMs) to "pre-market" their funds. (See also our note on this topic from 15 March 2019.)

How is pre-marketing defined and who is in scope?

The CBDF Directive provides the following definition of "pre-marketing":

"[T]he provision of information or communication, direct or indirect, on investment strategies or investment ideas by an EU AIFM or on its behalf, to potential professional investors domiciled or with a registered office in the Union in order to test their interest in an AIF or a compartment which is not yet established, or which is established, but not yet notified for marketing in accordance with Article 31 or 32, in that Member State where the potential investors are domiciled or have their registered office, and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment".

Under this definition, AIFMs may "sound out" prospective EU investors in an AIF before beginning marketing of a product, and before meeting the regulatory conditions for marketing.

Although the CBDF Directive's pre-marketing definition is only given in terms of pre-marketing activities conducted by EU AIFMs, the CBDF Directive makes it clear that national laws and regulations regarding pre-marketing need to keep EU and non-EU AIFMs on a level playing field. So, for example, the German act implementing the CBDF Directive explicitly applies the new pre-marketing rules to both EU and non-EU AIFMs (as previously discussed in our note from 7 December 2020). But because most EU member states have not yet published a draft implementation, there is uncertainty

Continued on page 20

1. Alongside the CBDF Directive, Regulation (EU) 2019/1156 on facilitating cross-border distribution of collective investment undertakings ("CBDF Regulation") was adopted and comes into effect the same day. The CBDF Regulation contains, inter alia, (i) the CBDF Directive corresponding provisions relating to EuVECA and EuSEF (two fund vehicles which are governed through two EU Regulations and for which therefore a EU Directive is not the appropriate instrument to implement changes), as well as (ii) uniform rules on marketing communications addressed to investors.

European Regulatory

Continued from page 19

whether and how the new pre-marketing rules will apply to non-EU AIFMs. At a minimum, we expect that those EU member states which permit marketing by non-EU AIFMs under the national private placement regime will apply the new pre-marketing rules to non-EU AIFMs as well.

What information and materials can be shared with prospective investors during pre-marketing?

During the pre-marketing phase, an AIFM may present information on the AIF to prospective professional investors, unless such information meets one or more of the following three criteria:

- it is sufficient to allow investors to commit to acquiring units or shares of a particular AIF
- it amounts to subscription forms or similar documents whether in a draft or a final form; and
- it amounts to constitutional documents, a prospectus or offering documents of a not-yet-established AIF in a final form.

We interpret the above rule such that draft prospectuses or offering documents may be provided to prospective investors, but it must be clear that they are still incomplete and subject to change, and we recommend including appropriate disclaimers.

Who can conduct pre-marketing?

In addition to the AIFM itself, pre-marketing can be done by a third party on behalf of the AIFM. However, any third party conducting pre-marketing activities must be a regulated EU firm, because the CBDF Directive only permits pre-marketing by:

- investment firms and tied agents authorised in accordance with Directive 2014/65/EU (MiFID);
- credit institutions authorised in accordance with Directive 2013/36/EU (CDR);
- UCITS management companies authorised in accordance with Directive 2009/65/EC (UCITS Directive); and
- AIFMs authorised in accordance with Directive 2011/61/EU ("AIFMD").

This requirement has raised serious concerns in the industry, as it appears to prohibit pre-marketing by UK and other non-EU entities, such as private fund placement agents and investor relations teams which are housed in an affiliated entity which is separate from the AIFM. These entities will have to consider practical solutions in order to continue to conduct pre-marketing, such as setting up an EU-based subsidiary with the relevant license, using EU AIFM structures or tied agent solutions, or ensuring the non-EU firm only conducts non-regulated activities.

What is the pre-marketing notification?

Within two weeks of beginning pre-marketing, EU AIFMs must send their home state regulator an "informal letter" specifying:

- the member states in which they intend to pre-market;

Continued on page 21

European Regulatory

Continued from page 20

- the periods during which the pre-marketing is taking or has taken place;
- a brief description of the pre-marketing including information on the investment strategies presented; and
- where relevant, a list of the AIFs and compartments of AIFs which are or were the subject of pre-marketing.

It is expected that the same notification requirements will be introduced by those EU member states that currently permit national private placements for non-EU managers, with no changes expected to the position of member states that do not permit private placements.

Does pre-marketing have any implication for reverse solicitation?

Although the CBDF Directive does not introduce a stricter definition of the "reverse solicitation" concept established in the AIFMD (where a fund is offered to an investor on the basis of the investor's own exclusive initiative), there is an aspect of the CBDF Directive that suggests that regulators will be taking a harder line regarding AIFMs that rely on reverse solicitation. There will be a requirement for AIFMs to notify their home state regulator if they engage in any pre-marketing, and any subscription that takes place within 18 months of an EU fund having begun pre-marketing, is considered to be the result of pre-marketing and subject to the applicable notification procedures. There is no clarity from regulators as to whether this would be interpreted to only include investors contacted at pre-marketing or all investors in a given jurisdiction.

Does de-notification have any implication for pre-marketing?

The CBDF Directive provides that, for a period of 36 months from the de-notification date, the AIFM cannot engage in pre-marketing of AIFs referred to in the de-notification, or engage in pre-marketing of "similar investment strategies" or "investment ideas." This broad restriction introduces the risk that any de-notification of a fund will result in a 36-month ban on the marketing of similar funds, such as successor funds. Therefore, managers will need to carefully think through what implication the de-notification of one fund may have on the ability to pre-market "similar strategies or ideas."

Do the marketing communication rules apply to pre-marketing?

Under the CBDF Regulation, AIFMs are obliged to ensure that marketing communications addressed to investors are identifiable as such, describe the risks and rewards of investing in the relevant fund in an equally prominent manner, and are fair, clear and not misleading. The CBDF Regulation directs the European Securities and Markets Authority (ESMA) to develop guidelines on marketing communication to further specify those requirements. Those guidelines, issued on 27 May 2021, have a very broad scope and apply to any kind of messages that market a fund to prospective investors, regardless of the medium, including print, electronic documents, or posted online. However, the guidelines clarify that, in particular, legal and regulatory documents, such as the prospectus or the disclosure information under Article 23

Continued on page 22

European Regulatory

Continued from page 21

AIFMD, should not be considered as marketing communications. The guidelines include special requirements and limitations regarding the presentation of costs and expenses, track record and expected future performance, and risk and reward.

Information issued in the context of pre-marketing is explicitly exempted from the scope of the guidelines. However, any communication after the pre-marketing phase should conform to the guidelines. If we assume that an AIFM will want to use pre-marketing and marketing materials that are consistent with each other, the pre-marketing materials excluded from the guidelines should nonetheless comply with them. The guidelines will be translated into the official languages of the EU and published on ESMA's website and will apply six months after the date of publication.

AIFMs adopted the practice of "pre-marketing" as a practical way of aligning their communications practices with the AIFMD's strict conditions on marketing funds. The CBDF Directive introduces a legislative basis and welcome legal certainty for this practice. However, it is important to remember that this clarity comes at the cost of some significant new conditions, such as the requirement for pre-marketing to be conducted by authorised EU firms, and that firms will need to apply those conditions to their marketing as well as pre-marketing activities.

Business Integrity/ESG

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Since our last *Private Equity Report*, ESG regulatory changes have continued apace across Europe. While space prevents us from mentioning everything that has happened in the last six months—including the many private sector initiatives—the following provides a summary of key developments relevant to the private equity industry.

European Union: Legislative Action

Sustainable Disclosure. The Sustainable Financial Disclosure Regulation ("SFDR") came into force on 10 March 2021. (Our webinar series covering SFDR can be seen here.) A month before, the Joint Committee of the European Supervisory Authorities released its final report on the draft Regulatory Technical Standards for the content, methodologies and presentation of disclosures required by the SFDR. The standards provide details and templates regarding the disclosure and reporting requirements for funds that specifically promote environmental and social criteria, for products with special impact strategies making sustainable investments, and for fund managers and others who comply with the adverse sustainability impact disclosure under Article 4 of SFDR. The European Commission was expected to endorse the draft standards earlier this year, but the application has been delayed to 1 January 2022.

Mandatory Human Rights Due Diligence (MHRDD) Law. The MHRDD law continues to move through the pipeline. The European Parliament has adopted a report on the law and has submitted recommendations to the European Commission. Private equity firms should note the broad scope of the proposed law, which covers not only large businesses but certain small and medium enterprises as well.

Continued on page 23

Business Integrity/ESG

Continued from page 22

The draft directive codifies a "duty" on companies to respect human rights, the environment and good governance. As a result, companies covered by the law are required to take all proportionate measures and make efforts within their means to prevent, mitigate and address adverse impacts in these areas. The law requires due diligence based on a risk-based methodology, and disclosure of both the methodology and results. It also focuses on ensuring a remedy for those affected by adverse impacts, and requires companies to establish a grievance mechanism. In addition, the MHRDD law requires that national jurisdictions provide for a civil liability scheme. Liability extends not only to the actions of the company itself, but also companies under their control.

EU Member States: Legislative Action

As the EU develops MHRDD legislation, there is similar movement in individual EU member states:

Germany. A mandatory human rights due diligence law, known as the "Supply Chain Law," was passed by the German legislature in June 2021. Beginning on 1 January 2023, it covers all enterprises headquartered in Germany that have more than 3000 employees; that threshold will be lowered to all companies with more than 1000 employees on 1 January 2024. The legislation requires companies to undertake rigorous due diligence of their business practices and of their supply chains regarding human rights and the environment, but—in a move that has been criticized—extends only to the supply chain's first tier.

Netherlands. The Dutch Bill for Responsible and Sustainable International Business Conduct was submitted to the Dutch Parliament in March 2021. The bill requires that companies conduct due diligence, put in place grievance mechanisms and reporting, and provide for administrative and criminal penalties. Similarly to the EU legislation, it would also allow third parties to hold companies liable for violations in civil court. If adopted, it would replace the current Child Labour Due Diligence Law. However, as the bill's proposing parties lost power in the March 2021 Dutch elections, the next steps for the bill remain uncertain.

Norway. In April 2021, the Norwegian Government proposed what is known as the "Transparency Law." The Act contains similar provisions to the German and Dutch legislation, requiring due diligence in relation to human rights including workers' rights. It adds a novel twist by introducing a right to information, which allows reasonable requests for information to be made to a company regarding how it manages its due diligence.

EU Member States: Judicial Action

In addition to legislative developments, there have also been a number of judicial developments in both EU and national courts that may impact companies' approaches to ESG issues. Two national court developments are of particular interest: In June 2021, the Hague District Court ordered Royal Dutch Shell to cut its emissions by 45 percent

Continued on page 24

Business Integrity/ESG

Continued from page 23

by 2030—the first time a corporation has been held legally liable for its contribution to carbon emissions and held responsible for the sufficiency of its global climate goals. Shell has announced that it will appeal the decision, but will also accelerate its response to halt greenhouse gas emissions.

In France, another judicial challenge was filed under the Vigilance law. This case was brought by 11 NGOs against the supermarket chain Casino Group, alleging that it has caused environmental and human rights abuses through involvement in the cattle industry in Brazil and Columbia.

United Kingdom

The UK government launched a public consultation in March 2021 on the climate-related disclosure regulation, which would introduce mandatory requirements for a wider range of listed issuers to disclose by 2022 the risks they face from climate change. Broader, mandatory requirements across all sectors of the economy are expected to be introduced by 2025.

Separately, the UK Government announced a package of measures designed to ensure that British organisations avoid either being implicated in or profiting from the alleged human rights violations in Xinjiang Province. These measures include due diligence guidance and financial penalties for failing to comply with an obligation under section 54 of the Modern Slavery Act to publish an annual statement describing the steps a business takes to ensure that slavery does not occur in their business or supply chains. As explained in our last update, last year the government announced reforms to strengthen the effectiveness of section 54. Earlier this year, the UK government created a central registry for publishing Modern Slavery Act statements and announced the creation of a government watchdog to protect the rights of UK workers. The authority will be responsible for tackling modern slavery and enforcing obligations under section 54. A bill to amend the Modern Slavery Act, including to strengthen section 54, is currently before the House of Lords.

Data Strategy and Security

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Ransomware: Six Tips for Preparations and Response

Ransomware continues to pose a significant threat to private equity sponsors and their portfolio companies. The growth of "ransomware as a service," where threat actors sell or lease ransomware variants to other attackers to execute, has significantly lowered barriers to entry, fuelling a rise in attacks.

Companies of all sizes and across all sectors are being targeted. Attackers are increasingly stealing data, threatening executives, and contacting customers to increase leverage. Seven figure ransoms are not uncommon.

Here are six steps that private equity sponsors and their portfolio companies should consider to help prevent and mitigate the impact of ransomware:

1. **Build you team in advance:** Responding to a ransomware attack often requires significant outside expertise. Consider on-boarding a forensic vendor, a ransom negotiator, and a crypto-payment provider ahead of time. Doing so through external counsel can protect attorney-client privilege.

2. **Know your controls:** Ask your technical team what controls are in place to prevent, detect, and mitigate ransomware attacks. For instance, endpoint detection solutions, admin credential controls, disabling of direct internet access to systems, as well as testing and segmenting of backups can all help prevent an attack or minimize its impact.

3. **Have a plan:** Consider creating a ransomware protocol to guide your response when an attack occurs. Even if you already have a general incident response plan, it is still helpful to document in advance who would be responsible for which parts of your ransomware response. Creating a procedure for deciding when, if ever, you would pay a cyber ransom demand – and who would sign-off doing so – is particularly important. Also consider creating draft internal and external communications and talking points that can be used as a template to save vital time.

4. **Practice:** Consider running a tabletop exercise or mock ransomware incident to give key stakeholders the chance to test and evaluate the ransomware protocol and to better understand their role in an incident. General cybersecurity awareness training across the organization is also key. Ransomware attackers often use phishing or other social engineering attacks to get a foothold in a network. Consider having staff practice spotting these attacks using simulated phishing tools or in-person training.

5. **Review your insurance:** Asses your insurance and consider adding ransom payment coverage if not included already—although it may be difficult to obtain. For example, AXA recently announced that it will no longer provide coverage for cyber ransom payments in France. Because insurers are increasingly involved in the decision of whether to pay a ransom, companies need to be mindful of how sharing investigative materials with insurers may affect privilege.

6. **Engage with law enforcement:** If you do suffer an attack, consider engaging with the FBI and other appropriate law enforcement agencies, either directly or through outside counsel. Law enforcement can often provide indicators of compromise or other intelligence that can help your response, including confirming that the attacker is not a sanctioned entity. Companies should consider building law enforcement contacts in advance.

U.S. Intellectual Property

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Avoiding Greenwashing in ESG Advertising

A company's environmental, social, and governance (ESG) policies and track record are influencing decisions by consumers, investors and employees more than ever. As a result, many companies are highlighting their ESG activities in their marketing. However, these marketing initiatives need to be carefully vetted so that organizations do not unintentionally misrepresent or exaggerate their brand's actual ESG efforts, since doing so can give rise to claims of "greenwashing." Private equity funds whose portfolio companies make ESG claims need to monitor this risk.

Greenwashing allegations can lead to reputational backlash and legal scrutiny. The Federal Trade Commission (FTC) has opened numerous investigations over claims of unfair or deceptive advertising relating to the environmental performance of products, and has issued consent orders and millions of dollars of fines. For example, the FTC recently ordered a number of major retailers to pay civil penalties totaling $1.3 million for falsely marketing rayon textiles as containing bamboo, which is considered environmentally friendly.

Greenwashing claims are also frequently asserted in class actions and Lanham Act false advertising lawsuits, in which plaintiffs allege that consumers were deceived into purchasing a product based on false or misleading advertising claims. Importantly, the literal truth of an advertising claim is not necessarily a complete defense if the claim nevertheless conveys a misleading impression. In one recent example, three large manufacturers of plastic bags sued the maker of durable, reusable shopping bags, alleging the reusable bag company made false and misleading marketing statements disparaging the environmental qualities of plastic bags. The parties ultimately settled and agreed to modify future marketing.

Green advertising claims have also been the subject of numerous administrative challenges— often by competitors—at the National Advertising Division ("NAD") of BBB National Programs (the advertising industry's forum for self-regulation). NAD decisions carry significant weight and companies that refuse to participate or follow NAD recommendations will be referred to the FTC for enforcement. NAD decisions can also form the basis for class action complaints or FTC investigations. In one recent example, the NAD recommended that a manufacturer of cleaning products discontinue its use of "non-toxic" claims because it conveyed an unsubstantiated message that the product would not pose any harm, however slight, to people, pets, or the environment, even if misused. After the NAD issued its recommendation, class action lawsuits were filed premised on the NAD's reasoning.

Even if civil liability is not found, allegations of greenwashing can generate significant negative publicity. The resulting reputational harm can be difficult to overcome.

In order to avoid these risks of litigation and reputational harm, brand owners should identify and assess the express and implied claims in their marketing materials and make sure that *all* reasonable takeaways—not just those which were intended—are substantiated. Companies should also review and comply with current guidance and regulations (like the FTC Green Guides) and consider whether to seek to obtain "green" certifications where relevant, both to promote their products and insulate themselves from greenwashing claims.

Real Estate

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Last year, markets were defined by stagnation and uncertainty as the world grappled with unprecedented disruptions brought on by the coronavirus pandemic. Fortunately, this narrative has shifted with the acceleration of the vaccine distribution effort, giving investors reason to believe that an industry-wide revival could finally be within reach. Halfway through 2021, however, it is evident that reality dictates a more tenuous state of affairs. Although prices are rebounding, deal volumes across all real estate asset classes are still well below pre-pandemic levels and recovery remains uneven, especially for the hardest hit sectors. The challenge for investors has thus become implementing strategies that are simultaneously reactive and proactive during this transitionary period.

The commercial office sector is one area where sponsors are betting on a major comeback despite the growing popularity of remote work. Evidencing this commitment is a recent uptick in the acquisition of distressed properties followed by plans to convert and redevelop the space for other uses, namely office, warehousing and mixed-residential and retail. Yet, developers and their investor partners are proceeding with caution, cognizant that the approach is not without its challenges. A fundamental obstacle is securing tenants, while another is the cost to attract the companies—particularly the big tech firms—willing to expand their footprint. For these tenants, traditional office space is no longer tenable for their employees accustomed to work-from-home flexibility. Consequently, property owners seeking to emerge from the fallout are racing to expend significant capital on office improvements as more states fully reopen their economies.

Investment firms that lightened up on traditional office holdings in exchange for space with specialized features suitable for life sciences, biotechnology labs and data centers, for example, have benefited tremendously throughout the pandemic's course, further fueling the surging demand for space that is poised to remain a bright spot for the foreseeable future. Warehouses, distribution hubs and fulfillment centers are predicted to maintain a similar trajectory. However, the boom in these facilities has recently driven down rents in a number of U.S. cities, serving as a reminder that even stars of the commercial property market are not immune to oversupply.

Closely tied to the health of the commercial sector are the multifamily and single-family markets. At the height of the downturn, coastal cities experienced rental income decline by double-digit percentages, forcing many landlords to warehouse inventory as a form of fiscal preservation until offices are prepared to reopen. By contrast, investors who seized on the urban exodus found relative success outside the primary markets due to a tenant pool of more modest, but steady, incomes in locations where workers have already returned to the office. Sovereign wealth funds have taken stock of these attractive housing gains in suburban neighborhoods and have notably thrown their hats into the already ultra-competitive ring alongside U.S. investment firms – all of whom are seemingly undeterred (for now) by prices at a fourteen-year high and increased costs due to shortages of construction materials.

Meanwhile, looming in the background is the prospect of inflation coupled with the Biden administration's proposed elimination of favorable tax treatment for real estate transactions. With respect to the inflation concern, single-family assets are likely best positioned to withstand potential turbulence during this inflationary period due to

Continued on page 28

Real Estate

Continued from page 27

yearly lease resets and rents being more closely tied to consumer prices. Owners of commercial space, however, may not fare as well, especially in markets where vacancies are prevalent and the negotiation leverage of landlords has been marginalized.

The Biden tax reform proposal, however, would be an even greater setback to the real estate industry as a whole as it would end the ability to engage in tax-free like-kind exchanges of real estate, as well as increase tax rates for capital gains for individuals earning over $1 million to ordinary income tax rates. The inability to defer capital gains when buying and selling real estate could stymie transaction volume and impact efforts to revive the most fragile of sectors, but it could also make other deferral options, such as tax-free capital contributions to an UPREIT structure, more attractive going forward. Although the proposed changes have yet to become law, property investors are nevertheless tasked once again with devising innovative and efficient strategies amidst the unknown.

Restructuring

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After a pandemic-dominated 2020 filled with liquidity challenges and broken financial covenants, 2021 has emerged as a markedly quieter year for restructuring. Pandemic-associated fiscal stimulus generated high levels of liquidity in the market, offering private equity sponsors an assortment of tools to access funding, extend maturities and modify debt covenants to provide breathing room for their portfolio companies navigating the COVID-19 crisis. Many borrowers were able to reset covenants or extend maturities to bridge to an expected post-pandemic recovery. In other cases, borrowers accessed new funding to improve liquidity and extend operating runways. More rarely, sponsors provided additional cash injections.

Looking forward, there is a risk that these "light touch" restructurings have merely deferred balance sheet challenges rather than eliminating them. Many predict a new wave of restructurings if businesses are unable to recover quickly enough to grow into the new debt on their balance sheets or meet their post-pandemic financial covenant targets. While certain industries that were directly affected by COVID-19, such as live entertainment, healthcare, hospitality and travel, may well see a sharp improvement in revenue and profitability, the impact on other challenged sectors, such as commercial real estate and retail, is yet to be fully understood. In addition, digital transformation, evolving consumer tastes and a changing regulatory environment are sure to challenge recoveries in certain sectors.

With no new financial stimulus on the horizon and interest rates rising, obtaining new money or amendments from existing lenders may become more difficult. Some investment management firms are poised to step into the breach, as special-situations and distressed-investment fundraising activity has been on the rise throughout 2020. While they typically demand higher returns than the cheaper debt made available by the stimulus during the pandemic, these funds' ability to execute complex deals quickly and their higher-risk appetites make them optimal sources for solution-based restructuring and refinancing capital in the second half of 2021 and beyond.

Continued on page 29

Restructuring

Continued from page 28

Continuing a previously noted trend, and further driven by the cash-flush distressed-opportunity funds, we expect that sponsors opting to pursue balance sheet alternatives will consider engaging directly with a select group of lenders who control a majority of the company's debt (or certain key tranches of debt). By limiting the number of lenders who participate in an uptier exchange or similar restructuring, sponsors can provide each of those lenders with more attractive recovery as an inducement to transact, thereby obtaining amendments or liquidity on more optimal overall terms. Litigation arising from recent transactions such as the Serta Simmons, Boardriders and TriMark debt exchanges will define the outer limits for such liability management transactions going forward, as portfolio companies continue to aggressively use available provisions in finance documents and applicable law to optimize balance sheet relief. The fact that private equity sponsors have, in some instances, been named as defendants provides a sharp reminder that a careful read of documentation and analysis of potential risks is an essential component of all balance sheet adjustments.

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Private Equity Healthcare Investing: Political Scrutiny Expected to Continue Despite Mostly Favorable MedPAC Report

Private equity firms continue to invest actively in healthcare companies, making new sources of capital and innovative ideas available to the industry. While many for-profit healthcare entities have been subject to criticism, PE firms in particular have been subject to heightened scrutiny by some members of Congress. Accordingly, in 2019, Congress directed the Medicare Payment Advisory Commission ("MedPAC"), a nonpartisan legislative branch agency, to assess the impact of PE investments in the healthcare ecosystem. On June 16, 2021, MedPAC issued its long-awaited report ("MedPAC Report"), which found that available data does not support—and indeed, in some cases, refutes—criticism of PE investments in healthcare.

As explained in greater detail below, the MedPAC Report serves as a counter-weight to some of the more critical assessments of PE healthcare investing. For example, a recent non-peer-reviewed working paper issued by the National Bureau of Economic Research ("NBER") alleged that PE ownership of nursing homes resulted in an increase in mortality rates for Medicare patients (and patient spending) along with a decrease in patient well-being. Subsequently, the American Investor Counsel ("AIC")—in conjunction with a number of additional entities—issued a response, found here, refuting the NBER working paper, citing studies contradicting NBER's conclusions.

Certain members of Congress have also questioned PE investments in healthcare. As we discussed here, Congressional action related to so-called "surprise billing"[2] was accompanied by letters to certain PE firms asking about their involvement in such alleged practices. More recently, in March 2021, Senator Warren (D-MA) wrote a letter to Genesis Healthcare, Inc., a nursing home operator with facilities across the country, questioning the propriety of a bonus paid to the CEO and of a private-equity-backed reorganization in light of the COVID-19 pandemic. Senator Warren also announced the intent to launch a broad-ranging investigation into for-profit nursing homes, particularly those under private equity ownership. That same month, the House Ways and Means Subcommittee on Oversight held a hearing titled "Private Equity's Expanded Role in the U.S. Health Care System," in which Representative Bill Pascrell (D-NJ) claimed PE incentives are inconsistent with patient needs. He also asked the Government Accountability Office to analyze the relationship between PE ownership and subsequent bankruptcies in the healthcare sector.

The recently released MedPAC Report provides an important fact-based counterweight to these criticisms. MedPAC found little to no evidence of substantial negative outcomes resulting from PE investment in the healthcare system. MedPAC studied PE investments in hospitals, nursing homes and physician practices and assessed the impact on economic measures (revenue, pricing and the like) and patient welfare/satisfaction. In conducting its assessment, MedPAC recognized the myriad forms PE investments

Continued on page 31

2. Our analysis of the "No Surprises Act," which was enacted in December 2020 to address "surprise billing," can be found here.

Healthcare

Continued from page 30

may take and acknowledged that, despite outsized attention, private equity still has a relatively limited presence in each sector.

For example, MedPAC found that while PE-owned hospitals tended to have slightly lower costs and patient satisfaction, the difference was minimal and not clearly caused by PE involvement. Further, MedPAC found that the data did not support the assertion made by critics that PE investment adversely affects the delivery of quality healthcare services. For nursing homes, MedPAC noted that while cost-reduction efforts could theoretically decrease the quality of care, PE owners may improve service quality and operational efficiency, even as they increase profitability. The impact on physician practices was the most variable and tended to be affected both by the approach of the investor and the type and size of physician practice at issue.

MedPAC emphasized that negative reports stemming from PE investments were largely speculative or anecdotal. Moreover, MedPAC also identified many positive impacts arising from PE investment including greater stability for independent physician practices and access to capital in a rapidly changing healthcare market.

Despite the MedPAC report findings, PE firms investing in the healthcare ecosystem should expect to remain under scrutiny for the foreseeable future. Accordingly, PE firms should continue to evaluate potential proactive steps they can take to mitigate risk. For example, to the extent representatives of PE firms sit on the boards of portfolio companies, those directors should support implementation by management of robust compliance oversight and quality improvement initiatives. In addition, it may be prudent for PE-owned portfolio companies to develop proactive communication strategies to have effective and thoughtful responses in place to unwarranted criticisms that may arise in the future.

Asset Management Litigation

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The year 2021 has been an active one for litigation involving asset managers, and we expect this to be the case into 2022. One reason for this is the increased willingness of Delaware's Chancery Court to give credit at the motion-to-dismiss stage to allegations imputing control to stockholders who own only a minority of voting shares.

This trend creates a notable increase in litigation risk for minority stockholders who seek to engage in transactions related to their public company investments. While stockholders are generally free to act in their own interests, "controlling" stockholders can be considered fiduciaries themselves, and transactions with a controller may be subject to the more searching "entire fairness" review. Delaware deems a stockholder controlling if it holds more than 50 percent of the voting stock or exercises "actual control" over the company or the challenged transaction. Stockholders who clear or approach the bright-line 50 percent threshold can readily identify the risk and can implement appropriate deal protections; but for minority blockholders, the shifting and fact intensive approach to "actual control" is troubling.

Until recently, a stockholder that held under forty percent of a public company's voting shares and had only minority representation on the board could—absent abusive conduct—reasonably expect that it would not be labeled as a controller in M&A litigation. Over the past few years, however, a number of decisions have, at least at the motion to dismiss stage, credited factual allegations claiming that a fund has "actual control" when it has a significant but minority stake in a public company, giving it a meaningful impact on stockholder votes, coupled with other connections to the company such as board representation, relationships with other directors and/or management, and contractual rights. On that basis, a number of decisions have denied motions to dismiss and allowed cases to proceed into discovery and trial. While dismissal remains a possibility—and there appears to be some split in approach among the Chancery bench—prolonged litigation over the facts required to establish "actual control" and testing the entire fairness of the transaction is a far greater risk. As this trend evolves, sophisticated investors with significant minority stakes in public companies cannot count on swift motion practice to dispose of complaints against them, and should anticipate more protracted litigation.

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