Debevoise & Plimpton

The Private Equity Report Quarterly

Spring 2024 | Volume 24, Issue 1

From the Editors

Climate-related disclosure rules in both the United States and the EU, as well as greater scrutiny of foreign investment, have further complicated the regulatory environment for private equity sponsors and LPs. In addition to these issues, the *Spring 2024 Private Equity Report* explores important considerations in transaction agreements and due diligence as well as reasons for optimism in growth equity activity.

Uptick in Growth Equity Activity Helps Signal a Thaw.

Private equity and venture firms are seeing green shoots in growth-stage companies that have survived the tech downturn and macro headwinds, with investment activity and fundraising in the space both picking up as a result.

Complying with—and Benefitting From—the EU's Sustainability Reporting Requirements.

The EU's Corporate Sustainability Reporting Directive (CSRD) presents numerous challenges for the EU and non-EU enterprises it covers but can also provide valuable insights for affected sponsors regarding sustainability-related risks and opportunities.

SEC Climate-Related Disclosure Rules: Key Considerations for PE Sponsors.

Although the SEC's adoption of its long-awaited climate disclosure rules has encountered legal resistance, SEC registrants and sponsors should be aware of its implications for M&A and securities transactions.

CFIUS Developments and Forecast: What Private Equity Sponsors Should Know.

The Committee on Foreign Investment in the United States (CFIUS) has been increasingly active since the enactment of FIRRMA in 2018—and has begun to closely scrutinize private equity transactions regardless of the nationality of the sponsor.

FDI Scrutiny of Private Equity Secondary Deals on the Rise.

Regulatory scrutiny of foreign direct investment is expanding in jurisdictions around the world—and turning greater attention to secondary transactions, requiring sponsors and investors to prepare accordingly.

Putting AI into the Due Diligence Equation.

The accelerating growth of artificial intelligence in business opens up a wide avenue for opportunity and risk—and a new set of due diligence considerations for sponsors, including IP protection and litigation, licensing, data privacy, cybersecurity and the allocation of risk with third parties.

continued on page 2

What's Inside

03 Uptick in Growth Equity Activity Helps Signal a Thaw

05 Complying with—and Benefitting from—the EU's Sustainability Reporting Requirements

08 SEC Climate-Related Disclosure Rules: Key Considerations for PE Sponsors

11 CFIUS Developments and Forecast: What Private Equity Sponsors Should Know

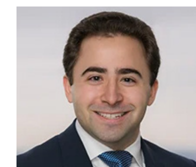
13 FDI Scrutiny of Private Equity Secondary Deals on the Rise

16 Putting AI into the Due Diligence Equation: Key Considerations for Sponsors

19 Management Equity Issues Arising in Continuation Fund Transactions

22 Choosing Your Battlefield: Selecting the Appropriate Dispute Resolution Process

Spring 2024 Issue Editors



Brett M. Novick
bmnovick@debevoise.com

Patricia Volhard
pvolhard@debevoise.com

Editorial Board

Sally Bergmann Hardesty
Jennifer L. Chu
Rafael Kariyev
Brett M. Novick
Patricia Volhard
Jin-Hyuk Jang

Paul S. Bird
Editor-in-Chief

Franci J. Blassberg
Founding Editor

Management Equity Issues in Continuation Funds.

Continuation funds have become an increasingly popular exit strategy, but they also raise potentially challenging questions and issues regarding how management equity and incentives should be treated in the transaction.

Choosing Your Battlefield: Selecting the Appropriate Dispute Resolution Process.

In the heat of negotiating a deal, dispute resolution clauses can seem an afterthought. But when a conflict arises, how that clause is drafted can make the difference between effective resolution and a prolonged, resource-draining dispute.

"Please tell me a story about a puppy who goes to Jupiter on her birthday to solve a mystery and is a mermaid, using an engaging and humorous tone, in approximately a thousand words, in the style of Ernest Hemingway."

This report is a publication of
Debevoise & Plimpton LLP

The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed in these articles.

Debevoise & Plimpton

Uptick in Growth Equity Activity Helps Signal a Thaw

Joe Binder
Partner

Aly Love Simons
Partner

Matthew M. Delja
Counsel

The fundraising environment is seeing green shoots in 2024 and growth equity investment is powering part of that trend. Fund managers and their investors are eager to reengage in sectors and asset classes where they can find attractive quality and pricing, even in a persistently high interest rate environment, and growth-stage companies check those boxes. Growth equity enterprises were among the hardest hit by the perfect storm of the tech downturn, the rise in interest rates, challenges in the banking industry and geopolitical headwinds. The companies that were able to survive those hostile conditions and emerge with durable businesses and sensible valuations are naturally highly attractive targets, driving an uptick in growth equity activity.

The numbers tell the story. Growth equity's share of total private equity deal value increased last year to 12.7% (up from 9.9% in the prior year) and represented 21.5% of all sponsor deals, compared with a five-year average of 18.0%. As *Pitchboo*k noted, last year marked the first time that growth equity deals accounted for a higher share of private equity transactions than LBOs. This increase in growth equity deal activity comes despite the fundraising challenges faced by the private equity industry overall, which, as McKinsey reported, saw a 30% reduction in fundraising for growth equity from the prior year.

Growth equity investors target relatively mature, privately held companies—oftentimes with an exit on the horizon through a sale, direct listing or IPO. Typically, these are minority investments, but they can take other forms, depending on the investment strategy of the particular fund. While the line between venture capital and growth equity continues to blur, traditionally, venture capital invests at earlier stages in the company lifecycle and casts a wider net of investments with longer hold periods. In contrast, growth equity investors focus on later-stage companies where operational improvements and revenue growth can be achieved with minimal leverage. In addition, growth equity investments often come with more complex preference structures [compared to venture capital investments] and guaranteed minimum returns.

A number of factors have made growth equity investing increasingly appealing to sponsors. These transactions are typically equity financed, removing the uncertainty currently posed by high interest rates in the debt markets. The greater maturity of these companies also allows sponsors to build off of their existing strengths to improve operations and thus yield better returns.

From 2020 through early 2022, many companies were in a position to command very friendly fundraising terms. Today, however, the market has shifted downward, particularly in the technology sector. Companies that are now running out of runway are increasingly turning to private equity for financing. Financial sponsors typically take a more robust approach on structure and governance which, in a down market, becomes more palatable than it was just two years ago. Many venture investors who financed earlier rounds are also increasingly more comfortable with having a private equity sponsor write the bigger check needed to get the company to a successful exit.

Despite these market shifts in favor of investors, a valuation gap—albeit one that is thinning ever slowly—continues to exist between founders and management, on the one hand, and growth investors, on the other. We expect to see that maturing companies that are not positioned to weather the continued storm of a down market will increasingly turn to sponsors as a source of financing.

We expect to see that maturing companies that are not positioned to weather the continued storm of a down market will increasingly turn to sponsors as a source of financing.

Complying with—and Benefitting from—the EU's Sustainability Reporting Requirements

Patricia Volhard
Partner

Dimitra Karakioulaki
Legal Research Assistant

The EU's Corporate Sustainability Reporting Directive (CSRD), adopted in November 2022, establishes a transformative framework that requires detailed reporting on sustainability performance from EU and non-EU undertakings that meet certain thresholds. Undertakings within the scope of the CSRD must publicize comprehensive annual sustainability reports alongside their financial statements.

Complying with the CSRD can be challenging due to continued changes in the regulatory landscape and the lack of existing systems to collect sustainability performance information. Despite these challenges, private equity firms have an opportunity to enhance their positioning through diligent CSRD reporting. This reporting will also help many firms comply with the pending Corporate Sustainability Due Diligence Directive (CSDDD), which will oblige firms exceeding certain thresholds to identify, mitigate and prevent environmental and social damage.

1. CSRD in a Nutshell

The CSRD introduced a new corporate sustainability reporting regime under which in-scope EU undertakings, including eligible subsidiaries of undertakings outside the EU, report the likely social and environmental impact of the undertaking's operations and value chain, and the likely impact that social and environmental matters will have on the undertaking. The directive aims to enhance transparency, enabling investors, analysts, consumers and other stakeholders to effectively assess the undertakings' sustainability performance and understand the associated business impacts and risks.

The CSRD will apply on a staggered basis, from 2024 through 2029, requiring that undertakings' annual reports contain both detailed sustainability reports and financial statements. It authorizes the introduction of varied reporting standards that will cater to the specific needs and capacities of different undertakings across a broad spectrum of industries and geographical locations:

- The European Sustainability Reporting Standards (ESRS), adopted in July 2023, apply to large EU subsidiaries and large issuers in EU-regulated markets, ensuring uniformity and comparability in reporting practices among significant market players. Additional sector-specific standards will also be developed for reporting on environmental, social and governance (ESG) issues for undertakings within certain sectors (e.g., energy production and utilities, finance).

- Sets of simplified standards will be tailored for in-scope Small and Medium Enterprises (SMEs), captive insurance and reinsurance undertakings and non-EU undertakings that will be indirectly brought into scope starting in 2028.

2. Determining Scope

The CSRD applies to large EU undertakings that meet at least two of the following three thresholds: at least 250 employees, a balance sheet total of €25 million or a net turnover of €50 million. Additionally, it covers EU parent undertakings of large groups that meet these criteria on a consolidated basis (including both EU and non-EU subsidiaries). Large undertakings which have their equity or debt securities listed on an EU-regulated market under the Markets in Financial Instruments Directive also fall within scope. The same applies to EU-listed SMEs with simplified reporting standards currently being developed. The CSRD also applies to large undertakings and parent undertakings of large groups incorporated outside the EU but listed in the EU as well as non-EU SMEs with EU listings.

Furthermore, *non-EU undertakings* typically outside the scope of the CSRD can become *indirectly* subject to its requirements starting in 2028 if they have an EU subsidiary that falls into scope or an EU branch generating revenues over €40 million. Such undertakings must report on a global consolidated level—including the non-EU parent and all its subsidiaries—if the non-EU parent's consolidated revenue in the EU exceeds €150 million. This requirement may coexist with the reporting obligations of the EU subsidiary itself. However, there is an exemption if the non-EU parent already produces a consolidated sustainability report that meets EU standards or an equivalent.

> CSRD applies to any undertaking meeting the prescribed thresholds, regardless of the industry; asset and fund managers are also in scope if they meet these thresholds or are listed.

3. The Double Materiality Assessment

While all undertakings covered under the CSRD must report the information specified in the ESRS, the information specified in the ESG standards must be reported only if it is material. The CSRD adopts a double-materiality approach, requiring undertakings to assess:

- *Impact materiality:* the short-, medium- and long-term impact their operations and value chain have or are likely to have on the environment and people (e.g., carbon emissions, workforce diversity, respect for human rights).
- *Financial materiality:* the risks and opportunities that sustainability matters present or are likely to present on the organization's financial performance in the short-, medium- and long-term (e.g., cash flows, risk, access to funding).

Reporting according to the double materiality principle goes beyond the disclosures proposed by the International Sustainability Standards Board by mandating the disclosure of information that is not financially material.

The CSRD requires that an external third party audits and assures the sustainability information and data reported by organizations.

4. Public Disclosure Requirements

Sustainability disclosures under the CSRD must adhere to EU rules on using a single electronic reporting format for financial reports. Undertakings must make their sustainability reports accessible free of charge on their website or, in the case of EU undertakings, on the central, commercial or company register of their Member State. To ensure reliable reporting, sustainability reports by non-EU undertakings should be accompanied by an assurance opinion of an authorized person or firm.

From 10 January 2029, Members States must ensure that sustainability disclosures are published on the European Single Access Point, a centralized data space offering free digital access to detailed information on EU corporations that was established by EU Regulation in 2023.

5. Looking Ahead

CSRD applies to any undertaking meeting the prescribed thresholds,

regardless of the industry; asset and fund managers are also in scope if they meet these thresholds or are listed. Although EU funds themselves are exempt (as they are covered by the Sustainable Finance Disclosure Regulation), non-EU funds can generally still qualify to be in scope. For example, non-EU funds that hold majority stakes in portfolio companies that are within scope of CSRD could be considered a parent undertaking and thus brought into scope in 2028. For non-EU funds structured in the form of partnerships, there is room to argue that they are out of scope.

Challenges. We anticipate that for many organizations, meeting CSRD's obligations presents a significant challenge. Many undertakings lack the existing systems and processes to gather the necessary information, which is often not easily accessible. Additionally, the regulatory environment is rapidly evolving. Several EU jurisdictions have yet to formally adopt the CSRD into local legislation before the July 2024 deadline. These jurisdictions may introduce additional requirements beyond those specified in the CSRD, complicating compliance for undertakings operating across multiple EU countries. Further, the CSDDD will introduce additional ESG-related requirements and increase the risk of sustainability-related litigation, allowing parties to bring civil liability claims for damages resulting from undertakings' failure to comply with due diligence obligations. Finally, businesses should be vigilant about new reporting mandates emerging outside the EU, such as the recent approval by the U. S. Securities and Exchange Commission of a comprehensive set of final rules regarding climate-related disclosures for public undertakings.

Opportunities. Private Equity (PE) firms can benefit from their efforts in CSRD reporting beyond the satisfaction of a compliance requirement. The data gathered for CSRD reporting (along with comparable and accurate data of portfolio companies not covered by CSRD), provides valuable insights for PE executives and deal teams into understanding market trends and how sustainability issues could impact the financial outcomes of portfolio companies or investment targets. This information is crucial for collaborating with portfolio company leaders to discover potential business opportunities and risks, leverage mechanisms for value creation, manage threats effectively and enhance their equity narratives. Further, being prepared for the CSRD can influence the valuation of a portfolio company at the time of exit, as some buyers are already considering the future costs associated with CSRD compliance and annual reporting in their acquisition strategies.

Action Points. We encourage PE firms to start actively preparing for CSRD requirements. Producing CSRD reports can be time consuming and require coordination among different teams (e.g., finance, information technology, sustainability, risk management and legal functions). PE sponsors should:

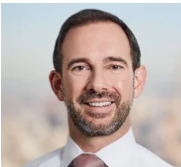
- Determine whether any of their undertakings or portfolio companies fall within regulatory scope. They should consolidate their information and assess sustainability issues, data points, impacts, risks and opportunities.
- Evaluate their reporting capabilities and set up the necessary processes to ensure that reporting is accurate, consistent and ready for auditing assessments. This might include educating and sharing best practices on CSRD reporting with undertakings in-scope, setting up internal reporting structures and processes to collect required data and preparing for information requests they might receive from undertakings in supply and distribution chains.
- Consider the status of structures, such as holding companies, co-investment vehicles, and non-EU funds, and determine to what extent they could be considered covered parent undertakings, thus bringing themselves and their subsidiaries into scope. Undertakings consolidated for financial reporting within a group will generally be likely to be consolidated for sustainability reporting under the CSRD.
- Consider CSDDD's forthcoming due diligence obligations (starting from 2027) when developing their strategies for CSRD compliance. Preparation for the CSRD should include integrating due diligence processes and ESG factors into investment strategies and improving portfolio companies' compliance with the CSDDD.

Debevoise & Plimpton

SEC Climate-Related Disclosure Rules: Key Considerations for PE Sponsors

Eric T. Juergens
Partner

Benjamin R. Pedersen
Partner


Paul M. Rodel
Partner

Kristin A. Snyder
Partner

Stuart Hammer
Counsel

Michael Keene
Associate

Amy Pereira
Associate

On March 6, 2024, the U.S. Securities and Exchange Commission adopted long-awaited rules requiring registrants, including foreign private issuers, to disclose extensive climate-related information in their registration statements and periodic reports. Almost immediately, the Rule met with legal challenges in six federal circuits, which were consolidated into a single case before the U.S. Court of Appeals for the Eight Circuit on March 21. On April 4, the SEC exercised its discretion to stay the Rule pending completion of judicial review in the Eighth Circuit but stated that it would continue "vigorously defending" the Rule in court.

Despite the legal challenges to the Rule, it raises a number of issues that SEC registrants and sponsors should consider when undertaking M&A and securities transactions. We outline key considerations below.

1. The Rule Does Not Apply to Private Companies

The Rule does not apply to private companies that are parties to business combination transactions involving a securities offering registered on Form S-4 or F-4 and certain transactions for which a proxy statement on Schedule 14A or information statement on Schedule 14C is required to be filed. This means that if the target being acquired is not an SEC registrant, climate-related disclosures with respect to the target are not required to be included in these forms.

Similarly, registrants that complete the acquisition of a private company and must disclose the financial statements of that acquired business under Item 9.01 of Form 8-K are not required to include the Regulation S-X footnote disclosure mandated by the Rule in the acquired company financial statements. In addition, any pro forma financial statements that are disclosed pursuant to Item 9.01 do not need to include the climate-related Regulation S-X disclosure to the extent that they relate to the acquired private company. As discussed below, however, (1) a private company engaging in an initial public offering on a Form S-1 or Form F-1 must comply with the Rule, without any exemption or additional phase-in, and (2) an acquiring public company must comply with the Rule after completing an acquisition of a private company.

2. The Rule's Reporting Requirements Apply to Covered Companies Acquired at Any Time During a Fiscal Year

Under the Rule and absent any future guidance from the SEC, registrants that acquire a business or asset at any time during a fiscal year—including acquisitions made in the final quarter of the fiscal year, must include those

businesses or assets in their climate-related disclosures for that year. This means that, depending on when in the fiscal year the acquisition takes place, registrants must be prepared to move quickly to collect from a target company the information required to make the necessary climate-related disclosures and must have the controls and procedures in place to assess the quality of such information.

3. Remedies Exist in Cases Where Information Is Unknown and Not Reasonably Available

In the adopting release, the SEC notes that, to the extent Scope 1 and/or Scope 2 GHG emissions disclosure is required by the Rule, registrants may avail themselves of Rule 409 of the 1933 Act and Rule 12b-21 of the 1934 Act. These rules allow a registrant to omit from their registration statements and periodic reports information that is unknown or not reasonably available, *provided* that (a) the registrant includes a statement to that effect, or otherwise indicates the absence of any affiliation with the person who possesses the information, and details any efforts to obtain the information from such person, and (b) the registrant discloses the information that it does have or can reasonably obtain. Registrants that acquire private companies for which Scope 1 and Scope 2 greenhouse gas emissions data are not available may consider using these rules until the registrant is able to produce the necessary information. We note that use of these rules is not limited to GHG emissions, and registrants may be able to invoke these rules for other disclosures required by the Rule.

As discussed below, parties also need to consider whether such disclosures should be made if an offering is planned or possible, and all material information must be disclosed.

4. If a Securities Offering is Planned or Possible, Registrants Must Consider the Need to Make Scope 1 and Scope 2 GHG Disclosures

The Rule provides that GHG emissions disclosure required to be included in an annual report on Form 10-K may be incorporated by reference from the registrant's quarterly report on Form 10-Q for the second fiscal quarter of the fiscal year in which such annual report is due or may be included in an amended Form 10-K no later than the due date for such Form 10-Q.

A registrant that avails itself of this accommodation should consider the need to make such disclosures prior to a securities offering to ensure that all material nonpublic information (MNPI) has been disclosed at the time of the offering. This is particularly important in the first year that a registrant is required to make GHG disclosures, if such disclosures are new to the market. In subsequent years, registrants and underwriters may manage the risks associated with potential MNPI through due diligence discussions about the registrant's expected GHG emissions reporting to ensure that the disclosure is unlikely to change materially from the prior year. Nevertheless, there remains some risk that GHG emissions will vary from expectations or prior year reporting, which may be addressed through additional (e.g., risk factors) disclosure in the offering document.

5. Prior to the Phasing in of Attestation Requirements, Underwriters Are Likely to Request Management Comfort on Scope 1 and Scope 2 GHG Emission Disclosures

The Rule phases in an attestation requirement for Scope 1 and Scope 2 GHG emissions for registrants required to provide such disclosure (*i.e.*, large accelerated filers and accelerated filers that are not smaller reporting companies (SRCs) or emerging growth companies (EGCs)). This attestation requirement will provide underwriters with comfort on the Scope 1 and Scope 2 GHG emissions disclosures.

However, before the attestations are required, underwriters may seek comfort in other ways if a voluntary attestation is not obtained by the issuer. For example, underwriters could require the Chief Financial Officer or Chief Sustainability Officer

> Despite the legal challenges to the Rule, it raises a number of issues that SEC registrants and sponsors should consider when undertaking M&A and securities transactions.

(or other appropriate executive officer) to provide a certification as to the accuracy of the information. Registrants need to be prepared to provide support for their GHG emissions disclosure for which they have not obtained attestation.

A similar issue arises in the context of issuers that are not subject to Scope 1 and Scope 2 GHG emissions disclosure requirements but who nevertheless voluntarily include such disclosure in their filings.

6. In Rule 144A and Other Unregistered Securities Offerings, Market Participants Could Request Inclusion of Climate-Related Disclosures

In Rule 144A offerings, the market generally looks to SEC disclosure requirements to inform the necessary disclosure in an offering document, with flexibility to omit SEC disclosure requirements that are not considered material. As a result, market participants may argue that the Regulation S-K (and for that matter, Regulation S-X) climate-related disclosures are presumptively material, even if the issuer is not otherwise required to make such disclosures in the offering document. Accordingly, issuers should be prepared to discuss the materiality of climate-related disclosures for their business in the context of an unregistered securities offering.

7. Companies Conducting Initial Public Offerings Will Be Subject to the Rule's Requirements

The Rule does not provide an exemption or transitional relief for registrants engaged in an IPO. A company that is subject to the Rule is required to provide disclosure for the registrant's most recently completed fiscal year for which audited financial statements are included in the filing. To the extent applicable, Regulation S-X footnote disclosure is required to be included in a company's audited financial statements and in their IPO registration statement and, therefore, will be considered "expertized" for securities law liability purposes.

That said, registrants that are smaller reporting companies (SRCs) or emerging growth companies (EGCs) have the benefit of extended phase-ins, as a result of which compliance must begin with respect to fiscal years beginning in 2027. Also, SRCs and EGCs are exempt from GHG emissions disclosure requirements altogether, as long as they maintain their status.

8. The Rule is Likely to Heighten the Sensitivity of Sponsors to Climate-Related Risks in Their M&A Transactions

Sponsors are increasingly conducting due diligence on the climate-related risks of a target when such risks are relevant to the target or the industry in which it operates. The Rule is likely to heighten the sensitivity of sponsors to climate-related risks of targets and to their Scope 1 and Scope 2 GHG emissions more generally, particularly in respect of targets that are or may become subject to the Rule.

Climate-specific representations and warranties are not yet a staple of acquisition agreements, and, in the short term, the Rule is not expected to change the status quo. However, the increased awareness of climate-related risks and disclosure obligations under the Rule could lead sponsors to include climate-specific provisions in their transaction documents.

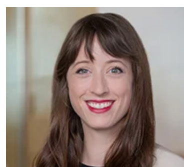
9. Registrants Will Need to Consider the Disclosures That They Make Outside of SEC Filings

To the extent a registrant makes climate-related disclosures outside of its SEC filings, including in publicly available corporate responsibility or sustainability reports or pursuant to U.S. Environmental Protection Agency regulations, California's climate disclosure rules or the EU's Corporate Sustainability Reporting Directive, registrants should consider whether such disclosures must also be included in SEC filings.

For example, although the Rule does not require registrants to disclose Scope 3 GHG emissions, if a registrant adopts a target that relates to Scope 3 GHG emissions, qualitative Scope 3 GHG emissions disclosure may be required to describe the registrant's progress towards the target or that achieving the target involves material costs for the registrant. The staff of the SEC has stated that the Rule does not require quantitative disclosure of Scope 3 GHG emissions in any instance.

CFIUS Developments and Forecast: What Private Equity Sponsors Should Know

Rick Sofield
Partner



Jordan Corrente Beck
Associate

The Committee on Foreign Investment in the United States (CFIUS) is increasingly scrutinizing private equity transactions. This new emphasis was reflected in an addition made last year to CFIUS's Frequently Asked Questions that highlighted the depth of information regarding passive non-U.S. limited partners that CFIUS may request, including the limited partner's identity and their governance and transaction rights—regardless of whether such information is subject to confidentiality restrictions. CFIUS's increased scrutiny of private equity mirrors trends within other federal agencies, and we expect it to continue, with a growing impact on direct and indirect foreign investment made through private equity.

CFIUS's enhanced attention to private equity should alert sponsors to the importance of monitoring CFIUS-related regulatory changes and guidance. Below, we provide a brief overview of some recent developments and look ahead to what may be on the horizon.

The Post-FIRRMA CFIUS Landscape

Since the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018, CFIUS has undergone remarkable change. Historically, CFIUS's jurisdiction was limited to potential transactions that could result in control of U.S. businesses by foreign persons. FIRRMA's implementing regulations expanded that scope to include certain noncontrolling, nonpassive investments in critical **t**echnologies, critical **i**nfrastructure or sensitive personal **d**ata (collectively defined in the regulations as "TID U.S. businesses") and certain real estate transactions. The regulations also introduced mandatory filings for certain transactions involving TID U.S. businesses.

Subsequent executive action further broadened CFIUS's reach. In September 2022, President Biden issued Executive Order 14083, expanding the list of national security factors CFIUS is required to consider when reviewing transactions, including the proposed transaction's impact on U.S. supply chain resiliency (both within and outside of the defense industrial base) and on U.S. technological leadership, with a particular focus on industries including (but not limited to) microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, advanced clean energy and climate adaption technologies. The Executive Order also directs the Office of Science and Technology Policy to periodically publish a list of industries of national security concern for CFIUS's consideration.

There have been additional efforts to enhance CFIUS's monitoring and enforcement capabilities, including most notably the publication of the CFIUS Enforcement and Penalty Guidelines by the U.S. Department of the Treasury. These guidelines identify certain actions or omissions that may trigger monetary penalties—namely, failure to make a mandatory filing, violation of a mitigation agreement entered into with CFIUS or material misstatements or omissions in information or certifications filed with CFIUS—as well as the aggravating and mitigating factors CFIUS may consider in determining an appropriate penalty. While few penalties have been issued to date, the numbers are expected to increase: In remarks at the 2023 annual CFIUS conference, Assistant Secretary of the Treasury for Investment Security Paul Rosen stated that CFIUS had issued two civil monetary penalties in 2023—the same number as issued in all of CFIUS's operating history—and had "several more pending at various stages."

> CFIUS's increased scrutiny of private equity mirrors trends within other federal agencies, and we expect it to continue, with a growing impact on direct and indirect foreign investment made through private equity.

Looking Ahead: Increased Regulation and Enforcement

The CFIUS regulatory environment is expected to continue to evolve in coming years. In particular, a recent proposed rule would enhance CFIUS's compliance and enforcement procedures in a manner that demonstrates CFIUS's commitment to heighted enforcement efforts. Among other things, the proposed rule would amend the CFIUS regulations by expanding obligations to respond to CFIUS inquiries regarding transactions not filed with CFIUS, instituting a timeline for parties to respond to CFIUS risk mitigation proposals, expanding CFIUS's ability to impose civil monetary penalties, increasing the amount of such penalties when imposed and expanding CFIUS's ability to use its subpoena authority.

Additionally, certain amendments to the CFIUS regulations are regularly under consideration, including those that would: (i) expand the list of "excepted foreign states" eligible for certain carve-outs and exemptions under the CFIUS regulations to include jurisdictions with robust foreign direct investment controls; and (ii) expand the list of sensitive sites that trigger CFIUS jurisdiction over real estate transactions. Recent executive action suggests increased attention to transactions involving sensitive personal data, as well as the possible expansion of U.S. government jurisdiction to reach certain outbound transactions in countries of concern. Although they address additional national security review processes outside of CFIUS, these executive actions represent areas in which CFIUS is likely to focus its reviews and enforcement efforts.

Implications for Private Equity Sponsors

In this new environment, private equity sponsors have increasingly needed to conduct intensive analyses of complex fund structures to determine whether their transactions may be subject to CFIUS review—and, in light of recent enforcement trends, the stakes for getting it right are now significantly higher. The FIRRMA implementing regulations include a number of provisions relevant to this detailed, fact-specific analysis, including: (i) the introduction of the defined term "principal place of business"; (ii) revisions to the definition of "control" to include the ability to appoint or dismiss a general partner; and (iii) exemptions for certain passive investments.

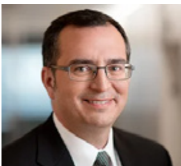
As demonstrated by the added FAQ, U.S. sponsors are finding themselves subject to enhanced diligence requests for information regarding non-U.S. limited partners in their fund structure, including noncontrolling passive limited partners, regardless of any confidentiality obligations binding on the sponsor. CFIUS is particularly interested in identifying non-U.S. limited partners from countries of concern and in the context of transactions involving particularly sensitive industries. As we expect this level of scrutiny to increase, sponsors should continue to monitor the rapidly developing CFIUS landscape and address CFIUS regulatory concerns early in any transaction.

Debevoise & Plimpton

FDI Scrutiny of Private Equity Secondary Deals on the Rise

Gavin Anderson
Partner

Katherine Ashton
Partner


Ezra Borut
Partner

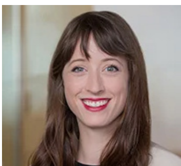
Geoffrey P. Burgess
Partner

Timothy McIver
Partner

John W. Rife III
Partner

Rick Sofield
Partner

Robert T. Dura
Counsel


Jordan Corrente Beck
Associate

Merger control review has long been a key factor in traditional private equity deals, particularly in the United States and European markets. PE sponsors are therefore typically well acquainted with allocating risks associated with, and managing the mechanics of, any required filings, including the impact on deal documentation, time to close and the collection of data about an acquiring fund and its portfolio companies.

Secondary transactions, whether GP led or LP led, have until recently largely escaped such regulatory scrutiny, since secondary investors generally only take relatively small indirect interests in the underlying assets, with the overall control of the sponsor remaining unchanged. However, in the last few years, in the wake of concerns regarding national security, economic vulnerability, and supply-chain disruption highlighted by the Covid-19 pandemic, foreign direct investment (FDI) screening has significantly expanded the scope of what is reportable in the United States, EU, UK and elsewhere. Now, any new money that has a connection to a third-country entity, even if taking indirect passive minority positions in existing fund assets, is potentially of interest to governments and can trigger FDI review in parallel with, or independent of, any required merger control approvals. As a result, navigating FDI requirements is increasingly important to deal making in the secondaries market.

What is FDI Review?

FDI screening gives governments the ability to review and approve investments in certain critical assets and infrastructure to ensure M&A activity will not harm national security or public order. Historically, FDI regimes, such as the Committee on Foreign Investment in the United States (CFIUS), focused on defence and similarly sensitive areas of the economy. Recent changes in investor profile and investment patterns—even when those changes have been the result of government policies promoting FDI—have resulted in a significant expansion in the scope of many national FDI regimes to include strategic sectors such as energy, healthcare, biotech, food security, raw materials, telecoms and businesses that collect or maintain sensitive personal data. Unlike merger control, FDI rules vary greatly between countries (the current efforts of the European Commission to harmonize regimes among Member States notwithstanding), and there is no consistent bright-line percentage threshold below which investors can be certain their investment will escape regulatory scrutiny. While most jurisdictions do have minimum thresholds, governments usually have the ability to call in any transaction they deem of national interest, regardless of its value.

In addition to the transaction structure and individual investment, an FDI filing analysis therefore mainly considers two factors:

(i) Target Risk: Any third-country entities investing in sectors considered to be of critical strategic importance need to consider whether the target falls under relevant national FDI rules and, if so, how sensitive its activities are.

(ii) Acquirer Risk: There is heightened scrutiny of third-country investors deemed to be "governmental investors," a definition that typically incudes not only state-owned enterprises and sovereign wealth funds but also entities such as public sector pension funds, universities, etc.

> Now, any new money that has a connection to a third-country entity, even if taking indirect passive minority positions in existing fund assets, is potentially of interest to governments and can trigger FDI review in parallel with, or independent of, any required merger control approvals.

Challenges for Secondaries

FDI filings can be onerous. In many cases, FDI reviews are suspensory and can take longer than merger-control ones, while at the same time being more opaque and less predictable in outcome due to the involvement of government intelligence services in the evaluation of transactions. In addition, FDI filings often have burdensome disclosure requirements that investors may find intrusive. These requirements can include details about the identity of the ultimate beneficial owners; personal information (such as passport data) of directors, officers [and investment professionals]; a detailed description of the source of funds; the investment structure (including any side agreements); and the identity of other passive investors in the fund.

Furthermore, investors are usually dealing with government departments beyond the established and independent competition regulator. In the UK, for example, decisions are taken centrally within the Cabinet Office, while in the United States, multiple disparate agencies, including the Departments of Treasury, State, Defense, Commerce, Energy and Justice are involved in the review of transactions. That often means, particularly in jurisdictions with relatively new or expanded regimes, less transparency and communication and thus greater uncertainty and delay.

As a result, sponsors are becoming more and more cognizant of FDI filing requirements and seek to preemptively address potentially problematic issues. Deal documentation therefore increasingly includes FDI-targeted clauses granting the GP the ability to:

- Restrict an investor's voting rights or participation on a limited partner advisory committee, or even expel an investor, if the GP determines its inclusion may have an adverse effect on the fund or underlying investments due to FDI restrictions.
- Withhold information to an investor where the GP determines such disclosure may have the potential to affect an FDI review of the fund's existing or future investments.
- Block a proposed transfer that could subject the fund to an FDI review.
- Block a proposed transfer of an interest where the GP determines such transfer may have the potential to affect the FDI review of the fund's existing or future investments.

Managing FDI Scrutiny

Given current geopolitical tensions, scrutiny of foreign investment can be expected to increase further. Secondary investors—particularly those involved in more complex secondary transactions, such as acquisitions of a portfolio of investments or fund restructurings—should be mindful of possible FDI implications. Even if an individual investor's holding may not itself trigger a filing requirement, the overall investor composition in the aggregate and/or the activities of the underlying assets may mean the investor will be referenced in a filing—for example, in a filing made by the lead investor. Therefore, investors should be prepared to address any FDI regulatory issues through

the implementation of mitigation measures prescribed by regulators.

Additionally, investors in secondary transactions involving sensitive industries should anticipate and plan for significant FDI scrutiny. Some examples of industries which can be expected to receive enhanced FDI review include: (i) climate adaptation and advanced clean energy; (ii) semiconductors, artificial intelligence, and advanced computing; (iii) insurance, financial institutions, social media, internet-connected vehicles and other companies which collect or maintain significant amounts of sensitive personal data; (iv) critical minerals and materials; and (v) critical infrastructure.

Finally, any filings that an investor is required to make or is part of, such as securities filings and merger-control filings, should be substantively consistent to avoid potentially invasive follow-up questioning—and, potentially, fines for providing misleading information. Care in this regard is particularly important given the increased information sharing taking place among national governments and intelligence agencies involved in FDI screening. The United States, for example, amended its CFIUS rules explicitly to permit the sharing of confidential company information with any foreign governmental entity of a United States ally or partner. The same is true of the relevant UK legislation. Similarly, the European Commission and the individual Member States within the EU actively cooperate with each other to exchange information and share concerns related to specific investments as well as with international partners such as the United States.

Debevoise & Plimpton

Putting AI into the Due Diligence Equation: Key Considerations for Sponsors

Megan K. Bannigan
Partner

Christopher S. Ford
Counsel

Caroline P. Geiger
Counsel

Tigist Kassahun
Counsel

Artificial intelligence is becoming increasingly central to businesses across the global economy. With AI having been used for some time in specific areas such as risk management models for insurance companies, fraud detection by credit card companies and customer support chatbots, companies in a wide range of sectors are now racing to harness AI to enhance their offerings and streamline their operations—everything from generating computer code to developing drugs to pricing real estate.

As companies build their own AI tools, use third-party AI applications and harness AI-generated content, AI-related assets are becoming a source of both value and risk for private equity sponsors evaluating these companies as investment targets. This article reviews some of the key issues sponsors should consider as they incorporate AI factors into their due diligence.

Due diligence of a target company's AI begins with determining what types of AI technologies are being used by the company, for what purpose and the value of AI to the relevant business—and therefore to its investors. Due diligence strategy is further shaped by whether the target company is developing and using its own proprietary AI model (including whether it is using the model for the benefit of third parties such as customers), if the company is relying on or sourcing AI-generated output from a third party and/or whether the company is providing data for use in training third-party AI models.

Rights and Regulations Considerations

AI models are built on algorithms trained on large collections of data, called training data, to produce output responsive to prompts provided by a user, which could be a business or its customers. The three separate parts of the AI workflow—the AI model itself, the training data inputted into the model and the output generated by the model—each bring their own diligence considerations regarding rights and regulations.

- **The AI Model.** If a target company has developed its own AI model, a sponsor should seek clarity as to how the company protects its model from unlicensed use by third parties to maintain value and market advantage. In the United States, copyright, patent and trade secret laws may provide some protection for proprietary AI tools (e.g., software algorithms and data compilations), but obtaining such protection presents unique challenges. Key considerations include who developed the model and whether the company has appropriate documentation in place with all individuals who contributed

to the model's development (such as IP assignment or work made-for-hire agreements with employees and contractors) as well as employee handbooks and other written policies addressing confidentiality and authorized use of the company's proprietary information.

- **Training Data.** A private equity sponsor evaluating a target company with a proprietary AI model should identify the sources of training data and confirm that the target company has all necessary rights to use the training data as such datasets are used and intended to be used by the company in its model. That inquiry should address intellectual property rights as well as rights in any potentially sensitive data. The sponsor should also evaluate the risk that the target will not be able to acquire rights to additional high-quality training data in the future, which could impact the long-term viability of the target's AI model.
- **AI Output.** Even if a target has secured the necessary rights in the training data for use with its AI model, rights in the AI output must be considered as well. For example, if a company is licensed to use for training data third-party content that is protected by copyright, the AI output generated by that training data is not necessarily covered by the same license. If the AI output includes reproductions or derivatives of copyrighted content, use of the output that is not expressly covered by the license might infringe the third party's rights. A team conducting diligence on the target company's rights with respect to AI should review the company's contracts with third parties that provide or have provided training data for the model to confirm that the company has sufficient rights to use and/or own the output and, to the extent applicable, make such output available to its customers.

In addition to IP issues, companies should also view their training and output data through the lens of existing and evolving data privacy laws applicable to the collection, use and other activities performed on applicable data and the mechanisms to protect that data. When companies are feeding training data into a vendor's AI model rather than something proprietary, they should be aware of how that input data is being used (which includes ensuring the vendor does not use such data for purposes outside of providing the services to the company) and protected by the AI vendor, particularly where necessary to ensure compliance with data privacy or other regulatory obligations.

Finally, companies must remember that the laws, regulations and standards for AI also include ethical considerations relating to bias, transparency and accountability. A private equity sponsor should confirm that the target company has a framework for addressing AI matters and associated risks including a plan to update the company's AI-related policies and practices as laws and regulations evolve.

Litigation Considerations

Litigation over AI has so far centered primarily on AI training data and output, with courts evaluating a number of lawsuits alleging both that AI training data impermissibly contained copyrighted works, and that the AI output was an unauthorized derivative work. Many of the plaintiffs in these cases have been the owners of copyrighted works, but we have also seen plaintiffs who own trademarks that were produced as part of an AI model's output (like Getty Images and T*he New York Times*) bring trademark claims as well. So far, courts have been very skeptical of infringement claims regarding AI output, especially where plaintiffs have not been able to tie the AI models' output to specific training data. But plaintiffs have been more successful—at least in preliminary litigation stages—with claims based on copyrighted training data.

Litigation challenging AI models is still in the very early stages, and while it seems unlikely to represent an existential threat to the AI industry, it can nevertheless pose challenges to AI companies and their customers. We expect significant litigation over the legality of AI models and their training data, as well as the scope of fair use defenses, that could take the courts decades to sort out—during which time this technology will continue evolving.

Cybersecurity and Risk Allocation Considerations

Because AI models depend on large datasets of training data that are

fed into algorithms and software, both AI vendors and proprietary AI models are susceptible to performance failures, data breaches, and other cyber attacks and incidents. Sponsors should thus review the target company's internal practices, including its policies and procedures (including how employees are trained), and contracts with third parties relating to the security and protection of both the AI tool itself and the relevant input and/or output. Whether the AI platform is proprietary or that of a third party, the company should take appropriate measures to maintain and protect the software, systems and servers that house the AI model, training data, any user-provided input data and output, as applicable.

Sponsors should also examine how risk has been allocated between the target company and third parties and whether the target company bears potentially significant risk associated with its use of AI models, input and training data, and output (e.g., if the output or use thereof infringes a third party's rights). Many companies are now requiring representations of noninfringement and data sourcing rights to get greater assurance that the third-party AI model does not infringe on third-party IP rights. The relevant contracts should clearly allocate risk through express obligations, representations and warranties, and indemnities addressing the issues discussed above, including system security and performance, ownership and rights to use AI input and output, non-infringement and other violations of intellectual property and other third-party rights, and compliance with applicable data privacy laws and ethical standards regarding use of AI.

> As companies build their own AI tools, use third-party AI applications and harness AI-generated content, AI-related assets are becoming a source of both value and risk for private equity sponsors evaluating these companies as investment targets.

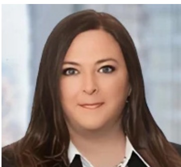
Conclusion

While development of AI tools and use of AI output has the potential to create substantial value for a target company, a private equity sponsor should carefully evaluate the company's practices with respect to AI to ensure that any potential risk exposure does not undermine the value of the sponsor's investment.

Management Equity Issues Arising in Continuation Fund Transactions

Meir D. Katz
Partner

Jonathan F. Lewis
Partner


Kathleen M. Emberger
Counsel

Over the past few years, continuation fund transactions have gained acceptance as an exit strategy from portfolio company investments for private equity funds.[1] Unlike a traditional sponsor exit from a portfolio company investment via an IPO or a sale to a third party, in a continuation fund transaction, the same sponsor typically continues to control the portfolio company. As a result, continuation fund transactions can raise unique considerations regarding management equity investments and awards, which we discuss below.

Overview

Continuation fund transactions can be appealing for a number of reasons: to provide liquidity to limited partners, to allow the sponsor to hold an investment beyond the existing fund's expected duration, or because market conditions for a traditional exit are unfavorable. In the transaction, the existing fund will sell the portfolio company investment to a new vehicle controlled by the new continuation fund, and some or all of the limited partners who hold interests in the existing fund may be offered the option either to roll their interests in this portfolio company investment into the continuation fund or to cash out of the investment. In addition, cash may be raised from new investors in the new vehicle to fund this cash out of investors from the existing fund. The transaction may or may not crystallize sponsor carried interest. After the closing of the transaction, the original sponsor continues to control the portfolio company through the new continuation fund and typically with new and continuing limited partners as co-investors.

Effect on Management Equity

As part of the preparations for a continuation fund transaction, a sponsor and its counsel will need to review the contractual provisions that apply to management's equity in the portfolio company, which may include both (1) "incentive equity," such as options or profits interests; and (2) "invested equity" that management rolled over or purchased when the sponsor originally acquired the portfolio company. Different considerations apply to each.

1. For example, an article from January 2024 notes that continuation fund transactions completed in 2021 were estimated to total $68 billion in deal value, "representing a 750% increase over five years." Kobi Kastiel and Yaron Nili, "*The Rise of Private Equity Continuation Funds*" Stigler Center for the Study of the Economy and the State, January 2024, New Working Paper Series No. #340.

1. Considerations Related to Management's Incentive Equity

A threshold question for a sponsor preparing for a continuation fund transaction is whether, *under the existing plan documents*, the transaction will constitute a vesting and/or liquidity event that accelerates the vesting of some or all of management's incentive equity. If so, the plan terms will typically need to be followed unless they can be amended, or management consents to a change. Often, the central factor in this analysis of the documentation will be the definition of key terms such as "change in control," "sale of the company" or "liquidity event." For example, if those definitions exempt affiliate transactions—as is frequently the case—and if the new fund and old fund are both controlled by the same sponsor, a continuation fund transaction often will not constitute a triggering event.

If the continuation fund transaction does not constitute a triggering event under the applicable plan documents, the sponsor will have more flexibility as to how to treat outstanding incentive equity in the transaction. However, there is little precedent or established market practice to guide that treatment. Sponsors and their co-investors may find it helpful to consider some or all of the following considerations in deciding whether it is fair and equitable for management to participate in the transaction as if it were a sponsor exit:

- Why is the continuation fund transaction occurring? Do the reasons for the transaction align better with liquidity for management (e.g., a long-held portfolio company) or a full management roll?
- Does the incentive equity still provide the right motivation and incentive? To what extent is the incentive equity vested? Are there any arguments that management would be receiving a windfall by being permitted to cash out, or that management is being treated unfairly in the transaction?
- What benefits is the sponsor receiving from the transaction, and how do those benefits compare with those received by management? Are there cogent reasons why the two should be treated differently?
- What are the management team's expectations and how reasonable are those expectations? How much leverage does the team have?
- How much value has the management team delivered through the date of the continuation fund transaction (i.e., how much embedded value is there in the incentive equity)? How compelling is the argument that significant value still remains to be realized?

Once these considerations are evaluated, a path forward can be identified. That path can take several forms. The sponsor could offer management the option to cash out, remain invested or take a limited amount of liquidity off the table. The incentive equity could be recapitalized into invested equity along the lines of a rollover in a third-party sale. Different tranches or types of incentive equity could be treated in different ways to maximize retention and incentive considerations (e.g., cashout of vested service-vesting equity and retention of MOIC-based or other unvested performance-vesting equity). The sponsor might require management to agree to re-vest some of their incentive equity in exchange for liquidity of other equity. In some cases, a continuation fund transaction might be treated as a full synthetic exit—in the same manner as an exit to a third party, with a negotiated elective rollover in which incentive equity is converted into fully vested invested equity, and a new incentive equity program is rolled out.

2. Considerations Related to Management's Invested Equity.

As with management's incentive equity, the baseline question regarding invested equity is whether the applicable subscription agreement and limited liability company, partnership or stockholders' agreement include provisions, such as tag-along rights, that may be triggered depending on the structure of the transaction. If not, sponsors would perform an analysis similar to that outlined above for incentive equity. If nonmanagement limited partners are being given the option of cashing out or rolling over their

Given the increasing viability and prevalence of continuation fund transactions, it would be a natural development for the market to begin to address the issues raised by these transactions at the outset, when equity plans are first established at a newly acquired portfolio company.

investment in a continuation fund transaction, management may have justifiably strong feelings about their ability to monetize a proportionate share of their invested equity. Sponsors may welcome the opportunity to provide management with liquidity, or may also negotiate for management to continue to keep as much "skin in the game" as possible. Typically, the resolution of the treatment of invested equity would be managed holistically with the treatment of incentive equity.

Looking Ahead

Given the increasing viability and prevalence of continuation fund transactions, it would be a natural development for the market to begin to address the issues raised by these transactions at the outset, when equity plans are first established at a newly acquired portfolio company. We have seen management counsel begin to raise continuation fund treatment in the initial management equity negotiations, although the range of variables and considerations makes it difficult to pre-bake the right outcome up front. Depending on the dynamics of negotiations with the management team, if the portfolio company is able to exclude a continuation fund transaction from an automatic triggering event, it will maximize flexibility at the time of the transaction. We expect that over time, a clearer sense of market practice regarding these issues will emerge.

Debevoise & Plimpton

Choosing Your Battlefield: Selecting the Appropriate Dispute Resolution Process

Mark W. Friedman
Partner

Jeffrey Sullivan KC
Partner

Gavin Chesney
International Counsel

Cameron Sim
International Counsel

Benjamin Teo
Associate

When a deal is being negotiated, dispute resolution clauses are usually a low priority, with efforts instead focused on the substantive terms of the transaction. But by treating dispute resolution as an afterthought, parties are potentially leaving money on the table.

A contract's dispute resolution clause can have a significant impact on the resilience of the parties' obligations in the face of conflict and on the long-term relationship of the parties. A well-drafted clause can save costs and time at the inception of a dispute, facilitate a more efficient resolution and even deter breaches of the agreement by having an effective dispute resolution mechanism already in place. Conversely, deficient dispute resolution clauses can complicate and prolong disputes and create uncertainty in their resolution and possibly even leave a party with an inadequate remedy when faced with a breach by the counterparty. In addition, from a strategic perspective, the dispute resolution clause can alter the balance of power in settlement negotiations.

Drafting an effective dispute resolution clause requires the parties to think through their likely posture in disputes that may arise and then translate that posture into a clause that maximizes the prospect of successful and efficient dispute resolution. Of the various decisions that must be made, the most fundamental is choosing whether the battlefield for the conflict will be litigation in a national court or arbitration under the rules of an arbitration institution. Each mechanism has its pros and cons and which to choose will always be context specific. The parties' respective positions may mean they each prefer a different process. Properly negotiating the dispute resolution clause will help ensure that a fair solution is found for both parties and create greater certainty for the efficient resolution of disputes.

In this article, we explore the key differences between litigation and arbitration for disputes in the private equity context and considerations to guide parties in negotiating appropriate dispute resolution clauses.

Arbitration vs. Litigation: Pros and Cons

In some respects, court litigation and arbitration are similar. Both have a decision-maker to whom the parties make written and oral submissions and present evidence. In contractual disputes, the decision will generally be based on the governing law chosen by the parties. However, in other respects, the processes differ substantially in ways that affect the conduct of the dispute and its resolution.

Some features of arbitration can come as a surprise to parties used to litigating disputes, particularly in U.S. or common-law courts. With some exceptions, arbitration procedures generally do not allow for U.S. style depositions of potential witnesses, and tribunals typically have no power to compel testimony. Document discovery or disclosure exercises are much more limited than is usually the case in common-law courts. All of these features can reduce the overall time and cost of arbitration, but it can also potentially limit the range of evidence to which parties have access.

> Some features of arbitration can come as a surprise to parties used to litigating disputes, particularly in U.S. or common-law courts.

Despite these limitations, a dispute resolution clause specifying arbitration is well worth considering when private equity firms are negotiating a deal. Court proceedings are almost universally held in full public view by default, subject only to limited circumstances where a court may grant an application to have some evidence redacted or the proceedings heard in private. Arbitration, by contrast, is almost always private and confidential, which a private equity firm may find particularly desirable when resolving a dispute. Confidentiality protects commercially sensitive information (for example, concerning structuring and pricing), helps to limit and manage reputational issues arising from adverse publicity and supports the preservation of long-term relationships between disputing parties.

Arbitration also generally allows the parties more control over who the decision-makers will be. Court systems allocate cases to a judge. In arbitration, parties normally influence the composition of the tribunal. The parties can seek to reach agreement on the identity of a sole arbitrator, or where the tribunal comprises of three members, each side usually appoints one arbitrator, and the third generally is appointed with some input from both sides. This allows better selection of arbitrators with relevant industry experience.

Enforceability of decisions is one of the most important considerations in choosing the dispute mechanism. There is usually no point pursuing a decision that cannot be enforced. Arbitral awards issued in the major arbitration-friendly jurisdictions will be enforceable in any of the 172 countries that are signatories of the Convention on the Recognition and Enforcement of Arbitral Awards (commonly known as the “New York Convention”). This provides relatively straightforward enforceability for arbitral awards in most jurisdictions. Arbitral awards are also generally not subject to appeal and can only be challenged on very limited grounds.

By contrast, enforcing court judgments outside of a court’s jurisdiction will depend on the particular court and foreign jurisdictions involved. Enforcement is also likely to depend on whether there are bilateral treaties in place between the relevant countries governing the reciprocal enforcement of court judgments. If there is no applicable treaty, enforcement can be difficult, onerous or even practically impossible. Even if there is, court decisions can be subject to appeal, which may delay enforcement for months or years.

Arbitration Caveats

When arbitration is selected, it is vital to ensure that the arbitration agreement is properly drafted. The drafting should be informed by careful consideration of the nature of the contract, the parties to the contract, the types of disputes that might be expected to arise under it and the jurisdictions likely to be involved in any dispute or enforcement procedure.

Risks arise where there is a suite of agreements between overlapping parties, and these agreements contain incompatible arbitration agreements. This can lead to the fragmentation of disputes and parallel arbitration proceedings. Careful drafting of arbitration agreements can remove this risk by enabling the parties to proceed under a single arbitration if a dispute arises under multiple contracts.

Common Dispute Scenarios

We turn now to consider common dispute scenarios that may arise in the private equity context and how these affect the preferable dispute resolution mechanism.

Disputes between GPs and Portfolio Companies

Potential disputes between GPs and portfolio companies can include allegations of breach of duty or mismanagement of the portfolio company; disputes relating to conflicts between fiduciary duties owed to the LPs and to portfolio company shareholders; disputes relating to the exercise of put rights or other exit rights; and failure by portfolio companies to recognise specific GP rights as to board representation, voting rights or other corporate governance issues.

Whether litigation or arbitration is preferable often depends on whether the GP would benefit from the threat of open-court proceedings, whether the coercive powers of courts are likely to be required (including interim measures such as freezing injunctions) and whether the portfolio company is expected to comply with the decision of the court or tribunal.

Disputes between GPs and Counterparties

Disputes may arise between GPs and counterparties in relation to a purchase or sale of portfolio company interests. In these instances, court litigation is likely to be a preferable forum for GPs in light of the generally broader disclosure and coercive powers at a court's disposal and the pressure that open court proceedings and public reporting of the dispute may place on counterparties.

Disputes between GPs and LPs

While uncommon, disputes can arise between GPs and LPs under the main fund agreements. These most frequently involve allegations that fund managers or the GP have breached duties owed to the LPs; allegations of mis-selling or breaches of securities laws; disputes over capital calls or failures by LPs to meet them; disputes over valuations or remuneration payable to managers; or breaches of confidentiality.

Generally, arbitration tends to be seen as preferable for GPs in light of the confidentiality benefits, comparatively limited disclosure and the potential for the arbitrator(s) to have industry expertise. However, LPs will not always be able or willing to consent to arbitration, and it is not uncommon for fund agreements to provide for court jurisdiction.

Disputes between GPs and Personnel

Disputes can also arise between GPs and their staff for a range of reasons, including issues arising from employment, or disputes over entitlement to carried interest. Whether arbitration or litigation is preferable may depend on the gravity of the situation, and whether the GP's preference is for the dispute to be kept out of the market. Arbitration is likely to provide a faster and cheaper alternative to court litigation, with the added benefit of confidentiality. However, the threat of the court's coercive powers may act as a stronger deterrent against misconduct by bad leavers.

Disputes between GPs and States or State-Owned Entities

GPs often deal with sovereign wealth funds or other State or parastatal entities (such as national oil companies and national pension funds). When disputes arise in the course of such dealings, local national courts may be a risky proposition. In certain jurisdictions, there may be legitimate concerns about a lack of impartiality when State interests are at play. Arbitration provides a neutral forum for the resolution of these disputes, and strengthens enforcement prospects against a State's commercial assets in New York Convention jurisdictions.

Dispute Resolution Clauses Are Always Worth Negotiating

Choosing the right battlefield for dispute resolution will allow parties to resolve their disputes in a faster and more cost-efficient manner, whereas the wrong battlefield can lead to long delays and unnecessary costs, impact a party's prospects success and even create an impossibility of enforcing the decision.

Whichever mechanism is chosen, it is important to remember that dispute resolution clauses are not boilerplate provisions. Drafting errors can have a tailspin effect at the outset of a dispute and can easily be avoided. Unless a party is content to leave money on the table, dispute resolution clauses should always be carefully considered and, where necessary, properly negotiated.

About the Debevoise Private Equity Group

A trusted partner and legal advisor to a majority of the world's largest private equity firms, Debevoise & Plimpton LLP has been a market leader in the Private Equity industry for over 40 years. The firm's Private Equity Group brings together the diverse skills and capabilities of more than 500 lawyers around the world from a multitude of practice areas, working together to advise our clients across the entire private equity life cycle. The Group's strong track record, leading-edge insights, deep bench and commitment to unified, agile teams are why, year after year, clients quoted in *Chambers Global, Chambers USA, The Legal 500* and *PEI* cite Debevoise for our close-knit partnership, breadth of resources and relentless focus on results.

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

Law 360

GROUPS of the YEAR

International Arbitration, Fund Formation, M&A, White Collar

Law 360

GROUPS of the YEAR

Investment Management, Intellectual Property

British Legal Awards

BANKING AND FINANCE TEAM OF THE YEAR

Private Equity International Awards Hall of Fame

20 PEI AWARDS

across North America, EMEA & Asia since 2001

Chambers USA Awards for Excellence

Law Firm of the Year

International Arbitration

Chambers Global, Chambers USA, The Legal 500 US

Ranked as a leading private equity-focused law firm

Benchmark Litigation

Private Equity lawyers recognized among Top 250 Women in Litigation

Private Equity Report

Circulated to more than 24,000 private equity professionals worldwide