Debevoise & Plimpton

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From the Editors

After a challenging two years, the private equity industry is undergoing a healthy rebound. But as deal flow picks up, there are a host of regulatory and legal developments to consider, from the priorities of the new administration to the implementation of the Corporate Alternate Minimum Tax. *The Fall 2024 Private Equity Report* delves into some of these topics as well as issues arising from opportunities in restructuring, real estate and AI.

SPOTLIGHT

Strange Bedfellows: Structuring Governance and Exit Rights for a Restructured Company

Debt investors whose holdings are converted to equity as the result of a restructuring face the prospect of negotiating governance and exit rights for the reorganized entity with other former debtholders, who may have very different priorities and levels of equity investment experience and orientation.

To File, or Not to File: The Changing Calculus for Voluntary CFIUS Filings.

Historically, many sponsors have made voluntary filings with CFIUS, the interagency body charged with examining the national security implications of investments by foreign entities made into U.S. businesses. Sponsors should carefully analyze the risk-reward of voluntary filings in light of CFIUS's more aggressive approach.

Data Centers: Navigating the Opportunities of a Unique Asset Class.

The explosive growth of AI has led to a sizable unmet demand for the data centers AI requires. While this presents real estate developers and investors with significant opportunities, there are also numerous factors to consider, ranging from the availability of power to regulatory developments.

SEC Private Fund Adviser Enforcement FY 2024 Highlights.

Over the past year, the SEC's Division of Enforcement has brought cases underscoring its ongoing focus on numerous regulatory issues important to private investment advisers, including continuing to focus on post-commitment management fee calculations, off-channel communications, fee and expense disclosures and MNPI controls.

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Fall 2024 Issue Editors

Sally Bergmann Hardesty
shardesty@debevoise.com

Rafael Kariyev
rkariyev@debevoise.com

Editorial Board

The Corporate Alternative Minimum Tax: A Primer for Sponsors and Investors.

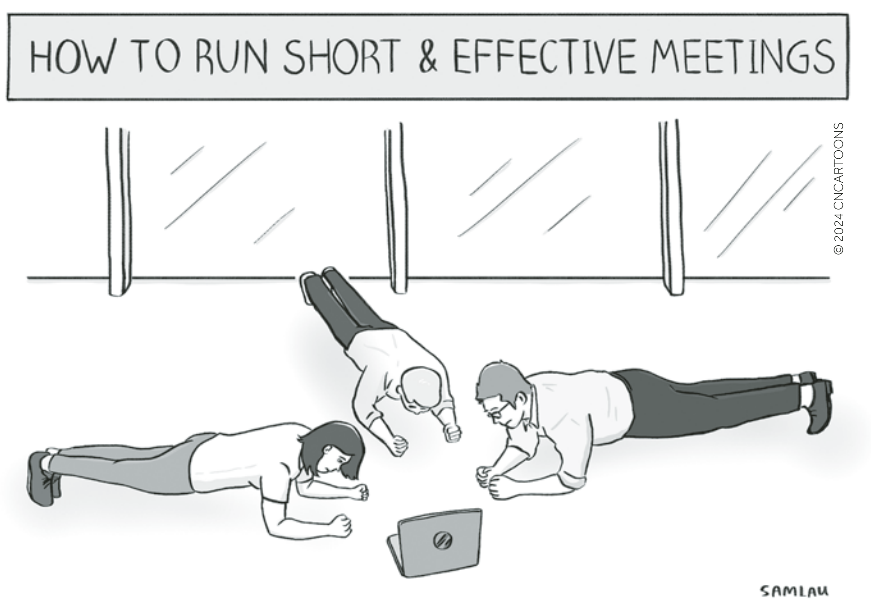
Proposed regulations regarding the Corporate Alternative Minimum Tax would have far-reaching implications for a broad swath of entities, including private equity firms. Certain sponsors and limited partners could find themselves having to navigate extensive annual compliance obligations, particularly regarding the calculation of income from the partnership.

Managing AI-Related Risks Associated with Vendors.

Sponsors using vendor-supplied products or services for investment or management functions that may involve AI need an effective approach for managing the AI-related risks associated with those vendors. This is particularly true given increased regulatory scrutiny of both outsourcing and AI use by financial service firms.

Supreme Court Case Could Increase Sponsors' Financial Liability in Trademark Disputes.

Plaintiffs that have suffered trademark infringement are entitled to recover the defendant's profits. Recently, a federal district court took an expansive view of "defendant's profits" to include the profits of legally separate, nonparty corporate affiliates of the defendant that shared common ownership. The case—with significant implications for sponsors—is now before the Supreme Court.



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SPOTLIGHT

Strange Bedfellows: Structuring Governance and Exit Rights for a Restructured Company

Kevin M. Schmidt
Partner

Nick S. Kaluk III
Counsel

Emily MacKay
Associate

For many years, private equity firms have partnered with one or more other sponsors to form consortiums to pursue large acquisition targets. In these situations, the group members want to be sure there is general philosophical alignment regarding governance, investment horizon and related matters, so they can operate as a team when overseeing the business post-closing. But with private equity firms increasingly raising credit funds, equity ownership of a portfolio company by multiple sponsors may arise in a more indirect way: as the consequence of a restructuring (whether in- or out-of-court) in which the company's debt is converted to equity. This transformation may result in the sponsor owning and controlling the reorganized business jointly with a group of fellow former debtholders, who may have very different levels of equity investment experience and orientation. For these soon-to-be strange bedfellows, anticipating corporate governance and liquidity pressure points is essential in negotiating contractual arrangements that reconcile different perspectives and align the new governance and exit/liquidity rights with their business objectives.

To highlight current market trends regarding post-restructuring governance, we surveyed governance documents—including charters, LLC agreements and shareholder agreements—for a number of restructured companies emerging from Chapter 11. The restructured companies examined spanned the energy, retail consumer products, healthcare and telecom industries and, in more than two-thirds of the cases, had assets and liabilities between $1 billion and $5 billion. We focused on situations that involved significant prepetition debtholders converting their holdings into significant ownership stakes in the reorganized companies. In our analysis, we refer to holders of 30% or more of a reorganized entity's common equity as "Controlling Shareholders," holders of between 10% and 30% as "Major Shareholders" and holders of less than 10% as "Minor Shareholders."

Our review of the governance terms of these restructurings underscored the view that a shareholder negotiating post-reorganization governance provisions should bargain for checks and balances tailored to how active a role that shareholder wants to take in the reorganized investment. Unsurprisingly, our review showed that Major Shareholders frequently bargained for **director designation rights** (some of which were transferrable, enhancing marketability of the equity position for those who held such rights), with such rights generally correlating with the relative size of the investor's position to the other investors in the deal.

In addition to director designation rights, we reviewed **approval requirements for particular corporate action**s. Regardless of the composition of the shareholder group, it was not unusual to see transformative actions like substantial asset sales or bankruptcy filings be subject to supermajority voting thresholds at the board or shareholder level, or for particular directors or shareholders to have veto rights over such decisions when their institutions held Controlling Shareholder or Major Shareholder equity stakes. The same held true for material debt and equity issuances.

Exit rights are also a hot topic for consideration and negotiation by investors. The cases we reviewed underscored that parties often carefully consider their future plans when negotiating an exit from bankruptcy and bargain for tailored flexibility while limiting the potential for nonconsensual hostile actions.

We review our findings below, including a detailed discussion of director designation rights and their transferability, approval regimes for certain significant corporate actions and exit considerations, including a review of transfer restrictions, tag and drag rights, rights of first offer or refusal and initial public offerings.

Director Designation Rights and Transferability

Board representation in the examples we reviewed followed the same general pattern: so long as a shareholder maintained a certain percentage ownership, it was entitled to appoint a roughly proportionate number of directors to the board, with the number of designees stepping down and ultimately falling away as the shareholder sold down or was diluted by new share issuances. In the seven cases we examined that included a single Controlling Shareholder with several Major Shareholders and Minor Shareholders, the minimum go-forward ownership required for Controlling Shareholders to maintain their original number of designees ranged from 20% to 50% of the equity. This suggests that Controlling Shareholders in crowded capital structures are expected, unsurprisingly, to maintain their substantial positions as a quid pro quo for substantial board representation.

> With private equity firms increasingly raising credit funds, equity ownership of a portfolio company by multiple sponsors may arise in a more indirect way: as the consequence of a restructuring (whether in- or out-of-court) in which the company's debt is converted to equity. This transformation may result in the sponsor owning and controlling the reorganized business jointly with a group of fellow former debtholders, who may have very different levels of equity investment experience and orientation.

Although all relevant governance documents we reviewed provided for **step-downs**, one company with several Major Shareholders and Minor Shareholders—but no single Controlling Shareholder—also provided for **step-ups**. In that case, designation rights fell away below 15% ownership, provided one designee between 15% and 35% ownership and provided two designees at or above 35%, with the total number of board seats automatically increasing to accommodate the change. The lack of a single Controlling Shareholder appears to have allowed for the fluidity of this provision of the agreement.

One tactic used by Minor Shareholders seeking to protect their interests in the face of the greater influence of Controlling Shareholders or Major Shareholders is to be allowed to **aggregate their holdings** and thereby collectively satisfy minimum designation ownership thresholds. For example, in one reorganization that included a Controlling Shareholder, two particular Minor Shareholders could designate one director as long as their combined equity holdings exceeded 7.9%, and four particular Minor Shareholders could designate five directors as long as their collective holdings were at least 25%. In another case with multiple Major Shareholders, two Minor Shareholders had the right to appoint one director as long as their combined holdings exceeded 15%.

The cases we examined cut both ways regarding **transferability of director designation rights**, with some allowing, and others disallowing, designation rights to be transferred, without any apparent correlation with the relative sizes of the parties involved. This is obviously an issue that is negotiated on a case-by-case basis.

While securing coveted director designation rights is often a goal for investors in a reorganized entity, such rights obviously impose **legal duties and responsibilities** for the individual designated. Unless the reorganized entity is a limited liability company or other legal entity that permits a fiduciary duty waiver—and all of the LLC examples we reviewed contained such waivers—directors must be aware of and abide by the fiduciary duties accompanying their position, such as the duty of care and the duty of loyalty. As we expected, most of the cases we examined included waivers of corporate opportunities (with narrow exceptions and obviously subject to confidentiality obligations) to limit the potential for directors to be caught between competing obligations amongst companies in their individual business portfolios.

Approval Rights and Supermajority Board Votes

All the reorganized companies we examined provided for approval rights over some, if not all, of the corporate actions discussed below. Note, however, that the rights discussed here represent only a few frequent examples of what is possible; governance documents may be negotiated to include various oversight mechanisms, or a lack thereof, over corporate actions ranging from material contracts and new lines of business to annual budgets and CEO compensation.

Investor protections around **significant asset sales** varied widely across cases, in part due to the range in business sizes. Dollar thresholds above which board approval was required ranged from $5 million to $125 million; one shareholder agreement provided for simple majority approval for sales outside the ordinary course between $1 million and $25 million, but for sales greater than $25 million, supermajority approval was required. Another shareholder agreement provided that asset sales above a certain percentage of the company's fair market value required two-thirds shareholder approval.

Approvals and dollar thresholds incurring **new debt and equity** also varied among companies, again likely reflecting that negotiations are driven by the situation's particular circumstances. Nonetheless, patterns were observed. For all cases reviewed where there was either a Controlling Shareholder or several Major Shareholders, all material new debt required one or more of supermajority board consent, supermajority shareholder consent or the consent of principal shareholders, affording all significant parties a meaningful opportunity to influence the outcome.

Similarly, approval thresholds for **new equity capital issuances** varied but tended to require, regardless of the breakdown of shareholder positions, supermajority board or supermajority shareholder approval. Three reorganized companies we examined, all of which involved a single Controlling Shareholder, required the approval of named investors for any new equity issuance. The tightest restrictions in the agreements examined prohibited share issuances to anyone other than existing parties to the shareholder agreement (which itself could not be amended without majority shareholder consent); that agreement involved a single Controlling Shareholder, in addition to several Major Shareholders and Minor Shareholders. On the other hand, we also found examples requiring only a simple board or shareholder majority vote.

Predictably, shareholders placed high hurdles in front of **future bankruptcy filings**. One shareholder agreement negotiated among several Major Shareholders stipulated that neither the company nor any of its subsidiaries could file bankruptcy without the prior approval of 75% of directors then *in office*—not just those present for the vote. Another situation involving one Controlling Shareholder and several Major Shareholders required not only a board majority but also the approval of each of three principal investors (one of whom had an ownership stake just under 40%, while the other two each held approximately 25%). Several other agreements required the individual consent of one or more Controlling Shareholders and Major Shareholders to file bankruptcy. It is worth noting that veto rights (sometimes called “golden shares”) held by creditors in bankruptcy situations, including those also holding equity positions, have been the subject of litigation. (A recent article by our Debevoise colleagues in the *ABI Journal* explores this topic in detail.)

Exit Considerations

When it comes to an entity’s ability to preserve its current holdings or make a full exit, the relevant rights are heavily negotiated and customized by the parties in question. The following overview of share transfer restrictions, tag and drag rights, rights of first offer or refusal and the ability to an initial public offering (IPO) highlight the range of possibilities for addressing the need for flexibility and transferability in a reorganized entity’s equity.

About two-thirds of the reorganized entities we reviewed included **share transfer restrictions** in their governance documents. Again, there was no clear correlation between the relative holdings of the negotiating parties and the type of restrictions put in place, indicating that business needs or other context-specific facts may have been more important than investor preferences in determining the final negotiated terms. Two entities had hold periods after closing (of two-and-a-half and three years) with an exception for sales to affiliates, while other entities prohibited sales to competitors (with one entity including a DQ list, additions to which had to be approved by at least two principal shareholders). One entity provided for no restrictions for investors in certain classes of stock, while investors in other classes needed board approval for transfers (again with a carveout for affiliate transfers). Other entities prohibited transfers prior to an IPO, yet one entity carved out its largest equity holder from this restriction.

> While an investor’s percentage ownership stake in the entity in question is a major factor in determining the negotiating weight they can leverage to secure the governance rights most important to their goals, the above analysis highlights the diversity of outcomes that are possible when creative negotiating is paired with solutions tailored to the facts and circumstances of the business entity and parties in play.

Similar to transfer restrictions, **tag and drag rights** for the entities assessed were varied. The minimum size of the proposed equity transfer triggering tag rights ranged from 10% to 50% of an issuer’s equity. Some provisions provided tag rights for all holders if the applicable minimum transferring threshold was met, while others limited rights to holders of more than 3% to 5% of the equity, leaving certain Minor Shareholders without the right to join a substantial equity sale. The most common drag structure required holders of more than 50% of the common stock (or specified classes of stock) to approve a sale transaction before other holders could be dragged into the sale (though one entity had an 80% shareholder approval threshold before drag rights could be exercised), indicating a permissive market position for general sale approval. Some entities provided time-based restrictions as well, ranging from 18 months to four years after reorganization, before a drag could be implemented. One entity we examined combined some of these elements, giving drag rights to any equitized debtholder that amassed a 66.67% equity position prior to the fifth anniversary of the restructuring or more than a 50% position thereafter.

In addition, almost all precedents reviewed included some form of a **right of first offer** (ROFO) or **right of first refusal** (ROFR) for share sales. Entities with a single Controlling Shareholder or multiple Major Shareholders as the largest holders often included exclusive ROFO or ROFR rights for such holders, highlighting the desirability of such rights when a shareholder has the negotiating power to secure them. Examples included providing a ROFO in favor of the company but, if not exercised by the company, in favor of principal stockholders; a ROFR held by the company and one specific Controlling Shareholder; and a ROFO expiring three years after the effective date reserved for the company and two Major Shareholders, as long as their individual ownership thresholds at the time of the offer continued to be at least 15%.

These types of transfer restrictions fell away upon an IPO (as they should if appropriately drafted). Supermajority board and shareholder votes were common for approving an IPO, ranging from 75% board majorities (in a deal among several Major Shareholders) to approval by all directors designated by principal shareholders (in a deal among a Controlling Shareholder and two Major Shareholders), to a single specified investor's consent (in a deal involving a Controlling Shareholder with almost two-thirds of the post-reorg equity), to the consent of at least one director appointed by the largest principal shareholder and one director appointed by another principal shareholder (in a deal with one Controlling Shareholder, several Major Shareholders and several Minor Shareholders). Still, a handful of entities required a simple majority board vote regardless of whether there was a Controlling Shareholder.

In the end, our recent market check suggests that parties can confidently advocate for protections that fit their priorities, making thoughtful post-reorganization planning a key exercise in any restructuring negotiation. While an investor's percentage ownership stake in the entity in question is a major factor in determining the negotiating weight they can leverage to secure the governance rights most important to their goals, the above analysis highlights the diversity of outcomes that are possible when creative negotiating is paired with solutions tailored to the facts and circumstances of the business entity and parties in play.

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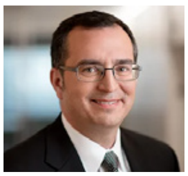
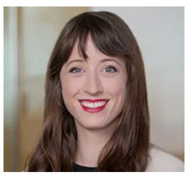
To File, or Not to File: The Changing Calculus for Voluntary CFIUS Filings


Ezra Borut
Partner


Rick Sofield
Partner


Jordan Corrente Beck
Associate


John M. Satira
Associate

As the Committee on Foreign Investment in the United States (CFIUS) continues to expand its reach and aggressively investigate foreign investment transactions, the calculus for determining whether to make voluntary filings has shifted. Where a fund investment or acquisition is subject to CFIUS jurisdiction, but a filing is not mandatory, private equity sponsors must confront the decision of whether to voluntarily make a CFIUS filing. For the reasons discussed below, sponsors or other transaction parties may want to consider not making a voluntary CFIUS filing, including in circumstances where they may have elected to make a voluntary filing in the past.

CFIUS is an interagency U.S. government body that has jurisdiction to evaluate whether certain transactions involving foreign investment in U.S. businesses raise national security concerns. If, after reviewing a transaction, CFIUS identifies a national security concern, it can either require the parties to implement national security risk mitigation measures or, if no mitigation measures are adequate and appropriate to address the identified national security concern, CFIUS can recommend that the President block the transaction or require a divestiture or unwinding. Should CFIUS determine that there are no unresolved national security concerns arising from a transaction, CFIUS essentially approves the transaction by informing the parties that it has concluded action, and the parties will then enjoy safe harbor from any further CFIUS scrutiny of the transaction. This safe harbor applies even if the national security landscape shifts in the future.

Securing that safe harbor and the regulatory certainty it brings, along with a desire to demonstrate good corporate citizenship, has prompted many private equity funds to choose to file voluntarily, even given the time and expense necessary to do so. The calculus of this decision, however, is changing due to CFIUS's more aggressive stance, which can be seen in the following:

- **Increased Politicization.** As widely reported, CFIUS has recently taken steps toward recommending that the President prohibit Nippon Steel's acquisition of U.S. Steel—a move that appears to have been motivated more by political considerations than national security concerns. However one interprets CFIUS's actions, the debate over the Nippon Steel-U.S. Steel transaction underscores the potential for CFIUS to be used for political ends. If sponsors no longer assume CFIUS will be a neutral arbiter of national security concerns, they may be disinclined to voluntarily subject a transaction to a review process that could be politically charged.

- **Onerous Mitigation.** CFIUS has increasingly required onerous mitigation steps to clear transactions in certain industries, even when the foreign investor is from an allied country. As we have previously discussed, in 2022 and 2023, nearly 20% of notices filed with CFIUS resulted in required mitigations—about twice the rate in 2020 and 2021. Further, the risk mitigation measures now required to gain CFIUS approval frequently include significant reporting obligations to the U.S. government, the appointment of Security Officers and other personnel to ensure compliance with risk mitigation measures, and restrictions on commercial relationships with vendors. These risk mitigation measures are then subject to increasingly aggressive scrutiny and enforcement by CFIUS.
- **Aggressive Enforcement.** CFIUS's evolution into an enforcement-focused body is illustrated by its November 18, 2024 final rule, which (1) expands the circumstances under which a civil monetary penalty may be imposed on transaction parties in the context of CFIUS's monitoring and compliance functions; (2) substantially increases the maximum civil monetary penalty for violations of risk mitigation compliance obligations; and (3) expands the instances in which CFIUS may use its subpoena authority. These rule changes come on the heels of a record $60 million civil monetary penalty and public naming—despite existing CFIUS regulations regarding confidentiality—of a company from a North Atlantic Treaty Organization ally that CFIUS found to have failed to comply with risk mitigation measures. Importantly, these aggressive CFIUS actions come at a time when CFIUS has reviewed the lowest number of notices since 2018 and only half the number of notices from China, CFIUS's principal country of concern, when compared to 2015.

Faced with an increasingly aggressive CFIUS, parties should carefully consider whether the benefits of making a voluntary CFIUS filing are worth inviting CFIUS scrutiny and the potential for perpetual government involvement in business operations. This consideration is particularly poignant given that the data suggests that transactions that are not voluntarily filed face little risk of being formally reviewed by CFIUS. According to CFIUS's 2023 Annual Report, CFIUS and its member agencies identified and considered thousands of transactions not filed with CFIUS (known as "non-notified transactions"), but formal inquiries were only opened into 60 of them. Of these, CFIUS requested filings for just 13, with another three transactions being submitted voluntarily after CFIUS initiated a formal inquiry.

CFIUS requests filings for such a small fraction of non-notified transactions because doing so is resource intensive and can only be initiated if senior executive branch officials approve the request. Given these limitations, CFIUS only seeks the filing of those non-notified transactions that are most likely to raise national security concerns. By contrast, if parties file voluntarily, senior executive branch officials from multiple agencies are required either to certify that there are no unresolved national security concerns arising from the transaction or to send the transaction to the President. And the reality is that those senior officials can more comfortably make the requisite certification—which may be subject to congressional scrutiny—if they impose national security risk mitigation measures as a condition. In other words, structural considerations both make it difficult for CFIUS to pursue parties that don't file and to let transactions that are filed pass without requiring mitigations. As a result, parties that file voluntarily may well end up having to perform mitigations they would not have needed to if they had not filed.

While parties should carefully consider each transaction's unique national security risk profile for purposes of making a voluntary CFIUS filing, overarching CFIUS trends currently suggest that only those transactions that are significantly at risk for a CFIUS non-notified request for a filing should be filed voluntarily. Otherwise, should they make a voluntary CFIUS filing, parties to a transaction may be unnecessarily inviting an increasingly aggressive CFIUS to require onerous and perpetual government scrutiny under threat of significant civil monetary penalties.

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Data Centers: Navigating the Opportunities of a Unique Asset Class

Peter J. Irwin
Partner

Andrea Bell
Associate

The possibilities presented by generative AI dominate headlines, business strategy and economic projections. But, however much these possibilities may depend on technological innovation and successfully developing markets around use cases, on an operational level, generative AI (and data storage and processing more generally) is inextricably tied to physical real estate: namely, data centers and their supporting infrastructure. As real estate developers and private investors seize these opportunities to respond to insatiable sector demand, they must do so thoughtfully in consideration of palpable resource constraints, public pressures and long lead times.

Healthy Demand, Lagging Supply

The United States is facing an impressive shortage of rentable data center facilities. As of the first half of 2024, the national rental vacancy for space at "colocation" centers (that is, data centers from which tenants rent space to operate their servers and processing equipment) reached a record low of 3%, with vacancy rates in certain core markets, such as Northern Virginia's "Data Center Alley," being as low as 1%. Moreover, the high preleasing rate for facilities under development—which currently exceeds 80%—likewise contributes to the low availability of space. Lease renewals are also ubiquitous, due not only to tight supply but also to the logistical challenges of relocating technical equipment, and, in concentrated markets, tenant rights of first offer for adjacent rental premises are common.

Unsurprisingly, high demand and low supply have allowed data center lessors to enjoy consistently increasing rental rates, and yields for data center developments remain high and outperform those for other industrial or residential asset classes. Yet the ability of real estate developers and investors to increase inventory and extract additional surplus faces several headwinds.

Power Availability and Geographic Risks

Data centers depend on the availability of affordable, consistent power. Data processing has always been power-intensive, but the meteoric rise of generative AI has amplified data centers' power needs: AI model training runs 24/7 with no predictable usage cycles, and such processes may be impaired by even momentary curtailments in power. In addition, the processors required for AI programs require more power than their predecessors. Indeed, total power consumption in the United States is projected to increase over the coming years—reversing years of relatively flat demand—partially as a result of generative AI and data processing growth. Data center developers and investors must therefore consider the availability and reliability of the surrounding power infrastructure, which has become strained in major markets. Grid interconnection for new data center developments may require significant time and resources; lead times for data centers to secure power are increasing and extensive, currently up to three years in certain markets.

> As real estate developers and private investors seize these opportunities to respond to insatiable sector demand, they must "do so thoughtfully in consideration of palpable resource constraints, public pressures and long lead times.

Closely related to—and oftentimes reliant on—power availability is the need for sufficient cooling capacity, as better cooling capability allows servers to be stored more closely and thus increases data center utilization per square foot. Nearby water resources greatly reduce the cost of cooling (proximity to the Potomac River is a factor in the dominance of Data Center Alley), though reliance on air-conditioning and electricity-powered cooling mechanisms are becoming more common as data center campuses move toward drier regions in search of more available and affordable grid capacity.

Beyond the availability of power and cooling, data center developers and investors should pay special consideration to other factors relating to the geographic locations of potential centers, especially natural disaster risks and proximity to populous areas. While proximate population centers offer a large pool of highly educated employees required for the operation of data facilities, nearby data centers may face nuisance complaints (as discussed below). Moreover, the unavailability of larger plots of land in or near population centers could be problematic, as building vertical, multistory data centers—which require specialized engineering to ensure that floors are adequately weight-bearing and that ventilation systems sufficiently insulate higher levels from heat—may not be a feasible option. On the other hand, establishing data centers far from large population clusters will result in latency for end users, though latency may be less of a concern for large model training processes.

Concern Among Utilities, Governing Bodies and the Public

Some power utility companies have begun to express concerns about projected grid overload due to data center growth. Earlier this year, for example, a large public utility company in Ohio requested that the state's utility commission approve discriminatory rate tariffs on data center customers—including the imposition of 10-year minimum billing commitments and exit fees for early termination, secured by collateral—to provide sufficient reserve capacity and lessen the risk that costs are passed onto ordinary consumers should data centers reduce their currently intended utilization or abandon their premises. Utility companies in Pennsylvania have likewise challenged a proposed interconnection services agreement between a data center and a co-located nuclear energy facility, reasoning that the agreement would divert critical grid capacity from and shift transmission costs onto other ratepaying consumers. And while the Federal Energy Regulatory Commission recently rejected a separate request for discriminatory rate tariffs, it left the door open for future requests going forward.

Areas that have become data center hubs are also seeing community opposition, and zoning commissions have started to react to perceived nuisances. Northern Virginia's Fairfax County, for example, enacted stricter zoning codes in September requiring equipment enclosures and imposing size limitations, larger setbacks, minimum distances from metro stations, noise studies and exterior design improvements.

Extended lead times to project completion compound the risks associated with public resistance to development. While the outcomes and frequency of public challenges to data centers and associated infrastructure development remain uncertain, developers and investors face the possibility that utility markets will saddle data center customers with long-term financial commitments untethered from the actual, realized energy utilization and tenant demand at the time the facility eventually comes online.

Regulatory Support

However, public sentiment towards data centers is not exclusively antagonistic. On the contrary, several local and federal initiatives appear to be warming to this unique asset class and its supporting infrastructure. While Fairfax County in Virgina may have imposed zoning codes unfavorable to further data center development, the nearby town of Culpeper reserved several hundred acres for use by incoming data center developers, planned for compatibility with nearby populations and energy infrastructure. Farther south and in consideration of data centers, Georgia's public service commission approved expansion of a utility's generation capacity—including fossil fuel-based generation.

Governmental bodies are also supporting nuclear power, attractive to data center customers due to its reliability and carbon-free emissions. For example, Pennsylvania is hosting an initiative to power data services with a decommissioned reactor at Three Mile Island. At the federal level, the Accelerating Development of Versatile, Advanced Nuclear for Clean Energy (ADVANCE) Act was enacted by Congress earlier this year and seeks to promote efficient licensing procedures for nuclear power and to encourage the reclamation of brownfields and retired fossil fuel sites for nuclear power. The U.S. Nuclear Regulatory Commission has also formally preapproved a small modular reactor design.

> Real estate developers and investors seeking to capitalize on the voracious demand for data processing facilities while balancing a range of uncertainties have several strategies available that can be tailored to their investment capital and risk appetite.

Developer and Investor Strategy Adaptation

Real estate developers and investors seeking to capitalize on the voracious demand for data processing facilities while balancing a range of uncertainties have several strategies available that can be tailored to their investment capital and risk appetite. At the most basic level, real estate investors can pursue a pure land play, acquiring parcels of land to later sell or lease to developers who will construct the facilities. Identifying desirable locations is key, and consideration must be given to projected access to reliable power infrastructure and cooling systems, natural disaster risk, proximity to population centers and demand once the facilities come online. Secondary markets with greater access to affordable power and capacity for renewables development may prove attractive, particularly to customers conducting large AI model training, which are less concerned with end-user latency.

At the other end of the spectrum, real estate investors may partner with specialized developers or tenants to build new data centers to suit and oversee the entire project, from land acquisition to contracting long-term power sources and outfitting all systems required for a tenant's operation on the premises. Small-scale facilities may elect to pool power procurement contracts and arrangements with co-located power facilities. Developers and investors of large-scale facilities may further seek to integrate modular power generators into data center sites.

Looking Forward

New demands and higher expectations for generative AI and other novel data processing applications show no signs of slowing. Although there are material challenges to the development of the data centers needed to support these applications, this unique asset class will continue to present ample opportunity for investors and developers going forward.

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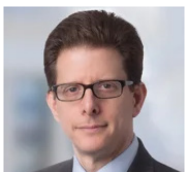
SEC Private Fund Adviser Enforcement FY 2024 Highlights

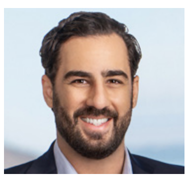

Andrew J. Ceresney
Partner


Charu A. Chandrasekhar
Partner


Robert B. Kaplan
Partner


Julie M. Riewe
Partner


Kristin A. Snyder
Partner


Sasha Semach
Associate

The cases brought by SEC's Division of Enforcement during fiscal year 2024 underscore the agency's focus over the last several years on post-commitment management fee calculations, recordkeeping and off-channel communications, fee and expense disclosures, controls related to material non-public information and conflicts of interest generally. We highlight below several notable cases and sweeps conducted over the past year involving these issues. In light of the U.S. presidential election results, however, we expect enforcement activity involving private fund advisers to slow in certain of these areas.

Post-Commitment Management Fee Calculations

Over the last several years, the SEC has brought a number of cases focusing on advisers' calculations of post-commitment management fees, in which the SEC has alleged that advisers have overcharged clients by failing to adhere to the disclosed fee calculation methodology. These cases have also alleged insufficient policies and procedures used for calculating post-commitment management fees. Prominent among these cases is the 2023 settled action against Insight Venture Management LLC. Insight developed and applied criteria in order to assess whether an investment was permanently impaired. In applying these criteria, however, Insight analyzed permanent impairment at the "portfolio company" level rather than at the "portfolio investment" level, as required by the funds' LPAs. As a result, Insight did not correctly apply the funds' LPAs in making a permanent impairment determination and, consequently, failed to accurately calculate the management fees it charged. In addition, Insight allegedly failed to adequately disclose conflicts related to its portfolio impairment calculation methodology. Because determining the appropriate management fee base and performing the correct fee calculations (which can be operationally challenging) directly affect what investors pay the adviser, we expect the SEC will continue to examine and investigate in this area, but that matters that result in enforcement actions will generally involve fraud rather than technical concerns about the adequacy of disclosure, as we have seen in recent years.

Recordkeeping

Registered investment advisers are required to maintain certain books and records related to their businesses and keep them easily accessible under the Investment Advisers Act of 1940 (and, depending on the firm's business, under other statutes and rules, such as the Securities Exchange Act of 1934 and FINRA and CFTC rules). Through fiscal year 2024, the SEC continued its scrutiny of firms' violations of recordkeeping requirements. For example, on August 14, 2024, as part of its off-channel communications sweep, the SEC announced that 26 financial firms agreed to pay more than $390 million in combined penalties to settle charges related to recordkeeping failures. The SEC alleged that these firms inadequately maintained and preserved electronic communications on personal devices used by their employees and that this recordkeeping failure limited the agency's ability to gather evidence, conduct investigations and enforce compliance with securities regulations. It remains to be seen whether a new SEC Chair and his or her Director of Enforcement will continue to pursue alleged recordkeeping violations as standalone cases; at a minimum, we expect the number of these standalone cases to decline, with those being brought likely involving lower penalty levels. Off-channel communications charges may continue as ancillary charges in matters involving substantive securities laws violations.

Custody Requirements

As crypto assets continue to make headlines, the SEC has shown an interest in ensuring that investment advisers that hold crypto assets do so with qualified custodians as defined by Rule 206(4)-2(d)(2). In this regard, on September 3, 2024, the SEC announced settled charges against Galois Capital Management LLC, which included the alleged failure to ensure that a qualified custodian maintained certain crypto asset securities. Custody is a perennial topic for the Division of Examinations and is an area of review in most private fund adviser examinations. While we expect that private fund adviser examinations will continue to focus on custody rule compliance, we anticipate fewer, if any, enforcement cases focused on technical violations of the custody rule.

> The cases brought by SEC's Division of Enforcement during fiscal year 2024 underscore the agency's focus over the last several years on post-commitment management fee calculations, recordkeeping and off-channel communications, fee and expense disclosures, controls related to material non-public information and conflicts of interest generally.

Whistleblower Rule

The SEC in FY 2024 showed an ongoing interest in pursuing violations of Rule 21F-17(a), also known as the whistleblower rule. Historically, much of the SEC's enforcement efforts in this area have been directed toward cases involving employment agreements. More recently, however, the SEC has pursued whistleblower rule violations beyond the employee-employer context, extending the risk of enforcement broadly to any agreements with individuals, including customers, investors and other third parties.

For example, on January 16, 2024, the SEC announced settled charges against J.P. Morgan Securities LLC (JPMS) for Rule 21F-17(a) violations in which JPMS agreed to pay an $18 million penalty. JPMS' violations related to covenants in a confidential release agreement shared with certain retail clients/customers that limited their ability to affirmatively report information to the SEC. Similarly, on September 9, 2024, as part of a whistleblower rule sweep, the SEC announced that seven public companies agreed to pay penalties ranging from $19,500 to $1.3 million (and totaling more than $3 million) to settle charges of whistleblower rule violations. The violations stemmed from the firms' alleged failure to appropriately carve out whistleblowing activities from confidentiality and other restrictive covenants in their employment agreements, separation agreements or independent contractor agreements. Under a new SEC Chair, we expect these cases, and the current effort to expand enforcement activity beyond the traditional scope of employer-employee relationships, to slow.

Material Non-Public Information

As it has over the past few years, the SEC has continued to bring cases related to firms' failures to establish, maintain and enforce internal policies and procedures to prevent the misuse of material non-public information (MNPI). Cases in fiscal year 2024 included settled charges against

> While we anticipate that the results of the U.S. presidential election will lead to a general slowdown in SEC enforcement activity, we nevertheless expect to see continuing examinations and enforcement investigations involving private fund advisers, even if ultimately those investigations do not result in enforcement cases.

Marathon Asset Management LP, which included the alleged failure to have policies and procedures that were reasonably designed to address risks related to the firm's receipt of non-public information from interactions with third parties, and against Sound Point Capital Management LP, for allegedly failing to adequately assess and update its compliance frameworks to address potential risks regarding use of MNPI, among others. Under a new SEC Chair, we expect to see a significant pullback in the SEC's willingness to bring enforcement cases triggered by alleged failures involving policies and procedures, absent allegations of other substantive violations of the federal securities law.

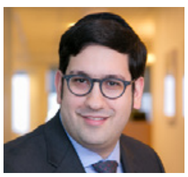
The cases brough by the SEC in fiscal year 2024 against private fund advisers reflect a continued focus on matters including post-commitment management fee calculations, private fund adviser recordkeeping and off-channel communications, fee and expense disclosures and adviser controls related to material non-public information. While we anticipate that the results of the U.S. presidential election will lead to a general slowdown in SEC enforcement activity, we nevertheless expect to see continuing examinations and enforcement investigations involving private fund advisers, even if ultimately those investigations do not result in enforcement cases.

Debevoise & Plimpton

The Corporate Alternative Minimum Tax: A Primer for Sponsors and Investors


Rafael Kariyev
Partner


Jay E. Evans
Associate


Samuel D. Krawiecz
Associate


Weichi Liu
Associate


Elliott Tuchman
Associate

On September 13, 2024, the U.S. Department of Treasury and the Internal Revenue Service released long-awaited proposed regulations regarding the corporate alternative minimum tax (CAMT), which was introduced as part of the Inflation Reduction Act of 2022. While CAMT was advertised to affect only a handful of the wealthiest corporations, the Proposed Regulations will have far-reaching implications for private equity funds.

Overview

The CAMT imposes a minimum tax on an "applicable corporation" equal to the excess of 15% of its adjusted financial statement income (AFSI) (minus a foreign tax credit) over its regular corporate tax for the year. An "applicable corporation" is any regular corporation with average annual AFSI greater than $1 billion for any three-year period ending during 2022 or later. The CAMT also applies to a U.S. corporate subsidiary of a foreign-parented multinational group (FPMG) if the FPMG has more than $1 billion and the U.S. subsidiary (together with certain affiliates) has at least $100 million, in each case, in average AFSI over a three-year period. However, neither the $1 billion nor the $100 million threshold is inflation indexed, potentially expanding the scope of applicable corporations over time.

An applicable corporation's AFSI is determined from the financial statement income (FSI) as reflected in its applicable financial statement, with various adjustments as allowed by Congress. The Proposed Regulations allow a corporation to use a simplified method to determine whether it is an applicable corporation. Under the simplified method, the thresholds are reduced by half and FSI is generally not adjusted.

The Proposed Regulations codify and build upon earlier CAMT guidance issued by Treasury and the IRS, as well as provide additional rules regarding partnerships, M&A transactions, financially distressed corporations, foreign corporations and other topics. The applicability of these rules is exceedingly broad, as many of the provisions apply by their terms not just to the relatively small group of large corporations that will be CAMT taxpayers, but to the much larger group of so-called "CAMT entities," which includes any entity that is regarded for tax purposes, even if not a CAMT taxpayer itself.

Determining AFSI from Interests in a Partnership

Large public sponsors and certain investors in private equity funds may be subject to CAMT, and therefore will need to determine their AFSI from investments in partnerships.

Basic Principles

The CAMT rules provide that the AFSI of a partner in a partnership is adjusted so that it only takes into account the partner's distributive share of the partnership's AFSI. In implementing this rule, the Proposed Regulations take a "bottom-up" approach, which starts with an AFSI determination at the partnership level. In Treasury's view, this approach allows for a consistent methodology for calculating the adjustments to AFSI in different structures. For example, a CAMT entity partner that reports its partnership interest on a mark-to-market basis would avoid having AFSI from market fluctuations in the value of its partnership interest under the bottom-up approach because the Proposed Regulations generally make adjustments to FSI to remove market fluctuations.

The "bottom-up" approach generally involves five steps, in this order:

1. The CAMT entity partner removes any FSI attributable to its interest in the partnership from the CAMT entity partner's applicable financial statement. Gain or loss on the sale or other disposition of a partnership interest reflected in the FSI of the CAMT entity partner, however, is still included, although FSI gain or loss is determined based on CAMT basis that reflects prior years' AFSI adjustments rather than cost.
2. The CAMT entity partner computes its "distributive share percentage," which generally is (x) the CAMT entity partner's FSI attributable to the partnership *divided by* (y) the partnership's total FSI. If the CAMT entity partner uses fair value accounting for its partnership interest, the denominator is based on the aggregate change in the fair value of the partnership.
3. The partnership computes its modified FSI, which is generally the partnership's AFSI after taking into account certain items required to be separately stated to the CAMT entity partner by the Proposed Regulations.
4. The CAMT entity partner determines the amount of its distributive share by *multiplying* (x) its distributive share percentage *by* (y) the partnership's modified FSI.
5. The CAMT entity partner includes the amount of its distributive share in its AFSI, subject to certain adjustments.

In the case of a tiered partnership structure, the Proposed Regulations require each partnership, starting with the lowest-tier partnership and continuing in order up the chain of ownership to the CAMT entity, to determine the distributive share of each CAMT entity partner in the tiered-partnership chain.

Reporting and Filing Requirements

The Proposed Regulations would impose far-reaching reporting and filing requirements on both the CAMT entity partner and the partnership and would represent a significant expansion of existing annual compliance obligations. Further, a partnership that fails to comply with such obligations would be subject to penalties.

Under the reporting requirements, each CAMT entity partner generally is required, within 30 days of the end of the year, to request from the partnership any information needed by the CAMT entity partner to determine its distributive share of the partnership's AFSI. Both the request for information and the information received must be maintained by the CAMT entity partner in its books and records.

A partnership is required to furnish information requested by a CAMT entity partner and to file that information with the IRS. An upper-tier partnership subject to these reporting and filing requirements must request information from a lower-tier partnership, which must provide it to the upper-tier partnership and file it with the IRS.

Overall, these reporting and filing requirements, if finalized as proposed, could impose significant compliance burdens on private equity funds. For example, the Proposed Regulations would impose this burden on a fund and each of its flow-through subsidiaries if a single fund investor is subject to CAMT. Additionally, whether the fund or the investor requesting CAMT information should be responsible for the incremental compliance expenses would likely become a point of negotiation.

We expect taxpayer comments to the Proposed Regulations will seek to limit these operational burdens.

Partnership Contributions and Distributions

Under basic tax principles, partners can contribute property with a built-in gain (or loss) (BIG Property) to a partnership without triggering gain (or loss), and partnerships can distribute property to its partners without triggering gain (or loss). For financial accounting purposes, transfers to and from a partnership are realization events and result in FSI. In a departure from interim IRS guidance that would have excluded such FSI from AFSI, the Proposed Regulations would create a new "deferred sale" regime that applies to such contributions and distributions to and from partnerships, turning these formerly tax-deferred transactions into taxable transactions for CAMT entities.

Mechanically, the Proposed Regulations would require a CAMT entity partner contributing BIG Property to a partnership to take into account when determining its AFSI any FSI from the contribution (which must be redetermined using the property's CAMT basis). This gain (or loss) is taken into account ratably over the applicable recovery period for the contributed property. The recovery period generally matches the tax depreciation schedule, and there are corresponding CAMT basis adjustments to the CAMT entity's partnership interest. Note, however, that the maximum recovery period is 15 years, which seems to apply even for an asset that does not depreciate. If the partnership sells or otherwise disposes of the contributed property, the CAMT entity partner's remaining deferred financial gain (or loss) accelerates. A disposition would seem to include a further contribution by an upper-tier partnership to a lower-tier partnership.

Similarly, the Proposed Regulations would apply a "deferred sale" construct to partnership distributions, requiring a CAMT entity partner to take into account when determining its AFSI its allocable share of any FSI from the distribution (which must be redetermined using the property's CAMT basis). As with contributions, this gain (or loss) is taken into account ratably over the applicable recovery period for the distributed property.

These deferred sale rules are intended to align the CAMT consequences of the contribution with the income tax rules by recognizing FSI over the applicable recovery period. As drafted, however, they would apply to many run-of-the-mill transactions and reorganizations utilized by private equity sponsors in forming common partnership-based investment structures. For example, these rules would apply to contributions of stock to a holding partnership in anticipation of a joint-venture or internal reorganization.

Open Scoping Question

The Proposed Regulations also present a technical question around scoping in the rules relating to FPMGs. As noted above, CAMT also applies to a U.S. corporate subsidiary of an FPMG if the group has over $1 billion, and the U.S. subsidiary (together with certain affiliates) has at least $100 million, in each case, in average AFSI over a three-year period. A foreign-parent group may be indifferent as to whether the holding company is a corporation for U.S. federal income tax purposes. Therefore, the Proposed Regulations deem certain non-corporate entities (which would include U.S. and non-U.S. partnerships) to be a corporation for these purposes.

For such a non-corporate entity and its subsidiaries to be within the scope of CAMT, they must have 50% or greater ownership of a foreign corporation and be required under the applicable financial accounting standard to consolidate with such foreign corporation. If that is the case, then the non-corporate entity is treated as the parent of an FPMG, potentially bringing all of its other U.S. subsidiaries into scope of CAMT. While on its face this rule may cover private equity funds that have at least one non-U.S. investment and could therefore bring all of their U.S. corporate investments into scope, in many cases, private equity funds do not consolidate their portfolio companies on their financial statements, preventing the aggregation of income of brother-sister portfolio companies under a single fund.[1]

1. An earlier draft of the legislation could have been interpreted to require aggregation of unrelated portfolio companies under a single private equity fund, but an amendment by Senator Thune was made to the draft legislation before it was finalized to prevent this result. The legislative history lends further support to the position that portfolio companies under a single private equity fund were not intended to be aggregated together for CAMT purposes.

Debevoise & Plimpton

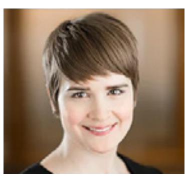
Managing AI-Related Risks Associated with Vendors


Charu A. Chandrasekhar
Partner


Avi Gesser
Partner


Kristin A. Snyder
Partner


Matt Kelly
Counsel


Johanna N. Skrzypczyk
Counsel


Joshua A. Goland
Associate

As private equity firms ramp up their AI adoption, one of the most difficult challenges they face is managing third-party risk. In practical terms, a great deal of AI adoption involves engaging third-party vendors to provide AI-enabled products or services. Firms often struggle when deciding what diligence to perform on these vendors and how to mitigate—through contractual conditions or other means—the risks identified in the diligence process.

Third-party diligence issues are especially salient given the SEC's 2025 Examination Priorities, which discuss the close scrutiny Registered Investment Advisers (RIAs) can expect from the SEC regarding any outsourcing of investment selection or management functions—as well as regarding an RIA's integration of AI into advisory functions, including portfolio management, trading, marketing and compliance. The SEC's proposed rules on Outsourcing by Investment Advisers ("Proposed Outsourcing Rules") and Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies and Business Development Companies ("Proposed Cybersecurity Rules") also emphasize the importance of vendor risk management for RIAs. Accordingly, as RIAs increasingly rely on AI to assist with their decision-making and investment processes, they must ensure that their risk and diligence procedures account for AI vendors that have the potential to cause a material adverse impact on the adviser's clients or on the adviser's ability to provide investment advisory services.

Establishing an AI Vendor Risk Management Program

Different AI vendors will present different levels of risk, depending on the nature of the product and how the product fits into the firm's workflow. An effective, risk-based third-party AI risk management program therefore centers on efficiently identifying, assessing and mitigating risks associated with each AI vendor. As the SEC's Proposed Outsourcing Rules observe, "due diligence should be reasonably tailored to the identified service provider and to the functions or services to be outsourced." Firms constructing an AI vendor risk management program should consider the following:

1. Determining Program Scope. Vendors can use AI in a variety of ways. A vendor may provide AI models for direct use by the firm, or it may provide software products that incorporate AI-enabled features but do not allow users any control of the underlying models. Other vendors may leverage AI on their own systems to provide goods and services to the firm without the firm having any interaction with those systems. An AI vendor risk management program should define its scope against this range of possibilities.

2. Defining AI. Part of determining the program's scope is defining what is meant by "AI." Will the program apply only to circumstances involving generative AI, or will it cover a broader range of machine-learning technologies? The firm should also consider whether to cover vendor offerings such as algorithmic models that do not leverage AI or machine learning but that might present similar reputational or regulatory risks.

3. **Integrating with Other Diligence Programs.** Many of the risks associated with AI vendors overlap with risks addressed through cybersecurity and data privacy diligence, including maintaining confidentiality, access to data, sharing sensitive data with third parties, and deletion of data when it is no longer needed. Firms should consider whether AI and cyber diligence remain separate (while eliminating redundancies between them) or if they should be integrated as part of a comprehensive technology diligence process. This issue is particularly critical in light of the Proposed Outsourcing Rules' requirements for vendor diligence, under which firms must conduct diligence on any vendors that perform "covered functions," and identify how to mitigate potential risks posed by such vendors.

4. **Program Standardization.** Many AI-related risks—such as those associated with intellectual property, confidentiality, cybersecurity and quality control—will be applicable to a wide range of AI vendors. But other risks, such as the risk of bias or discrimination, may arise only for certain tools and in certain use cases. Such variation may limit a firm's ability to standardize components of its AI vendor risk management program, such as diligence questionnaires or model contract provisions. This limitation means that firms may have to tailor their AI diligence to the risks presented by the particular category of vendor, so the onboarding of low-risk vendors is not impeded by an inappropriately high level of scrutiny (which can result in circumvention of controls or so-called "shadow IT" risks).

5. **Managing the Risks of New Features for Existing Services.** Many vendor AI services are part of existing software packages covered by existing contractual agreements. It can be a challenge to determine when the release of new AI features should be treated as a new procurement or engagement that requires renewing or revisiting that vendor's diligence and risk management analysis. This question is complicated by the fact that vendor updates are not timed to coincide with contract cycles. As a result, even if a firm does choose to revisit the risk analysis for a particular vendor, it can be difficult or even impossible to act on the results of the analysis in the middle of an ongoing engagement with a predefined term of service.

6. **Distinguishing Between Tool Risk and Use Case Risk.** Some AI tools are built for specific use cases and thus will involve specific risks (such as the regulatory compliance of a resume-screening tool) that should be addressed in the vendor onboarding process. But other tools are more in a general purpose category, and the associated risks are dependent on the particular use cases that emerge only after the tool has been onboarded. Likewise, there are some risks (such as risks related to accuracy and reliability) that require longer study and use in order to fully understand and mitigate, making those risks hard to address prior to engagement. It is tricky but therefore important to sort out which risks are better addressed through the vendor risk management process and which are better left to be mitigated through ongoing AI governance.

> As RIAs increasingly rely on AI to assist with their decision-making and investment processes, they must ensure that their risk and diligence procedures account for AI vendors that have the potential to cause a material adverse impact on the adviser's clients or on the adviser's ability to provide investment advisory services.

7. **Integrating with SEC Compliance.** Sponsors also need to consider how their AI vendor risk management aligns with the SEC's current expectations and potential new regulatory requirements. This includes, for example, identifying which AI vendors may be subject to the Proposed Outsourcing Rules because they provide "covered functions," and which AI vendors have access to RIA information or systems such that they are subject to the Proposed Cybersecurity Rules.

Managing Identified AI Vendor Risks

Depending on the answers to the questions above, firms should consider whether their existing third-party risk management structures are sufficient (in terms of resources, expertise, scope and mandate) to assess the risks presented by AI vendors. They also should consider the range of procedural, contractual, technical and other mitigations that may be deployed to lessen the risks identified during their vendor risk management process.

Some steps to consider when identifying effective mitigations include:

1. **Conducting Internal Diligence.** As part of performing diligence on the AI vendor itself, consider conducting internal diligence as to why the vendor's services—and, specifically, their AI-enabled products or services—are necessary. This includes mapping intended use cases, the data to be used, best-case and worst-case scenarios, how success will be defined for the engagement and whether there will be a pilot program.

2. **Itemizing Risks, Diligence and Terms.** Consider creating a checklist of potential risks that the firm will contemplate when engaging an AI vendor. For each risk that can be addressed through contract, consider whether it is possible to have a playbook with model diligence questions, ideal contract terms and acceptable fallback terms. Also consider organizing these risks into standard risks (those that will be addressed for all AI vendor engagements) and nonstandard risks (those that will only need to be addressed in specific contexts), and identify which risks are covered by other diligence efforts (cyber, privacy, etc.) as opposed to those risks that are only addressed through AI-specific diligence. Finally, consider whether there are any risks (such as regulatory compliance with hiring, lending or biometric laws) that will require review and sign-off from specific subject-matter experts, such as the legal team, compliance staff or HR.

3. **Identifying Noncontractual Mitigations.** In certain circumstances, firms may decide to move forward with an AI vendor even if there are identified risks that have not been (or cannot be) fully mitigated via contract or through diligence. For these residual risks, firms should consider whether there are noncontractual measures (including technical or operational measures) that can be implemented at the use-case stage as further mitigants. For example, to minimize risk associated with allowing an AI vendor to process sensitive data using an AI system, firms may want to consider functional means of preventing such data from being exposed to the vendor in the first place. Or, to address business continuity risks associated with key vendor-supported AI systems, firms may want to consider creating business continuity plans featuring backups or workarounds that will allow them to meet obligations in the event of a vendor disruption.

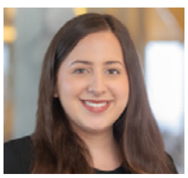
> An effective, risk-based third-party AI risk management program therefore centers on efficiently identifying, assessing and mitigating risks associated with each AI vendor.

Debevoise & Plimpton

Supreme Court Case Could Increase Sponsors' Financial Liability in Trademark Disputes

Megan K. Bannigan
Partner

Jared I. Kagan
Counsel



Clara Correa
Associate

Chris Zheng
Associate

This term, the U.S. Supreme Court is set to weigh in on a trademark dispute that has the potential to impute financial liability on a private equity sponsor or acquiring company, even if it was not directly involved in the litigation. Under the Lanham Act, plaintiffs that have suffered trademark infringement are entitled to recover, subject to the court's discretion, the defendant's profits. In a recent trademark dispute, a federal district court took—and the appellate court affirmed—an expansive view of "defendant's profits" to include the profits of legally separate, nonparty corporate affiliates of the defendant that shared common ownership. The matter, *Dewberry Group Inc. v. Dewberry Engineers, Inc.*, is now on the docket at the Supreme Court, which will take up the question of how broadly "defendant's profits" can be defined. Below, we review the case and its potential implications.

The Lanham Act and *Dewberry*

Respondent Dewberry Engineers is a commercial real estate development corporation that owns two federal trademarks for "Dewberry." Petitioner Dewberry Group is a Georgia real estate development business owned by developer John Dewberry. In 2006, Dewberry Group—then doing business as Dewberry Capital—sent Dewberry Engineers a cease-and-desist letter asserting common law trademark rights to "Dewberry" and claiming a likelihood of confusion between the parties' marks. Dewberry Engineers responded by suing Dewberry Capital for registered trademark infringement. The parties settled a year later, signing a confidential settlement agreement allowing Dewberry Engineers unfettered use of its registered marks and putting strict limitations on Dewberry Capital's use of the term "Dewberry."

The parties operated peacefully under this agreement until 2017, when Dewberry Capital rebranded as Dewberry Group and filed several Dewberry-formative trademark applications with the United States Patent and Trademark Office, in violation of the settlement agreement. Dewberry Engineers sued Dewberry Group in May 2020 for breach of contract and for trademark infringement, and on August 11, 2021, the federal district court for the Eastern District of Virginia granted summary judgment in favor of Dewberry Engineers on both of its claims. In its judgment, the district court held that under the Lanham Act, a disgorgement of more than $42 million of Dewberry Group's profits was appropriate. Although Dewberry Group had presented evidence from its tax returns that it generated no profits, the court calculated the profits award by considering the revenues and profits of

Dewberry Group's affiliated entities. Though the court had previously acknowledged that the affiliates were "third parties, separated by the corporate veil" and were not parties to the litigation, the court found that Dewberry Group depended on the profits of its corporate affiliates to make up for decades of massive losses. Thus, without the revenue generated by the affiliate entities, Dewberry Group as an ongoing, standalone entity would not exist.

> The U.S. Supreme Court is set to weigh in on a trademark dispute that has the potential to impute financial liability on a private equity sponsor or acquiring company, even if it was not directly involved in the litigation.

A divided Fourth Circuit panel affirmed, noting that a court's disgorgement award is "subject to the principles of equity" and that the district court weighed the equities and appropriately exercised its discretion to hold Dewberry Group to account. The Fourth Circuit further held that the district court properly exercised its equitable discretion to include in that account affiliates under common ownership, following the district court's reasoning that doing so was necessary to prevent trademark infringers from using corporate formalities to insulate their infringement from financial consequences and shirk legal accountability.

Dewberry Group filed a petition for certiorari to the Supreme Court on February 16, 2024, which the Supreme Court granted on June 24, 2024. The case has been briefed, and oral argument is scheduled for December 11, 2024.

Dewberry Group argues that the Fourth Circuit's holding contravenes the Lanham Act's text, which limits any profits-disgorgement award to *defendant's* own profits and disrupts the bedrock principle of corporate separateness by overriding the presumption that legally separate entities are distinct unless the corporate veil is pierced. Further, Dewberry Group argues that the Fourth Circuit overstates concerns that companies would use corporate separateness to evade responsibility for infringement, given that plaintiffs can still be compensated by the Lanham Act's provisions allowing for any damages sustained by the plaintiff, the costs of the action, and, in exceptional cases, attorneys' fees. Additionally, plaintiffs can opt to name corporate affiliates as defendants to the lawsuit. Dewberry Engineers counters that the district court and the Fourth Circuit's decision was correct under the broad discretion afforded under the plain language of the Lanham Act, which allows courts to set the amount of a disgorgement award to reflect the "true profits" when an infringer has gained more than the infringer's profits reflect. Dewberry Engineers also contends that the Fourth Circuit's decision did not expand the scope of liability because it did not hold a nonparty jointly liable, but only treated the companies as a single corporate entity for the limited purpose of calculating the award against the named party.

On September 6, 2024, Debevoise attorneys, on behalf of the International Trademark Association (INTA), filed an amicus brief with the Supreme Court in support of neither party, arguing for the narrower definition of "defendant's profits" consistent with the actual text of the statute. INTA contends that including nonparties' profits in the damages calculation usurps established guardrails—such as piercing the corporate veil or joining additional defendants—and risks undermining the fundamental principles of corporate separateness. The brief emphasizes that trademark owners have numerous avenues for securing full and just compensation under the law without the need to implicate nonparties, and the Fourth Circuit's decision risks exposing corporations to unpredictable and expansive liability.

Legal and Business Implications of *Dewberry*

If the Supreme Court rules in favor of Petitioner Dewberry Group, the status quo will be maintained, and private equity sponsors can take comfort in the security of corporate formalities and corporate separateness as methods to protect assets and limit the scope of litigation discovery and potential liability in intellectual property cases.

On the other hand, if Respondent Dewberry Engineers prevails, subject to the specifics of the decision, there are enhanced risks that businesses may need to consider in the private equity space:

> **A ruling in *Dewberry* upholding the lower courts' decisions may influence the approach of private equity firms to assessing and integrating the intellectual properties of target companies.**

- **Corporate and Tax Structuring:** A ruling for the Respondent in *Dewberry* means that courts can consider the profits of nonparty affiliates when assessing damages, even without a piercing of the corporate veil having occurred. Businesses will face greater challenges and risks when relying on corporate formalities and the doctrine of corporate separateness to shield assets in the damages phase of trademark cases.
- **Enhanced Due Diligence Needs and Strategic Brand Management:** Private equity firms will need to intensify their due diligence of the intellectual property portfolios of target companies' affiliates and subsidiaries. And acquiring and target companies will want to strategize to ensure that their use of trademarks and branding aligns across the whole company, paying close attention to the clarity of trademark ownership or risk of trademark dilution post-acquisition.
- **Implications for Scope of Discovery and Legal Risk:** Companies with affiliated business entities will need to consider potential risks and costs associated with litigation discovery, the scope of which could be expanded to encompass legally separate corporate affiliates' information and documents. And the broader scope of discovery could also lead to greater risks of liability where opposing parties have greater leeway to obtain documents that could form the basis for direct liability.
- **Considering Corporate Affiliates in Potential Litigation:** Companies seeking to recover monetary damages in connection with an infringement of its intellectual property rights will want to take a prospective defendant's corporate structure and any corporate affiliates into account when determining the appropriate value of the dispute. Even if the infringing party lacks recoverable profits, a favorable decision for the Respondent in *Dewberry* would mean a defendant's parent company or other nonparty corporate affiliate's profits could be considered in determining a damages award.

Conclusion

As we await the Supreme Court's decision in *Dewberry*, private equity sponsors and corporate boards and management must prepare for the possibility that the risk landscape could be altered by new guidance for courts evaluating disgorgement in trademark infringement and dilution cases.

A ruling in *Dewberry* upholding the lower courts' decisions may influence the approach of private equity firms to assessing and integrating the intellectual properties of target companies. Businesses would then need to think carefully about how to manage their brand strategies to effectively mitigate legal risks and protect brand equity, especially if they are restructuring or marketing for acquisition. And plaintiffs seeking to vindicate their intellectual property rights could demand more extensive discovery of financial records, even into entities that are not named as defendants in a lawsuit. Regardless of the outcome, however, *Dewberry* underscores the importance of comprehensive intellectual property evaluations during due diligence and the strategic alignment of brand portfolios post-acquisition. By understanding and preparing for both potential outcomes, businesses can better navigate the complexities of trademark law and leverage their intellectual property for competitive advantage.

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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.

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