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Weil Private Equity Sponsor Sync

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FROM THE EDITORS

As Weil Private Equity Sponsor Sync evolves, we're embarking on new territories and deepening our commitment to delivering cutting-edge insights. In this issue we introduce a quarterly leveraged finance update, providing a pulse on debt markets, data, and pricing – a vital tool for financial investors to stay ahead of market developments. Another inaugural feature is a dialogue with our partners – in this issue, John Barry, head of Weil's Employment Practice Group – marking the start of regular interviews with Firm practice leaders to offer direct perspectives from those at the forefront of legal and market changes on matters affecting sponsors and their investments. This quarter also unveils our first guest article in collaboration with Global SWF, shedding light on Sovereign Wealth Fund investors in private equity, alongside essential reads on restructuring trends (be careful of "board flips"), secondaries, which are playing an increasingly prominent role in liquidity solutions for sponsors, and practical advice on the Corporate Transparency Act. With these additions and more, our aim is to not just inform but empower our readers with actionable knowledge in our dynamic financial landscape.

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P17 Deal Certainty Under Delaware Law: Recent Cases and Practical Implications for Private Equity Sponsors Two recent cases before the Delaware Court of Chancery provide important lessons for sponsors on matters of deal certainty: one on financing cooperation covenants (potentially being a sword for a buyer to walk away from a deal), and another on the significance of correct fundamental representations. These cases serve as reminders of the importance of drafting precision in allocating which party bears closing risk if covenants, reps or warranties are breached before closing.

P20 From Courtroom to Boardroom: the Impact of *Moelis* On Corporate Governance Governance provisions granting a founder excessive control over board actions and composition were recently struck down in *West Palm Beach Firefighters Pension Fund v. Moelis & Company*, spotlighting legal boundaries in corporate governance arrangements.

P23 Delaware Will Enforce "Forfeiture-for-Competition" Provisions Without Regard to Reasonableness Earlier this year the Delaware Supreme Court unequivocally reaffirmed Delaware's "reverential" view of "unambiguous contractual undertakings."

WEIL LOAN TRACKER
Q1'24

Average First-Lien Broadly Syndicated Spread for B-Flat Rated Borrowers:	Average First-Lien Broadly Syndicated Spread for B-Minus Rated Borrowers:	Average Sponsor-Backed Private Credit Spread:	Volume of Refinancings of U.S. Private Credit Loans into Syndicated Loan Market:	Volume of Repricings of U.S. Leveraged Loans:
S + 405 (down 27.5 bps Q over Q)	**S + 441** (down 5 bps Q over Q)	**S + 550** (down 36 bps Q over Q)	**$11.5 billion**	**$143 billion**

U.S. LEVERAGED FINANCE MARKET UPDATE

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SMART SUMMARY

- U.S. leveraged finance market started 2024 with a bang, driven by refinancings, repricings, and dividend recap transactions, signaling robust investor demand and capital liquidity.
- A **re-opened syndicated loan market** enabled a wave of refinancing private credit loans with broadly syndicated loans, as borrowers looked for ways to lower spreads.
- Early signs of M&A activity resurgence, with a number of recently priced LBOs, showcased a shift in market dynamics and sponsor strategies.
- As high interest rates persist, we expect a continuation of borrowers leveraging existing credit facilities via incremental capacity and/or portability features. We also expect **more amend-to-extend activity** in light of upcoming debt maturities, and **increased use of junior debt and/or preferred equity financing structures.**

With spring in the air, the U.S. leveraged loan market, too, is in bloom. After a difficult 2023 for LBO issuances and for the syndicated loan market more broadly, the U.S. leveraged loan market kicked off 2024 with a bang in January, stemming from a surge of opportunistic repricings, refinancings and dividend recap transactions (see page 5). Although new-issue loan volume has remained relatively muted in Q1'24 when viewed as a whole, investor demand remains strong, there is ample dry powder available and there are indications that M&A activity is beginning to pick up, with a few large LBO's that recently successfully worked their way through the syndicated loan market. We expect incremental debt incurrences under existing credit facilities to continue for as long as interest rates remain high and, with the re-opening the syndicated loan market, also expect a resurgence of capital structures with junior debt.

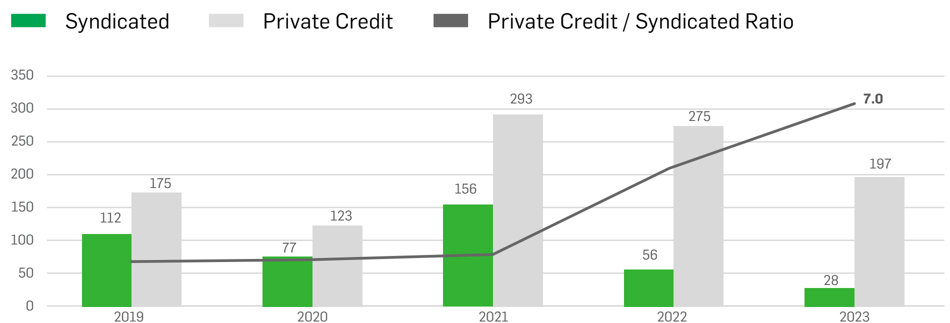
2023 Recap

2023 was characterized by tight credit conditions, rising interest rates and a mostly closed U.S. syndicated loan market. Lenders became more focused on credit quality, demanding "tighter covenants, higher spreads, lower leverage and increased equity contributions."[1] According to S&P Global, buyout leverage sat at a 13-year low, and interest coverage on LBOs hit a 16-year low.[2] Moreover, average debt to EBITDA ratios at the time of issuance averaged 5.0x for large corporate borrowers,[3] and equity contributions exceeded 50%.

M&A activity felt the chill as well. Of the $234 billion of total institutional U.S. leveraged loan issuance in 2023, 58% of that value represented refinancings, and only 30% represented M&A activity – down 79% from 2021 and the lowest level since 2010.[4]

Because the syndicated loan market in particular was closed off for most of the year, 2023 also will be

Number of Loans: Private Credit vs. Syndicated Loan Markets



Source: Pitchbook Q4 2023 U.S. Credit Markets Quarterly Wrap.

of the year, 2023 also will be remembered as a banner year for private credit. Of the LBO's completed in 2023, private credit lenders stepped in to finance a staggering 86% of them.[5] In light of challenging market conditions, many Sponsors dual-tracked potential financings between both private credit lenders and institutional lenders, to maximize optionality.

2023 Showers Bring Q1'24 Flowers

Q1'24 Market Conditions: Green Shoots for Syndicated Loan Market

Despite a challenging 2023, the syndicated loan market capitalized on the "new year, new me" mentality in 2024, with January boasting the highest volume of institutional lending activity since March 2021,[6] resulting from a surge in refinancings, repricings and dividend recap activity.

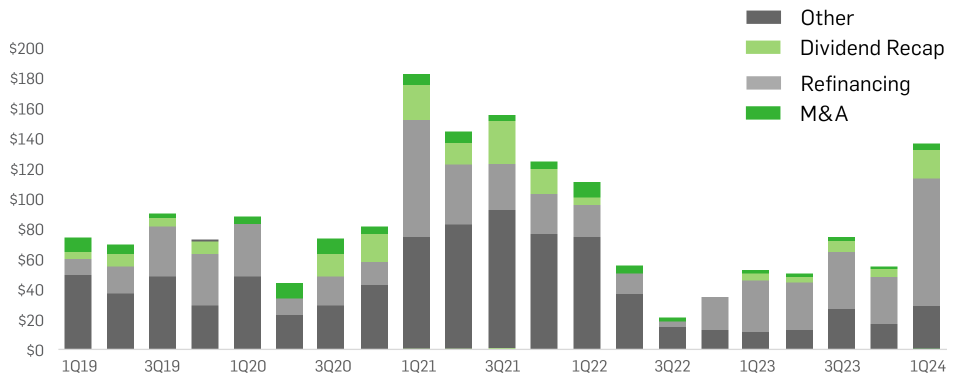
Repricing activity in particular was up 503% year-over-year by mid-February alone[7], as borrowers capitalized on improved conditions to seek relief from the high interest rate environment that denominated 2022 and 2023, as well as pay down more expensive junior debt. With direct lending spreads starting off the year as much as 250 basis points higher than broadly syndicated loans (the highest spread difference in a decade), much of the repricing activity occurred in the syndicated loan market.[8] From the beginning of the year through the end of March, roughly 11% of the $1.4 trillion Morningstar LSTA US Leveraged Loan Index asset class had been repriced, with borrowers reducing spreads by an average of 54 bps.[9]

Market conditions cooled somewhat in February off the back of the U.S. Fed's more conservative-than-expected outlook on interest rates. As a result, some lower-rated borrowers in the market for repricings had to amend terms and, in the most dramatic of cases, pull deals entirely. Despite this, higher-rated borrowers were able to maintain market interest and February closed the month with $54.4 billion of total deal activity – lower when compared to $166 billion in January, but a meaningful improvement from the $32.4 billion monthly average from 2023.[10]

There was also another resurgence of repricing activity in March with approximately $55 billion of repricings[11], even for borrowers rated B2 and B3, which came on the back of strong CLO issuance (with CLO issuance in February marking the second busiest month on record) and limited supply of new money opportunities[12]. By the end of March, term loans issued to B minus rated borrowers were priced at an average margin of S+441, which is less than 15 bps wide of the low mark set in 2021[13].

With sponsors holding onto portfolio companies for longer, dividend recap activity took off in Q1'24 as well, reaching $15.3 billion by the end of the quarter, which was the highest level in three years.[14] Refinancing activity in Q1'24 more broadly also hit the second-highest level on record.[15]

Number of Loans: Increases in Q1'24



Note: Q1'24 includes completed and pipeline volume *Source: LSEG LPC*

LBO Market: A spring awakening

LBO activity got off to a slow start in 2024 accounting for only around 7% of total U.S. leveraged loan volume as of the last week in January[16], but may have hit its stride beginning in February. February 2024 marked the second-highest read in 20 months for new loans for buyouts, tack-on-acquisitions and other corporate M&A, totaling $10.9 billion.[17] By the end of

Q1, loan volume related to buyouts, corporate or sponsored acquisitions, and other types of M&A reached $29.2 billion[18].

For broadly syndicated M&A loans in the market in Q1'24, average pro forma leverage levels ticked up to 4.40x for first lien leverage, the highest read since 2022.[19] Average equity contributions backing LBOs stayed above 50%, hitting 52.4% by the end of February.

Market observers have looked to a handful of recently priced LBOs as litmus tests for the receptiveness of the broadly syndicated loan market to large-scale M&A going forward. This includes among others, (1) the $1.2 billion financing package backing Partner Group's LBO of Swiss oil and gas pipeline Rosen, (2) the $5 billion financing package backing KKR's purchase of a 50% ownership stake of healthcare analytics company Cotiviti from Veritas capital and (3) the $8 billion financing package backing Stone Point and CD&R's LBO of Truist Insurance Holdings.

The syndicated loan market may be re-open for junior debt as well. Second-lien issuance for the first quarter of 2024 has already exceeded levels for the full year of 2023[20]. This is in part driven by the $1.9 billion syndicated second lien loan in connection with the Truist LBO, which set a number of records: (i) one of the biggest second lien loans since 2022, (ii) one of the largest ever second lien loans to support an LBO and (iii) the lowest spread on a syndicated second-lien for an LBO (with final pricing at S+475) since the great financial crisis[21].

2024 Outlook: Blooming With Possibilities

As we look toward the remainder of 2024, a few trends are expected to continue.

First, as high interest rates persist, we expect borrowers will continue to look to incremental capacity under their existing credit facilities. Absent any MFN triggers, incurring an incremental under an existing credit facility can allow a borrower to keep the terms of its existing credit facilities intact, which may be more attractive than seeking out entirely new, but possibly more expensive, financing. In some deals, another option is to utilize portability features to permit a change of control while allowing the target company's existing credit facilities to remain outstanding, in lieu of seeking new debt financing. Moreover, an uptick in amend-to-extend activity is likely in light of upcoming debt maturities.

We also expect to see a return to the use of first lien/second lien financing structures, with junior debt provided by either private credit lenders or in the syndicated market. This could include second lien term loans, PIK Notes and/or mezzanine debt. We also expect Preferred Equity will continue to serve as another common financing alternative on the back-end of 2024. W

1 Thomas Merceica, "Navigating the Evolving Landscape of Leveraged Finance: Insights from 2023", S&P Global Market Intelligence (October 12, 2023).

2 Rachelle Kakouris, "US LBO update: Record-high funding costs drive down interest coverage, leverage", PitchBook (January 31, 2024).

3 Jonathan Hemingway, "2024 US Leveraged Loan Outlook: Strong returns, improved issuance likely", PitchBook (December 17, 2023).

4 Jonathan Hemingway, "Q4 US Volume Wrap: Refinancings grab record share as M&A withers", Pitchbook (December 20, 2023);
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8 Abby Latour, "Syndicated market attracts $10B of direct lending deals for refi YTD – BofA", LCD (February 9, 2024).

9 Marina Lukatsky, "March Wrap: Leveraged loans gain 0.85%; Q1 return is 2.46% amid supply shortage", LCDNews (April 1, 2024).

10 Marina Lukatsky, "February Wrap: Loans return 0.91%; market size grows for first time in 5 months", Leveraged Commentary & Data (March 1, 2024).

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12 GoldSheets, LSEG LPC (March 18, 2024).

13 Q1 US Leveraged Loan Market Wrap: As prices rally, opportunistic activity soars, LCD (March 26, 2026).

14 Marina Lukatsky, "Quick Take: Dividend recap volume on record pace; leveraged remains modest" (March 6, 2024).

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19 Covenant Review TrendLines Topical Report: M&A Debt Multiples Climbed in Q1 as Risk Tolerance Grows (April 3, 2024).

20 Abby Latour, "Q1 Private Credit Wrap: Syndicated lenders strike back in about-face for market", LCD (March 20, 2024); Q1 US Leveraged Loan Market Wrap: As prices rally, opportunistic activity soars, LCD (March 26, 2026).

21 Michael Tobin and Jeanine Amodeo, "Truist Sells $1.9 Billion Junior Loan in Buyout Record (Correct)", Bloomberg Law (March 8, 2024).

DEEPER DIVE
DIVIDEND RECAPS

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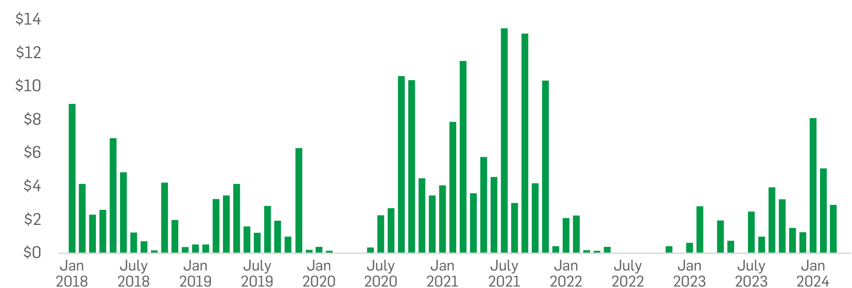
QUICKEST START TO A YEAR, EVER, ON SPONSORS LEVERAGING DIVIDEND RECAPS

As noted in our U.S. Leveraged Finance Market Update, dividend recapitalization transactions have gained notable momentum. In fact, by the end of February, dividend recap activity already reached $13.2 billion, the highest amount, ever, for any initial two-month span of a year (first quarters are typically quieter). Further underscoring this trend, the six-month cumulative volume of dividend recaps as of February 2024 reached $23.3 billion, a two-year high.

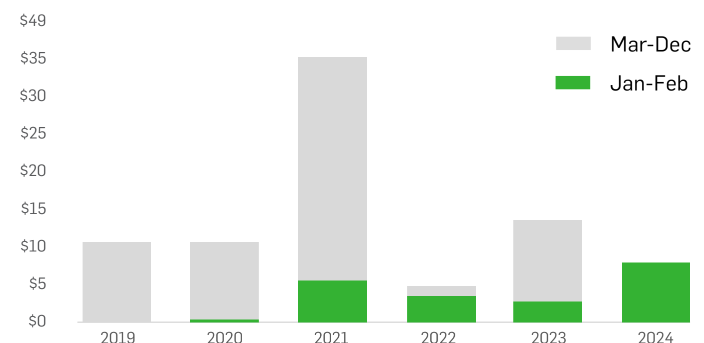
U.S. Leveraged Loan Volume to Fund Dividend Recaps ($B)



Source: Pitchbook | LCD • Data through Mar 31, 2024

With challenging exit dynamics (in 2023, the median age for PE-exited companies reached an all-time high of 6.4 years, and the median age for PE-owned portfolio companies hit an 11-year peak at 4.2 years), PE sponsors have been on the hunt for alternative liquidity solutions to return capital to LPs (ranging from secondaries, to minority stakes, to dividend recaps). Of the $13.2 billion of dividend recap activity noted above, PE sponsors received approximately $11.7 billion of it. Recap activity (so far) in 2024 is already on par with the entirety of 2023, illustrating the speed at which PE sponsors and portfolio companies have moved to benefit from better pricing and terms in the leverage finance market.

Dividends Paid Out via Leveraged Loan Market ($B)



Source: Pitchbook | LCD • Data through Feb 29, 2024

Prominent PE-backed dividend recap transactions used to fund dividends or distributions in the early months of 2024 include: Pacific Dental Services securing a $1 billion term loan due March 2031, IntraFi Network's $300 million incremental term loan, SubCom's $1.4 billion term loan, 1-800 Contacts' $953 million term loan due November 2027, and numerous others that we have advised already this year.

Q1'24 Selection of Sponsored Dividend Recap Loans

Company	Sponsor	TLB Amount ($M)	Borrower rating	LBO date
Caliber Collision	Hellman & Friedman	2,725	B/B3	Jan 2019
SunSource	Clayton, Dubilier & Rice	1,685	B-/B2	Dec 2017
SubCom	Cerberus Capital Management	1,350	B+/B1	Oct 2018
Angus Media	General Atlantic Partners	1,200	B+/B2	May 2016
PlayCore	Court Square Capital Partner	1,100	B/B2	Sept 2017
Foundation Building Materials LLC	American Securities Capital Partners	1,000	B/B2	Jan 2021
1-800 Contacts Inc	Kohlberg, Kravis & Roberts	565	B/B3	Oct 2020
Kodiak Building Partners	Court Square Capital	450	B+/B1	Dec 2017

Source: Pitchbook | LCD • Data through Mar 31, 2024

PLEDGED EQUITY PROXY RIGHTS AND THE RISE OF THE BOARD "FLIP"

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SMART SUMMARY

- Sponsors should be aware of recent situations in which **lenders have exercised voting rights given to a collateral agent through proxies in credit documents** aiming to take control of distressed boards following events of default.
- These **board "flips" can box in sponsors**, who are left with equity-in-name-only (without any voting rights), and can prevent a chapter 11 filing to restructure a portfolio company's debt.
- Sponsors should be careful when a portfolio company show signs of financial distress; operating the business without a forbearance in place puts the business at risk and will likely close doors to some restructuring options.

Background

Distress happens, even at portfolio companies that once appeared financially solid. When it does, the portfolio company, its sponsor, and its lenders often enter into restructuring discussions in search of a consensual path forward, typically under the terms of a forbearance agreement.

Recently, however, some lenders (particularly in the middle-market private credit space) have sought to short-circuit the traditional restructuring process. Rather than negotiate with their borrower (and its sponsor) on the terms of a forbearance or more holistic capital structure solution, certain middle-market private credit lenders have turned to previously underutilized provisions in security documents – the exercise of voting rights given to a collateral agent through a voting proxy as part of the pledge of a borrower's equity, otherwise known as Pledged Equity Proxy Rights.

In a traditional secured financing, a parent holding company – which owns the equity of a borrower entity lower in the corporate structure – will pledge the borrower's equity to secure the loan. As part of that pledge, the holding company often grants a contractual proxy to the collateral agent. Other than to the extent agreed in

the credit documents, that pledge should not affect the holding company's ability to vote the pledged equity prior to the occurrence of an event of default – the holding company acts as a traditional corporate parent as long as it complies with credit documents.

But, when a proxy is granted as part of the collateral package, the occurrence of an event of default often will empower the collateral agent to exercise the rights of a borrower's shareholders to appoint board members (*i.e.*, the Pledged Equity Proxy Rights) if so directed by the required lenders. If that happens, the collateral agent can exercise such Pledged Equity Proxy Rights to remove existing directors and "flip" the board, installing directors friendly to lenders instead. Further, if the company has also pledged equity of any of the borrower's subsidiaries (which often happens), the collateral agent can remove and replace directors at those subsidiary boards as well. Credit documents vary on how much notice is required prior to the exercise of such Pledged Equity Proxy Rights, with a trend, at least in private credit deals, toward no notice requirement at all following the occurrence of an event of default.

Once lenders have control of a borrower's board, they can replace officers, hire advisors, and otherwise direct the governance of the company, notwithstanding a sponsor's equity ownership.

"When a proxy is granted as part of a collateral package, the occurrence of an event of default often will empower the collateral agent to exercise the rights of a borrower's shareholders... to remove existing directors and 'flip' the board."

Practical Consequences

Beyond the obvious consequence, a "flip" can exacerbate issues faced by an already distressed company. With the loss of control of the borrower's board (and perhaps the boards of subsidiaries as well), a sponsor loses significant leverage in restructuring discussions with lenders. Filing for voluntary bankruptcy relief requires proper corporate authorization, and, without control of the borrower's board, the sponsor loses the ability to file its portfolio company for chapter 11 and, with it, the threat of filing, which itself can be a powerful tool in restructuring negotiations.

Though relatively little case law exists on these issues, at least one court, the United States Bankruptcy Court for the District of Delaware in *In re CII Parent, Inc.*, No. 22-11345 (LSS) (Bankr. D. Del. Apr. 12, 2023), held that a proper pre-bankruptcy exercise of Pledged Equity Proxy Rights by lenders to effectuate a board "flip" was enforceable and could not be unwound in a bankruptcy case of the borrower's corporate parent. There, the debtor-parent argued that the agent violated the automatic stay provisions of the Bankruptcy Code by exercising control over bankruptcy estate property (*i.e.*, the pledged equity in the debtor's subsidiaries). The court disagreed, holding that the proxy decoupled the voting rights from the ownership of the equity, the agent complied with the credit documents in exercising the rights granted under the proxy, and nothing in the Bankruptcy Code prohibited the lenders' pre-bankruptcy actions. Therefore, the debtor could not recover control of its pledged subsidiaries in its bankruptcy cases. In effect, the company lost the ability to file itself and its subsidiaries for bankruptcy protection and use the bankruptcy cases to restructure its debt.

A change in the board composition of a borrower (which often is an operating entity) also may trigger "change of control" default and/or notice provisions in material contracts and leases. A "flip," therefore, could result in counterparties tightening trade terms or terminating contracts altogether. Further, if a company has other funded debt obligations, it may also trigger direct defaults or cross-defaults under those credit documents, which may strain intercreditor relations. Either of the foregoing could result in a liquidity crunch – especially if the other funded debt is in the form of a revolver or similar instrument – or exercise by such parties of self-help remedies.

Takeaways

As soon as a portfolio company shows signs of financial distress, professionals (like Weil) should be engaged to review the credit documents and determine potential exposure and mitigation strategies. If problems continue and a portfolio company is teetering on the edge of a default, the portfolio company and sponsor should prioritize negotiating for a forbearance (or similar agreement) with lenders. A sponsor should also be careful not to rely on handshake deals and relationships with lenders when its portfolio company faces a potential default. In the world of private credit and direct lending, we have seen an uptick in aggressive tactics (like board flips) that may have been less palatable to a traditional credit syndicate. And, if restructuring discussions stall with a default looming, the Company's board should consider its strategic alternatives – including a potential voluntary bankruptcy filing – to protect control of the company.

HSR ACT THRESHOLDS AND FILING FEES INCREASED ON MARCH 6, 2024

The HSR size of transaction threshold increased to $119.5 million for transactions closing on or after March 6, 2024. Other HSR jurisdictional thresholds, civil penalties for violations of the HSR Act, and thresholds for the prohibition of interlocking directorates also recently increased. The HSR Act requirements may apply to acquisitions resulting in the acquiring person holding assets and/or equity of the acquired person valued in excess of $119.5 million. The HSR filing fees and filing fee thresholds also increased (as required by the 2022 Merger Filing Fee Modernization Act). For filings made on or after March 6, 2024, the filing fees now range from $30,000 to $2,335,000 – depending on the size of transaction.

Expansive HSR Rule Changes Still Pending

The Federal Trade Commission has not yet announced a final rulemaking in connection with the proposed revised HSR rules it published in June of 2023. As proposed, the revised rules would significantly expand the scope of information required of parties submitting HSR filings to include, among other things: certain draft and ordinary-course-of-business documents; and information regarding officers and directors, limited partners, co-investors and other interest holders, creditors, prior acquisitions, labor markets, and certain foreign subsidies. There is not a public timetable for when the final rulemaking may be published, so watch this space.

WHAT YOU REALLY NEED TO KNOW ABOUT THE CORPORATE TRANSPARENCY ACT

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What:

On January 1, 2024, FinCEN opened the United States' first national registry of business entities and their owners under the Corporate Transparency Act (CTA). Under the CTA, every entity formed by a state filing must either report to FinCEN or be eligible for one of twenty-three exemptions (see page 10 for the most common exemptions for private funds). Reports must list information about the reporting company itself, as well as the reporting company's beneficial owners – including 25% equity owners and those with substantial control over the reporting company. Civil penalties of $500 per day, per entity, and imprisonment of up to two years await the willfully non-compliant. In light of these risks, private equity firms and financial investors should consider CTA compliance in connection with entity formation, maintenance, and transactions. Below is a brief summary of the practical considerations for private equity firms deciding if and when to file reports under the CTA.

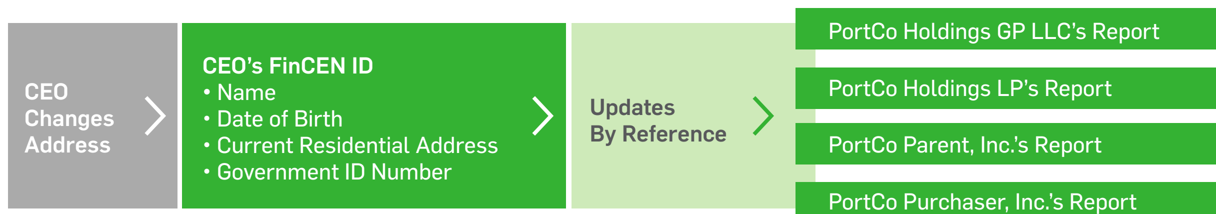
When:

Initial reports must be filed with FinCEN online by the applicable deadline shown. Foreign entities that register to do business in a state must also file according to a similar schedule. After an initial report is filed, changes to beneficial ownership information (including changes to senior officers) must be reported within thirty days.

Entity Formed Before 2024	Entity Formed During 2024	Entity Formed After 2024
File by **January 1, 2025**	File within **90 days**	File within **30 days**

How:

Compliance with the CTA requires more than a single filing. With minor exceptions, all reported information about a reporting company and its beneficial owners must be kept current. For example, if a stockholder crosses above or below the CTA's thresholds of 25% or "substantial control," an updated report must be filed accordingly. Appointment or removal of a senior officer also requires an updated filing. Furthermore, the ongoing compliance obligation extends beyond identity to all identifying information. For example, if the CEO's residential address changes or a 25% stockholder's driver's license number changes, a report must be filed within 30 days. If this CEO or stockholder is a beneficial owner of more than one reporting company, the administrative burden multiplies. Fortunately, the CTA has built in tools to manage the burden of duplicative updates while remaining compliant. The most important of these is the FinCEN ID. For example, the potential resulting workflow for a CEO's change of address could include:



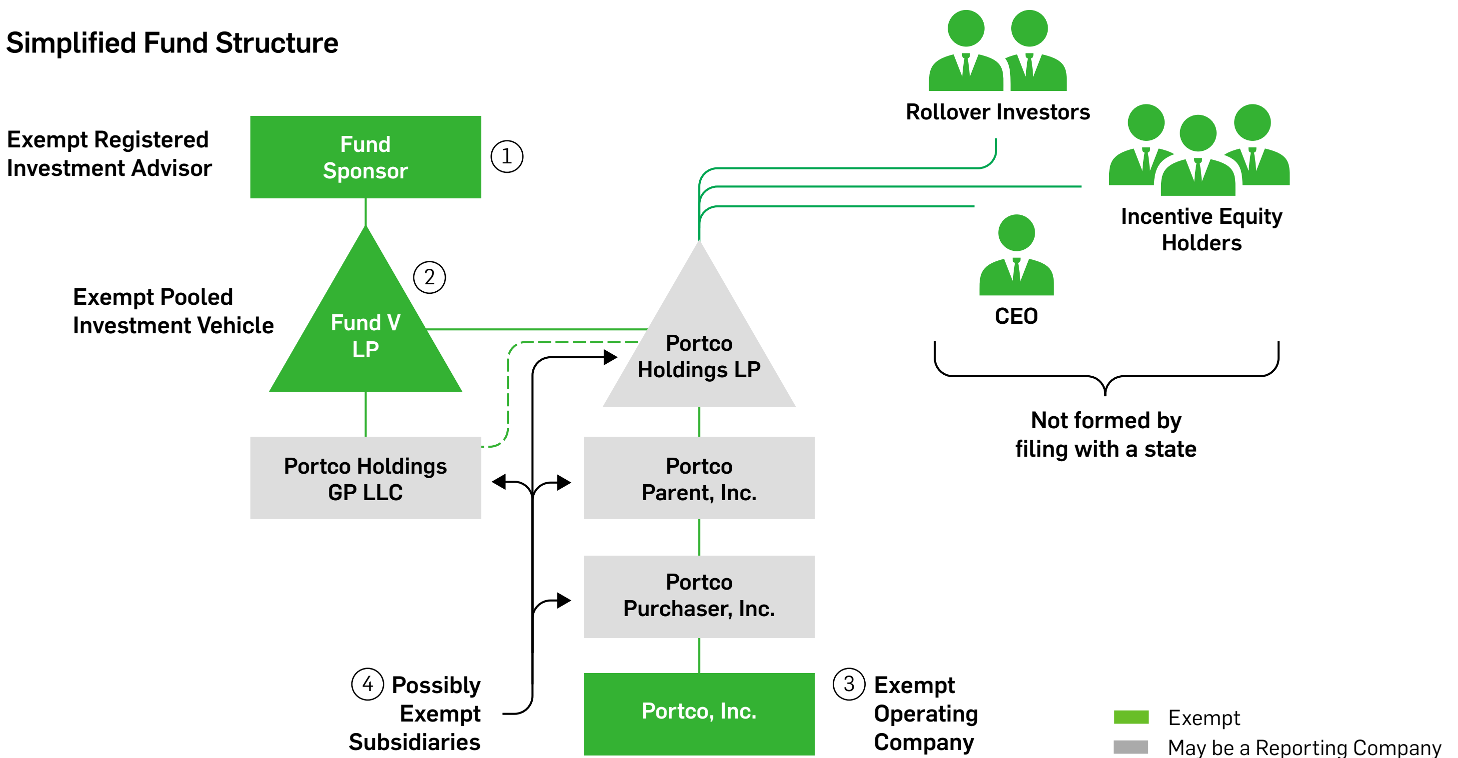
Most Relevant Exemptions

Below is a simplified fund structure illustrating four common exemptions from the reporting requirements of the CTA that are most relevant to private equity firms:

1. the registered investment adviser exemption,
2. the pooled investment vehicle exemption,
3. the large operating company exemption and
4. the subsidiary exemption.

At the top of the chart (Fund Sponsor), entities that are registered with the SEC under the Investment Advisers Act are exempt (the exemption generally being on the basis that the government already has sufficient information). The fund-level partnership (Fund V LP) is exempt as a pooled investment vehicle, but technical requirements of the CTA prevent this exemption from covering other investment related entities. At the bottom of the chart (Portco, Inc), large operating companies are exempt if they have a physical office in the United States, twenty or more employees and over $5M in sales in the prior tax year. The individuals shown will not have to file their own reports under the CTA, but depending on their ownership and control, they may be listed as beneficial owners of a reporting company.

As illustrated in the chart below, the entities labeled with (4) may be exempt under the subsidiary exemption if they are wholly controlled or wholly owned by the registered investment adviser. The scope of this exemption and whether such holding companies need to report under the CTA is not fully clear as of the publication of this issue of Sponsor Sync. FinCEN's guidance is open to interpretation, but if after an analysis of the ownership and governance arrangements it can be argued that the exempt sponsor wholly controls the holdings entities (even if it does not wholly own them), applying the subsidiary exemption may be a way for private equity firms to exclude common ownership structures from CTA reporting.



THE RISE OF THE CONTINUATION FUND

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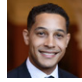
Langdon Neal
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SMART SUMMARY

- The **rise in GP-led transactions signifies a strategic pivot to continuation funds, facilitating liquidity for limited partners while enabling sponsors to potentially reap new fees** and negotiate new carry waterfalls, despite broader market uncertainty.
- **Scrutiny from the SEC and ILPA aims to bolster deal transparency** and fairness in continuation fund transactions, demanding clear disclosures on the valuation process and conflicts of interest, setting new standards for the structuring of these deals.
- As the market for continuation funds grows, driven by diverse interest across sectors and the pursuit of liquidity solutions for a broader range of assets, they present a **strategic liquidity option amidst fluctuating market conditions.**

Introduction

In 2023, the secondary transaction market remained resilient against broader market uncertainty for private equity sponsors seeking liquidity for their limited partners. Sponsor-backed M&A declined by 44% in value and 24% in deal count as compared to 2022[1]. And while the value of IPO related exits increased meaningfully in 2023 versus 2022 (by approximately 72%), IPOs only represented an estimated 3% of the total PE sponsor exit volume[2].

As M&A, IPO and recapitalization transactions have been constrained due to market conditions, sponsors and limited partners have turned to secondary transactions, including GP-led and LP-led transactions, as an alternative method to generate liquidity for limited partners, with 2023 representing the second highest value of secondary transactions to date.[3]

LP-led vs. GP-led Transactions

In a LP-led transaction, a limited partner seeks to sell its interests in a fund (or a portfolio of funds) to a third-party buyer prior to the expiration of that fund or funds. Alternatively, in a typical GP-led transaction, a sponsor will initiate a transaction to transfer for value one or more of its portfolio companies to a new investment vehicle (a continuation fund) formed and managed by the sponsor for (a) the benefit of any existing limited partners that seek to continue their indirect investment in the portfolio company or companies (i.e. "rollover" limited partners) and (b) new investors in the continuation fund.

The new investors provide the capital needed to compensate those limited partners who seek to "cash out" their respective indirect investment in the portfolio company or companies.

In developing a thesis around the use of continuation funds, sponsors often seek to address (a) underperforming assets in the short term that can ultimately create significant value for limited partners, (b) well performing companies that may be able to generate significant additional value beyond the fund's lifespan and/or (c) the need for additional investment capital when the fund is outside of its investment period.[4] In addition to these goals, the continuation fund presents the sponsor with the opportunity to potentially receive new management fees on the portfolio company, crystalize existing carry and negotiate a new carry waterfall solely with respect to the continuation fund's

newly acquired portfolio company or portfolio companies.

Over the past several years, GP-led continuation fund transactions have gained market share as a percentage of the overall number of secondaries transactions consummated. In 2023, GP-led transactions constituted approximately 44% of secondaries transactions, up from 33% in 2019, but down from the high watermark of approximately 50% in 2021 and 2020.[5] Within GP-led transactions, 2023 also witnessed an increase in the number of multi-asset GP-led transactions versus the number of single-asset GP-led transactions.[6] This shift was driven by the pursuit of additional diversification by traditional secondary buyers, along with the desire of sponsors to find liquidity options for even more of their respective portfolio companies.

Buyout funds are the typical target for continuation funds, with nearly two-thirds of "dry powder" in the secondary market concentrated on these funds. However, there is an increasing interest in Infrastructure/Real Asset focused funds due to the long dated nature of the assets as well as in Credit Funds, with modest interest in Growth and Venture Funds. In 2023, the top 3 industries that saw continuation fund activity included Healthcare, Industrials and Business Services.[7]

"Buyout funds are the typical target for continuation funds, with nearly two-thirds of 'dry powder' in the secondary market concentrated on these funds. However, there is an increasing interest in Infrastructure/ Real Asset… funds due to the long dated nature of the assets."

Value of Continuation Funds in the Current Market

In offering this comprehensive solution to its limited partners with respect to a single portfolio company or several portfolio companies, the sponsor is often able to offer its limited partners liquidity at or close to the sponsor's mark for the assets.[8] Having price discovery at this level offers an attractive alternative to the pricing pressures arising from current auction processes involving other sponsors and strategic acquirers. In addition, continuation funds often permit (a) existing portfolio company management teams to remain in place, (b) the retention of existing credit agreements, (c) a reduction in regulatory uncertainty associated with a typical change of control transaction and (d) the sponsor to retain its existing corporate governance framework, subject to certain minority protections offered to the new investors.

Additional Oversight of the Continuation Fund Transactions

In 2023, the SEC and the Institutional Limited Partners Association (ILPA) took affirmative steps in an effort to enhance transparency of the deal process and price determination in continuation fund transactions. In August 2023, the SEC adopted rules that require the inclusion by the sponsor of a fairness/valuation opinion in connection with the delivery of disclosure documentation and election forms to existing limited partners in a GP-led transaction. In addition, ILPA has, among other recommendations, requested that sponsors disclose the rationale for a continuation fund transaction as an alternative to other liquidity options and why a certain portfolio company or companies have been selected for the transaction. In addition to these matters, the SEC and ILPA also seek disclosure of any conflicts of interests that the sponsor has in the transaction (including with respect to the fairness/valuation opinion provider) as well as all material benefits that the sponsor will receive as a result of the transaction.

Final Thoughts

GP-led continuation funds continue to provide a useful liquidity tool for sponsors and their limited partners in a fluctuating transaction market. And there is a growing consensus that

continuation funds will continue to flourish as new advisors and secondary sponsors use increasing amounts of fresh capital to pursue the thousands of portfolio companies held by sponsors.

1 Bain & Company Global Private Equity Report 2024.

2 Bain & Company Global Private Equity Report 2024.

3 Lazard Private Capital Advisory: Secondary Market Report 2023.

4 The Rise of Private Equity Continuation Funds, Kobi Kastiel and Yaron Nili, January 2024.

5 Lazard Private Capital Advisory: Secondary Market Report 2023.

6 Houlihan Lokey: 2023 Continuation Fund and Cross-Fund Market Insights.

7 PJT Park Hill: FY 2023 Secondary Market Insight Investor Roadmap.

8 PJT Park Hill: FY 2023 Secondary Market Insight Investor Roadmap.

PARTNER PERSPECTIVES

Institutional Investors Committed-as-ever on Directs and Co-Invests

Arnie Fridhandler
Partner
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Tim Burns
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Private Equity

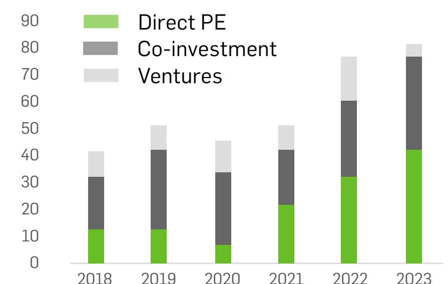
Diego López
Founder and Managing Director
Global SWF

As our friends at Global SWF have pointed out, despite a year in which the private equity industry saw historically low deal volume, sovereign investors and public pensions actually deployed more capital than ever into private equity. Focus and activity shifted from venture investments to mega-deals, and overall, the value of private equity deals by these investors grew 4% to a record-high $79.4 billion in 2023. Unsurprisingly, the theme of slightly more dollars into far fewer deals also paralleled the general sponsor M&A market. On the real asset and infrastructure side, 2023 was a quieter year with the backdrop of rising interest rates, though we note bright spots with digital infrastructure (150% growth in value year-over-year) and hospitality and leisure having a strong repeat year from 2023.

Globally, sovereign investors and public pensions continued the trend of more direct investing, which saw a 41% increase to $42.1 billion in deal value and representing 53% of private equity capital deployed. Co-investments, a staple of public investors, remained stable, comprising 41% of all deal value, up from 38% in 2022, as funds seeking exposure in new markets and sectors in particular leaned on more experienced players to execute, potentially with a view to co-origination in the future. The increased preference for direct investments and co-invests by SWF investors, combined with a nearly 75% decline in venture investments, drove the average transaction value up 53% from $229 million to $351 million. While by no means do we expect venture investment to stay quiet for long – and, indeed, recent data reflects as much – we do expect to see the higher levels of direct investment to continue as sovereign and pension investors will increasingly prefer to go under the radar in their dealmaking, or wish for full control without having to yield to the needs and sometimes conflicting approaches of other institutional investors.

Looking ahead, Diego Lopez, Founder and Managing Director of Global SWF, noted, "we see SWFs and PPFs allocating more and more to PE, and relying on external managers and JVs to deploy capital globally." The team at Weil has also seen these trends manifest in the first quarter of 2024, with new firm mandates for SWF/PPF direct investments and co-underwritten co-invests significantly increasing from H2 2023.

PE Investments by SWFs & PPFs



Source: Global SWF

CAPSTONES AND CORNER OFFICES: NAVIGATING THE C-SUITE IN 2024

The Editors Interview with John Barry

Arnie Fridhandler
Partner
Private Equity

David Gail
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Private Equity

John Barry
Partner
Head, Employment Practice Group

SMART SUMMARY

- The Editors sat down with John Barry, Head of Weil's Employment Practice Group, on trends and traps for the unwary in today's climate of portfolio management and executive team refinement.
- Importantly, **sponsors should be mindful that restrictive covenants are not overly broad and ensure generally consistent terms across the growing number of executive agreements** to minimize risks in litigating and pursuing enforcement.
- Sponsors can better safeguard intellectual property and mitigate joint employer exposure during C-suite changes with **quick action and appropriate non-deal team members involved in separations.**

Around the corridors of investors and sponsors alike, the art of managing executive relationships and management teams within investments has become as nuanced as it is necessary. Over the past several years, sponsors have refreshed on value creation exercises and unfurled a tapestry of complexities in the C-suite. The stakes of mismanagement of operating investments are not just high – for some businesses, they are existential. Well-executed business plans and strong managers are as crucial to underwriting and strategy success as are sector tailwinds and interest rates.

As detailed in discussions between the Editors and John Barry, Head of Weil's Employment Practice Group, the landscape of financial investors' relationships with management teams is one of profound change, marked by a kaleidoscope of challenges and opportunities.

Central to these deliberations is the recognition of a market undergoing dislocation, hyper-focus on value creation, and resulting executive churn. We have witnessed a surge in executive transitions of sponsor-backed companies, a trend underscored by increasing demands on Weil's Employment Practice Group's C-suite counseling. The shift is not merely numerical but strategic, compelling a reexamination of how investors engage with their most senior operating company leaders.

The Editors' conversation with Mr. Barry centered around two topics – *first*, the latest tensions on enforcement and application of restrictive covenants and *second*, the traps for the unwary on protecting company intellectual property and against joint sponsor-company employer risks.

With Restrictive Covenant Complexity Comes Enforcement Perils

On restrictive covenants, the delicate architecture of restrictions and the legal tightrope walked in company acquisitions has led to restrictive covenants cropping up across more documents than ever – from purchase agreements, to incentive plans, to employment contracts and shareholder agreements. The push to give managers liquidity but also incentivize long-term value creation has resulted in an avalanche of documents in modern structures. Sometimes these documents are created at the same time, though more often not. In this domain, our conversation focused on the need for a harmonized approach on restrictive covenants. Even though only 10% of the times Weil's Employment Practice Group is consulted on potential restrictive covenant enforcement will such matter translate into litigation, contractual gymnastics are not just a matter of legal compliance and contract strength, but of strategic foresight. For example, ensuring the lowest common time period applies across agreements will avoid threats to effective enforcement – a scenario increasingly common in the jurisprudence of states like Delaware.

"It has become even more challenging to unpack and potentially enforce [the mazes of documents] in today's judicial and regulatory climate… being aware of the lowest common denominator in documents across a variety of terms, and being careful not to draft overly-broadly, is more important now than ever before."

John also noted that while Delaware is a "default" jurisdiction for many corporate contracts (including restrictive covenant agreements), recent developments in Delaware courts have created a minefield for enforceability claims, including a finding that overly-broad restrictions resulting from affiliate references could render entire restrictions unenforceable. Sponsors need to think twice in selecting governing law and jurisdiction in employment-related contracts.

Simply put, as difficult as it is designing the web of restrictive covenants (with unique structures, forms, durations and scopes), in the context of sponsor and company protections, it has become even more challenging to unpack and potentially enforce these mazes in today's judicial and regulatory climate. Being aware of the lowest common denominator in documents across a variety of terms, and being careful not to draft overly-broadly, is more important now than ever before.

Executive Exits

Another pressing area of focus in the Editors' conversation was the evolving trend of more frequent senior executive exits. In some cases, sponsors have seen C-suite managers turn over multiple times in short periods of time. The balance between respect for the individual and the imperatives of the investor can be crystallized into two issues often overlooked – the protection of intellectual property, and the management of joint employer exposure risks.

Protection of IP

On protection of intellectual property, it is not uncommon for a departing executive to leave with sensitive intangible information and knowledge, and in fewer (unfortunate) cases, tangible documents and company belongings. Often, issues with intellectual property leaving with an executive are only addressed after the proverbial toothpaste is out of the tube, and in many cases, hindsight (and our advice) is that where an executive can see the writing on the wall, and a decision is made to separate with a manager,

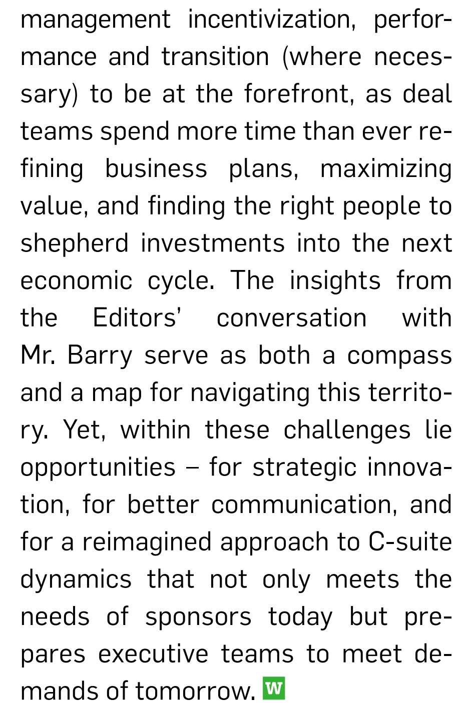
both the sponsor and company are best protected when the process is accelerated. Quicker separations and careful communications (keeping information on a need-to-know basis at investee companies) naturally prevents nefarious collection and departure of sensitive information on exits.

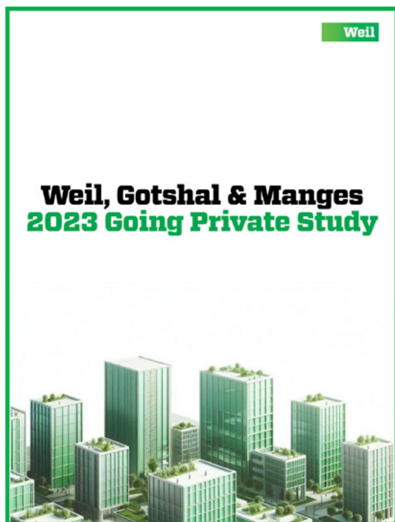
Joint Employer Risks

On the other hand, joint liability is another area often overlooked but fraught with risk. A sponsor's fingerprints on an executive exit may be cause for joint employer risks, and there are tactics to reduce joint employer exposure by having clear governance guidelines on who and how decisions are made around separations. Steering away from ad-hoc actions that may be seen, after the fact, as sponsor decisions, is crucial. For example, a deal team member at a sponsor should not be involved in communicating or exiting a manager, and where possible, boards of directors or other managers should be part of the deliberations and execution. The more detangled sponsors can be from separations, the better.

Final Thoughts

As we peer into the remainder of 2024, it is evident that the landscape of PE is not just evolving; it is being actively redrawn. As a firm, we expect demand for advice around management incentivization, performance and transition (where necessary) to be at the forefront, as deal teams spend more time than ever refining business plans, maximizing value, and finding the right people to shepherd investments into the next economic cycle. The insights from the Editors' conversation with Mr. Barry serve as both a compass and a map for navigating this territory. Yet, within these challenges lie opportunities – for strategic innovation, for better communication, and for a reimagined approach to C-suite dynamics that not only meets the needs of sponsors today but prepares executive teams to meet demands of tomorrow.





2023 GOING PRIVATE STUDY

We are delighted to share Weil's 17th annual survey of U.S. sponsor-backed going private transactions. We first published this survey back in 2007, and, as was the case then, we are in a very dynamic and fluid market. This survey analyzes certain key transaction terms and trends (or expected future trends) of going private transactions signed in 2023 that we think are most relevant for U.S. sponsors. We are happy to discuss the detailed findings and analyses underlying this survey.

View Weil's 2023 Going Private Study.

DEAL CERTAINTY UNDER DELAWARE LAW: RECENT CASES AND PRACTICAL IMPLICATIONS FOR PRIVATE EQUITY SPONSORS

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SMART SUMMARY

- Two recent cases before the Delaware Court of Chancery provide important lessons for sponsors on matters of deal certainty: one on financing cooperation covenants (potentially being a sword for a buyer to walk away from a deal), and another on the significance of correct fundamental representations. These cases serve as reminders of the importance of drafting precision in allocating which party bears closing risk if covenants, reps or warranties are breached before closing.
- On closing conditions for covenant performance, consider whether a seller's breach of financing assistance obligations should permit a buyer to walk away ***only*** if that breach results in buyer's inability to obtain financing (that distinction matters).
- On closing conditions for bring-down of representations, it's not uncommon for fundamental representations to be "brought-down" at closing to flat standards, and Delaware courts can find even minor inaccuracies could prove fatal for a transaction.

The Delaware Court of Chancery was recently faced with several issues relating to deal certainty, a core tenet of M&A that is of paramount importance to private equity sponsors when they are transacting (both on the buy-side and the sell-side). In particular, Delaware courts had to grapple with scenarios where buyers sought to terminate acquisition agreements based on sellers' alleged breaches of covenants, representations and warranties, which arguably led to certain closing conditions not being satisfied (and thus giving these buyers an "out" from their respective deals). There are important practical insights to glean from these cases, which sponsors should be mindful of as they continue to negotiate transactions in 2024 and beyond.

1. Termination Based on Breach of Financing Cooperation Covenants

In *Omni Newco, LLC v. Forward Air Corporation*, Forward Air entered into a definitive agreement to acquire Omni by way of merger for a combination of cash in the amount of $150 million and stock in Forward Air, the cash component of which would be financed using debt. In connection with Forward obtaining acquisition debt financing, Omni agreed to certain customary financing cooperation covenants, including providing reasonable access to Omni's books and records, furnishing information, and using reasonable best efforts to cooperate with Forward's financing efforts during the interim period. While negotiating the merger agreement, Omni sought, but did not succeed in obtaining, a provision that failure for it to comply with these obligations would ***only*** result in the closing condition regarding covenant performance not being satisfied if and to the extent that the buyer was not able to obtain its debt financing as a result of Omni's breach. Essentially, Omni didn't want its efforts to help the buyer obtain acquisition financing to be a potential reason Forward could refuse to close.

In looking to terminate the agreement and walk away from the deal, Forward alleged (i) Omni failed to comply with its financing cooperation covenants by failing to timely provide certain requested information and (ii) the (applicable) closing condition was not satisfied so Forward would not be required to close the transaction.

While the parties were able to cut a new deal on the first day of trial (a purchase price discount of approximately $175-$200 million), private equity sponsors should consider the impact of including (or rejecting) language that failure to comply with financing cooperation covenants will only constitute a failure to satisfy a closing condition "*if the buyer's debt financing is not obtained as a result*". For sellers, including this language provides enhanced deal certainty that footfaults will not give ammunition to an anxious buyer; still, sellers should be wary of the legislative negotiating history that asking for, but ultimately conceding, this language creates (redlines and negotiations could, in some cases, be introduced as evidence where a contract is unclear). Sellers also should consider the potential cost of failing to provide requested information and financing assistance on a timely basis. For buyers, consider resisting this type of language in order to preserve flexibility and preserve the ability to walk away from a transaction if the sellers do not comply with their obligations in connection with obtaining acquisition financing.

"[P]rivate equity sponsors should consider the impact of including (or rejecting) language that failure to comply with financing cooperation covenants will only constitute a failure to satisfy a closing condition 'if the buyer's debt financing is not obtained as a result'."

2. Termination Based on Breach of Capitalization Representation

In HControl Holdings LLC v. Antin Infrastructure Partner S.A.S., Antin entered into a definitive agreement to acquire OpticalTel by way of merger. The merger agreement included a typical capitalization representation, which was subject to a "flat bring-down" at closing, meaning the representation was required to be true and correct in all respects at closing in order for the closing condition to be satisfied (*i.e.*, not subject to any exception for *de minimis* inaccuracies). After the deal was announced, a former OpticalTel employee came forward alleging an ownership stake in a subsidiary of the company, based on a commercial contract that entitled him to a "5% ownership [interest]... to be distributed upon a liquidation event". The Court had two important findings:

(i) OpticalTel did in fact breach the capitalization representation as a result of this commercial contract (i.e, the capitalization representation was not entirely accurate) because the representation spoke to not just (traditional) equity but also lowercase "phantom equity" of subsidiaries; and

(ii) Antin validly terminated the merger agreement because the representation needed to be true and correct in all respects at closing, which was not the case.

On the sell-side, this case illustrates the importance of sell-side diligence and how crucial it is for sellers and management to have a complete and accurate understanding of the target company's cap table and to identify any exceptions to all representations, particularly those subject to a higher bring-down standard. In addition, sellers should be wary of overly broad definitions of "Equity Securities", which (as was the case in Antin) may pick up quasi-equity, such as contractual rights to proceeds and other items that parties may not traditionally view as equity. On the buy-side, always consider pushing for capitalization (and any and all other fundamental representations) to be subject to a "flat" bring-down.

As one would expect, both buyers and sellers tend to be very focused on deal certainty issues when unexpected macro events put deals in jeopardy. It is even more important, however, for private equity sponsors to think proactively and focus on deal certainty issues in relatively tranquil times like the environment that we are in now (and to work with thoughtful advisors to confront those issues). These two Delaware cases serve as reminders that specificity (particularly around closing conditions and the other sections of acquisition agreements that feed into these conditions), are extremely important to consider through the lens of deal certainty and who ought to bear the risk of any representation not being entirely true, or covenant not being perfectly performed.

"As one would expect, both buyers and sellers tend to be very focused on deal certainty issues when unexpected macro events put deals in jeopardy. It is even more important, however, for private equity sponsors to think proactively and focus on deal certainty issues in relatively tranquil times."

FROM COURTROOM TO BOARDROOM: THE IMPACT OF *MOELIS* ON CORPORATE GOVERNANCE

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SMART SUMMARY

- Governance provisions granting a founder excessive control over board actions and composition were recently struck down in *West Palm Beach Firefighters Pension Fund v. Moelis & Company*, spotlighting legal boundaries in corporate governance arrangements.
- **Incorporating critical governance provisions into a corporate charter rather than shareholder agreements may offer stronger legal standing**, albeit within DGCL's mandatory constraints.
- The nuanced evaluation of governance agreements by the court suggests a **delicate balance in aligning corporate governance structures with legal standards**, guiding future corporate agreement formulations.
- The **Delaware State Bar Association issued proposed amendments to the DGCL which would address the *Moelis* holding**, by granting corporations authority under the DGCL to contract with stockholders regarding consent rights.

In *West Palm Beach Firefighters Pension Fund v. Moelis & Company*, Vice Chancellor Laster issued a 133-page opinion addressing governance rights in stockholder agreements and putting into question whether stockholder agreements were limited to some extent by law. In response to *Moelis*, the Delaware State Bar Association proposed amending the Delaware General Corporation Law (DGCL) (and these changes are expected to be introduced to the Delaware General Assembly for consideration during its 2024 regular session). If the amendments are enacted, Section 122 of the DGCL would clarify and expressly enable a corporation to enter into a governance agreement with certain positive and negative stockholder rights – on one hand, expressly permitting stockholder approvals be sought before taking corporate actions, and on the other hand, permitting covenants with affirmative obligations on a corporation to take certain actions per the governance contract if so specified.

At issue in this case is the Moelis & Co. stockholder agreement, which stated that the company's board must obtain Ken Moelis' approval before taking virtually any action. The stockholder agreement also ensured that Moelis was able to select a majority of the members on the board and its committees. The plaintiffs argued that the challenged provisions in the stockholder agreement fail the *Abercrombie* test because they prevented members of the board from exercising their own

judgment and discretion. Here, the court addressed three categories of challenged provisions in the stockholder agreement: (1) pre-approval requirements, which stated the board must obtain Moelis' prior written consent before taking virtually any action; (2) board composition provisions, which ensured Moelis could select a majority of the board's members; and (3) committee composition provisions, which "forced the board to populate any committee with a number of Moelis' designees proportionate to the number of designees on the full Board."

How Much Control is "Too Much Control"

The court took issue with the increasingly common practice of implementing internal governance arrangements through stockholder agreements, and emphasized the importance of Section 141(a) of the DGCL, which states that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." In deciding that Section 141(a) applied, the court surveyed precedent and found that "a court applying Section 141(a) must first determine whether the challenged provision constitutes part of the corporation's internal governance arrangement. If not, then the inquiry ends. If so, then Section 141(a) applies." Here, "[t]he Challenged Provisions are prototypical governance provisions in a prototypical governance agreement. As such, they are part of the Company's internal governance arrangement. Even though they appear in a separate contract, they are subject to Section 141(a)."

The court noted that the pre-approval requirements included in the Moelis stockholder agreement "are explicit and direct limitations on the Board's ability to take action . . . The provisions purport to bind and constrain the Board." Indeed, "[t]he directors can only act to the extent Moelis lets them. The Pre-Approval Requirements have the effect of removing from the directors in a very substantial way their duty to use their own best judgment on virtually every management matter," and are thus facially invalid. The court similarly found the provisions assigning Moelis power to effectively select board and committee members were facially invalid.

The court also rejected the Company's argument that Moelis was only given veto rights. The court stated that these were pre-approval rights which prevented the board from acting without obtaining Moelis' prior written approval. Reframing the pre-approval requirement as a veto would still lead to the same end result, however, because "Moelis has expansive power to review, which gives him the power to decide." The court also found that other requirements in the shareholders agreement were also facially invalid.

"The court took issue with the increasingly common practice of implementing internal governance arrangements through stockholder agreements, and emphasized the... DGCL, which states that 'the business and affairs of every corporation... shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.'"

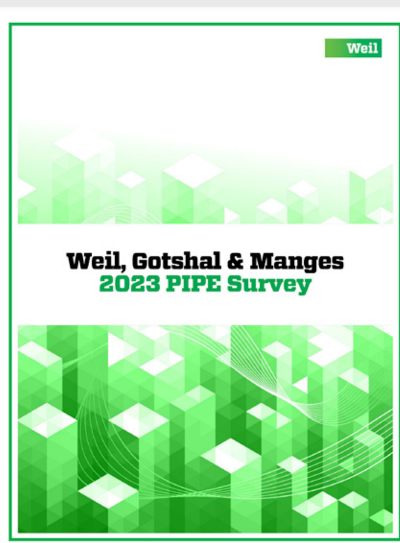
Ultimately, the court found some provisions in the stockholder agreement were acceptable however, concluding that the designation right, nomination right and efforts requirements were acceptable. In arriving at this conclusion, the court held that on its own, the designation requirement "only gives Moelis the ability to propose a specific number of designees. It does not force the Board or the Company to do anything with the designees," the nomination requirement "obligates the Company to include Moelis designees in the Company's slate of nominees by 'nominating such designees to be

elected as directors,'" and the efforts requirement required the Company to take "ministerial steps to ensure that stockholders can consider Moelis' nominees and potentially elect them, such as by adding Moelis' designees to the Company's proxy card or by including information about them in the Company's proxy statement." Taken together, these actions did not constitute meaningful infringement on the Board's authority.

Charters Would Have Afforded Greater Protection

If the provisions at issue were in the Moelis & Company's certificate of incorporation, most of the provisions at issue would have complied with Section 141(a). "Although some might find it bizarre that the DGCL would prohibit one means of accomplishing a goal while allowing another, that is what the doctrine of independent legal significance contemplates." In fact, "[e]ven now, the Board could implement many of the Challenged Provisions by using its blank check authority to issue Moelis preferred stock carrying a set of voting rights and director appointment rights. . . because the provisions would appear in the Charter, they would comply with Section 141(a)." However, a footnote in the decision stated that "[e]ven a charter provision cannot override a mandatory feature of the DGCL." As such, the court left open the possibility that certain restrictions on board actions would still be invalid even if they appeared in the charter. For example, "[s]ome transactions, like mergers, require a specific sequence of events in which the board initiates action, then the stockholders vote. . . It is unclear whether a charter provision could require a stockholder's pre-approval before the board could act." The proposed amendments to the DGCL noted above would address some of these open questions and largely circumvent the need to include the governance provisions in the corporate charter as opposed to a shareholder agreement.

While the Moelis governance rights here were notionally aggressive, the decision goes into great detail and describes the state of the law on various types of restrictions. As such, the decision provides helpful information for less onerous agreements or provisions. If there are any questions about specific provisions, counsel should determine whether the issue may have been addressed directly or indirectly by the court and determine where in governance documents the rights should reside to afford maximum protection from challenge, including whether updates to the DGCL ameliorate these concerns or not.



View Weil's 2023 PIPE Survey.

2023 PIPE SURVEY

As profiled by PEI, we are excited to share Weil's 17th survey of U.S. sponsor-backed PIPE transactions. In 2023, the U.S. sponsor-backed PIPE market experienced a complex interplay of market dynamics, reflecting broader economic trends and sponsor sentiments. This report delves into the intricacies of these transactions, offering insights as to the factors that have influenced the sponsor-backed PIPE market over the year. From shifting interest rates to evolving sector-specific M&A trends, we explore how these elements have shaped sponsor strategies and the strategic importance of sponsor-backed PIPE transactions in today's market. We also consider PIPE data from the past decade and offer insights into future trends and the PIPE market's trajectory. As we have done annually for 17 years, this study also focuses on the key terms of those U.S. sponsor-backed PIPEs that signed throughout the year, including financial terms, liquidity mechanisms and governance rights. We are happy to discuss the detailed findings and analyses underlying this survey.

DELAWARE WILL ENFORCE "FORFEITURE-FOR-COMPETITION" PROVISIONS WITHOUT REGARD TO REASONABLENESS

Glenn D. West
Retired Partner
Private Equity

Earlier this year, on my birthday, the Delaware Supreme Court, in *Cantor Fitzgerald, L.P. v. Ainslie*, 2024 WL 315193 (Del. Jan. 29, 2024), unequivocally reaffirmed Delaware's "reverential" view of "unambiguous contractual undertakings" – i.e., they almost always will be enforced as written. In doing so, the court reversed a decision of the Court of Chancery rendered last January that had treated a "forfeiture-for-competition" provision as being subject to the same reasonableness review as a "covenant not to compete."

The "forfeiture-for-competition" provision was contained in a limited partnership agreement; and it conditioned the payout of a withdrawing partner's capital account on that former partner not having competed with the partnership or its affiliates during the four year payout period.

Although it appears that the majority of states treat "forfeiture-for-competition" provisions as substantively different than an actual non-compete (and not subject to the typical review for reasonableness), Vice Chancellor Zurn had sided with the apparent minority view in the Court of Chancery opinion and treated the "forfeiture-for-competition" provision as having essentially the same effect as a "covenant not to compete."

As noted in a prior Weil Private Equity blog posting discussing the Court of Chancery opinion, there is a fundamental difference between a forfeiture-for-competition provision and a covenant not to compete – i.e., in a forfeiture-for-competition provision (unlike a covenant not to compete) an employee can choose to leave their employment and compete (without fear of a suit for damages or injunctive relief), as long as they are prepared to forgo the payments that are conditioned upon the former employee not competing.

Noting that the forfeiture-for competition provision did not prevent the former partner/employee from competing and was contained in a limited partnership agreement, which was subject to the enhanced "freedom of contract" policy set forth in the Delaware Revised Limited Partnership

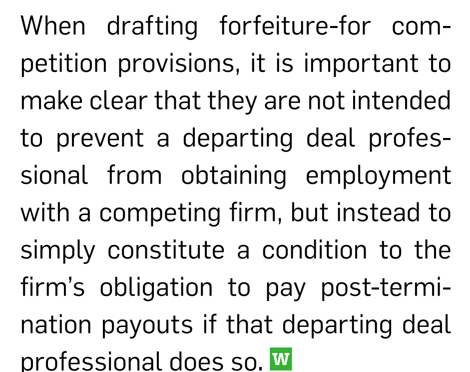
“There is a fundamental difference between a forfeiture-for-competition provision and a covenant not to compete – i.e., in a forfeiture-for-competition provision (unlike a covenant not to compete) an employee can choose to leave their employment and compete (without fear of a suit for damages or injunctive relief), as long as they are prepared to forgo the payments that are conditioned upon the former employee not competing.”

Act (6 Del. C. § 17-1101(c)), the Delaware Supreme Court determined that the forfeiture-for competition provision was not a restraint of trade (like a covenant not to compete), and was therefore not subject to a public policy override requiring a reasonableness review. Instead, the court concluded that “[w]hen sophisticated parties agree in a limited partnership agreement that a partner, who voluntarily withdraws from, and then competes with, the partnership, will forfeit contingent post-withdrawal financial benefits, public-policy considerations weigh in favor of enforcing that agreement.”

Forfeiture-for competition provisions are common elements of private equity arrangements granting the deal team equity interests and financially incentivizing loyalty. As long as these provisions are contained in limited partnership agreements or limited liability company agreements (which also have an enhanced “freedom of contract” policy, 6 Del. C. § 18-1101(b)), Delaware courts are prepared to enforce them as written without reference to public policy overrides for reasonableness that might otherwise apply to a covenant that actually restricts the partner/employee’s ability to obtain employment in the same business.

According to the Delaware Supreme Court:

The distinction between a restrictive non-competition covenant that precludes a former employee from earning a living in his chosen field and an agreement that allows a former partner to compete but at the cost of relinquishing a contingent benefit is, in our observation, significant. In the restrictive-covenant context, the former employee is effectively deprived of his livelihood and, correspondingly, exposed to the risk of serious financial hardship. This gives rise to the strong policy interest that justifies the review of unambiguous contract provisions for reasonableness and a balancing of the equities, two exercises typically foreign to judicial review in contract actions. By contrast, however, forfeiture-for-competition provisions, which, unlike restrictive covenants, are not enforceable through injunctive relief, do not prohibit employees from competing and remaining in their chosen profession, and do not deprive the public of the employee’s services, present no such concern. The policy interest that preponderates in the former case is diminished – if it does not vanish – in the latter. To put it another way, the interest to be vindicated when evaluating a covenant that prohibits competition and that might even preclude gainful employment is significantly weakened when competition – often (as in this case) highly remunerative – is permitted. That diminished interest is insufficient to override DRULPA’s directive to “give maximum effect to the principle of freedom of contract and the enforceability of partnership agreements.”



When drafting forfeiture-for competition provisions, it is important to make clear that they are not intended to prevent a departing deal professional from obtaining employment with a competing firm, but instead to simply constitute a condition to the firm’s obligation to pay post-termination payouts if that departing deal professional does so. W

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RECENT HIGHLIGHTS

Weil Private Equity is proud of our broad representations and the successes of our clients. Below is a small sampling of our recent work:

- Weil advised American Securities in the sale of a majority stake in Foundation Building Materials, LLC to funds managed by Clayton Dubilier & Rice
- Weil advised Cove Hill Partners in its acquisition of Incident IQ, LLC
- Weil advised Clayton Dubilier & Rice in the merger of its portfolio company Cynosure with Lutronic Corporation
- Weil advised Galvanize Climate Solutions, along with Rubicon Technology Partners and Silversmith Capital Partners, in the acquisition of Ascend Analytics, LLC
- Weil advised Genstar Capital and its portfolio company Clarience Technologies in the acquisition of Safe Fleet
- Weil advised Kainos Capital and its portfolio company Evriholder Products in the acquisitions of Axe Holdings, LLC and Home Sweet Home Holdings, Inc.
- Weil advised PSG in its investment in Packback Inc.
- Weil is advising Pacific Avenue Capital Partners in its proposed acquisition of the filtration business of Sogefi SpA

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