PE VIEWS

OUR INSIGHTS ON THE WORLD OF PRIVATE EQUITY

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Watch What You Write: Communications on Personal Devices Could Be Disclosable in Litigation

When it comes to personal devices, people increasingly communicate across multiple platforms, often in an informal and unguarded manner. However, high levels of litigation driven by the COVID-19 pandemic (including insolvency and restructuring litigation), the recent M&A boom (including shareholder disputes and other transactional litigation), and the rise of remote/hybrid work mean that PE firms must remain alert to the risk of personal device communications being disclosed in litigation.

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As seen in recent cases, the English courts place value in contemporaneous written evidence, and take a pragmatic and targeted approach to disclosure. While English courts are mindful of the privacy rights of individuals, they recognise that employees conduct work on personal devices and non-proprietary third-party apps.

However, the location of the data is not sufficient to avoid a disclosure order, and PE firms should consider how to best protect themselves.

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Check Your Policies and Staff Contracts
Recent court cases have focused on company policies regarding access to work-related communication on personal devices, including when and how it is permitted, and when access may be required. The English courts have required a company to enforce its right to access the personal mobile phones of a former employee, because he had a contractual obligation to allow the company access to work communications (including emails, text messages, and app based messages) on his personal devices.

Control of data and devices is also a key issue. The English courts also recently ordered defendants in a competition claim to write to specified current and former employees to request that those individuals voluntarily allow data-recovery experts engaged by the defendant access to their personal mobile phones and emails, to facilitate searches for work-related communications.

Remember Privilege, but Tread Carefully
Legal professional privilege allows clients to withhold disclosure of information related to legal issues. Privilege (which extends to legal advice and to documents prepared for litigation) does not generally depend on the mode of communication, but the protection has limits. For example, legal advice privilege only covers communications that are confidential; from a "lawyer"; to a "client"; and for the purpose of giving or seeking "legal advice", all of which can be complex issues. For example, a communication chain involving lawyers, clients, and non-clients for purposes other than seeking legal advice is unlikely to be privileged, and may therefore be disclosable. Seek advice before engaging in sensitive communications.

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Think Before You Commit Anything to Writing
PE firms should communicate their protocols and expectations clearly to staff. All staff should keep in mind that what is written is potentially disclosable, even on third-party platforms. Informal communications can create a misleading narrative. However, such communications often provide an excellent snapshot of events that transpired, should a dispute arise, and so they can also be useful to capture a contemporaneous record of events.

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Beyond the English Courts
Sponsors should be alert to the increased willingness of the English courts to grant targeted disclosure, including orders directed at requiring voluntary disclosure from third parties, bypassing potentially complex issues of whether documents are in a defendant's control.

In addition, PE firms may not always be able to predict or control where a dispute will arise. As such, the disclosure rules of other jurisdictions may come into play, adding further complexity — and requiring expert legal counsel.

WHAT IS DISCLOSURE AND WHY DOES IT MATTER?

- Disclosure is the process by which litigants are required to search for relevant documents and provide them to each other.
- All parties to English civil proceedings must give disclosure, even of harmful documents, subject to some very narrow exceptions.
- The English court places value in contemporaneous written evidence, often more so than witness evidence.
- The process is intended to ensure that the parties share documentary evidence at an early stage.

Could PE Benefit From the Universal Adoption of "Super Senior" RCFs in Leveraged Financings?

Undrawn revolving credit facilities (RCFs) are essential to private equity. They are a backup in the event of mismatches in the working capital cycle, provide comfort for a rainy day, and preserve swift access to deal-making when other financing sources are unavailable, or less easily accessible. The COVID-19 pandemic could not have proved the importance of undrawn RCFs more clearly. Within a few weeks of the onset of the pandemic, as credit markets gummed up and businesses worldwide grappled with evaporating liquidity, leveraged companies dashed for cash and drew revolving lines.

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PE firms may be able to persuade banks to offer RCF commitments more freely by transcending the limitations of current transactional templates and allowing banks to consistently provide undrawn revolving credit in its most secure form — alongside all leveraged loans and secured bonds, rather than just on bond backed deals, as is current practice.

Dealmakers are well aware of the imbalance between high demand of RCFs by private equity and short supply by banks

The Current Imbalance in Supply and Demand of RCFs

Banks are the primary (and almost exclusive) source of undrawn RCF commitments. But because the product commands tight pricing in the market and generally is not very profitable, banks tend not to view it as a compelling use of their capital. Instead, they treat RCFs as relationship-driven transactions that grant access to other types of non-credit borrower business, typically capital markets activities and M&A advisory work.

Dealmakers are well aware of the imbalance between high demand for RCFs by private equity and short supply by banks — sponsors requests for a turn of leverage (or more) in RCF commitments can be cut down by underwriting syndicates.

A Novel Idea to Help Solve the Imbalance

Economic theory suggests that the cure for the supply/demand imbalance would be for the pricing of RCFs to rise, but that would be unattractive to PE and futile for banks, which are used to treating the product as a loss leader and are mostly concerned about the constraint that undrawn credit lines put on their ability to lend capital elsewhere.

Enhancing the appeal of RCFs to banks by making RCFs less onerous to bear on bank balance sheets, could be a better approach. This could be achieved by elevating the ranking of RCFs to "super senior" status in all PE financings

In our view, enhancing the appeal of RCFs to banks by making RCFs less onerous to bear on bank balance sheets, could be a better approach. This could be achieved by elevating the ranking of RCFs to "super senior" status in all PE financings including those with loans (see box below).

Recent Experience — Ranking of Loans and Bonds

Experience in the recent wave of restructurings shows that super senior RCFs are rarely impaired, even in cases in which term creditors face substantial write-offs. Banks that hold pari passu RCF commitments are not as fortunate, and often end up with the same scaling-down of claims as other secured creditors. The difference in recovery outcomes explains why banks apply a more lenient capital charge to super senior RCFs and why their credit committees tend to have fewer reservations in booking super senior commitments than pari passu ones.

Balancing Risks and Rewards

While this new capital structure, in which super senior RCFs coexist with term loans, is yet to be adopted in mainstream PE transactions, the convergence in both investor base and terms across leveraged loans and secured bonds makes the different ranking of RCFs across the two types of capital structure anachronistic.

Market acceptance may not come without execution challenges, including a few initial loan syndications being more involved than usual, as loan investors digest the proposal, but the new transaction model would be mutually advantageous for PE and banks.

Sponsors may get more of what they want — reliable evergreen sources of liquidity, at a lower price. Banks may be more generous in extending RCF credit when they know they can rely on the comfort of super senior security. And recent examples (including Altice and several deals in the unitranche market) suggest that acceptance of the new capital structure may wind up as more of an anti-climax than a cliff-hanger.

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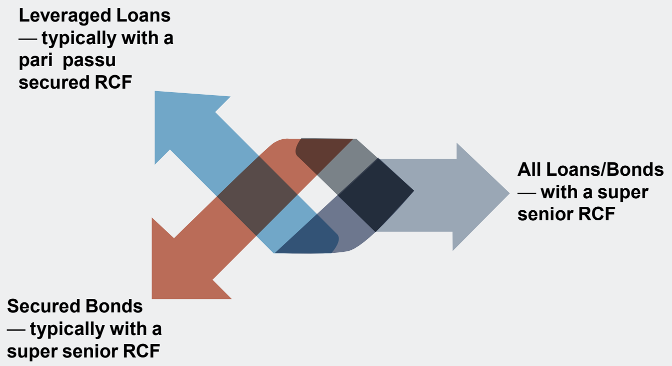
LEVERAGED BORROWERS

Currently, leveraged borrowers carry one of two capital structures:

- When their long-term debt is entirely in the form of loans, they have a pari passu capital structure, in which all secured claims (including RCFs) rank equally
- Conversely, when their long-term debt is in the form of secured bonds, they tend to have a super senior capital structure, in which banks holding RCFs get first dibs on any enforcement proceeds

Sponsors may persuade banks to offer RCF commitments more freely by adopting "super senior" capital structures in all their leveraged financings, regardless of whether they feature term loans or secured bonds



ESG Toolkit Expands for European PE

Market sentiment and the increasing importance of environmental, social, and governance (ESG) to firms' competitiveness across the market, combined with wide-ranging and rapidly developing ESG regulatory reforms, are driving increased focus on ESG at both LP and GP levels across Europe. As a result, the market is showing demand for enhanced diligence, and a wider range of deal provisions are being considered in light of their potential to enhance the ESG outlook of PE investments.

From Diligence

We continue to see growing demand from acquirers for enhanced ESG diligence. Key themes include climate change, supply chain issues (such as human rights and modern slavery), diversity, data privacy, and governance as a whole. In Europe, regulations such as the Sustainable Finance Disclosure Regulation (SFDR) are broadening disclosure and transparency requirements in relation to ESG matters. Increasingly, in-scope PE firms must ensure that relevant ESG credentials of a PE fund are attained through individual investments, including through diligence.

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To Reporting

The trend of greater data availability and disclosure in the market is increasing the level of scrutiny from LPs in relation to the ESG credentials of funds more generally. This level of scrutiny will become even more acute in Europe when the Taxonomy Regulation takes effect in January 2022, which will require certain funds to make enhanced ESG disclosures.

A recent FCA consultation on disclosure reform, which, if implemented, would capture certain PE firms at the entity and fund product level and, would require annual reporting disclosures against standard climate-related metrics from 2023/2024, depending on firm size. The consultation specifies that the proposed approach aims to bring into scope the asset management activities of PE and other private market firms — a development that firms will need to monitor.

DISCLOSURE REGULATION IN EUROPE

What is SFDR?

- SFDR requires in-scope financial market participants to classify funds in one of three ways: Article 8 (funds that promote environmental or social characteristics), Article 9 (funds with sustainable investments as their objective), and Article 6 (all other funds).
- GPs are (depending on their structure) likely to be subject to these rules if they are based in Europe or market into Europe.
- LPs may also be subject to these rules, driving further focus on the importance of ESG diligence within acquisition and lifecycle monitoring. LPs may need information on the ESG credentials of a PE fund to discharge the LP's own obligations.
- Classification as an Article 8 or 9 fund under SFDR imposes a number of ongoing regulatory obligations, including the need to embed sustainability considerations within the investment decision-making process. This necessitates enhanced ESG diligence to ensure that the fund's relevant ESG credentials are attained through individual investments; failure to do so risks potential greenwashing, litigation, and/or reputational risks.

What is the European Taxonomy Regulation?

- The Taxonomy Regulation establishes a classification system to determine the environmental sustainability of economic activities, to address the current absence of consistent terminology in relation to how to define whether a particular activity qualifies as "green".
- GPs and LPs that are in scope of the SFDR and have classified their funds as either "Article 8" or "Article 9" will be subject to enhanced disclosure obligations when the Taxonomy Regulation takes effect in January 2022 in relation to any fund that promotes certain environmental objectives.

What is the FCA Consultation in relation to enhanced climate-related disclosures for asset managers?

- The FCA is currently consulting on introducing climate-related financial disclosure rules for FCA-regulated asset managers. The draft proposals would capture UK-regulated GPs undertaking asset management activities.
- The disclosures are aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and would require an annual entity level TCFD report on how climate-related risks and opportunities are taken into account in managing investments on behalf of investors as well as annual fund level disclosures against certain climate metrics.
- The final rules, which are expected in late 2021, will determine the precise impact of this initiative on private equity firms.

To Documentation

Access to ESG-linked financial products and loan facilities has become more widespread in recent years, providing greater opportunity for PE sponsors to obtain capital on favourable terms if certain ESG-specific targets or conditions are met. While ESG-linked M&A deal terms have largely remained off the table for auction processes (often due to the competitive tension and compressed timetables imposed on bidders), on suitable deals we have seen early interest in ESG-linked terms (such as ratchets, but nothing more substantive as yet).

Linking ESG-related performance metrics (i.e., UN Sustainable Development Goals) to employee remuneration has been seen in publicly listed companies. While currently uncommon for PE deals, meaningful performance targets and/or earn-out provisions that align to a PE firm's expected investment horizon have been discussed on some deals and can be a useful tool to help foster stakeholder alignment on the importance of post-completion ESG enhancements to a target business.

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Balancing Demands

Deal teams must continue to balance the demands of regulators, investors, sellers, and other stakeholders, particularly given the highly competitive, seller-friendly market across much of Europe and the US. However, these developments represent a positive opportunity to move towards a more holistic approach to tackling ESG matters on transactions.

Private Equity Market Study 2021

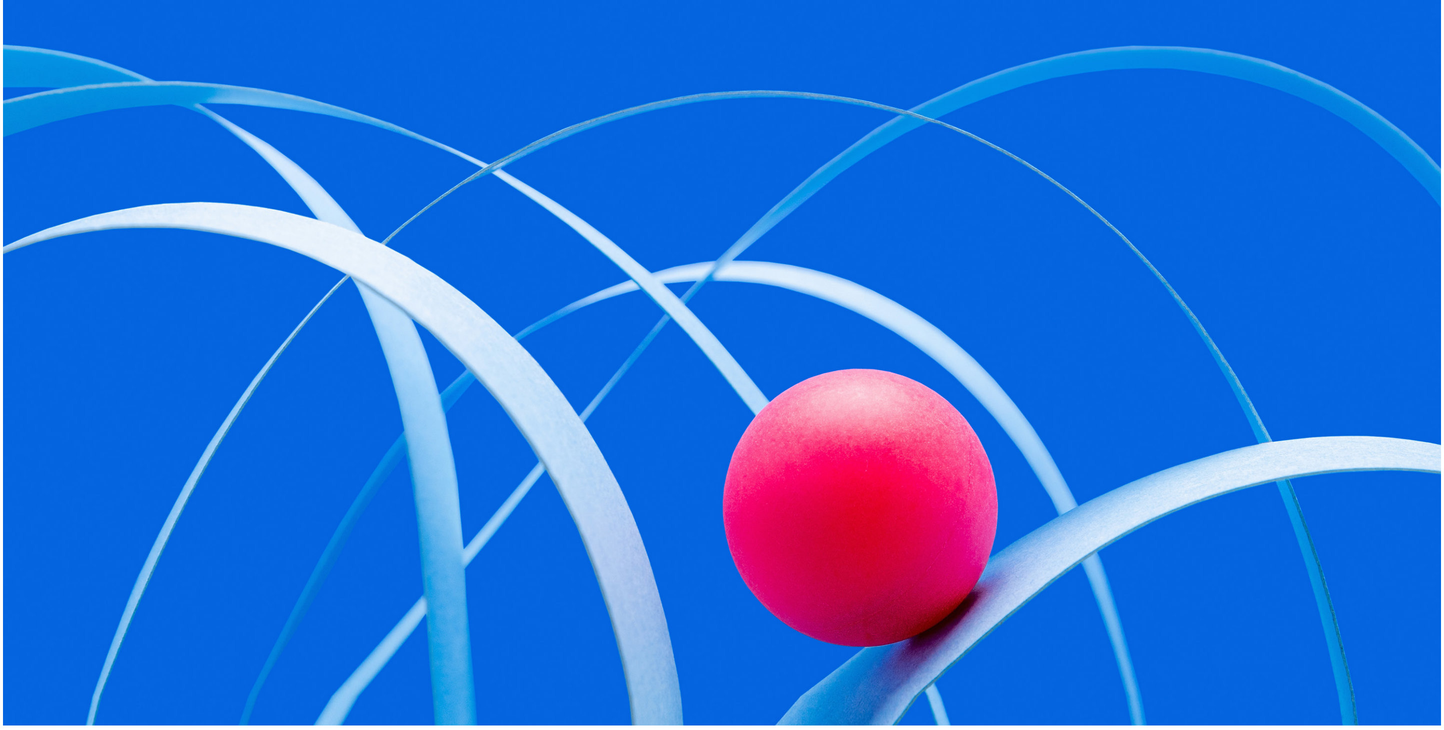
We will shortly be releasing the eighth edition of our annual survey of European private equity transactions, highlighting key trends and market developments. We would be delighted to present our findings to your team and discuss how our findings could impact your approach to deal negotiations.

Over **320** European deals

Signing or closing between **July 2019** and **June 2021**

A mix of seller, buyer, borrower, and lender representations

Representations for private equity and corporate buyers and sellers



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