

# PREFERRED RETURNS



/// PAGE 2

## Message from the Chair

Our "mini-theme" for this meeting is Corporate Venture Capital.



// PAGE 3-6

## Looking Ahead to Vancouver

What's in Store / Subcommittee Meetings Dates & Times / Dial-in Numbers / CLE Panel Previews



/ PAGE 12

## BREXIT

Uncertainty continues until the very last minute

## GROWTH PRIVATE EQUITY INVESTMENT IN THE FINTECH SECTOR



Often referred to as the intersection between venture capital and leveraged buyouts,<sup>1</sup> growth private equity investment ("growth equity") has skyrocketed in recent years and continues to draw the attention of limited partners seeking exposure to emerging technology companies with potentially lower risk profiles than those financed at earlier stages of development.<sup>2</sup> In 2018, growth equity investment reached record levels, with \$66.1 billion invested across 1,057 deals in the U.S. alone.<sup>3</sup> 2018 also saw the largest ever growth equity fundraise with the close of New York-based Insight Venture Partners' \$6.3 billion technology-focused growth equity fund.<sup>4</sup> This article will provide an overview of growth equity as an

alternative investment asset class, and will also discuss its increasingly important presence in the financial technology ("Fintech") sector.

### I. DEFINING GROWTH EQUITY

To date, there is no universally accepted definition of growth equity (also commonly referred to as growth capital or expansion capital) due, in part, to its similarity to other forms of alternative investment. The U.S. National Venture Capital Association ("NVCA") and its Growth Equity Group have described growth equity as a "critical component" of the venture capital industry, and have defined growth equity investments as those that exhibit some, if not all,

of the following characteristics: investors typically acquire a non-controlling minority interest in the company; investments are often unlevered or use only light leverage; the company is founder-owned and/or founder-managed with a proven business model, positive cash flows and rapidly growing revenues; and, invested capital is geared toward company expansion and/or shareholder liquidity, with additional financing rounds typically not expected until the growth equity investor's exit.<sup>5</sup> The European Bank for Reconstruction and Development has defined growth equity in a similar way, but has specifically included mezzanine financing within its definition as a result of

>> Continued on Page 7



Jonathan Cardenas  
Associate, Crowell & Moring

# PREFERRED RETURNS

// SPRING 2019 EDITION

## PRIVATE EQUITY & VENTURE CAPITAL COMMITTEE LEADERSHIP

**Eric Klinger-Wilensky**  
*Chair*

**Steve Wilson**  
*Co-Vice Chair*

**Joshua Geffon**  
*Co-Vice Chair*

**Brett Stewart**  
*Editor, Preferred Returns & Membership Director*

**William Bratton & Brian Broughman**  
*Co-Chairs, Academic Subcommittee*

**Matthew Kittay & Emily Yukich**  
*Co-Chairs, Angel Venture Capital Subcommittee*

**Benedict Kwon & David Louis**  
*Co-Chairs, Funds Subcommittee*

**William McIntosh & Katrien Vorlat**  
*Co-Chairs, International Venture Capital & Private Equity Subcommittee*

**Thomas Mullen & Lisa Stark**  
*Co-Chairs, Jurisprudence Subcommittee*

**David Albin, Chair**  
**Mireille Fontaine, Co-Vice Chair**  
**& Samantha Horn, Co-Vice Chair**  
*Private Equity M&A Joint Subcommittee*

**Scott Bleier & Joshua Geffon**  
*Co-Chairs, Venture Capital Financing Subcommittee*

**Jonathan Cardenas, Chair and Andrea Tinianow, Vice Chair**  
*Financial Services Technology Joint Subcommittee*

**Jon Gworek**  
*Chair, Programs Subcommittee and immediate past chair of the Committee*

**Ernest Holtzheimer**  
*Technology Director*

**Gesta Abols**  
*Co-Chair, Private Equity & Venture Capital Dictionary Task Force*

**Mike Halloran**  
*Business Law Advisor*

**Sam Glasscock**  
*Judicial Liaison – Vice Chancellor*

LEADERSHIP CONTACT INFO: PAGE 20

# Message from the Chair

I'll be honest with you. I had a fairly bland introductory paragraph for this edition of Preferred Returns. And then I wrote the rest of the message. And I just got excited. Excited to see so many of my friends – true friends I've gained through these in-person meetings. Excited to learn from the substantive content the Committee has planned. Excited to see our fantastic leadership team at work. And excited just to be a part of what truly is a vibrant community of practitioners, judges and academics in the Private Equity and Venture Capital space. So I rewrote this paragraph to say I can't wait to see many of you in Vancouver and hopefully have folks who cannot join in person dial in to our Committee, Subcommittee and Task Force meetings from home.

I once again start with a tremendous thank you to our sponsors – Houlihan Lokey and SRS Acquiom. Thanks to them – and to the stealth work of Samantha Horn and her team in reserving the space – we have an incredible dinner planned at Five Sails restaurant on Thursday evening. I'm told this is one of the best venues in the City! In addition, representatives from both sponsors will be presenting fantastic content at our main Committee meeting. Please join me in thanking them when you see them in Vancouver.

Continuing a tradition we started in Austin, our meetings will kick off with a Welcome Breakfast at 8:00 AM Pacific. Please come join us and get to know members of our leadership

team in an informal setting. The Welcome Breakfast will run directly into our main Committee meeting. We are going to take some time at this meeting for all of our Subcommittee chairs to discuss what they have planned at this meeting and more generally. Among other things, we will be introducing at this meeting a new Joint Subcommittee – the Financial Services Technology Joint Subcommittee (with the Commercial Finance Committee). This Joint Subcommittee is designed to provide a forum for commercial finance, private equity and venture capital attorneys to exchange views on emerging financial technologies and their implications for corporate and financial transactions. In addition, we will be rebooting our PEVC Dictionary Task Force, with Gesta Abols of Fasken taking the lead. Come to our main Committee meeting and hear all of what we have planned!

Our "mini-theme" for this meeting is Corporate Venture Capital. To that end, at our main Committee meeting, Samantha Horn will interview Rob Peets of Telus Ventures. In addition, Jon Gworek will moderate a CLE Panel on Friday from 8:00-10:00 Pacific on legal and other considerations for Corporate Venture Capital. Jon will be joined by Kelly Warrick, Chief Investment Counsel at GE Ventures, and Sandi Knox, counsel in Sidley's Palo Alto office.

As we have done for several years now, we will be sponsoring a second CLE at this meeting – this one entitled "Delaware Hodgepodge". The panel, comprised of three

Delaware practitioners (Andy Johnston, Morris Nichols; Amy Simmerman, Wilson Sonsini; and John Mark Zerbekiewicz, Richards Layton) as well as former Justice Holland of the Delaware Supreme Court, will explore several issues relevant to Private Equity and Venture Capital, none of which alone would fill a CLE, but together I'm not quite sure how they'll fit in – but they will! Topics to be discussed include transfer restrictions, information rights, imposing mid-stream pay-to-plays, corporate opportunity waivers and information sharing, and effecting corporate action via electronic means. This program will be held Thursday from 2:30-4:30.

As always, all of our other Subcommittees (other than our Academic Subcommittee, which only meets once a year) will be meeting in Vancouver. Additional information regarding times, places and dial in information is included in this edition of Preferred Returns. Thanks once again to Brett Stewart for putting together this newsletter – herding the many sheep of our leadership team is no easy task and we all appreciate it.

I wish all of you heading to Vancouver safe travels and I look forward to seeing many of you next week.

Best,  
Eric



**Eric Klinger-Wilensky**  
*Chair*

# Looking Ahead to Vancouver

→ What the Committee Has in Store

>> Continued on Page 4



## PRIVATE EQUITY AND VENTURE CAPITAL COMMITTEE MEETING

Thursday March 28, 2019  
(9:00 AM – 11:00 AM)  
East Meeting Level, Room 11

At our main Private Equity and Venture Capital Committee Meeting we will be hearing from both of our generous sponsors, Houlihan Lokey and SRS Acquiom. As well, Samantha Horn (Stikeman Elliott) will interview Rob Peets (Telus Ventures) about corporate venture capital.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488  
**International dial-in number:** (707) 287-9583  
**Conference code:** 4373590974

## ANGEL FINANCING CAPITAL SUBCOMMITTEE MEETING

Thursday March 28, 2019  
(1:30 PM – 2:30 PM)  
East Meeting Level, Room 11

Please join the Angel Financing Subcommittee for a presentation entitled “2019: The Year Regulation A+ Comes of Age?” as Kristen Howell (Fox Rothschild) discusses the process and considerations for completing a Reg A+ offering, sharing some of the knowledge she learned completing one of the first offerings of this kind.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488  
**International dial-in number:** (707) 287-9583  
**Conference code:** 4373590974

## INTERNATIONAL VC & PE SUBCOMMITTEE MEETING

Thursday March 28, 2019  
(4:30 PM – 5:30 PM)  
East Meeting Level, Room 14

Our International Subcommittee will meet to discuss the increasing number of private equity funds in Europe taking minority interest stakes and the impact this trend will have on certainty of exits, minority rights and governance issues.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488  
**International dial-in number:** (707) 287-9583  
**Conference code:** 7059859464

## VENTURE CAPITAL FINANCING SUBCOMMITTEE MEETING

Friday March 29, 2019  
(2:30 PM – 3:30 PM)  
West Level 2, Room 212

The Venture Capital Financing Subcommittee meeting will feature a panel discussion regarding trends, terms and other interesting developments regarding incubators/accelerators across North America, with a highlight on the Pacific Northwest community.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488  
**International dial-in number:** (707) 287-9583  
**Conference code:** 3870540632

## PRIVATE EQUITY M&A JOINT SUBCOMMITTEE MEETING

Friday March 29, 2019  
(10:30 AM – 12:00 PM)  
West Level 3, Room 301 - 305

The Private Equity M&A Joint Subcommittee will have two panel presentations. David Albin (Finn, Dixon & Herling), Glen West (Weil Gotshal) and Jeffrey Katz (BDO) will present “Drafting Proper Working Capital Dispute Resolution Provisions – What Can Be Learned from Penton Business Media Holdings. This panel will discuss the Penton Business Media Holdings decision, how the M&A Committee’s model agreements dealt with the issue and what happens when an accounting firm is asked to make legal decisions on how to run the process of resolving working capital disputes. The second panel, consisting of Samantha Horn (Stikeman Elliott), Elliot Greenstone (Davies), Tracy McVicar (CAD), Maria Parella (Penderfund) and Rob Wildeman (Jericho) will discuss the Vancouver and Canadian Private Equity scene and cross border private equity into the U.S.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488

**International dial-in number:** (707) 287-9583

**Conference code:** 4793632869

## PRIVATE EQUITY AND VENTURE CAPITAL FUNDS SUBCOMMITTEE MEETING

Friday March 29, 2019  
(1:30 PM – 2:30 PM)  
West Level 2, Room 212

The Private Equity and Venture Capital Funds Subcommittee will be hosting a panel on “Investment Funds in the Crypto Asset Space”. Focusing on the emergence of investment funds in the crypto asset space, the panel will discuss the crypto asset investment fund ecosystem, crypto asset investment fund structures, and emerging issues in the international crypto asset investment fund context and will include the participation of Benedict Kwon (Sheppard Mullin Richter & Hampton LLP), David Louis (Charles Russell Speechlys), Jonathan Cardenas (Crowell & Moring LLP), Colin Nimsz (Chief Strategy Officer & General Counsel, Brickblock.io) and Alfonse Mandese (Sr. Director of Enterprise Sales, Ledger SAS).

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488

**International dial-in number:** (707) 287-9583

**Conference code:** 3870540632

## INAUGURAL MEETING

## FINANCIAL SERVICES TECHNOLOGY JOINT SUBCOMMITTEE MEETING

Thursday March 28, 2019  
(11:00 AM – 12:00 PM)  
East Meeting Level, Room 13

The Financial Services Technology Joint Subcommittee will host a panel on “Cross-Border Fintech Investment: From Venture Financing to Private Equity and Beyond”. Moderated by Jonathan Cardenas (Crowell & Moring), the panel will include Alex Acree (Managing Director & General Counsel, Fenway Summer Ventures), Robin Eyben (Osborne Clarke), Richard Holbrook (Crowell & Moring) and Greg Smith (Financial Technology Partners).

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488

**International dial-in number:** (707) 287-9583

**Conference code:** 5716725219

## JURISPRUDENCE SUBCOMMITTEE MEETING

Friday March 29, 2019  
(3:30 PM – 4:30 PM)  
West Level 2, Room 212

The Jurisprudence Subcommittee meeting will feature presentations from a panel including Scott Bleier (Morse Barnes-Brown & Pendleton), Lisa Hedrick (Hirschler), Meghan Adams (Morris James), Aaron Atkinson (Davies), and Pamela Mallard (Potter Anderson) on recent judicial developments relating to private equity and venture capital in the US and Canada. Recent rulings on dilutive financings, rights offerings, appraisal rights and fiduciary duties in the PE/VC context will be discussed.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488

**International dial-in number:** (707) 287-9583

**Conference code:** 3870540632

## JOINT TASKFORCE CONTRACTUAL GOVERNANCE OF BUSINESS ENTITIES JOINT TASK FORCE

Friday March 29, 2019 (9:00 AM – 10:00 AM)  
West Level 1, Room 121

The Task Force will continue its work on a book focused on the Top 10 issues in governance of contractual business entities. Anyone interested in participating is invited to attend.

**Toll-free dial-in number (U.S. and Canada):** (866) 646-6488

**International dial-in number:** (707) 287-9583

**Conference code:** 4597613352

## WE'RE SPONSORING 2 FABULOUS CLEs

### DELAWARE HODGEPODGE: A REVIEW OF FREQUENT QUESTIONS DELAWARE LAW PRACTITIONERS RECEIVE REGARDING PRIVATE EQUITY AND VENTURE CAPITAL

Thursday March 28, 2019 (2:30 PM - 4:30 PM) | *East Meeting Level, Room 8*

**Co-sponsoring Committees:** LLCs, Partnerships and Unincorporated Entities, Middle Market and Small Business

**Chair:** Eric Klinger-Wilensky

### CORPORATE VENTURE CAPITAL: LEGAL AND OTHER CONSIDERATIONS

Friday March 29, 2019 (8:00 AM - 10:00 AM) | *West Level 2, Room 205 & 206*

**Co-sponsoring Committee:** Federal Regulation of Securities

**Chair:** Jonathan D. Gworek

## AND CO-SPONSORING 4 MORE!

### THE NUTS & BOLTS OF IP IN BUSINESS TRANSACTIONS

Thursday March 28, 2019 (10:30 AM - 12:00 PM) | *West Level 2, Room 204*

**Sponsoring Committee:** Intellectual Property

**Co-sponsoring Committees:** International Business Law, International Coordinating; Mergers and Acquisitions, Private Equity and Venture Capital, Young Lawyer

**Chair:** Jeremy Smith

### LLC BOOT CAMP: WHAT EVERY ASSOCIATE (AND EVERY PARTNER) NEEDS TO KNOW

Thursday March 28, 2019 (10:30 AM - 12:30 PM) | *West Level 2, Room 208 & 209*

**Sponsoring Committee:** LLCs, Partnerships and Unincorporated Entities

**Co-sponsoring Committees:** Private Equity and Venture Capital, Young Lawyer

**Chair:** Brian T. Lewis

### RATIFICATION OF DEFECTIVE CORPORATE ACTS - DELAWARE, THE MODEL BUSINESS CORPORATION ACT AND BEYOND

Friday March 29, 2019 (2:30 PM - 4:00 PM) | *West Level 2, Room 220*

**Sponsoring Committee:** Corporate Laws

**Co-sponsoring Committees:** Corporate Compliance, Corporate Governance, Mergers and Acquisitions, Private Equity and Venture Capital

**Co-chairs:** John Lawrence and Patricia Vella

### TEN TIPS ON BOARD OVERSIGHT OF M&A TRANSACTIONS - GOVERNANCE HANDBOOK COMES TO THE RESCUE!

Friday March 29, 2019 (3:00 PM - 4:30 PM) | *West Level 2, Room 202 & 203*

**Sponsoring Committee:** Mergers and Acquisitions

**Co-sponsoring Committees:** Corporate Governance, Middle Market and Small Business, Private Equity and Venture Capital

**Chair:** Diane Holt Frankle

# Schedule of Events

## → Business Law Section's Spring Meeting | Vancouver | March 2019

Dial-in codes listed below | Toll-free dial-in number (U.S. and Canada): (866) 646-6488 | International dial-in number: (707) 287-9583 <sup>1</sup>

Thursday March 28, 2019	Location / Dial-in Code	Time
Welcome Breakfast – Private Equity and Venture Capital Committee	East Meeting Level, Room 11	8:00 AM – 9:00 AM
Private Equity and Venture Capital Committee Meeting	East Meeting Level, Room 11 Conference code: 4373590974	9:00 AM – 11:00 AM
Co-sponsored CLE Program: The Nuts & Bolts of IP in Business Transactions	West Level 2, Room 204	10:30 AM – 12:00 PM
Co-sponsored CLE Program: LLC Boot Camp: What Every Associate (And Every Partner) Needs To Know	West Level 2, Room 208 & 209	10:30 AM – 12:30 PM
Financial Services Technology Joint Subcommittee Meeting	East Meeting Level, Room 13 Conference code: 5716725219	11:00 AM – 12:00 PM
Private Equity and Venture Capital Committee Leadership Lunch (Ticketed Event – Open to Committee Leadership Only)	Miku Restaurant 70-200 Granville Street	12:00 PM – 1:30 PM
Angel Financing Capital Subcommittee Meeting	East Meeting Level, Room 11 Conference code: 4373590974	1:30 PM – 2:30 PM
Sponsored CLE Program: Delaware Hodgepodge: A Review Of Frequent Questions Delaware Law Practitioners Receive Regarding Private Equity and Venture Capital	East Meeting Level, Room 8	2:30 PM – 4:30 PM
International Subcommittee Meeting	East Meeting Level, Room 14 Conference code: 7059859464	4:30 PM – 5:30 PM
Private Equity and Venture Capital Committee Dinner (Ticketed Event)	Five Sails (inside the Pan Pacific Hotel) 999 Canada Place, Vancouver, BC	7:30 PM – 10:00 PM
Friday March 29, 2019	Location / Dial-in Code	Time
Sponsored CLE Program: Corporate Venture Capital: Legal and Other Considerations	West Level 2, Room 205 & 206	8:00 AM – 10:00 AM
Contractual Governance of Business Entities Joint Task Force Meeting	West Level 1, Room 121 Conference code: 4597613352	9:00 AM – 10:00 AM
Private Equity M&A Joint Subcommittee Meeting	West Level 3, Room 301 - 305 Conference code: 4793632869	10:30 AM – 12:00 PM
Private Equity and Venture Capital Funds Subcommittee Meeting	West Level 2, Room 212 Conference code: 3870540632	1:30 PM – 2:30 PM
Venture Capital Financing Subcommittee Meeting	West Level 2, Room 212 Conference code: 3870540632	2:30 PM – 3:30 PM
Co-Sponsored CLE Program: Ratification of Defective Corporate Acts-- Delaware, the Model Business Corporation Act and Beyond Use of Alternative Entities Capital Funds	West Level 2, Room 220	2:30 PM – 4:00 PM
Co-Sponsored CLE Program: Ten Tips on Board Oversight of M&A Transactions - Governance Handbook Comes to The Rescue!	West Level 2, Room 202 & 203	3:00 PM – 4:30 PM
Private Equity and Venture Capital Jurisprudence Subcommittee Meeting	West Level 2, Room 212 Conference code: 3870540632	3:30 PM – 4:30 PM

<sup>1</sup> Note: CLE Programs are not accessible by Dial-in.

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private equity investment patterns in the emerging Europe and Central Asia regions, which typically consist of combinations of venture, growth and buyout strategies.<sup>6</sup>

From the company perspective, growth equity investment, in its varying shapes and sizes, fundamentally serves as a financing mechanism that fuels later-stage expansion into new product and/or geographic markets, often in preparation for a future merger, acquisition or initial public offering. In contrast to multi-investor early-stage venture financing rounds, growth equity investment may provide the company with the benefit of a higher-stake single investor who can provide strategic business and operational guidance that can translate into greater market share and profitability. This benefit, however, can become a double-edged sword for founders as a result of the growth equity investor's potentially more significant influence over management decisions.

## II. GROWTH EQUITY INVESTORS

Growth equity investors include, but are not limited to, traditional private equity and venture capital firms that offer growth equity as one of several investment strategies, specialist growth equity firms, strategic corporate investors,

and non-traditional institutional investors, such as pension funds and single family offices, which historically have not invested in emerging companies. According to Pitchbook data, the ten most active growth equity investors in 2018 were Business Growth Fund, Bpifrance, Foresight Group, Warburg Pincus, Kohlberg Kravis Roberts, The Blackstone Group, CM-CIC Investissement, Caisse de dépôt et placement du Québec, TPG Capital and General Atlantic. Of the 24 most active growth equity investors in 2018, the majority were concentrated in the United States, France and the United Kingdom ("UK"), respectively.<sup>7</sup>

## III. GROWTH EQUITY INVESTMENT IN FINTECH

From an industry perspective, technology startups are considered attractive growth equity invest-

ment targets as a result of their perceived revenue stability and high growth potential.<sup>8</sup> Software startups in the Fintech sector, in particular, which received an aggregate of \$11.9 billion in total funding in 2018,<sup>9</sup> continue to attract strong interest from growth equity investors. Pitchbook-NVCA Venture Monitor data in the below graph evidences this trend.<sup>10</sup>

In the UK alone, growth equity investment in the Fintech sector rose by 57% to \$1.6 billion in 2018,<sup>11</sup> including General Atlantic's \$250M investment in lending startup Greensill Capital and Banco Bilbao Vizcaya Argentaria's £85.4 million investment in mobile-banking platform Atom Bank. In the U.S., recent examples of growth equity investment in Fintech include DST Global's lead investment into Chime Bank, Goldman Sachs Principal

Strategic Investments' lead investment into Nav Technologies, and Edison Partners' lead investment into YieldStreet.

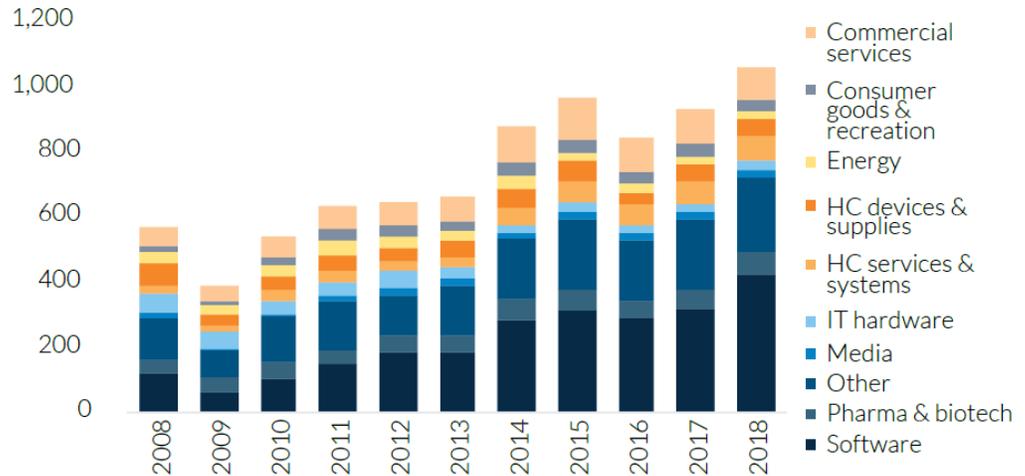
With injections of growth equity financing, Fintech startups are able to deepen their domestic market share, as well as their international reach. Growth equity investment in UK Fintech startups, in particular, has contributed to their expansion into the U.S. market. One such example is UK-based small and medium-sized enterprise lending platform Oak North, which plans to launch in the U.S. in 2019 following a \$440 million growth equity investment from Softbank Vision Fund and the Clermont Group.

## IV. CONCLUSION

Growth equity is projected to continue its upward trend as an investment strategy of choice for later-stage

# Growth equity deals in software startups increase in 2018

US growth equity deals (#) by industry



PitchBook-NVCA Venture Monitor

investors in the Fintech sector. With higher levels of growth equity invested in promising Fintech startups, Fintech M&A and IPO activity is likely on the way. Private equity and venture capital attorneys should therefore pay close attention to developments in this space. ■

## Endnotes

- 1 PitchBook, 3Q 2018 US PE Breakdown (2018).
- 2 Preqin, "Growth Equity: Return Expectations and Prospects in Growth PE Investing," November 15, 2017.
- 3 PitchBook, 4Q 2018 Pitchbook-NVCA Venture Monitor (2019).
- 4 PitchBook, 3Q 2018 US PE Breakdown (2018). Insight Venture Partners, "Software Investor Insight Venture Partners Closes \$6.3 Billion Fund X," July 19, 2018.
- 5 National Venture Capital Association, "Growth Equity Group." Available at: <https://nvca.org/growth-equity-group/>.
- 6 European Bank for Reconstruction and Development, "EBRD Transition Report 2015-16." Available at: <https://www.ebrd.com/news/publications/transition-report/ebdr-transition-report-201516.html>
- 7 PitchBook, 2018 Annual Global League Tables (2019).
- 8 PitchBook, 1Q 2018 Pitchbook-NVCA Venture Monitor (2018).
- 9 American Banker, "Money Keeps Flowing to Fintechs," March 14, 2019. Available at: <https://www.americanbanker.com/list/money-keeps-flowing-to-fintechs>
- 10 PitchBook, 4Q 2018 Pitchbook-NVCA Venture Monitor (2019).
- 11 Innovate Finance, "2018 FinTech VC Investment Landscape," February 2019.

# SOUND THE ALARM



Delaware Supreme Court Upholds Dismissal Of Trade Secrets Case Against PE Fund

by Amit Singh



**Amit Singh**  
Shareholder, Stradling

**T**he Delaware Supreme Court has refused to revive Alarm.com's trade secrets case against a private equity firm stakeholder that made investments in a rival company, leaving in place a ruling that highlights the importance

of carefully crafted agreements and charter documents.

The state Supreme Court on Feb. 6 summarily affirmed the Chancery Court's 2018 decision to dismiss a complaint Alarm.com Holdings Inc. brought against ABS Capital Partners Inc. alleging the firm misused confidential information by investing in its competitor.

The Chancery Court found various agree-

ments between Alarm and ABS, including a non-disclosure agreement, specifically considered ABS would invest in competitors and established an understanding that such an investment, by itself, would not give rise to a claim for misappropriation of trade secrets.

The ruling serves as an important lesson to startups, which frequently turn to non-disclosure agreements to protect trade secrets and other con-

fidential information when seeking to attract investments. Companies need to consider how those agreements are drafted and remain aware of exceptions contained within that could impact their ability to later bring a trade secrets case.

ABS and Alarm's relationship dates back at least to 2008, when ABS began exploring an investment in the Virginia-based technology company. ABS eventually acquired a

controlling stake in Alarm through two funds that it managed, ABS Partners V LLC and ABS Partners VII LLC.

Various ABS partners served on Alarm's board of directors, including Ralph Terkowitz, who was involved in a number of Alarm's important business decisions, including its business model, and helped oversee its

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>> *Continued on Page 9*

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research and development pipeline. Over time, the two entities entered various agreements, including a non-disclosure agreement and a stockholders' agreement.

trade secrets under the Delaware Uniform Trade Secrets Act.

The case was dismissed in June 2018 by Vice Chancellor J. Travis Laster, who said the complaint did not support a "reasonably

For example, Alarm acknowledged in a 2008 NDA that the private equity firm "deal[s] with many companies, some of which may...pursue similar or competitive paths" to Alarm. The document went on to say that "nothing in this letter agreement will prevent you from evaluating a possible investment in and/or collaboration with, or entering into any transaction with (including any investment in), a company whose business is similar or competitive with the business of the company."

Although the 2008 agreement expired years ago, the court said it demonstrates the original understanding that ABS was able to invest in competing companies. This understanding was also evident in a pair of stockholder agreements, including one from 2012 that expressly stated "nothing contained herein shall prevent ABS . . . from . . . investing in or engaging in investment discussions with any other company (whether or not competitive with the [Alarm])."

Cementing this understanding was a corporate charter Alarm adopted in 2012. The charter included a provision that exempted stockholders from any duty not to pursue opportunities that otherwise may arguably belong to Alarm. With this provision, Alarm effectively waived a claim against ABS for breach of the fiduciary

duty of loyalty based on usurpation of a corporate opportunity. In doing so, Alarm gave up "the most powerful remedial tool that a court of equity possesses," the judge said.

"Once a corporation has given up its most effective check on fiduciary misbehavior, it would be counterintuitive to permit the same corporation to pursue the lesser theories that could be asserted against a non-fiduciary," the judge wrote.

In addition to highlighting important considerations for startups negotiating investments, the ruling should also provide some degree of comfort to private equity investors and venture capitalists, as it demonstrates that properly crafted agreements and charter documents can provide protection against lawsuits when investing in competing companies. Here is an example of language from the National Venture Capital Association form charter:

*The Corporation renounces, to the fullest extent permitted by law, any interest or expectancy of the Corporation in, or in being offered an opportunity to participate in, any Excluded Opportunity. An "Excluded Opportunity" is any matter, transaction or interest that is presented to, or acquired, created or developed by, or which otherwise comes into the possession of (i) any director of the Corporation*

*who is not an employee of the Corporation or any of its subsidiaries, or (ii) any holder of Series A Preferred Stock or any partner, member, director, stockholder, employee, affiliate or agent of any such holder, other than someone who is an employee of the Corporation or any of its subsidiaries (collectively, the persons referred to in clauses (i) and (ii) are "Covered Persons"), unless such matter, transaction or interest is presented to, or acquired, created or developed by, or otherwise comes into the possession of, a Covered Person expressly and solely in such Covered Person's capacity as a director of the Corporation while such Covered Person is performing services in such capacity. Any repeal or modification of this Article Eleventh will only be prospective and will not affect the rights under this Article Eleventh in effect at the time of the occurrence of any actions or omissions to act giving rise to liability. Notwithstanding anything to the contrary contained elsewhere in this Amended and Restated Certificate of Incorporation, the affirmative vote of the holders of at least [specify percentage] of the shares of Series A Preferred Stock the outstanding, will be required to amend or repeal, or to adopt any provisions inconsistent with this Article Eleventh. ■*

## **"ONCE A CORPORATION HAS GIVEN UP ITS MOST EFFECTIVE CHECK ON FIDUCIARY MISBEHAVIOR, IT WOULD BE COUNTERINTUITIVE TO PERMIT THE SAME CORPORATION TO PURSUE THE LESSER THEORIES THAT COULD BE ASSERTED AGAINST A NON-FIDUCIARY," THE JUDGE WROTE.**

Seven years after ABS and Alarm's began their courtship, in September 2017, ABS acquired a significant stake in Resolution Products Inc., the Wisconsin company behind the Helix security system and a direct competitor to Alarm. ABS appointed another partner, Phil Clough, to Resolution's board.

Alarm subsequently filed a lawsuit against ABS and its two funds in the Chancery court. Citing ABS' investment in Resolution and Clough's service on the board, Alarm alleged the private equity firm acquired confidential information, including Alarm's trade secrets, and misused that information. Alarm brought a claim for misappropriation of

conceivable inference of misappropriation." The court highlighted that ABS' investment in Resolution was made more than a year after Terkowitz left Alarm and followed an auction in which ABS outbid other potential investors.

"In my view, these circumstances only support an inference that AMS invested in a company that competes with Alarm, just as Alarm always understood ABS could do," the judge wrote.

This "shared understanding" dated back to the beginning of Alarm and ABS' relationship and was evident in various agreements between the two sides, according to the court.

# STRATEGIC MINORITY INVESTOR AGREEMENTS



Jacob W. Stasny  
Of Counsel, Sumner Schick LLP

## A. INTRODUCTION

Consider the following scenario: You represent one of four passive minority investors in a corporation, each owing 12.5% of outstanding shares and voting control, the other 50% being owned by the active founding shareholder. When the minority investors purchased their shares, all shareholders executed a comprehensive

shareholders' agreement providing for typical share-transfer restrictions, including a provision conditioning any share transfer on approval by a majority vote of then-outstanding shares. Some time later, your client learns that the 50% active founder seeks to buy out one or more of the minority investors, a transaction that, if consummated, would tip the balance of corporate control decidedly in the founder's favor, and would substantially limit certain protections afforded to minority shareholders. To avoid this outcome, your client proposes to enter into an agreement with the other minority

shareholders prohibiting them from transferring any portion of their shares to the founder without the consent of all minority shareholders, and has asked you to draft the proposed voting agreement. The client would prefer not to disclose the agreement to the founder.

Is such an agreement enforceable? Are there any legal conditions to its enforceability? Is the outcome different if a board approval is required instead of shareholder approval? What about if the company is organized as an LLC instead of a corporation?

## B. TRANSFERS SUBJECT TO SHAREHOLDER OR MEMBER APPROVAL

The answer to this problem is fairly straightforward in the case of corporate share transfers requiring shareholder approval. The Model Business Corporations Act provides in relevant part as follows:

- a. Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose.
- b. A voting agreement created under this section is specifically enforceable.<sup>1</sup>

Thirty-two states have specifically adopted the Model Act provision, and another seventeen have adopted its substance either by statute or at common law.<sup>2</sup> Accordingly, the voting agreement of the minority shareholders in our hypothetical would be generally enforceable in any state. However, counsel for the minority investor should be aware that, to the extent the minority shareholder agreement conflicts with or purports to modify an existing shareholder agreement (or any governing document of the corporation), care should be taken to ensure that the voting agreement does not constitute an unauthorized modification of the original shareholder agreement.

The outcome in the case of an LLC is less clear, and will typically be determined by the form of the LLC's governing documents. While a comprehensive review of the various state LLC statutes is beyond the scope of this article, analysis of the Revised Uniform Limited Liability Company Act (RULLCA) and the Delaware Limited Liability Company Act (the "LLC Act") is informative.

RULLCA, adopted by 21 states, makes only tangential reference to non-unanimous voting agreements by defining an "operating agreement," as an agreement of "all the members" of the LLC that governs the rights and obligations *inter se* the LLC and its members and managers.<sup>3</sup> This proviso means that a non-unanimous voting agreement cannot be an "operating agreement," but the text provides scant further direction other than a comment that such an agreement "might well be enforceable among those members as parties..."<sup>4</sup> without any guidance as to the scope or effect of such potential enforceability. Notwithstanding this general ambiguity, RULLCA does clearly address our hypothetical, providing that an operating agreement is the exclusive consensual means to modify its various default rules, which include share-transfer restrictions.<sup>5</sup> It is therefore not likely that a non-unanimous voting agreement in a

<sup>1</sup> REVISED MODEL BUS. CORP. ACT § 7.31 (Am. Bar ass'n 2005).  
<sup>2</sup> For a complete directory of relevant state statutes and a thorough examination, see Val Ricks, Strategic Shareholder and Member Voting Agreements Under Texas Business Entity Law, 68 Baylor L. Rev. 335, at n. 30-32 (2016). The remaining state, Texas, adopted the Model Act with additional disclosure requirements. See Tex. Bus. Orgs. Code § 6.252.  
<sup>3</sup> REVISED UNIFORM LIMITED LIABILITY CO. ACT §§ 102(13), 105(a)(1) (Unif. Law Comm'n 2013).  
<sup>4</sup> *Id.*, at cmt. to § 102(13).  
<sup>5</sup> *Id.*, at cmt. to § 105.

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Uniform Act state would be an effective means of locking up the minority interests as desired by our hypothetical client, and even less so when share-transfer restrictions have already been provided by operating agreement.

Whereas RULLCA is exclusive, providing that the act and the operating agreement are the only sources of authority, the Delaware LLC Act is inclusive, stating that common law and equity rules govern when the LLC Act does not.<sup>6</sup> Moreover, the LLC Act acknowledges on at least three occasions that members' obligations and rights – including voting rights – may be derived from “other agreements” separate from the operating agreement.<sup>7</sup> The LLC Act also provides members the default right to vote by proxy.<sup>8</sup> These provisions taken together strongly imply that non-unanimous voting agreements subject to the LLC Act would survive judicial scrutiny. This implication is especially strong for LLCs mimicking the traditional corporate structure (governance by board of managers, issuance of units instead of interests, etc.), since the reviewing court would likely draw from the corporate law in its analysis.<sup>9</sup>

This apparent amenability to non-unanimous voting agreements

notwithstanding, the LLC Act does not support the objectives of our hypothetical client since it provides that an LLC interest “is assignable...except as provided in a limited liability company agreement.”<sup>10</sup> This provision most likely precludes a non-unanimous voting agreement of the type sought by the client because the LLC Act's definition of “company agreement” assumes a singular agreement binding all members.<sup>11</sup> Nevertheless, the LLC Act presumably allows other strategic voting agreements as to functions not specifically governed by the LCC Act, such as designation of the company's managers and approval of certain fundamental business transactions.

### C. TRANSFERS SUBJECT TO BOARD APPROVAL

Under conventional rules of corporate governance, administration of the internal affairs of the entity is reserved to its board, and shareholders generally cannot assume or direct board authority by shareholder agreement. However, courts have on numerous occasions found exceptions to this general rule by applying a variety of legal theories. When share transfers require board approval, the viability of a non-unanimous voting agreement seeking to control or influence such a board vote is a fact-intensive undertaking primarily

driven by the terms of the entity's governing documents, the nature and scope of the managerial authority the voting agreement seeks to influence, and the relative rights of non-party shareholders. While a complete treatment of this fact-driven analysis is beyond the scope of this article, some bright lines have been drawn at common-law with respect to the following types of voting agreements: (1) agreements assigning complete managerial control to a shareholder are typically avoided as against public policy; (2) agreements directing the board to employ particular persons as officers are typically held valid; (3) agreements violating the rights of non-party shareholders are generally avoided as against public policy; and (4) agreements allowing shareholders to veto proposed corporate action are typically held enforceable to the extent the vetoed action would have affected the shareholders.<sup>12</sup> Although some courts have validated voting agreements on the ground that they do not actually infringe on board authority, many courts have held voting agreements enforceable despite finding they encroached on traditional board authority, adopting the general view that such encroachment need not necessitate invalidation of the voting agreement “so long as the rights of innocent third parties,

## WHEREAS RULLCA IS EXCLUSIVE, PROVIDING THAT THE ACT AND THE OPERATING AGREEMENT ARE THE ONLY SOURCES OF AUTHORITY, THE DELAWARE LLC ACT IS INCLUSIVE, STATING THAT COMMON LAW AND EQUITY RULES GOVERN WHEN THE LLC ACT DOES NOT.

such as nonagreeing shareholders, are not adversely affected.”<sup>13</sup>

When seeking to influence share-transfer restrictions requiring board approval, before incurring the time and expense of the fact-intensive analysis summarized above, competent investor's counsel and other private equity participants are well-served to first thoroughly read the entity's governing documents, especially with respect to an LLC, it being a “creature of contract” whose operating agreement could be engrafted with any number of provisions that may open the door to non-unanimous voting agreements. Seeking out a contractual means to accomplish your client's goals will likely produce better results than the time-consuming factual analysis that will ultimately yield only a best guess as to how a court will resolve the matter in the event of corporate challenge or shareholder dissent.

### D. DISCLOSURE

Enforceability of an otherwise permissible non-unanimous voting agreement is rarely conditioned on disclosure, and in the absence of express statutory or contractual provision to the contrary there is ostensibly no obligation to disclose at the entity or shareholder levels. Nevertheless, the venerable adage “sunlight is the best disinfectant” applies here. While disclosure may not be required, in the absence of compelling countervailing motivations the wise practitioner will counsel over-disclosure if there is any possibility of judicial scrutiny, which could be decided in part on general principles of fairness and consideration of whether management and non-participating shareholders had notice and opportunity to take appropriate responsive action. ■

<sup>6</sup> Del. C. § 18-1104.

<sup>7</sup> See Del. C. §§ 18-110(b), 18-215(d) & 18-301(e).

<sup>8</sup> Del. C. § 18-302(d).

<sup>9</sup> See, e.g., *Obeid v. Hogan*, 2016 WL 3356851, at \*6 (No. 11900-VCL) (Del. Ch. Jun. 10, 2016).

<sup>10</sup> Del. C. § 18-702(a).

<sup>11</sup> See 6 Del. C. § 18-101(7).

<sup>12</sup> See, generally, 15 A.L.L.R.4<sup>th</sup> 1078 (1982) (collecting cases).

<sup>13</sup> See *id.*, at § 2[a].

# BREXIT



## UNCERTAINTY CONTINUES UNTIL THE VERY LAST MINUTE

Steve Wilson

Providing an update on Brexit is almost impossible, as the direction, deadline and possible outcomes change on a very regular basis. At the time of writing, we know that the UK Prime Minister Teresa May's proposed agreement with the EU has been rejected twice by the UK Parliament and despite her attempts to have it considered for a third time this week, a technical rule has prevented that from happening (at least for now). The UK

Parliament has also voted (though on a non-binding basis) that there should be no "no deal" Brexit on March 29<sup>th</sup>, which is the date on which the UK is due to leave under the EU Treaties...and therefore remains the legal date on which the UK will be leaving the EU.

In order to avoid a no-deal exit, Mrs May has asked the remaining 27 EU Member States for an extension to Brexit date. Such extension was discussed at the European Council meet-

ing on March 21<sup>st</sup> and 2 extensions have been agreed:

1. The first is to May 22<sup>nd</sup> provided Mrs May's Withdrawal Agreement is approved by UK's Parliament next week (the technical block mentioned above remains an issue requiring the proposal to be "substantially different" than the two versions previously offered).
2. If the Agreement is rejected again, then

the new Brexit date becomes 12th April 2019 - a shorter extension: either for the UK to leave without a deal or otherwise explain next steps (including the possibility of applying for a longer extension)

European Council President Donald Tusk has previously said EU leaders could be open to a long extension "if the UK finds it necessary to rethink its Brexit strategy" but the short extension agreed ensures

the UK will not participate in the European elections which start on May 23<sup>rd</sup>. Any further extension needs the unanimous agreement of the remaining 27 Member States. An obvious question that follows is whether the Prime Minister will resign - because her efforts to deliver Brexit on time have failed if her Agreement is not approved next week - and if so whether the UK would hold a general election, or whether

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the Conservative Party would instead appoint a new leader to become Prime Minister for the remainder of the Parliamentary term (in the UK, it is the majority party that forms a government rather than the individual) which is scheduled to end in May 2022.

So there remains great uncertainty as to exactly what will happen, and when. A proposal amongst the recent Parliamentary votes that a further Brexit referendum be held was rejected, although the leader of the main opposition party, Jeremy Corbyn, has publically supported a further referendum in certain circumstances (though he is undoubtedly

lukewarm about such a second vote).

However, notwithstanding all the above workings of a dynamic democracy – every step of which is celebrated in detail by the media - the UK economy and business remain positive. The pound is historically weak, allowing non-UK investors to invest at relatively cheap valuations, and the opportunities and competition for deals remains intact. Of course this month has seen a step back in deal activity as many try to avoid completing transactions over; but whatever the outcome of Brexit, it is hoped that deal activity will resume. Economists predict modest growth, which is more positive than many were expecting.

A significant impact for post-Brexit Britain for PE/VC is the loss of passporting rights for fundraising which allows funds to be marketed to professional investors across the EU on the basis of approval within one EU jurisdiction without additional approvals required in the other jurisdictions. As a result UK funds will, like US funds currently, have to register under individual regimes in each EU member state in order to market funds. UK domiciled funds will of course continue to be able to raise funds from UK based investors.

Beyond that, some deals – particularly those with a pan-European structure or target market - have seen the inclusion of “Brex-

it” clauses to provide for different scenarios depending on outcome: these include issues relating to governing law, the impact on immigration and employment status, any necessary IP re-registrations, and the changes in trade tariffs, customs regulations and the potential disruption in the movement of goods and services both to and from the UK that a no deal Brexit would bring. So far, the UK government has reassured business that nothing will change immediately and that in the event of a no deal Brexit it will adopt the same laws as have previously been in place via the EU.

It was hoped that by the time this article was written, we would have had more clarity

and definitive advice around how best to handle a post-Brexit Europe (and for the avoidance of doubt, Britain will remain in Europe...just not the EU!), but regrettably that approach will need to be covered in a future edition. In the meantime, from both side of the divide, businesses continue to focus on trading, start-ups continue to be funded and capital raising continue to be successful...and long may that scenario continue. ■



Steve Wilson  
Head of Osborne Clarke's  
New York Office



## TO OUR GENEROUS SPONSORS

We have a fantastic event planned for the *Private Equity and Venture Capital Committee Dinner* on Thursday, March 28th at 7:30 p.m. The dinner will be held at **Five Sails Restaurant** (located within the Pan Pacific Hotel) and tickets are almost gone, be sure to get yours today!

Please join us in thanking our generous sponsors,  
without whose assistance this event would not be possible.



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# THE SURGE *of* PRIVATE EQUITY DIRECT LENDING, ITS RISKS FOR LENDERS, *and* GUIDANCE FOR LENDER'S COUNSEL



**Andrew White, JD**  
*Supervision & Regulation, Federal Reserve Bank of Chicago*

*The views expressed in this article do not necessarily represent the views of the Federal Reserve System.*

**T**he private debt market is not a new market. However, the 2008 financial crisis catalyzed the current enthusiasm in the private lending space. Following the financial crisis, the surge of regulation and risk aversion have made traditional banks reluctant to lend to risky corporate borrowers.

As a result, lending activity has migrated away from banks

toward private equity firms, among other private, less-regulated funds. The number of leveraged loans has grown precipitously in recent years, and private investing firms have had an increasingly larger share of the action. This, coupled with a low yield environment, has led to a surge of investor capital into the private equity firms, hedge funds, and business development companies that make the loans.

This glut in the supply of capital in the direct lending space has caused intense competition for borrowers between direct lenders. This, in turn, has forced lenders to lower interest rates and loosen credit covenant terms in loan documents to woo borrowers,

referred to as “covenant-lite” loans.

Covenant-lite loans are effective at attracting borrowers, but these loan facilities deprive direct lenders who are not subject to post-2008 regulation of important risk of loss protections, thereby reducing direct lenders’ odds of recovery in the event of default. In the event of a market downturn, direct lenders may be left with substantial exposure and minimal remedies for recovery.

Thus, it is imperative that lender’s counsel instruct clients participating in direct lending transactions by informing them of their legal risk exposure. It is critical that clients understand the potential ramifications of sacrificing certain

loan provisions in the negotiation process. In addition, it is beneficial for lender’s counsel to understand the market within which their clients are operating to appreciate their motivations. Lastly, it is valuable for lender’s counsel to monitor the market and credit cycle to anticipate clients’ needs and changes in client priorities.

## **THE FINANCIAL CRISIS, ITS REPERCUSSIONS, AND THE INCREASE OF PRIVATE EQUITY DIRECT LENDING**

In the years leading up to the financial crisis, banks took risks in their lending practices and took advantage of the leveraged loan market. Resultantly, banks were vulnerable to high levels of risk exposure

when the crisis struck.

Banks were hurt in the financial crisis because of their over exposure to bad debt. In response, the government overhauled the banking regulatory scheme. Regulators implemented measures to reduce risk in the leveraged loan market, increasing expectations for commercial banks by limiting borrower’s debt to EBITDA ratio. Banks increasingly included financial maintenance covenants in their loans—provisions that limit the amount of leverage a corporate borrower could take on, or mandated thresholds that require a certain amount of cash on hand to service interest on debt.<sup>1</sup>

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Increased regulation and institutional risk aversion following the financial crisis decreased risky lending by commercial banks. An unintended effect of this was a migration of leveraged loan activity away from banks toward private equity firms and other private funds. Part of this shift is because private equity firms, and other firms offering private credit, are not subject to the regulations of commercial banks.<sup>ii</sup> This gave them agility to make loans to riskier borrowers who would not be able to access commercial bank credit.

The shift to non-bank, private fund lending, coupled with the low rates of return in the market following the financial crisis, led institutional investors to pour capital into firms taking part in private direct lending, creating an immense growth of private credit markets in recent years, surpassing the pre-crisis high.<sup>iii</sup>

### RISKS PRESENT FOR PRIVATE EQUITY DIRECT LENDERS

Private equity direct lending has grown to a \$500 billion industry. Nonbank direct lending for commercial deals has grown at almost twice the rate of traditional commercial bank loans in 2018.<sup>iv</sup> The influx of capital into the market from investors has led to intense competition for borrowers. This borrower-friendly environment has led to increased negotiation of price and covenant

terms, which has led, in turn, to increased lender risk exposure.

Direct loans often have a floating rate, benefiting borrowers in the low rate environment. In addition to negotiating rates, new deals have almost entirely done away with financial maintenance requirements protecting lenders from default. Referred to as “covenant-lite,” these loans have evolved to the largest segment of the market today. Weak covenants may at times allow borrowers to inflate EBITDA projections and borrow more after the closing of the deal. New loans with EBITDA add-backs or adjustments that conceal deteriorated leverage are also becoming increasingly commonplace.<sup>v</sup>

EBITDA add-backs usually consist of fees and expenses that increase the EBITDA during the loan syndication process. For additional debt after closing, loan structures include a debt incurrence clause that allows the borrower to add debt subject to the satisfaction of certain financial ratios along with fixed-dollar debt baskets that permit the borrower to incur more debt without reference to a maintenance covenant or other financial ratio. Further, covenant-lite loans are often stripped of lender protections, such as financial maintenance tests requiring the borrower to meet monthly or quarterly performance standards. Such tests serve as early warning signs

of a potential default.<sup>vi</sup>

In a recent survey by Carl Marks Advisors regarding private equity lending in the face of aggressive market conditions, covenant-lite loans or covenants with lower triggers were identified as being of primary concern for 2018 respondents, followed by the allowance of EBITDA add-backs.<sup>vii</sup>

Willingness to reduce or negotiate away these loan terms has become necessary to compete in the current market. The risk with negotiating away loan terms is that it increases credit risk for the lender and weakens protections for the lender’s investors. Further, floating rate loans extended to high-risk borrowers are lower risks in a low rate environment; however, these present a higher risk of default as rates rise. Continued interest rate increases could give lenders more power to dictate loan terms, but additional increases appear to be on hold for the immediate future.

With private capital supply continuing to outpace demand for capital and no indication of further interest rate increases, covenant-lite loans remain the most popular private credit loans. So long as the bull market and borrower-friendly rates continue, it is likely that the trend of direct lending will continue with it. However, domestic and international policy-makers have started to raise concerns about the potential risks

covenant-lite private loans pose to the market, lenders, and their investors. Because of the mounting risk and competition in the space, it is imperative that private equity direct lenders have counsel that can consider all the moving pieces in the private direct lending market.

### GUIDANCE FOR LENDER’S COUNSEL

It appears that the current trend toward borrower-friendly private equity direct loans will remain popular. Since private equity firms’ activities aren’t regulated like commercial banks, there are not as many checks in place to protect these firms from a rapid rise in defaults.

As lender’s counsel, it is imperative that private equity clients participating in direct lending transactions are informed of their risk exposure in a covenant-lite loan. Counsel should engage with clients throughout the deal bidding process and when negotiating terms, so that counsel and the private equity firm are on the same page about what protections they are willing to sacrifice, and the implications of losing discrete legal covenants in loan documents.

In addition, it is helpful for counsel to understand the market within which their client is operating. If the attorney advising a private equity firm understands their client’s competition for direct lending deals and the

client’s investors’ demand for direct lending returns, it will provide context for negotiation and execution of direct lending transactions. Further, it is beneficial for counsel to understand the credit market cycle because this will help tailor counsel’s advice to private equity client’s about when to make certain legal sacrifices and ways in which clients can abate their risk of loss upon a shift in defaults, such as through restructuring preparations.

The current market stands to make private equity firms and their investors a high rate of return through direct lending. However, with that opportunity comes significant risks in the event of a change in the market. It is important for attorneys advising direct lending transactions to understand where the market is in its cycle, what pressures are driving clients’ decision-making, and how to advise clients in mitigating their risk of loss despite having fewer protections in transaction documents. ■

i. Joe Rennison & Colby Smith, Debt Machine: Are Risks Piling Up In Leveraged Loans?, FINANCIAL TIMES, Jan. 20, 2019, <https://www.ft.com/content/64c965e-1814-11e9-9e64-d150b3105d21>.

ii. IMF, Global Financial Stability Report April 2018: A Bumpy Road Ahead, INTERNATIONAL MONETARY FUND, April 2018, <https://www.imf.org/en/Publications/GFSR/Issues/2018/04/02/Global-Financial-Stability-Report-April-2018>.

iii. Leela Parker Deo, U.S. Mid-Market Lenders Concerned About Leverage, Loan Docs: Report, REUTERS, Jan. 9, 2018, <https://www.reuters.com/article/mmsurvey-carlmarks/lpc-us-mid-market-lenders-concerned-about-leverage-loan-docs-report-idUSL1N1P405T>.

iv. Miriam Gottfried, The New Business Banker: A Private-Equity Firm, WALL STREET JOURNAL, Aug. 12, 2018, <https://www.wsj.com/articles/the-new-business-banker-a-private-equity-firm-1534075200>.

v. See IMF at ii.

vi. See IMF at ii.

vii. See Deo at iii.

## COMMITTEE HIGHLIGHTS

### INTRODUCING THE NEW FINANCIAL SERVICES TECHNOLOGY JOINT SUBCOMMITTEE

The 2019 Business Law Section Spring Meeting marks the launch of the Financial Services Technology (“Fintech”) Joint Subcommittee, a collaborative undertaking between the Commercial Finance Committee and Private Equity & Venture Capital Committee of the ABA Business Law Section. The newly established Fintech Joint Subcommittee will continue to serve as a forum for commercial finance, private equity and venture capital attorneys to exchange views on emerging financial technologies and their implications for corporate and financial law practice. The Subcommittee, chaired by Jonathan Cardenas (Crowell & Moring LLP) and vice-chaired by Andrea Tinianow (Global Compass Strategies) will host a panel on “Cross-Border Fintech Investment: From Venture Financing to Private Equity and Beyond” at the 2019 Spring Meeting in Vancouver.

### RELAUNCH OF THE PE & VC DICTIONARY TASK FORCE

After a brief break the PE & VC Dictionary Task Force is getting ready to relaunch. Under the leadership of Gesta Abols (Fasken) the taskforce will be officially relaunching at the annual meeting in Washington in September. Please reach out to Gesta if you would like to participate, it’s a fabulous opportunity to get more involved in our committee.

### WE’RE ON SOCIAL MEDIA

If you haven’t yet, please follow us on social media. It’s a great way to stay current on what the Committee is up to and what’s in store for upcoming meetings.



[linkedin.com/groups/2395267](https://www.linkedin.com/groups/2395267)  
[facebook.com/ABABLSPEVC](https://www.facebook.com/ABABLSPEVC)

### WELCOME BREAKFAST

Did you know the Private Equity Venture Capital Committees hosts a welcome breakfast? Beginning at 8am on Thursday March 28, the Committee hosts a breakfast that leads up to the main Committee meeting at 9am. It’s a fabulous opportunity to meet the Committee’s leadership, mingle with other members, and fuel up before our main Committee meeting. We hope to see you there!

# PRIVATE EQUITY M&A SUBCOMMITTEE

**March 29, 2019** - The Private Equity M&A Subcommittee last met on Friday, January 28 at 10:30 a.m. local time, in Laguna Beach, California, as part of the Merger and Acquisitions Committee’s Standalone Meeting. We had two presentations at our meeting. First, based on the feedback that our discussion on Eagle Force Holdings in Austin generated, we revisited the topic in Laguna Beach. I participated in a panel discussion with The Honorable Leo Strine, Chief Justice of the Delaware Supreme Court and Lisa Stark of K&L Gates in Wilmington, Delaware. The panel reviewed what we discussed in Austin, mentioned how Vice Chancellor Laster’s decision in Acorn effects the discussion, reviewed some of the feedback that I had received after

our Austin discussion and heard the Chief Justice’s thoughts on the matter. Second, as it was exactly two years ago that our Subcommittee had its first program on representation and warranty insurance, I was joined by Bill Monat of WTW, who participated in the original panel discussion two years ago, and Philip Henry of AON, for an update on R&W insurance entitled “Representation and Warranty Insurance – an Update on Current Terms, Trends and Claims.”

The Private Equity M&A Joint Subcommittee will meet again on Friday, March 29, 2019 at 10:30 a.m. local time in Vancouver, British Columbia as part of the Business Law Sections’ Spring Meeting. We have two panel presentations on the menu. First, I’ll

be joined on a panel by Glen West of Weil Gotshal in Dallas, Texas and Jeffrey Katz of BDO in New York, New York for a discussion entitled “Drafting Proper Working Capital Dispute Resolution Provisions – What Can Be Learned from Penton Business Media Holdings. The panel will discuss the Penton Business Media Holdings decision, how the M&A Committee’s model agreements dealt with the issue and what happens when an accounting firm is asked to make legal decisions on how to run the process of resolving working capital disputes. On the second panel, Subcommittee Vice Chair Samantha Horn of Stikeman Elliott in Toronto, Ontario will be joined by Elliot Greenstone of Davies Ward in Montreal, Quebec, and three

Vancouver based panelists — Tracy McVicar of CAI, Maria Parella of Penderfund and Rob Wildeman of Jericho to discuss the Vancouver and Canadian PE scene and cross border Private Equity into the U.S. The panel will discuss industry focus, trends, the competitive landscape for deals and differences and similarities across the Canada/US border.

My Vice Chairs (Mireille Fontaine of BLF in Montreal, Quebec and the aforementioned Samantha Horn) and I continue to seek **YOUR** feedback as to the meetings and the Joint Subcommittee, either by talking to one of us in Vancouver or reaching out to one of us afterwards. We are always looking for ideas for future programs, presentations and projects, as well as vol-

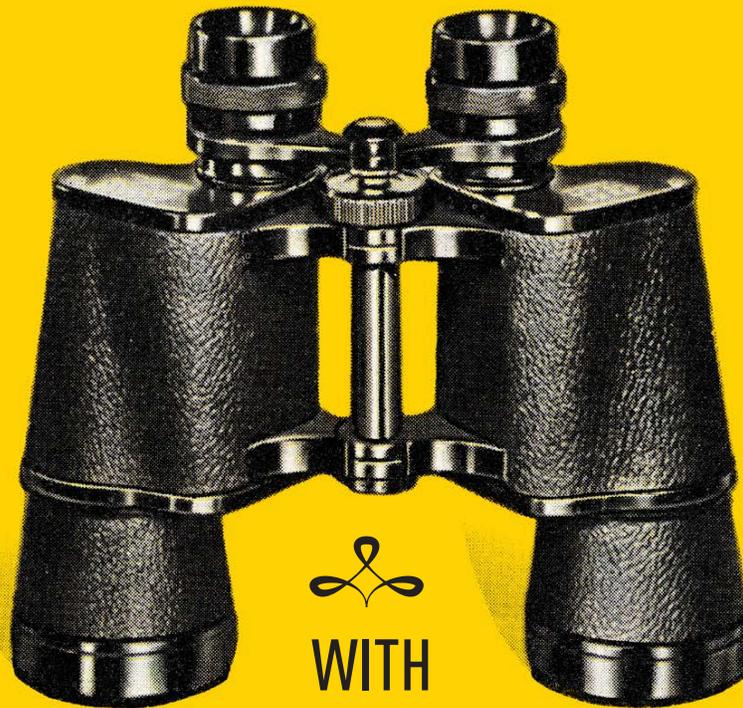
unteers for all of them. And, as I’ve said before, if you don’t know me and you are at the Vancouver meetings, please feel free to come by and introduce yourself.

I look forward to seeing many of you in Vancouver on Friday, March 29<sup>th</sup> at 10:30 a.m. local time (1:30 eastern). If you are unable to be there, please feel free to dial in and listen using the instructions set forth elsewhere in Deal Points or Preferred Returns.



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# FEE COMPRESSION ON THE RISE, IS IT FINALLY TIME TO SAY HINDSIGHT IS 2 AND 20?

By Aaron Brown and Paul Hallgren



**Aaron Brown**  
*Associate, Ballard Spahr LLP*



**Paul Hallgren**  
*Associate, Ballard Spahr LLP*

**D**uring the hedge fund industry's heyday, 2 and 20 — meaning a two percent management fee and twenty percent performance fee — became the quintessential fee structure. Although the 2 and 20 model was significantly higher than the typical fees associated with other active and passive investments, investors were willing to pay more because the average fund's performance justified

the higher fee. Take, for example, the HFRX Global Hedge Fund Index's stunning 16.1 percent return between its inception in 1998 to 2003. The HFRX Index's return was particularly impressive as compared to other indices during the same period, such as the S&P 500 Index (4.5 percent), the Bloomberg BC Aggregate Bond Index (8.4 percent), and the MSCI ACWI EX-US Index (4.3 percent). But, over the next 12 years (partic-

ularly those following the Great Recession) the average return for the HFRX Global Hedge Fund Index was an anemic 0.6 percent, which was 4.2 percent lower than the next lowest index (the Bloomberg BC Aggregate Bond Index). Another illustration of this trend is evident upon review of the HFRI Fund Weighted Composite Index over the past 30 years. From 1990 to 1993, the HFRI Index's alpha returns were an eye-popping

15.3 percent, followed by respectable alpha returns of 4.5 percent, 5.0 percent, and 6.6 percent for the years of 1994 to 1997, 1998 to 2001, and 2002 to 2005, respectively. Then, after a decade and a half, the index's alpha returns fell to around 3.3 percent from 2006 to 2009, -.09 percent from 2010 to 2013, and 0.2 percent from 2014 to 2017.

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The 180-degree turn in performance over the past decade has been linked to several factors, including the Federal Reserve Bank's zero interest rate policy following the Great Recession, enormous industry growth (which in 1997 had a little over 2,000 funds and just over \$100 billion in assets and now has close to 15,000 funds and over \$3.2 trillion in assets), and the misaligned interests between funds and their investors that this explosive growth in assets has created, among other reasons. Regardless, aside from the very top echelon of funds, the adage "come for the high fees, stay for the underperformance" seems to become more reflective of reality year after year. Thus, the question now becomes, will the vast majority of hedge funds be able to survive by maintaining the status quo with their current fee arrangements in the new world of robo-advisors, low-cost index funds, liquid alternative funds, and their own (in the aggregate) performance, or will a totally revamped fee structure hit virtually the entire industry?

In 2009, the average hedge fund charged around 1.6 percent in management fees and 20 percent in performance fees. By the middle of 2018, those amounts were slightly lower with the average management fee tracking at around 1.5 per-

cent and the performance fee at around 17 percent. This fee range would put the fee trend in line with the idea that fees could settle around 1.5 and 15 instead of old arrangement of 2 and 20 (besides, of course, for the select few over-performers in the industry). But simply reducing the fees leaves intact what many investors and commentators constantly complain about—similar or better performance by passive investment strategies and diverging interests between funds and investors. That is where an added emphasis on primarily alpha-based fees could come in to play.

#### ALPHA-BASED FEES

Several funds have begun experimenting with elevated levels of performance-based fees, lower percentages of management fees, and, in some cases, penalties for underperformance to address the criticism that the industry is not compensated on creating alpha returns but is instead favorably compensated by posting beta-level returns and pulling in extravagant amounts of assets. Although there are many variations of these primarily alpha-based fees (also known as Fulcrum Fees), their hallmarks are that funds do not receive compensation for beta-level returns, and the fund commonly accrues a higher percentage of the alpha-level returns.

## A SYSTEM EMPLOYING ALPHA-BASED FEES, AS THE ARGUMENT GOES, ALIGNS INTERESTS WITH INVESTORS BECAUSE THE STRUCTURE WILL RICHLY REWARD FUNDS THAT OVER-PERFORM MARKET RETURNS WHILE NOT OVERPAYING FOR UNDERPERFORMANCE.

A system employing alpha-based fees, as the argument goes, aligns interests with investors because the structure will richly reward funds that over-perform market returns while not overpaying for underperformance. This alignment of interests between funds and their investors is even greater when the management fees are reduced to a percentage seen for other active investments; or in the alternative, penalty payments for not achieving alpha, which provides a great amount of risk mitigation for investors.

To see how this works on paper, imagine a fund that has \$100 million in assets and charges a 1 percent management fee, a 30 percent performance fee on alpha returns, and returns 30 percent for returns below beta. In that example, if the market rises 8 percent in the first year, and the fund outperforms the market by 100

would gain \$1.3 million in fees (\$1 million from the management fee and \$300,000 from the 30 percent gain on the 1 percent over performance). On the other hand, a typical 2 and 20 fee structure without a hurdle rate would gain \$3.8 million (\$2 million from the management fee and \$1.8 million from the performance fee, which means a very small percentage of the fee is tied to an alpha-related return). Using the exact same assets-under-management numbers, imagine a world in which the market rose 8 percent, but the fund underperformed by 100 basis points. Here, the alpha-based fees fund would gain \$700,000 (\$1 million in management fees and a refund of \$300,000 due to underperforming the market by 100 basis points). For comparison, the typical 2 and 20 fee structure would gain \$3.4 million (\$2 million in management fees and \$1.4 million in performance fees for finish-

ing 100 basis points below the market).

Much like investing generally, it is challenging to know what the future holds. But with the advent of low-cost passive investing and the rapidly changing landscape for funds, it is likely that the fund industry will continue to feel fee compression going forward. What is certain is that most investors are willing to pay a premium for returns that exceed market-based returns, and they are becoming less inclined to pay a premium for returns they could receive on one of the hundreds of ETFs or Fintech apps that will charge 20 basis points yearly to secure beta-level returns. Our prediction is that this pressure will lead the hedge fund world to consider putting more of an emphasis on outperforming the market and less of an emphasis on asset accumulation as it moves forward into a reality where 2 and 20 is not the norm but the exception. ■

# THE BEST OF *Vancouver* B . C . C A N A D A

1. **Best Live Music** – If a great vibe is what you seek, the live music at *Guild & Co* is hard to beat.
2. **Best View** – The *Capilano Suspension Bridge* is a fabulous escape from the city. 70 meters above the forest's floor, the bridge offers unparalleled views of the canon and river below.
3. **Best Running Route** – Whether you want to run, walk or cycle head to *Stanely Park* to experience the ultimate path along the nearly 20 mile seawall. The path starts just outside of the Convention Centre!
4. **Best Skiing** – A 2 hr shuttle will get you to *Whistler/Blackcombe*, one of the largest ski areas in North America. With 1,530 of vertical, two mountains and a peak-to-peak gondala the skiing is epic!
5. **Best Cocktail** – Gastown's *The Diamond* is known for it's cocktails, and it's Paper Plain in particular, but if you can't get much more Canadian than a spicy Ceasar with brunch at Timber.
6. **Best Sushi** – A trip to Vancouver wouldn't be complete without enjoying some great sushi. *Miku* has some of the best around and is rumored to be a favorite of Beyonce and Jay-Z.
7. **Best Food Truck** – *Chickpea*. Conveniently located just across the street from the Convention Centre you will find Chickpea, one of Vancouver's favorite food trucks. Famous for its vegan comfort food including tempeh shawarma, crispy eggplant, and fried cauliflower.
8. **Best Hike** – *Grouse Grind*. If you want a true challenge and a great view, grab your sneakers and head to Grouse Mountain where you will find a 2.9 km trail often referred to as "mother nature's stairmaster" due to its 2,830 stairs. Or if your feeling less ambitious and still want to take in the view, enjoy the gondola ride to the top.
9. **Best Shopping** – For the best shopping Vancouver has to offer head to *Gastown* where you'll find trendy boutiques including lots of local brands.
10. **Best Accessory** – *An umbrella*. Vancouverites say there is no such thing as bad weather, only bad gear. Don't let a seasonal shower make you miss out on all that Vancouver has to offer and do yourself a favor, pack an umbrella.



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## NEXT MEETING

SEPTEMBER

**Business Law Section  
Annual Meeting**

September 12-14, 2019

Washington, D.C.



## ARTICLES & AUTHORS NEEDED

The Committee is collecting articles for future newsletters which are circulated to our members worldwide. Please send your submissions to Brett Stewart at [brett.stewart@mcmillan.ca](mailto:brett.stewart@mcmillan.ca)

Articles should be 1500 words or less, and on any topic of interest to practitioners in the private equity and venture capital sectors. From short scholarly articles, to practice tips, reviews/summaries of a Section program, life in the trenches, interesting pro bono projects, humorous looks at life and the law, or even how you balance work and personal life. We appreciate your help in making this newsletter a success.



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