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INVESTORS AND INVESTING

Effective International Risk Strategies for Nontraditional Investments

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Proliferation of Nontraditional Investments

Private equity firms and other financial investors facing overpriced or oversubscribed equity auctions are chasing returns using investment structures not traditionally associated with ''buyout shops'' — increasingly funded from dedicated credit-focused and distressed debt or ''tactical'' investment funds. Firms that traditionally made their names doing majority equity buyouts now deploy billions in capital in relatively novel ways, such as:

- direct lending (acquisition funding, refinancing, bridge loans, and debtor-in-possession loans, whether unitranche or syndicated);
- purchase of hybrid instruments with equity convertible features and/or control rights;
- secondary acquisition of debt claims in a distressed debtor as part of a strategy to eventually acquire equity or assets in a bankruptcy or negotiated workout;
- formation of orphan note issuer vehicles backed by receivables or other assets; and
- partnerships to take large portfolios of nonperforming loans off the books of traditional financial in-

stitutions in exchange for notes backed by income from servicing and working out these portfolios.

How can an investor craft a risk-based approach that balances cost and effectiveness in the face of often limited access to information and shifting concepts of 'control' over the lifetime of a nontraditional investment?

The main street acceptance of alternative investment structures poses unique anti-corruption and sanctions risk mitigation challenges to private equity sponsors and their legal counsel. Whereas the typical sale of a company is accompanied by a due diligence process to facilitate the free exchange of information, information can be scarce in a nontraditional structure. Perhaps management is preoccupied with bankruptcy proceedings or too busy keeping the target solvent. In other contexts, a company may have the bargaining leverage to avoid responding to diligence requests or market practice might not support a full-scale process. Or, management might not even be a party to the transaction, as in a case where a buyer is consolidating a company's debt claims on the secondary market hoping to force an involuntary bankruptcy or negotiate a flip into equity.

How can an investor craft a risk-based approach that balances cost and effectiveness in the face of limited access to information and shifting concepts of ''control'' over the lifetime of a nontraditional investment?

The Importance of 'Getting It Right'

Complicating the picture, it should be clear by 2018 that more traditional due diligence and risk mitigation considerations of legal liability and financial impairment alone do not capture the full picture of relevant concerns. Investors increasingly have other audiences than their regulators: their shareholders, limited partners and prospective limited partners, lenders, and insurers are increasingly evaluating investor compliance due diligence procedures as part of their own investment diligence. And they are evaluating not just legal risk from corruption and sanctions, but adjacent concepts of business ethics and good corporate citizenship. Not only are these other actors assessing investor diligence using additional criteria, unlike the Department of Justice or the Securities and Exchange Commission, they can assign ''fault'' to an investor even in the absence of actual legal liability.

Scoping the Risk

The starting place for a legal analysis of risk exposure is ''control'' — the extent to which a sponsor and its investment professionals might be exposed to liability for the target company's misconduct under an agency theory of liability. As a threshold matter, investors and their counsel should ensure they have clearly defined the nature and spectrum of possible outcomes in a nontraditional transaction. Consider hallmarks of ''control'' at the time of closing the proposed investment and over the lifetime of the investment. This will require thoughtful discussions with the deal professionals. For debt or hybrid debt/equity instruments, aspects of control might be present via:

- securities that entitle the investor to appoint a director to the board;
- debt instruments that vote like equity securities before they are converted; and
- shareholders' agreements and/or securities purchase agreements that grant negative control (veto) rights over certain business decisions.

Even within veto right scenarios, investors should consider where their interest falls on the control spectrum, based on the significance of the right. For example, veto rights around issuance of new securities that merely amount to traditional minority anti-dilution protection is a less impactful means of control over a company's operation than a veto right over its adoption of a business plan, decision to undertake a geographical expansion, and/or ability to make capital expenditures over a certain materiality threshold.

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CASE STUDY 1

Scenario 1: A U.S.-based sponsor will enter a bid to participate in a syndicated convertible note offering being run by a global public works/infrastructure company. The notes carry with them an observer seat but no voting or negative control rights — only customary minority anti-dilution protection. The option to convert the notes into equity is triggered by certain economic performance benchmarks.

On the basis that the issuer is unwilling to undergo a detailed compliance diligence process during the bid phase, the sponsor opts for a two-phase compliance diligence program: first, prior to buying the notes, the sponsor undertakes an adverse media review and sanctions database check and negotiates for customary anti-corruption and sanctions representations and warranties in the purchase agreement; second, the sponsor uses its observer seat to collect additional compliance-related information, and prior to the equity conversion a year later, administers its compliance questionnaire and refreshes its media check and sanctions screen.

Also, concepts of control may change over the lifetime of an investment. Even if a security does not contain springing or other shifting control rights on its face, economic and practical realities might dictate the intended holding period of the investment and likelihood that the investor's deal team will negotiate for a debt-for-equity swap. True, these considerations turn, in large part, on the target's performance over time and other external and unpredictable factors. But the deal team should give deal counsel at least a preliminary steer in light of their financial due diligence, market outlook, and investment thesis.

Crafting a Diligence and Ongoing Monitoring Strategy

It is important to employ a risk-based diligence strategy sliding on two axes:

- first, the inherent risk of the investment target (e.g., geographies of operation, industry risk, nature and extent of government interactions, and involvement in historical misconduct); and
- second, the control features present in the transaction — those discussed in the preceding section.

CASE STUDY 2

Scenario 2: U.S.-based sponsor will acquire a portfolio of nonperforming commercial loans from a large European ''bad'' bank. The sponsor will engage a third-party servicer to administer the portfolio, and it plans to negotiate workouts or foreclose on the loans, then sell or rent the properties. As the pool of loans was initially assembled in haste from multiple financial institutions during the financial crisis, the seller is unable to give any compliance representations about the composition of the borrowers. Furthermore, due to data privacy laws, the seller will not disclose the names of the borrowers in the portfolio until after signing.

The sponsor, therefore, negotiates for knowledge-qualified compliance representations from the seller, and obtains a put-back right exercisable between signing and closing to permit the sponsor's administrator to screen the borrowers in the loan portfolio for sanctioned parties, politically exposed persons, and individuals associated with criminal activity.

A compliance diligence strategy should make thoughtful, escalating use of those more intrusive and time-consuming diligence components, which likely will include some combination of: a desktop review of negative media, retention of third-party expert investigators or forensic accountants, diligence Q&A and document requests, and management interviews — to the extent feasible in the transaction structure.

Deploying all of these diligence components in the first instance for a low-risk lending transaction would not be warranted. But an effective anti-corruption/sanctions diligence strategy would take a risk-based and potentially phased approach. Particularly suited for a convertible note transaction or in a distressed context with long odds that the sponsor will ever end up with a meaningful equity stake or board control, this approach pairs a lower up-front level of diligence commensurate with a pure debt transaction with a second, contingent phase of diligence closer in time to the sponsor actually obtaining control. Although this two-phased approach might reveal compliance concerns at the target company only when the sponsor is committed to taking an equity position, it has the benefit of flagging risks and allowing the sponsor to proactively remedy concerns before exercising control.

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