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FROM THE EDITORS

In the dynamic landscape of private equity, staying informed is not just important; it's essential. 'Weil Private Equity Sponsor Sync,' our latest endeavor at Weil Private Equity, embodies this ethos. As a market-leading private equity firm, we're excited to relaunch our quarterly publications with Sponsor Sync. It's more than just a newsletter – it's a reflection of our finger always being on the market's pulse. At Weil, we don't just follow trends; we foresee and shape them. Sponsor Sync will be an embodiment of our deep market knowledge and our proficiency in turning insights into successful outcomes. Each issue promises to offer not just information, but actionable and practical insights, keeping you well-equipped in this ever-evolving industry. We are proud to publish our inaugural issue of Sponsor Sync, featuring 2024 PE predictions from U.S. Private Equity Co-Head Chris Machera and Global Private Equity Co-Head Doug Warner, along with other musings from Glenn West and our esteemed Antitrust colleagues, as well as an AI overview from Arnie Fridhandler and Olivia Greer.

IN THIS ISSUE

THE BULL CASE

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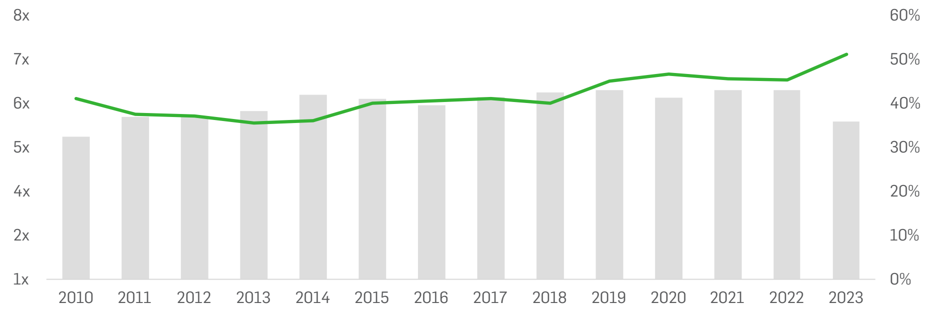
Heading into 2023, many predicted a dramatic rebound to the private equity deal market. It didn't happen, but that is not going to prevent us from predicting a dramatic rebound to the private equity deal market in 2024. In fact, we're downright bullish. More on that in a bit – to start, let us recap 2023.

Without being pollyanish, there were some positives from the past year. First, notwithstanding the dearth of LBO financings (according to PitchBook, new LBO supply was at a 13 year low this year, at just $30.7 billion), over the course of the year the debt markets normalized and financing for leveraged buyouts became broadly available across industries. There are some caveats to that normalization: again according to PitchBook, the average debt / EBITDA ratio for de novo LBOs fell to 5x (the lowest since 2010), and equity contributions for the first time topped 50%. And as everyone is painfully aware, debt was materially more expensive in 2023 given the dramatic rate increases that began in the summer of 2022 and which continued through the end of this year. But throughout 2023, a discernible confidence began to permeate financing markets, which allowed sponsors to go into sale processes knowing that reluctant lenders would not trip them up at the final hour (as happened with some frequency in 2022). The same was true for the preferred equity market, which – for the right price – was broadly available thanks in part to the availability of capital from newly minted special situation funds. In a similar spirit, there was an overall sense amongst private equity professionals that investment committees were receptive to new deals in 2023 in a way that many were not in 2022, when dead deals were seemingly worn by those committees as badges of honor.

LBO Equity Contributions and Debt/EBITDA Ratios



Debt/EBITDA ratio of large corp LBO loans
Equity contribution: LBO

Source: Pitchbook | LCD (a/o Sept. 30, 2023)

Another positive development from the past year is that buyers and sellers began to bridge what had been a persistent valuation gap, in some cases through creative approaches to contingent value and in some cases by meeting more in the middle, with sellers in several industries giving up the ghost on 2021 multiples (although some still got them). We have separately discussed those creative approaches, but by and large they included earn-outs and structured equity, which could be utilized where sellers rolled equity into a junior security that allowed buyers to justify valuations that they were still not entirely comfortable with. While we did see some auction processes stall out based upon a failure to find that middle ground, it was met much more often in 2023 than it had been the previous year. It was helpful also in this regard that many irregularities that had affected businesses during the pandemic and immediately post-pandemic had worked their way through the system by the end of 2023 and so there generally was less acrimony in finding appropriate run-rate EBITDA and normalized working capital targets.

A final positive development during 2023 is that deals involving public companies were relatively active this year, both through take privates as well as carve-outs. Some of this was a function of recently IPOed and deSPACed companies that were not ready for public markets, a trend which we had predicted earlier this year in our Going Private Study, and which accelerated throughout the year. Thanks to this trend, the dearth of deals involving private equity sellers (more on that directly below) was offset somewhat by take privates and carve-outs (along with founder deals), and overall private equity deal volume was down materially but not catastrophically. We note though that the increase in sponsor-backed take privates was somewhat curtailed as the year ended and public company stock valuations were up generally (very materially in some sectors).

All that said, there were a number of negative developments that were hard to ignore and on the whole 2023 was a disappointing year for private equity. As has been widely reported, deal count was down dramatically and an increasing number of deals involved non-financial sellers (e.g., founders). According to PitchBook, the value of private equity exits was down in 2023 to 7.6% as a percentage of prior year AUM (down from 11.6% in 2022 and from an anomalous 41.3% in 2021). Again, focusing on the psychology of the market, this tended to reflect, and exacerbate, the sense that it was not a good time for smart money to be selling. This had a negative flywheel effect, where less sales by private equity firms led to fewer LP distributions, which hurt fundraising, extended fund lives and reduced

available capital for new deals. The lack of private equity exits also took up time for private equity professionals, who had to spend a disproportionate amount of their days focusing on existing portfolio companies, which were being held for longer and had in some cases with additional time created additional headaches.

When we look back on 2023, though, our biggest takeaway is that it was a frustrating year of fits and stops, where people saw signs of life at various points throughout the year, but the shoots never fully took. The deal market as we have noted before is really just where you are on the fear-greed continuum and in 2023 there was an element of fear that people couldn't kick. As the year ended, we started to see some confidence return to the market, and it is that psychological pivot that we think will take hold in 2024.

So in sum, in 2024, we see things turning for the better, in a material way. And with that, here are our predictions:

1 Private Equity Sellers Return

As noted above, by and large, private equity firms were reluctant to sell in 2023, and when they did, it was oftentimes partial sales that were designed to obtain some liquidity (and perhaps mark an investment for fund-raising purposes), through either secondary sponsor sales or to continuation funds. According to PitchBook, the median private equity hold period in 2023 was the longest it has been since the financial crisis – 6.4 years, and the portfolio company inventory count set a record at over 10,000 (by way of reference that number was less than 4000 when Chris started practicing in 2005; no data available for when Doug started practicing). This trend is not tenable. The number of companies that sponsors are trying to sell, are thinking about selling, or have failed to sell is at some point going to cause a deluge of exits, and we think that it will begin this year. Indeed, there are numerous sponsors who tried unsuccessfully to sell portfolio companies over the past few years that are now due to come back to the market and when they do it will be difficult – for myriad reasons – for the sponsors to push another process. And while it has been easier to refinance debt recently, sponsors with maturing debt in 2025 or 2026 may not want to roll the dice that they will be able to roll over those pending maturities down the road. In sum, we think that many private equity firms (not a small number of whom are fund raising or who have had to delay fund raising) are going to look at the next couple years, including an inevitably precarious election cycle this fall, and feel like they need to sell. While they may not get 2021 valuations, 2024 valuations may not be too far behind.

"The number of companies that sponsors are trying to sell, are thinking about selling, or have failed to sell is at some point going to cause a deluge of exits, and we think that it will begin this year."

2 Incentive Equity Pools Shrink

One consequence of the rise in the number of founder sales over the last couple years is a marked uptick in the economics of incentive equity packages that private equity buyers gave to those founders and their teams in order to get the founder across the finish line – i.e., they could justify a lower purchase price by giving the founder and his or her team a greater share of the equity upside on a go-forward basis. During this time, we have seen the size of pools increase, vesting trend more towards time-vesting, and performance-vesting hurdles lowered. When the sellers are private equity firms, as opposed to founders, who are exiting completely, they are of course more indifferent to the go forward management incentive equity plan (although to their credit many sponsors do take this into account). As private equity sellers return to the fold, we see private equity buyers squeezing value from management teams in order to bridge the afore-mentioned valuation gap. It could be that more incentive equity is parked as "home run" options or other methods but in any event when you run the numbers on the base case there will be a value transfer from management teams to sponsors.

3 Syndicated Loans Return

Again, looking at the big picture, if the deal market is going to return in a meaningful way, one of the key challenges will be the persistent valuation gap. Being more disciplined on incentive equity is one way to do that. Using lower cost financing is another way. And as you all know, syndicated loans are generally cheaper than direct lending, and syndicated loans have effectively disappeared from the market over the last couple years (as noted above 2023 saw the lowest leveraged loan volume since the financial crisis). We see this changing in a dramatic way in 2024 and frankly it has already begun to turn in the last few weeks of this year (for example with the recent Cotiviti financing where sponsors turned to the syndicated loan market in the face of competition for the financing from direct lenders). In addition to helping the math work for sponsors by offering a lower cost of capital than direct loans, there is going to be increasing pressure on banks to generate fees, and syndicated loans are an incredible profit center for banks when the market is open. As the backlog of hung deals post-Twitter has worked its way through the market, we think that banks will be open for business. While the amount of available capital for direct lenders has been widely reported, at a certain point sponsors are going to take a harder look at some of the costs that come with that availability. In particular, many sponsors have come to learn during the choppy last few years that direct lenders may not be the reliable friends that they had thought they were. Banks are often not much friendlier, but as noted their capital is cheaper, and given the focus on the valuation gap in 2024 we think that will be paramount.

4 Club Deals Come Back as Well

Many sponsors have been reluctant to partner with other private equity firms in the wake of anti-trust litigation that several firms were subject to several years back (that lawsuit was filed in 2007 and settled definitively in 2014). While sponsors will of course bear in mind some of the lessons learned from that settlement, there are a few trends that portend a return of club deals in 2024. As noted above, the financing markets are currently requiring (and we expect at least in the near-mid term will continue to require) that sponsors write larger equity checks to support larger financings. While there are some mega-funds with plenty of dry powder, even the largest sponsors will tap out at a certain point (and not every sponsor is a mega-fund). Over the last several years, sponsors (mega and otherwise) have routinely plugged equity holes with co-investments from LPs – ordinarily sovereign wealth funds and similarly situated investors, which in some cases exceeded $1 billion. While we expect that many of those LPs will continue to be ready, willing and able to fund large equity checks alongside their favorite GPs, there are two things to note: those LPs have been (1) increasingly selective in deploying capital (thanks to lack of sponsor distributions and otherwise) and (2) more assertive and focused on diligence and governance, which may cause sponsors to view them as something other than a smooth and friendly path to capital. Given those dynamics, some of the calls that historically had gone to LPs may now also be made to other sponsors (sell side bankers in get-a-deal-done mode may also be helpful in this regard). And again, sponsors with smart lawyers will tread carefully here, but in the real world there is an inherent quid pro quo with sponsor deals and there are many reasons for sponsors and sell-side bankers to want to be on friendly terms. Another factor that we think could beget more club deals is the rise of specialized funds with unique or unique-ish advantages and selling points that they can bring to a target (e.g., through a global platform, advisors with bespoke networks, etc.), which could make a consortium of different sponsors bringing different benefits to the table more attractive to a management team. A final variable that could lead to more club deals is that as you as all know, we live in an increasingly regulated environment, and there will be certain deals where sponsors splitting the equity check and taking non-control positions will help with filings and other red tape that accompany investments in certain industries (note also that many LPs are non-U.S. investors that may have difficulty investing in certain regulated industries). Careful readers of Weil's Going Private Study will remember that in our inaugural survey in 2007, we noted that 91% of take privates over $5 billion were club deals and 51% of take privates from $1 billion to $5 billion were club deals – we are not quite predicting a return to those halcyon days but we do predict a meaningful and material increase in club deals in 2024.

5 More Buyers Push for Indemnities … And Lose the Fight More Often

As noted above, many of the sales over the last year (and longer) have involved founder-owned companies and carve-outs. One consequence of that is that indemnities have become more common, as sponsors generally look with greater scrutiny at founder-backed companies and carve-outs and push for some protection from the sellers if issues are uncovered post-closing. But private equity sellers – even those with limited leverage in less than robust sale processes – have continued to successfully hold the line on indemnities. Looking ahead, we see private equity buyers continuing to push for indemnities even as private equity sellers return to the market, and we see private equity sellers being pushed hard. Private equity buyers will also be particularly drawn to indemnities in an effort to try to bridge the valuation gap (given that an indemnity ordinarily obviates the need for rep and warranty insurance, the premium of which is a material cost on the buy side, even with falling premiums). However, while we do predict buyers will push even harder for indemnities in 2024, we also predict that private equity sellers will continue to push back (successfully) and indemnities will decrease year over year given the mix of deals that we foresee. Private equity sellers will retain their historic aversion to any post-closing liabilities when they exit companies, and in fact will be even more loathe to provide indemnities given that many of the portfolio companies that they are selling in the coming year will be older investments from older funds. And as a buyer's market becomes a seller's market, buyers will have to take no for an answer.

We have focused here on five predictions that relate to what we believe will be the return of a bull market for private equity. It may not be 2021, which was an aberration for other reasons, but we think that the stage is set for a big year. If that happens (and we hope it does), we will likely be making a very different set of predictions this time next year.

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2023 LAW FIRM OF THE YEAR NORTH AMERICA TRANSACTIONS

PERE

SHORTLISTINGS

FIVE KEY TAKEAWAYS FROM FTC'S CHALLENGE OF "ROLL UPS" BY SPONSOR AND PORTFOLIO COMPANY


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In 2023, the FTC sued Welsh Carson and its portfolio company, U.S. Anesthesia Partners (USAP), in the Southern District of Texas, alleging various antitrust violations. This is the first enforcement action coming out of the FTC's initiative to retroactively investigate private equity "roll up" strategies that was announced shortly after Chair Lina Khan's appointment in June 2021. In a memo to FTC staff dated September 22, 2021, Chair Khan wrote:

> "*The growing role of private equity and other investment vehicles invites us to examine how these business models* ***may distort ordinary incentives in ways that strip productive capacity and may facilitate unfair methods of competition*** *and consumer protection violations.*"

The FTC alleges that Welsh Carson and USAP undertook a series of acquisitions that, taken as a whole, gave USAP a high market share and monopoly power in the markets for certain anesthesia services in Houston, Dallas, and Austin. In addition, the FTC alleges that USAP entered into price-setting and market allocation agreements with competitors.

Five Key Takeaways from the Complaint

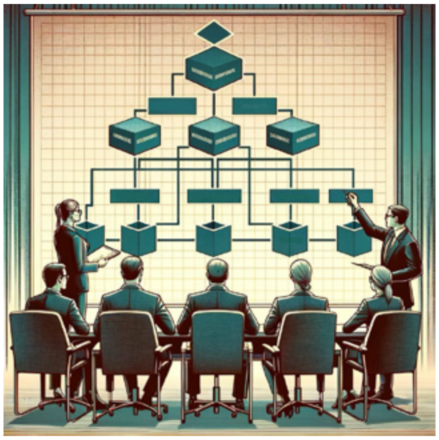
1 The FTC's allegations encompass all available civil antitrust violations.

Citing activity as far back as 2012, the complaint alleges ten counts of anticompetitive conduct in certain Texas "hospital-only anesthesia" markets, including monopolization, price fixing, and market allocation agreements. Rather than simply alleging that an acquisition led to market power, this case weaves in additional agreements with competitors as part of the anticompetitive behavior.

2 The "roll-ups" and "tuck-in" acquisitions are presented as if the activities themselves are anticompetitive.

The complaint is replete with references to Welsh Carson's "consolidation strategy" via "roll-ups" or "tuck-in" acquisitions, a term frequently used by private equity business teams to describe smaller deals in one industry that are often unreportable under the HSR statute.

The FTC uses market share and HHI charts to allege that even though



the acquisitions individually did not materially increase concentration, the series of provider acquisitions taken as a group left USAP with market shares of over 60-70% – and monopoly power. These levels, when achieved by acquisition, are often viewed as problematic by enforcers.

3 Welsh Carson is portrayed as the mastermind behind the strategy and thus equally liable.

The FTC alleges that Welsh Carson "formulated, directed, controlled, had the authority to control, dictated, encouraged, or actively and directly participated in the anticompetitive conduct" described in the complaint. The allegations focus on Welsh

"Weil guidance remains the same. We continue to recommend involving antitrust counsel early in consideration of deals or embarking on sector-focused acquisition strategies (even if not large or HSR reportable), implementing rigorous document creation controls to avoid miscommunication, engaging in early planning for acquisitions of multiple targets in one industry, and recognizing that post-transaction price increases are very likely to be viewed by authorities as reflecting the exertion of newly-attained market power."

Carson's substantial involvement in acquisition strategy, negotiating and overseeing contracts with insurers, providing operational, strategic and financial support, and otherwise playing a significant role in the alleged anticompetitive conduct. Welsh Carson has filed a motion to dismiss the charges against the firm and its entities, arguing that it is well-established corporate law that a parent corporation is not liable for the acts of its subsidiaries, and that the FTC fails to allege facts showing that any Welsh Carson entity independently participated in any unlawful conduct.

4 Internal documents remain critical in enforcement actions.

Though the FTC presents data appearing to demonstrate high market shares and monopoly power, that evidence is amplified by quotes from internal documents to animate the anticompetitive intent of Welsh Carson's and USAP's conduct. Notable examples include a USAP executive writing "cha-ching" after a price increase implemented through an acquisition; pursuing an acquisition because the target could enter the space and "spoil the market"; and multiple documents suggesting that USAP employees were aware of possible compliance implications of the company's conduct.

5 Private equity acquisitions will remain enforcement targets.

Though the complaint may be viewed by some as a "shot across the bow" at private equity M&A, the facts alleged here – very high market shares, monopoly power, evidence of anticompetitive intent, an awareness of anticompetitive effects, and per se unlawful agreements with competitors – are unusually strong and not present in most private equity M&A. It is also notable that the FTC has been focused on healthcare markets, and that the facts here may particularly resonate with a court (e.g., meaningful price increases flowing directly from acquisitions).

Weil guidance remains the same. We continue to recommend involving antitrust counsel early in consideration of deals or embarking on sector-focused acquisition strategies (even if not large or HSR reportable), implementing rigorous document creation controls to avoid miscommunication, engaging in early planning for acquisitions of multiple targets in one industry, and recognizing that post-transaction price increases are very likely to be viewed by authorities as reflecting the exertion of newly-attained market power.

INNOVATE OR HESITATE: AI IN PRIVATE EQUITY IN 2024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As recently as 2022, artificial intelligence (AI) was a mere afterthought, something from the movies, something occasionally mentioned by Elon Musk as the biggest threat to humanity, but certainly not a central topic of investment committees nor office chatter by anyone other than software engineers in Silicon Valley. With a simple stroke of the keyboard and public launch of ChatGPT, 2023 turned out to be the year AI burst into the mainstream. Any and every industry conference (or room with more than 10 people in it, for that matter) was guaranteed to include some discussion or panel about AI. Millions of people from all backgrounds and occupations had the opportunity to experiment and interact with the latest AI technology, including many (most) private equity deal professionals. AI has catapulted from a niche technological feature to a transformative tool. With advancements in generative AI and computational power, AI is no longer the exclusive domain of tech giants; it's becoming a staple in modern business operations, including private equity (law firms too are considering many of the same opportunities and challenges around AI as private equity firms, but we'll save that for another issue of Sponsor Sync).

This article captures, at a very high level, the current (practical) state of AI deployment in private equity. We've engaged with a number of our sponsor clients that have institutionally grappled with, and deployed, AI technologies, and have included those perspectives in this article. We have found most sponsors to be in "wait and see" (cautionary) mode, while others are dedicating significant resources to scaling up capabilities and use of AI (still with appropriate guard rails). We expect that 2024 will be the year that dichotomy will decidedly tilt one direction – to innovation, and we look forward to continuing to update our clients with the best-in-class perspective and enable our clients to benefit from our expertise and broad network (Weil too has and will lean into AI innovation, developing our own tools and enabling AI where possible in various test cases).

The private equity market is beginning to perceive AI as a differentiator. AI is not a standalone product and has become an integral layer enhancing existing tools and processes. From Microsoft Office Co-Pilot to Zoom AI Meeting Summaries, AI has been seamlessly integrated into ubiquitous tools already installed at PE firms. It's also reshaping internal systems, like deal flow trackers and portfolio company reporting. We've also seen the integration of AI in opening doors for new software entrants who use AI as a sales tool to introduce SAAS products but with an added layer of AI.

Investment in AI-focused tech companies is also beginning to disrupt traditional value propositions, creating new opportunities and risks. The implications of AI's advancements span across sectors, from manufacturing to business services and every sector in between. The tidal wave of attention and talent around AI signifies a paradigm shift, marking a new era of possibilities and challenges.

Despite the optimism, concerns about AI's accuracy, inherent biases, confidentiality (including with respect to sensitive personal information, raising privacy concerns in a range of jurisdictions), and ethical implications persist. There's skepticism about over-reliance on AI for complex decision-making, particularly in an industry that thrives on nuanced judgments. A current barrier is the need for cloud-based large language models (LLMs) like ChatGPT or Anthropic, which raises questions about data confidentiality (virtually all PE firms we've caucused with have policy restrictions around uploading confidential proprietary information to and through LLMs). The practical considerations raised by these issues will be complicated by emerging legislation and rulemaking on AI, with the White House Executive Order on AI at the end of 2023, and Europe's Artificial Intelligence Act expected to be finalized early this year.

In practice, PE firms are experimenting with AI in "low-hanging fruit" use cases. Many are customizing publicly available tools, like a branded GPT-4 chat, or employing AI to index and search less-sensitive parts of file systems and public data feeds. Others are permitting (sometimes implicitly) deal teams experiment with public tools, and many junior and mid-level deal professionals are leaning into the opportunity to pioneer the use of AI for tasks, like writing passages and unpacking complex Excel functions. Larger firms with robust technology back offices are also aggressively exploring AI's potential and adding headcount to software engineering and AI-specific roles.

The future of AI in PE hinges on continuous experimentation and the development of high impact use cases. As software providers evolve their product features and start-up SAAS PE-focused products gain traction, AI will increasingly influence deal processes, CRM/sourcing, investment modeling, and reporting. Addressing concerns around confidentiality and data protection will be crucial for the widespread adoption and trust in AI within the PE sector. As the understanding and knowledge of high-impact AI use cases (which are still developing) permeates the PE market, we expect more firms to lean from AI hesitant to AI innovative.

"Investment in AI-focused tech companies is also beginning to disrupt traditional value propositions, creating new opportunities and risks."

We are keenly aware that AI in private equity is a double-edged sword, offering groundbreaking opportunities while demanding careful navigation of its challenges. As the industry grapples with these dynamics, the path forward will be marked by a blend of innovation, caution, and a keen eye on ethical and practical implications. Weil will be at the forefront of these developments in the private equity context and will have the best perspective, market practice, and innovative lens to share with our clients as both we and our PE clients push ahead into the technological abyss of AI within the bounds of our regulatory and ethical sandboxes.

PURCHASE PRICE ADJUSTMENTS: ARBITRATIONS, EXPERT DETERMINATIONS, STUFF IN BETWEEN, AND THE SPECTOR OF A "MALICIOUS" ADJUSTMENT CLAIM

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Many private company acquisition agreements contain provisions providing a mechanism for resolving disputes over post-closing purchase price adjustments, without resort to litigation. In most cases, this involves contractually referring the dispute to an independent accountant with limited authority to resolve the parties' disagreements regarding accounting methodology and calculations. It is rare that contracting parties actually intend to imbue an independent accountant with court-like authority to make legal determinations that go beyond an accountant's typical role of making specific factual determinations. Nonetheless, a general failure to understand the difference between an "expert determination" and an "arbitration," or a lack of clarity in drafting for the intended outcome, has led to much litigation over the actual scope of an independent accountant's role in resolving post-closing purchase price adjustments. And Vice-Chancellor Laster's recent opinion in *Archkey Intermediate Holdings Inc. v. Mona*, 2023 WL 6442815 (Del. Ch. Oct. 3, 2023) serves as warning to transactional lawyers to say what they mean, and know what they say actually means, when it comes to the alternative dispute resolution arena. There is also a warning in Archkey concerning the possible existence of an implied covenant not to act "maliciously" in making post-closing adjustments.

Expert Determination versus Arbitration.

A little over ten years ago, the Committee on International Commercial Disputes of the Association of the Bar of the City of New York issued a report that noted that "[t]here is significant confusion as to just what a purchase price adjustment proceeding is from a legal point of view." [1] The conclusion of the report was that "many practitioners assume that a Purchase Price Adjustment Clause must be an arbitration agreement because, if it is not an arbitration agreement, then it is not clear what else it could be." As a result, there is sometimes a tendency to use words in these clauses that have arbitral overtones. But an "arbitration" is fundamentally different than the normally limited "expert determination" contemplated by referring a purchase price adjustment dispute to an independent accountant. And just because an expert determination is not a binding arbitration agreement does not make the expert's determination any less binding, at least as to factual issues.[2] The basic distinctions between a binding arbitration agreement and an expert determination were summarized in two prior posts to *Weil's Global Private Equity* blog as follows:

> *The powers granted to an arbitrator are "analogous to the powers of a judge." In an arbitration, "[a]rbitrators are expected to rule on issues of law, make binding interpretations of contracts, resolve disputed issues of fact, determine liability, and award damages or other forms of relief." And pursuant to the Federal Arbitration Act, an arbitrator's award is enforceable by a court and there are very limited rights to appeal or review that award.*
>
> *An expert determination, on the other hand, is not a quasi-judicial proceeding at all, but instead is simply an informal determination by an expert of a specific factual issue that a contract requires to be so determined by the designated expert. One must still utilize the courts to enforce that determination as part*

> *of a broader breach of contract action. But courts typically do so if the contract so provides. And, unlike an arbitration, the contract can also establish the court's standard of review, such as "the expert's determination shall be binding on all parties, except in the case of manifest error."* [3]

In those prior blog posts, these distinctions were likened to the fundamental differences between zebras and horses (whether striped or not).

And that brings us to what Vice Chancellor Laster called the "Accountant True-Up Mechanism" contained in the Stock Purchase Agreement (the "SPA") at issue in the recent *Archkey* decision. In *Archkey*, a private equity-backed buyer purchased a private company from its founder. The headline purchase price was made subject to certain potential adjustments based on the difference between the estimated closing balance sheet for the company (the "November Balance Sheet"), which had been used to determine the headline price paid at closing, and an "Adjusted Closing Balance Sheet," prepared by the buyer after closing. As is customary, the buyer was obligated to prepare the Adjusted Closing Balance Sheet "in good faith and in accordance with GAAP and consistent with the past practices of [the Company] and the November Balance Sheet." As is also customary, the seller was entitled to object to the Adjusted Closing Balance Sheet and, to the extent the buyer and seller were unable to resolve those objections, the dispute was to then be submitted to an "Independent Accountant" whose determinations regarding the disputed items in the Adjusted Closing Balance Sheet "shall be final, binding, conclusive and non-appealable for all purposes hereunder, other than manifest error." All pretty standard. But to throw a wrench into the Accountant True-Up Mechanism, the SPA specified that "[t]he Independent Accountant shall act as *an arbitrator*."

The buyer's position was that, by specifying that the Independent Accountant was to "act as arbitrator," the Accountant True-Up Mechanism was effectively an arbitration provision and the Independent Accountant was to make all decisions, both legal and factual, concerning any disputes arising out of the disputed purchase price adjustments. The seller, on the other hand, contended that the Accountant True-up Mechanism was an expert determination only, and that the court retained authority to make all decisions as the meaning of the contractual provisions that governed the determinations the expert was required to make.

Notwithstanding the reference to the Independent Accountant acting "as an arbitrator," Vice Chancellor Laster agreed that the Accountant True-Up Mechanism was an expert determination, not an arbitration provision. Thus, "the Federal Arbitration Act and its associated doctrinal framework, including the concepts or substantive and procedural arbitrability," were inapplicable. But in so deciding, the Vice Chancellor also noted that the general distinctions between an expert determination and an arbitration do not always apply, even when a provision is clearly an expert determination provision and not an arbitration provision. Rather, arbitration and expert determination are "[b]oth forms of binding ADR [Alternative Dispute Resolution]" that "fall along a spectrum" depending on the language used in the contract creating those mechanics. Nonetheless, a standard "Accountant True-Up Mechanism is far enough along the spectrum that it is not legal arbitration, no matter what labels the parties use for the independent accountant." Here, Vice Chancellor Laster concluded that the Accountant True-Up Mechanism was a "beefed-up expert determination, not a slimmed down legal arbitration." But the "beefed-up" part meant that the seller's position as to the limits of the Independent Accountant's role was no more correct than buyer's view of the expansive role the Independent Accountant had as an "arbitrator." Instead, it was somewhere in between the two extremes (more like a domesticated zebra).

Having determined that the Accountant True-Up Mechanism was a "beefed up" expert determination provision, not an arbitration agreement, Vice Chancellor Laster proceeded to determine what issues the court needed to resolve in order for the Independent Accountant to do its work. The seller argued that the court needed to "declare what 'past practices' means" to permit the Independent Accountant to then resolve whether the Adjusted Closing Balance Sheet was prepared "in accordance with GAAP and consistent with the past practices of the Company and the November Balance Sheet." While noting that the seller's position was "too extreme," and that "[t]he more closely related the term or provision is to the expert's area of expertise, the more likely it is that an expert can interpret the term without judicial assistance," Vice Chancellor Laster nonetheless provided some guidance.

First, according to Vice Chancellor Laster, "[past practices in accordance with GAAP] and its variants simply mean using the same method of accounting treatment that was used in the reference statement, provided that method is currently in accordance with GAAP." And, "[t]o the extent an item requires the exercise of judgment, as accounting statements often do, the concept of consistency with past practice calls for reaching an outcome by a method that is as analogous as possible to the method management used historically." Or, "[p]ut another way, the outcome for the post- closing statement should be, to the extent possible, the outcome that the management team would have reached if the same circumstances had been presented when they prepared the reference statement." Second, the GAAP compliance requirement simply means that "past practices" cannot trump GAAP to the extent those past practices were not GAAP compliant. But in selecting a GAAP-compliant method for the Adjusted Closing Balance Sheet, when the November Balance Sheet used a method that was not GAAP-compliant, the buyer is required to choose the GAAP-compliant method that is the most consistent with the Company's past practices, not just the one that may be the most advantageous to the buyer. But, "[a]ccountants operating within the framework of Accountant True-Up Mechanisms routinely make determination about consistency with past practice[,] [and] [t]he Independent Accountant can do so here."

The seller also argued that it was up to the court to decide now before the Independent Accountant was asked to make its expert determination, whether the Adjusted Closing Balance Sheet had been prepared in "good faith," as was expressly required by the Accountant True-Up Mechanism. The seller argued that this requirement was an overriding obligation to act in good faith in the entire transaction. Vice Chancellor Laster rejected that interpretation of the good faith requirement: "The good faith requirement relates to the preparation and delivery of the Adjusted Closing Balance Sheet. It is not a freestanding obligation to act in good faith." Instead, "[t]he concept of good faith in this setting means that the preparer must believe that the accounting entries are accurate, fairly reflect the financial position of the company, and comply with the contractual standard." And according to Vice Chancellor Laster, it was well within the Independent Accountant's expertise to determine whether the accounting determination that the buyer made in the Adjusted Closing Balance Sheet were "so extreme as to show a lack of good faith." Thus, Vice Chancellor Laster noted that the Independent Accountant's determination as to whether the Adjusted Closing Balance Sheet was prepared in good faith would "bind the parties for purposes of any further proceedings in this court."

"[t]here is significant confusion as to just what a purchase price adjustment proceeding is from a legal point of view."

With this guidance Vice Chancellor Laster stayed the court proceedings until the Independent Accountant could make its determinations regarding the disputed items in the Adjusted Closing Balance Sheet because "[f]urther litigation in this court will take into account the Independent Accountant's determinations."

Implied Anti-Maliciousness Covenant

Despite the limited meaning of the express good faith requirement, and the Independent Accountant's role in determining whether the Adjusted Closing Balance Sheet was prepared consistent with that requirement, Vice Chancellor held open the possibility that the seller might still have a separate claim for breach of an implied obligation of good faith and fair dealing. According to Vice Chancellor Laster, a recent Delaware Supreme Court decision, *Baldwin v. New Wood Res. LLC*, 283 A.3d 1099 (Del. 2022), may have expanded the covenant of good faith and fair dealing to include an implied covenant not to take any action "maliciously in an effort to harm the contractual counterparty." And, based on the facts pled by the seller and evidence introduced, Vice Chancellor Laster noted that the seller's "amalgamation of evidence suggest that the Purchaser made adjustments when preparing the [Adjusted Closing Balance Sheet] that are so extreme as to indicate malice." The seller's basic claim was that the buyer had completely changed the company's accounting approach post-closing such that it was in fact inconsistent with past practices and specifically designed to reduce the purchase price as much as possible.

Here, the proposed adjustment was over $12.6 million off a headline price of $21 million (i.e., 2/3rds of the headline price). But "extreme" presumably must be determined by comparison to the actual calculation that was required by the express terms of the purchase agreement (which was required to be consistent with past practices), not just the actual size of the adjustment itself.

Delaware contract law, unlike tort law, has fairly consistently treated intentional breaches of contract the same as unintentional breaches, unless there is something in the contract requiring a different outcome in the event of a "willful breach." Indeed the concept of "efficient breach" suggests that parties should be able to breach an agreement for any reason provided that they are prepared to pay the resulting damages occasioned by that breach. Is a "malicious" contractual breach an exception to that rule, even in the absence of a tort connected to that maliciousness? Vice Chancellor Laster notes that "the intent to harm intentionally—malice—goes beyond an intent to take self-interested action that happens to inflict consequential or collateral harm[,] [and] [i]t thus transcend situations involving efficient breach or intentional failure to comply with a contractual obligation that gives rise to a claim for damages."

But, doesn't compliance with an implied covenant, even one not to act maliciously, also constitute a mere breach of contract giving rise to damages? And because implied covenants are traditionally gap-fillers, what gap is being filled by this implied covenant given that the purchase agreement already contained a contractual standard (good faith) against which the preparation of the Adjusted Closing Balance Sheet was to be judged? A prior blog post interpreted the Delaware Supreme Court's decision, in *Baldwin v. New Wood Res. LLC*, as simply providing, as a gap filler, an implied contractual standard (good faith) to govern the making of an otherwise fully discretionary decision by one party concerning whether another party was in compliance with an agreed standard of conduct.[4] Is there more to it than that? Vice Chancellor Laster suggests there well may be.

But, if the Independent Accountant determines that the Adjusted Closing Balance Sheet was not prepared in good faith, what additional remedy would there be as a result of the court's determination that there had also been a breach of an implied covenant not to act maliciously in preparing that Adjusted Closing Balance Sheet? There is no suggestion that the buyer committed a tort in the preparation of the Adjusted Closing Balance Sheet, even though the term "malicious" has a tort-like flavor.[5]

If, on the other hand, the Independent Accountant determines that the Adjusted Closing Balance Sheet was prepared in good faith, is the court bound by that determination for purposes of invoking the implied covenant? The court suggests that it is. After all, the test for determining express good faith by the Independent

Accountant was whether the adjustment was so extreme as to indicate a lack of good faith, and the test for maliciousness is similarly the extreme nature of the adjustment.

There are many questions left unanswered by the possible existence of an implied covenant that serves as a means of testing a party's intent in breaching a contract's express terms. There is undoubtedly more to come.

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1 N.Y.C. Bar Report by Comm. on Int'l Commercial Disputes, *Purchase Price Adjustment Clauses and Expert Determinations: Legal Issues, Practical Problems and Suggested Improvements*, at 2 (June, 2013).

2 *See* Glenn West, *Contractually Designating a Valuation Expert as the Binding Decision Maker Means Just That, Even if the Expert Turns Out to be Wrong*, Weil's Global Private Equity Watch, January 6, 2016. The binding effect of an expert determination appears limited, however, to factual determinations, not legal determinations. Thus, according to a recent Delaware Supreme Court decision, *Terrell v. Kiromic Biopharma, Inc.*, 297 A.3d 610 (Del. 2023), where an expert has been granted the right to interpret legal documents, those legal determinations, unlike in the case of an arbitration decision, are subject to a de novo review by a court.

3 Glenn West & Miae Woo, *The Zebra versus Striped Horse Phenomenon Rears its Head Again—Distinguishing an Expert Determination from an Arbitration*, Weil's Global Private Equity Watch, February 13, 2019; Glenn West, *Post-Closing Purchase Price Adjustment Mechanics—Distinguishing Expert Determinations from Arbitrations*, Weil's Global Private Equity Watch, August 6, 2018, both quoting Steven H. Reisberg, What is Expert Determination? *The Secret Alternative to Arbitration*, N.Y.L.J., Vol. 250, No. 115 (Dec. 13, 2013).

4 *See* Glenn West, *Musings on the Exercise of "Sole Discretion,"* Weil Global Private Equity Watch, August 29, 2022.

5 Purchase Price Adjustment mechanics have not been immune from claims of fraud. See Roma Landmark Theaters, LLC v. Cohen Exhibition Company LLC, 2020 WL 58165759 (Del. Ch. Sept. 30, 2020), *discussed* in Glenn West, *The Latest Effort to Use Fraud to Overcome a No-Indemnity Deal—The Target's Preparation of the Preliminary Closing Statement*, Weil Insights, Weil's Global Private Equity Watch, October 14, 2020.

NON-COMPETE BAN STILL ON SIDELINES IN NEW YORK

2023 was another busy year for legislators looking to ban non-competes following the FTC's proposed rules. The New York legislature passed a bill banning most non-compete agreements (with few exceptions), and submitted it to Governor Hochul to sign into law. The bill would have made enforcement of executive-level non-competes (common practice in PE portfolio companies) difficult. Governor Hochul's stated desire is for a law to protect middle class and lower-wage workers, not a broad prohibition, so on December 22, 2023, Governor Hochul vetoed the bill. We expect some form of the bill will re-emerge with a narrower focus and we will continue contributing to the legislative dialogue and inform clients with the latest developments.

INDEMNIFICATION 101: WITHOUT A LOSS THERE IS NO CLAIM

Glenn D. West
Retired Partner
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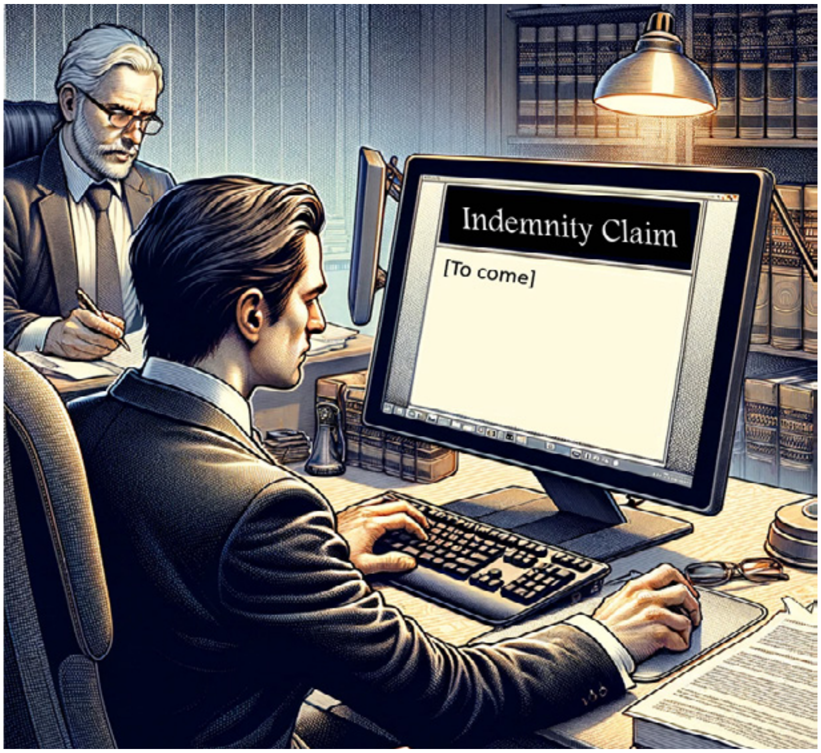
In the context of an indemnification regime in a private company acquisition agreement, a "placeholder claim" is a purported notice of a claim made prior to the expiration of the "survival period" based upon the existence of a "potential" loss that might arise in the future. But, as illustrated by a recent Delaware Superior Court decision, *NSI-MI Holdings, LLC v. Ametek, Inc.*, 2023 WL 7482590 (Del. Super. Ct. Nov. 13, 2023), the language used in many indemnification provisions, or in the attendant escrow agreements, do not permit placeholder claims to be used as a means of effectively extending the survival period when no indemnifiable loss has actually been incurred as of the expiration of the survival period.

Ametek involved a post-closing dispute over the acquisition by Ametek, Inc. of all of the membership interests in NSI-MI Technologies, LLC from its owner NSI-MI Holdings, LLC. The membership interest purchase agreement (the "MIPA") required the seller, NSI-MI Holdings, to indemnify Ametek, Inc. "from and against any and all Losses incurred or sustained by, or imposed upon, [Ametek or is affiliates] upon arising out of, with respect to or by reason of …(g) the Raytheon Matter." The "Raytheon Matter" was defined in the Disclosure Schedules as a contractual dispute that had arisen between Raytheon and NSI-MI Technologies and which had resulted in Raytheon delivering a Default and Reservation of Rights Letter to NSI-MI Technologies approximately six months prior to the date the MIPA was signed. For reasons known only to the parties who negotiated the MIPA, the indemnification obligation respecting the Raytheon Matter had a survival period that extended for six years after the closing date, but the escrow agreement that was executed to govern the disposition of the funds that were ear-marked to pay any such indemnification obligation had a termination date of only 15 months after the closing.

As the 15-month termination date set forth in the escrow agreement was coming to an end, Ametek, Inc. submitted a claims notice regarding the Raytheon Matter insisting that the escrow agent continue to withhold the escrowed funds based on the still unresolved Raytheon Matter. But the



seller objected on the basis that the purported claims notice was ineffective because Ametek, Inc. had not actually incurred any Loss related to the Raytheon Matter as of the end of the 15-month escrow period notwithstanding that the possibility of such a Loss remained. In other words, even though Losses related to the Raytheon Matter remained a real possibility and negotiations regarding that matter were continuing, no actual Loss had occurred as of the date the purported claims notice was issued and the 15-month escrow period was now ended. According to the Delaware Superior Court:

> *The Court finds the MIPA clear—there must be a statement of an already-extant owing to another by AMETEK for a reimbursable or compensable loss to be a valid indemnity claim and a trigger of encumbrance of escrow funds via Section 5 of the Escrow Agreement.*
>
> *. . .*
>
> *The mere possibility of a "Loss" does not create a valid indemnity claim. In Raytheon's Reservation of Rights, Raytheon expressly reserved "all rights and remedies available," including "Raytheon's right to collect and recover all costs or other damages it may incur." Despite its reservations, Raytheon has not initiated any actions against AMETEK. Raytheon's Reservation of Rights, without more, is not a reimbursable or compensable "Loss."*

"So depending on whether you are on the sell-side or the buy-side, and there is still some kind of indemnify or escrow involved, you may just want to review your forms and make sure these issues are appropriately addressed."

Accordingly, the court ordered the escrow agent to release the funds to the seller. Whether those funds or others will be available to pay any indemnity obligation for any Loss that may actually be incurred by Ametek, Inc., within the remaining six year term of the actual indemnity agreement, is anyone's guess. But the escrowed funds are no longer being held for that purpose.

While the unusual situation where the survival period for the indemnification obligation does not match up with the termination date of the escrow agreement may seem sui generis, the issue of "potential claims" not constituting actual claims for purposes of indemnification regimes and their survival periods comes up in a lot of differing contexts. For example, in a typical situation involving an indemnification obligation for any "breach of any representation and warranty made by the seller," what happens when a third party claim is made just prior to the expiration of the survival period, which, if true, would constitute a breach of a representation and warranty made by the seller, but the truth of the third party claim is yet to be determined. Has a breach actually occurred within the survival period so a valid claims notice can be issued? And what losses have been incurred upon which to base that claim in any event. Can you submit the claim based on the possibility of future losses? We have addressed these issues in prior Weil Private Equity Blog posts, *How a 12 Month Survival Period Can Become A Lot Longer (or Not)—the Required Notice of Claim* and *Making Sure Your Survival Periods Actually Work as Intended*; and there is an excellent Hotshot Video detailing the drafting issues involved in the "if true" scenario. So depending on whether you are on the sell-side or the buy-side, and there is still some kind of indemnify or escrow involved, you may just want to review your forms and make sure these issues are appropriately addressed.

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RECENT HIGHLIGHTS

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

- Weil advised American Securities in connection with its $1.9 billion sale of Paragon Medical to AMETEK, Inc.
- Weil advised GHK Capital Partners LP in connection with its acquisition of JohnsByrne Company
- Weil advised Goldman Sachs Asset Management in connection with its $1 billion investment in World Insurance Associates LLC
- Weil advised Greater Sum Ventures in connection with its majority investment in Utility Associates, Inc.
- Weil advised PAI Partners in connection with its buyout, for more than $1 billion, of Alphia, Inc.
- Weil advised PSG and its portfolio company mPulse in connection with the acquisition of HealthTrio and Decision Point Healthcare Solutions
- Weil advised TPG Inc. in connection with its $2.7 billion acquisition of Angelo, Gordon & Co., L.P.
- Weil advised TruArc Partners in connection with its acquisition of Watchtower Security, LLC

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