



FALL - 2015

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## The Crackdown on Private Equity Conflicts of Interest Regarding Fee and Expense Allocation: Proactive Steps That Sponsors Can Take

By **John McDonald, Michael Weinsier, James Kaplan, John Owen Gwathmey, Coby Beck, Andrea Farley, Olivia Lee, Paul Steffens and Alec Watson**

Private equity sponsors are coming under fire on multiple fronts from allegations of conflicts of interest, primarily focused on fee and expense allocation practices. This article briefly summarizes those conflicts of interest and provides some proactive steps that private equity sponsors can take to help address them.

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## Optimal Ruling for Equity Investors in Optim Energy Chapter 11 Case

By **Hollace Cohen**

In the Optim Energy, LLC chapter 11 case a creditor of the debtor brought a motion seeking standing to sue the equity investors of a debtor affiliate for breach of fiduciary duty and recharacterization or equitable subordination of the equity investors' secured claims and liens arising from the equity investors' guaranty of the affiliate's debt. The decision of the Bankruptcy Court for the District of Delaware denying the standing motion and the affirmance of that decision by the District Court on appeal provide an important and instructive precedent as to the circumstances under which an equity investor may owe no fiduciary duty and the claims and liens of the equity investor may not be

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recharacterized or equitably subordinated.

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## Pre-IPO Investments Made in Hong Kong with Private Equity Funds

By [Rossana Chu](#) and [Emmy Lo](#)

Apart from disclosure, pre-IPO investments made in Hong Kong are subject to the overriding principle that “all holders of listed securities must be treated fairly and equally”. Before listing, pre-IPO investors must demonstrate that they have assumed genuine investment risks. After listing, they cannot continue to enjoy those rights which do not extend to all other shareholders.

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## Recent SEC Whistleblower Award To Compliance Officer And DOJ’s Hiring Of First Compliance Counsel Raise The Bar For Corporate Corrective Measures And Corporate Compliance Programs

By [Sharie Brown](#)

When the U.S. Securities and Exchange Commission (SEC) gives a compliance officer a \$1.5 million whistleblower award for providing information about illegal conduct that went unaddressed by the compliance officer’s employer when first reported internally, every firm and company should take steps to ensure that senior management and the board of directors are taking appropriate corrective measures in response to internal reports of corporate misconduct. The Department of Justice (DOJ) may still decide to prosecute your company (as well as the offending employee) if DOJ’s new Compliance Counsel reviews your corporate compliance program, and determines that the procedures are inadequate and not reasonably designed to prevent, detect, and punish the corporate misconduct being investigated by DOJ. This article shares details about new ways for companies to avoid a negative fate with the SEC and DOJ before and during a government investigation.

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## Healthcare IT Investments – The Risks You Should Be Considering

By [Erin Whaley](#)

Investments in health information technology companies present new and substantial risks that deserve special attention. To help mitigate these risks, we offer several suggestions to supplement an investor’s traditional diligence process.

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## CORPORATE

## The Crackdown on Private Equity Conflicts of Interest Regarding Fee and Expense Allocation: Proactive Steps That Sponsors Can Take

By John McDonald, Michael Weinsier, James Kaplan, John Owen Gwathmey, Coby Beck, Andrea Farley, Olivia Lee, Paul Steffens and Alec Watson

Private equity sponsors are coming under fire on multiple fronts from allegations of conflicts of interest, primarily focused on fee and expense allocation practices. This article briefly summarizes those conflicts of interest and provides some proactive steps that private equity sponsors can take to help address them.

### *The Most Recent Allegations*

In June 2015, private equity sponsor Kohlberg, Kravis, Roberts & Co. (KKR) agreed to pay nearly \$30 million to settle SEC charges that it misallocated approximately \$17 million in broken-deal expenses to its flagship private equity funds (in which its LPs invested), rather than to co-invest vehicles through which KKR management members and other favored parties invested.[1] In July 2015, a coalition of state treasurers managing pension funds that are substantial LP investors in private equity funds submitted a letter to the SEC in which they called on the SEC to require private equity sponsors to provide greater transparency into asset valuations, profits reporting, waterfall distribution calculations and other issues.[2] A well-publicized June 2015 article in the *New York Times* entitled “When Private Equity Firms Give Retirees the Short End” used populist tones in alleging improprieties by private equity firms at the expense of firefighters, police officers, teachers and others whose retirement funds are invested in private equity funds. Those alleged improprieties included private equity sponsors receiving discounts on attorneys’ and accountants’ fees for fund formation and other work performed for, and borne by, the sponsors and their affiliates, while attorneys’ and accountants’ fees for acquisition and divestiture work, which were borne by the funds’ LP investors, were billed at either “full freight” or “premium” rates. The allegations were based on disclosures in SEC filings made by private equity sponsors Carlyle Investment Management and the Blackstone Group.[3]

### *SEC Officials’ Speeches About Private Equity Conflicts of Interest*

Those actions came on the heels of a series of speeches by senior SEC officials in which those officials alleged improprieties by private equity sponsors relating to undisclosed and misallocated fees and expenses and warned that SEC enforcement actions would result from those improprieties. In May 2014, Andrew Bowden, who was then the Director of the SEC’s Office of Compliance Inspections and Examinations (OCIE), gave what has since become known as the “Sunshine Speech,” in which he noted that over 50% of OCIE compliance inspections of private equity sponsors identified violations of law or material weaknesses in controls, principally relating to collection of fees and allocation

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of expenses.[4] Bowden expressed concern over the use by private equity sponsors of affiliated “operating partners,” who provide advice to portfolio companies, but whose fees are not (in his view) adequately disclosed to LP investors or offset against the sponsor’s management fees. He also expressed concern with monitoring fees whose durations exceed the holding period of the portfolio company investment and accelerate upon sale of the portfolio company. Finally, Bowden expressed concern about misleading statements made by sponsors in connection with their marketing and fundraising processes, including using interim valuations for portfolio companies calculated using methodologies that are different from those described in materials provided to LP investors, are “marked-up” from those used by the sponsors in their internal management processes, exclude the impact of fees assessed on internal rates of return, reflect “cherry picking” of comparables, improperly add-back items to EBITDA, or change from period to period (e.g., from trailing to forward) without disclosure of the change.



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Most recently, in May 2015, Marc Wyatt, the Acting Director of the OCIE, gave a speech further building on the Sunshine Speech, in which he noted that the OCIE had conducted inspections of more than 150 private equity sponsors, focusing principally on collection of fees, allocation of expenses, marketing practices and portfolio company valuation methodologies, which he said revealed numerous issues. Citing “expense shifting” and “hidden fees” as being among the most problematic of those issues, Wyatt asserted that private equity sponsors have “an affirmative duty to fully and fairly describe ‘the deal’ to investors, including discussing in a meaningful way how expenses will be assessed and fees will be collected.” Rebutting the assertion by some in the private equity industry that sophisticated LP investors were already aware of these expense allocation and fees assessment practices and did not have an issue with them, Wyatt observed that, since the Sunshine Speech, LP investors have increasingly focused on fee and expense issues. He further noted that private equity sponsors have already started to revise their practices in this area, which he viewed as a “positive change.” However, Wyatt also noted his view that private equity sponsors “still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty.”[5]



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### ***Proactive Steps that Private Equity Sponsors Can Take***

So what can private equity sponsors do to help protect themselves from SEC compliance inspection deficiency assessments and the SEC enforcement actions that may follow? Fortunately, the SEC speeches described above provide a roadmap of some “good” practices that private equity sponsors can implement, and some “bad” practices that they can avoid, relating to conflict of interest issues.

On the “good practices to implement” side, private equity sponsors can do the following:

- Provide more robust disclosure of fee assessment and expense allocation practices in the private placement memorandums for their funds, including use by portfolio companies of “shared services” arrangements organized by sponsors.
- Empower their funds’ limited partner advisory committees (LPACs) by providing them with meaningful disclosure of important aspects of fund operations, including fee assessment and expense allocation practices, and consider giving their LPACs approval rights concerning matters that may involve a conflict of interest between the fund and the sponsor.
- Retain an independent third party advisor to evaluate and provide recommendations concerning fee assessment and expense allocation practices between the fund and the sponsor.
- Devote increased resources to developing “world class” compliance operations, consistent with those of registered mutual funds (which seem to be the benchmark used by the SEC when evaluating private equity sponsors’ compliance departments), including splitting the Chief Compliance Officer function from the General Counsel and Chief Financial Officer functions and better integrating the Chief Compliance Officer into the everyday operations of the fund.



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- Provide clear disclosure in their funds' private placement memoranda concerning payment by portfolio companies of fees to "operating partners" and consider including such fees within the scope of the management fee offset.
- Either clearly describe in their funds' private placement memoranda how monitoring fees are calculated based on an assumed term of "x" years, which is accelerated upon sale of the portfolio company, or consider matching monitoring fee terms to the duration of the portfolio company investments and thereby eliminating acceleration of monitoring fees upon sale of portfolio companies.

On the "bad practices to avoid" side, private equity sponsors can do the following:

- Avoid allocations of broken-deal and other expenses that don't result in the "main" fund and any co-investment vehicles bearing such expenses on a *pro rata* basis.
- Avoid billing practices with fund attorneys and accountants in which billing discounts (and premium billing arrangements) do not apply equally to expenses borne by the sponsor and its affiliates, on the one hand, and those borne by the fund's LP investors (either directly or through portfolio companies), on the other hand.
- Either avoid non-*pro rata* allocation of co-investment opportunities among LP investors or clearly describe in their funds' private placement memoranda how co-investment opportunities may be allocated to certain LP investors based on financial or non-financial criteria, including the amount of the LP's investment in the fund and particular relationships, goodwill, access to investment opportunities and unique institutional, industry or market knowledge that the LP may be able to provide to the fund, which may enhance the sourcing and execution of certain portfolio company investments.

### Conclusion

While these are not exhaustive lists, private equity sponsors that take the above actions can help avoid some of the more common mistakes that SEC compliance inspectors and enforcement attorneys may cite in assessing compliance deficiencies and commencing enforcement actions against their funds. Please don't hesitate to contact the authors of this article with any questions concerning the matters discussed above.

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1. See *SEC Charges KKR With Misallocating Broken Deal Expenses*, SEC Press Release, June 29, 2015, available at: <http://www.sec.gov/news/pressrelease/2015-131.html>.

2. See *State Treasurers to call on SEC to push for more PE transparency*, PE Hub, July 21, 2015, available at: <https://www.pehub.com/2015/07/exclusive-state-treasurers-to-call-on-sec-to-push-for-more-pe-transparency/>.

3. See *When Private Equity Firms Give Retirees the Short End*, Gretchen Morgensen, The New York Times, June 13, 2015, available at: <http://www.nytimes.com/2015/06/14/business/retirement/when-private-equity-firms-give-retirees-the-short-end.html>.

4. See *Spreading Sunshine in Private Equity*, Private Equity International - Private Fund Compliance Forum 2014, Andrew Bowden, May 6, 2014, available at: <http://www.sec.gov/news/speech/2014--spch05062014ab.html>.

5. See *Private Equity: A Look Back and a Glimpse Ahead*, Private Equity International - Private Fund Compliance Forum 2015, Marc Wyatt, May 13, 2015, available at: <http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html>.



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## ENERGY

## Optimal Ruling for Equity Investors in Optim Energy Chapter 11 Case

By **Hollace Cohen**

In *In re Optim Energy, LLC, et al.*,<sup>1</sup> the Optim Debtors' single largest unsecured creditor, brought a motion for derivative standing (the "Standing Motion") to sue ECJV Holdings, Inc. ("ECJV"), its 100% equity owner, and ECJV's parent, Cascade Investments, LLC ("Cascade"),<sup>2</sup> for breach of fiduciary duty and recharacterization or equitable subordination of their secured claims arising from their guarantee of a loan made by Wells Fargo Bank NA ("Wells Fargo") to Optim. The decision of the Bankruptcy Court for the District of Delaware denying the Standing Motion for failure of the creditor to state a "colorable claim"<sup>3</sup>, and the affirmance of the decision by the District Court for the District of Delaware on appeal, provide an important and instructive precedent for any equity investor who guarantees an affiliate's credit facility debt and later faces a challenge of its resulting secured claims in the bankruptcy case of its affiliate.

### Background

Optim Energy, LLC ("Optim") and seven affiliated debtors (collectively, the "Optim Debtors") filed for proceedings under chapter 11 of the Bankruptcy Code in February 2014. Optim was a co-venture formed by Cascade through its wholly owned subsidiary ECJV and PNM Resources, Inc. ("PNMR") in January 2007 for the purpose of entering the deregulated Texas electricity market. PNMR contributed an existing power plant and Cascade/ECJV contributed cash resulting in each holding a 50% interest in Optim. To provide funds for acquisitions and operations, Optim entered into a five-year unsecured credit facility with Wells Fargo in the initial amount of \$1 billion, which was later increased to \$1.25 billion and extended as to maturity. As a condition to the loan, Wells Fargo required that Cascade and ECJV guaranty the loan. On the same day that Cascade and ECJV (collectively, the "Guarantors") each signed a continuing guarantee (collectively, the "Guarantees") they entered into a Guaranty Reimbursement Agreement with Optim whereby Optim agreed to pay Cascade and ECJV within 30 days of notice that the Guarantors had paid under the Guarantees (the "Reimbursement Obligations").<sup>4</sup> To secure the Reimbursement Obligations, Optim entered into a Pledge and Security Agreement through which Cascade and ECJV were granted liens and security interests in substantially all of the assets of the Optim Debtors. Several years later, ECJV made additional capital contributions to Optim which reduced and ultimately extinguished PNMR's interest in January 2012.

Immediately prior to the Optim chapter 11 filing, Cascade and ECJV deposited funds with Wells Fargo and upon the filing of the chapter 11 proceeding (which constituted an event of default under the Guarantees), the Guarantors paid off the more than \$700 million indebtedness outstanding under the Wells Fargo loan which resulted in Cascade holding a claim in that amount secured by substantially all of the assets of the Optim Debtors.

After entry of an order that approved debtor-in-possession financing provided to Optim by Cascade and ECJV, Walnut Creek Mining Company ("Walnut Creek"), the largest unsecured creditor, filed the Standing Motion alleging that Cascade and ECJV had devised a scheme whereby they would transform their equity position into that of senior secured lenders. The Bankruptcy Court considered each of the allegations asserted by Walnut Creek as the basis for the causes of action for recharacterization, equitable subordination and breach of fiduciary duty and determined that Walnut Creek had failed to state "colorable claims",<sup>5</sup> and accordingly, denied the Standing Motion.<sup>6</sup>

### No Breach of Fiduciary Duty

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The Bankruptcy Court first considered the claims of breach of fiduciary duty by ECJV and of aiding and abetting breach of fiduciary duty by Cascade. The Bankruptcy Court easily disposed of these proposed causes of action by noting that Optim's amended limited liability operating agreement expressly provided that no fiduciary duties were owed by its members, as permitted by 6 Del. Code § 18-1101(c).<sup>7</sup>

### **No Basis for Recharacterization**

Walnut Creek made various allegations in support of recharacterization of Cascade's and ECJV's secured claims as equity, including that: (i) the Debtors were inadequately capitalized at the time they entered into the guarantee agreements; (ii) Cascade and ECJV guaranteed the Wells Fargo Credit Facility when no prudent, *bona fide* lender would do so; and (iii) the [Optim] Debtors granted Cascade and ECJV security interests at a time that they did not owe any debt to Cascade or ECJV.<sup>8</sup> The Bankruptcy Court considered each of the allegations and concluded that "the transactions and financial arrangements that gave rise to Cascade and ECJV's secured claims were structured and intended as debt obligations and are not susceptible to being recharacterized as equity transactions."<sup>9</sup>

Notably, as to the alleged inadequate capitalization, the Bankruptcy Court held that "courts should not put too much emphasis on inadequate capitalization because all companies in bankruptcy are in some sense undercapitalized".<sup>10</sup> The Bankruptcy Court found the age of the transaction significant in that the Guarantees and Guaranty Reimbursement Agreement were part of the Optim Debtors' financial structure from the outset of the loan transaction and were in place for seven years before the Optim Debtors filed for bankruptcy. Moreover, the Court noted that no new equity or expanded ownership rights were provided with the Guarantees and if the Guarantees were intended as equity, then ECJV's contribution would have been \$1 billion more than PNMR's contribution and its equity interest in Optim would have reflected that fact.<sup>11</sup> The Bankruptcy Court also found no merit in the allegation that no prudent *bona fide* lender would have guaranteed the Debtors' obligations and noted that the fact that the lender required the insiders to guaranty the loan is not proof of undercapitalization.<sup>12</sup> In addition, the loan was not only contingent upon the Guarantees but also the grant of liens and security interests to secure the Reimbursement Obligations.<sup>13</sup>

### **No Basis for Equitable Subordination**

The Bankruptcy Court looked to cases that acknowledge that equitable subordination is a "drastic" and "unusual" remedy that requires a finding of (1) inequitable conduct; (2) the misconduct must have caused harm to creditors or conferred an unfair advantage on the claimant; and (3) equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code.<sup>14</sup> While acknowledging that an insider's conduct is rigorously scrutinized, the Court noted that the plaintiff has the burden of proving the unfair conduct.<sup>15</sup> No such proof was made and therefore no colorable claim for equitable subordination was alleged.

### **The District Court's Affirmance**

Walnut Creek appealed from the Bankruptcy Court's decision and maintained that the court had erred in determining that Walnut Creek lacked standing to bring its causes of action for recharacterization and equitable subordination. The District Court observed that "[t]he focus of the recharacterization inquiry is whether a debt actually exists..." and "the determinative inquiry in classifying advances as debt or equity is the intent of the parties as it existed at the time of the transaction."<sup>16</sup>

The District Court held that the allegation that the Debtor was inadequately capitalized at the time of the Wells Fargo loan transaction was insufficient to state a claim for recharacterization since "the fact that a party lends to an inadequately capitalized company does not necessarily imply that it intends to infuse the company with capital; instead, it may have a pre-existing interest in the borrower it is trying to protect."<sup>17</sup> The District Court considered the allegation that no prudent lender would have guaranteed the Debtors' obligations and found persuasive that the Wells Fargo loan required Cascade to enter into the Guaranty and concluded even if it were imprudent to enter into the Guaranty that does not bear on Cascade's intent with respect to entering into the Guaranty Reimbursement Agreement.

As for equitable subordination, the District Court agreed with the analysis of the Bankruptcy Court that there was no proof of wrongful conduct in the performance of Cascade and ECJV under the terms of the Guarantees, which had been in existence for almost seven years. The allegations that the “Cascade-Appellees strategically designed the Cascade investments so that their own investments would be secured and senior to the trade creditors...” did not convince the District Court that the Bankruptcy Court was incorrect in its determination, since “[o]btaining a security interest—without more—is not inequitable conduct.”<sup>18</sup> The District Court pointed out that this was not a case where corporate insiders seeking an advantage over other creditors converted their equity to secured debt.<sup>19</sup> The District Court held that “[i]t is not inequitable for a lender, even an insider lender, to obtain a lien on the borrower’s assets in order to secure its position above other creditors in the event of the borrower’s default.”<sup>20</sup> The District Court noted that there was no allegation that Cascade achieved its secured position through illegitimate means, or control of the Debtor, or used Optim as an alter ego and held that obtaining a superior position as a result of the June 1, 2007 loan transaction did not in itself constitute inequitable conduct.<sup>21</sup>

### Practice Pointers

The District Court’s decision confirms that insiders may obtain claims that have priority over the claims of unsecured creditors where there has been no inequitable conduct on the insiders’ part in achieving that result. Both the Bankruptcy Court and District Court decisions provide an instructive analysis of the circumstances under which debt held by an insider cannot be recharacterized or equitably subordinated. They also suggest that if the affiliated entity is a Delaware limited liability company, it may be helpful to insiders for the operating agreement to provide that the members and directors of the limited liability company have no fiduciary duties.

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1 2014 Bankr. LEXIS 2155 (Bankr. Del. May 13, 2014); *aff’d* by the District Court for the District of Delaware in an unpublished memorandum decision, Civ. No. 14–718–LPS (D. Del. March 13, 2015) (Document 29) (the “Memorandum Decision”).

2 ECJV was a wholly-owned subsidiary of Cascade.

3 2014 Bankr. Lexis 2155 at \*36. The other requirements are (1) that the debtor has unjustifiably refused to pursue the claim or to consent to the moving party’s pursuit of the claim and (2) the moving party has received leave to sue from the bankruptcy court. 2014 Bankr. Lexis 2155 at \*17, citing, Official Committee of Unsecured Creditors of Cybergenics v. Chinery, 330 F.3d 548 (3d Cir. 2003).

4 The Guaranty Reimbursement Agreement also stated “the Debtors’ Reimbursement Obligations constitute indebtedness of the Debtors and shall not, in any event, constitute or be treated as equity or capital contribution by the Guarantors.” 2014 Bankr. Lexis 2155 at \*10.

5 The Bankruptcy Court stated that “In deciding whether there is a colorable claim, the court should undertake the same analysis as when a defendant moves to dismiss a complaint for failure to state a claim.” (citing, *In re Centaur, LLC*, 2010 Bankr. Lexis 3918, 2010 WL 4624910, at \*4 (Bankr. D. Del. Nov. 5, 2010), 2014 Bankr. Lexis 2155 at \*17-18.

6 2014 Bankr. Lexis 2155 at \*36.

7 2014 Bankr. Lexis 2155 at \*20.

8 2014 Bankr. Lexis 2155 at \*21-22.

9 2014 Bankr. Lexis 2155 at \* 22.

10 Citing, *In re BH S & B Holdings, LLC*, 420 BR 112, 159 (Bankr. S.D.N.Y. 2009) *aff’d* as modified, 807 F. Supp. 2d 199 (S.D.N.Y. 2011), 2014 Bankr. Lexis 2155 at \*23.

11 2014 Bankr. Lexis 2155 at \*25-26.

12 2014 Bankr. Lexis 2155 at \*27.

13 2014 Bankr. Lexis 2155 at \*27.

- 14 2014 Bankr. Lexis 2155 at \*32.
- 15 2014 Bankr. Lexis 2155 at \*33.
- 16 Memorandum Decision at page 6, citing, In re SubMicron Sys. Corp., 432 F.3d 448,455- 457 (3rd Cir. 2006).
- 17 Memorandum Decision at page 7.
- 18 Memorandum Decision at page 11, citing, United States v. State St. Bank and Trust Co., 520 B.R. 29, 84 (Bankr. D. Del. 2014).
- 19 Memorandum Decision at pages 11-12.
- 20 Memorandum Decision at page 12, citing, State St. Bank, 520 B.R. at 84.
- 21 Memorandum Decision at page 13.

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**Hollace Cohen** has practiced in the bankruptcy and corporate reorganization areas for over 35 years representing creditors' committees, bondholders, indenture trustees, debtors, debtor-in-possession financiers, secured and unsecured debtholders, lessors and trade creditors in numerous proceedings under the Bankruptcy Act and Bankruptcy Code. She has extensive experience in representing debtors, indenture trustees, and bondholders in out-of-court restructurings and prepackaged plans. Hollace is listed on the register of mediators maintained by the Bankruptcy Court for the Southern District of New York.

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## FINANCE

## Pre-IPO Investments Made in Hong Kong with Private Equity Funds

By [Rossana Chu](#) and [Emmy Lo](#)

### How common are pre-IPO investments in Hong Kong

Out of the 122 initial public offerings (IPOs)[1] conducted on the Hong Kong Stock Exchange in 2014, there were 31 companies with pre-IPO investments by private equity or venture capital funds. Hong Kong Pre-IPO investments are often made in the form of convertible instruments, such as convertible or exchangeable bonds, but some PE funds invest in ordinary or preference shares.

### General requirements in Hong Kong

Apart from disclosure, pre-IPO investments made in Hong Kong are subject to the overriding principle that “all holders of listed securities must be treated fairly and equally”. Before listing, pre-IPO investors must demonstrate that they have assumed genuine investment risks. After listing, they cannot continue to enjoy those rights which do not extend to all other shareholders.

The Hong Kong Stock Exchange published three guidance letters HKEx-GL-29-12, HKEx-GL43-12 and HKEx-GL44-12 that set out its current practices in vetting pre-IPO investments, which are summarized below.

**The 28-day/180-day requirement** – Pre-IPO investments must be completed either (a) at least 28 clear days before the date of the listing application is submitted or (b) 180 clear days before the listing date. Pre-IPO investments are considered completed when the funds are irrevocably settled and received by the listing applicant. The Hong Kong regulators consider that if the pre-IPO investment is made when the IPO is a near certainty, the investor is not taking any risk different from that taken by the IPO investors and thus protections under the pre-IPO investment cannot be justified.

**Price adjustments** – Any price adjustment provision, such as a guaranteed discount to the IPO price or an adjustment linked to the market capitalization of the listing applicant, is disallowed if such adjustment effectively creates two different prices for the same securities for pre-IPO investors and other shareholders at the time of listing, which is inconsistent with the fairness principle. Similarly, any conversion price reset in convertible instruments should be removed before listing, because the conversion price should be a fixed dollar amount or at the IPO price.

**Put or exit options** – All put or exit options grant to pre-IPO investors to put back the investments to the listing applicant or its controlling shareholder are not allowed. Regulators only allow a put or exit option applicable to the case when listing does not take place.

**Director / senior management nomination rights** – A pre-IPO investor may nominate or appoint a director before listing, but such right should not survive after listing. While rights to nominate senior management are allowed, such appointment is subject to the decision of the listing applicant’s board of directors, which is not obligated to approve the pre-IPO investor’s nominations without exercising its own judgment.

**Veto rights** – Any contractual right given to pre-IPO investors to veto the listing applicant’s major corporate actions, such as passing a resolution to wind up the company, should be terminated upon listing.

**Anti-dilution rights** – Pre-IPO investors can exercise anti-dilution rights at the

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time of the IPO only if (a) it is necessary to give effect to the pre-existing contractual rights pre-agreed, (b) full disclosures are made in the prospectus and the allotment results announcement, and (c) the subscription will be made at the IPO price. However, such right should be terminated upon listing.

**Profit guarantee** – A profit guarantee is allowed only if the compensation is settled by a shareholder (rather than the listing applicant) and is not linked to the market price or capitalization of the shares.

**Negative pledges** – Such pledges should be terminated upon listing unless they are widely accepted provisions in loan agreements, are not egregious and do not contravene the above-mentioned fairness principle. Widely accepted provisions include the listing applicant's pledges not to create any mortgage, charge or other security interest on its assets and a controlling shareholder's pledges not to dispose of its interest in the applicant over a period of time.

**Prior consent for corporate actions** – These terms are generally required to be terminated upon listing.

**Information rights** – Such right can only survive after listing if the information is made available to the general public at the same time.

**Right of first refusal and tag-along rights** – A right of first refusal obtained from the listing applicant's controlling shareholder (i.e. the shareholder must offer to sell its shares to the pre-IPO investor at the same price and on the same terms as a proposed sale to a third party) and a tag-along right (i.e. if the pre-IPO investor does not purchase the controlling shareholder's shares, it may include its own shares for sale together) are allowed to survive after listing.

**Partial conversions** - Partial conversion of the convertible instruments to retain special rights after listing is not allowed. Partial conversion is only allowed if all atypical special rights are terminated upon listing.

**Redemptions and early redemptions** – Early redemption at a price enabling the holders to receive a fixed internal rate of return (IRR) on the principal amount of a convertible instrument is allowed. Upon maturity, all outstanding convertible instruments will be payable at a price including the same fixed IRR. The Hong Kong regulators consider the IRR on redemption as compensation for the investment risk undertaken by the pre-IPO investors and therefore allow such redemption provisions to survive the listing.

If a pre-IPO investment does not follow the guidance letters, the Hong Kong Stock Exchange will require the listing applicant to amend the terms of the pre-IPO investment and follow the 180-Day requirement or unwind the pre-IPO investment.

## **Common lock-up requests**

Pre-IPO investors are usually requested by the applicant and/or the underwriters to lock-up the shares they obtained from the IPO for a period of six months or more after the listing date.

If you have any questions on the above, please contact the authors in our Hong Kong office.

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*[1] Listing in Hong Kong Bi-Monthly Newsletter Issue No. 4 published by the Hong Kong Exchanges and Clearing Limited*

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FALL - 2015

## GOVERNMENT REGULATORY

## Recent SEC Whistleblower Award To Compliance Officer And DOJ's Hiring Of First Compliance Counsel Raise The Bar For Corporate Corrective Measures And Corporate Compliance Programs

By [Sharie Brown](#)

### ***Compliance officer receives \$1.5 Million whistleblower award from the SEC***

When the Securities and Exchange Commission ("SEC" or "Commission") announced a whistleblower award of close to \$1.5 million to a compliance officer who voluntarily provided "original information" to the Commission that led to the successful enforcement of an action against the compliance officer's company, other corporate compliance officers had little reason to celebrate. See *Whistleblower Award Proceeding*, Exchange Act Release No. 74781, 2015 SEC LEXIS 1489 (April 22, 2015). SEC whistleblower awards for a violation of securities laws, including the U.S. Foreign Corrupt Practices Act ("FCPA"), can range from 10 percent to 30 percent of a financial award collected in an enforcement action if the financial award collected using information from the whistleblower exceeds \$1 million. The SEC is also required to protect the confidentiality of the whistleblower award recipient. Thus, in this action, the whistleblower was not named, the nature of the company's violation was not described, and the offending company was not named. Nonetheless, several compliance officers and corporate general counsels privately expressed concern that the trust bond that ideally ought to exist between compliance officers and their corporate business leaders could be threatened by such whistleblower awards to a compliance officer.

Corporate compliance officers believe that they should be invited to operational business meetings and included in advance planning for new projects, new market entries, new business partnerships, and strategic acquisitions, so that they can timely identify and help address possible compliance issues associated with the company's activities. However, some compliance officers and general counsels fear that business managers will not want to share certain important business information if the business managers view the compliance officer as a "cop" to be avoided because they are primarily incentivized to receive a large whistleblower award; not in helping the business manager and the company achieve their business goals using compliance tools that enable the company to conduct its business lawfully in challenging global environments.

Under Rule 21F-4(b)(1), in order for a whistleblower submission to be considered original information provided to the SEC, it must, among other requirements, be derived from the whistleblower's independent knowledge or independent analysis. See 17 C.F.R. § 240.21F-4(b)(1). The general rule is that the SEC will not consider information to be derived from a whistleblower's independent knowledge or independent analysis if the whistleblower obtained the information because the whistleblower was an employee whose principal duties involve compliance or internal audit responsibilities. See 17 C.F.R. § 21F-4(b)(4)(iii)(B).

However, here the SEC ordered the award under Rule 21F-4(b)(4)(v)(A), an exception to the general rule because the Commission found that the compliance officer had a reasonable basis to believe that disclosure of the

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information to the Commission was necessary to prevent the company from engaging in conduct that was likely to cause substantial injury to the financial interest or property of the company or its investors. *Whistleblower Award Proceeding*, Exchange Act Release No. 74781, 2015 SEC LEXIS 1489, at \*n.1 (April 22, 2015).

According to Andrew Ceresney, Director of the SEC's Division of Enforcement, the "compliance officer reported misconduct after responsible management at the entity became aware of potentially impending harm to investors and failed to take steps to prevent it." Press Release 2015-73, SEC, *SEC announces Million-Dollar Whistleblower Award to Compliance Officer* (April 22, 2015), <http://www.sec.gov/news/pressrelease/2015-73.html>.

This award constitutes the second time the Commission has given an award to a compliance professional for reporting wrongdoing. On August 29, 2014 the SEC announced an award of \$300,000 to an employee who performed audit and compliance function. The Commission determined that the whistleblower was eligible to receive 20% of the monetary sanctions collected in the enforcement action against the company. The SEC further found that the award was appropriate under Rule 21F-4(b)(4)(v)(C) because the compliance officer reported the wrongdoing internally within the company, at least 120 days before reporting the information to the SEC. *See generally Whistleblower Award Proceeding*, Exchange Act Release No. 72941, 2014 SEC LEXIS 3117 (Aug. 29, 2014). The prior August 2014 whistleblower award recipient first reported concerns of wrongdoing to appropriate personnel within the company, including a supervisor, and only went to the Commission after the company took no action. *See* Press Release 2014-180, SEC, *SEC Announces \$300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing* (Aug. 29, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812>.

While two SEC whistleblower awards to compliance officers are not frequent enough to constitute a trend, public companies and financial institutions should not disregard reports of misconduct from compliance professionals, as the compliance professionals may feel obliged to report to the SEC or other law enforcement officials if the company does not take appropriate action regarding the reported misconduct. Companies should keep in mind that any corrective action taken should be timely (within 120 days of receiving the internal report of misconduct); otherwise, the whistleblower may become eligible to receive the whistleblower bounty from the SEC. Importantly, companies should actively seek and seriously consider the input from the internally reporting compliance professional on appropriate proposals for remediation and corrective measures related to the reported misconduct. Taking prompt action upon receiving the whistleblower's report, and showing a high level of interest in the professional insights and findings of the compliance officer, could communicate a level of management commitment to compliance that will encourage the compliance officer to help management address the problem *internally* in a manner that serves the interests of the company, the investing public and law enforcement, as well as the ongoing professional relationship of the compliance professional with the company or financial firm.

### ***DOJ Announces Plans To Hire First Compliance Counsel***

Companies and financial firms should also start updating their compliance program policies and procedures in light of recent press reports about the U.S. Department of Justice's ("DOJ") intention to hire its first ever compliance counsel, who has been selected but not yet publicly named. *The Wall Street Journal* and several other news organizations reported that DOJ's compliance counsel will have responsibility for evaluating a company's compliance program and procedures, and helping DOJ prosecutors determine whether to bring an action against a company under the U.S. Foreign Corrupt Practices Act ("FCPA"), and other federal criminal laws, including health care fraud and securities fraud.

The compliance counsel will help Fraud Section prosecutors determine if a bribe or criminal misconduct resulted from a rogue employee's circumvention of reasonable and adequate company compliance policies and procedures, or because the company's compliance procedures and practices were so inadequate that the company was willfully blind. The new compliance counsel will also provide companies more detailed guidance on what level of compliance procedures and controls are commensurate with the company's compliance risks.

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**Sharie Brown** is a recognized leader in ethics, compliance and internal investigations involving financial fraud and corruption for US and non-US companies. As a former federal prosecutor, a Mobil Oil compliance and ethics officer, and a leader of white collar and compliance practices at major law firms, Sharie is regarded as a trusted advisor, counselor and skilled investigator for board audit committees, corporate senior management and general counsels in several regions of the world. Her experience, leadership and frequent media contributions regarding corporate fraud and corruption make her an international thought leader in the field.

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FALL - 2015

## HEALTHCARE

## Healthcare IT Investments – The Risks You Should Be Considering

By **Erin Whaley**

The headlines say it all:

- “Bazillions of VC dollars flowing in health IT”<sup>[1]</sup>
- “Health-Care Startups Raise Record \$3.9 Billion in Venture Capital in First Quarter”<sup>[2]</sup>
- “Global healthcare IT market projected to hit \$66 billion by 2020”<sup>[3]</sup>
- “mHealth market is estimated to reach \$58.8B by end of 2020”<sup>[4]</sup>
- “Report: Global HIE market to reach \$878 million by 2018”<sup>[5]</sup>

By whatever name you call it – health information technology (IT), digital health, mobile health (“mHealth”), telehealth – there is a lot of private equity and venture capital money flowing to this space. Many factors have contributed to the explosion of health IT companies, including the rise of new payment models that depend on strong analytics for success, meaningful use (that is, incentive payments providers receive based upon use of electronic health records), the desire to streamline workflow processes, and the proliferation of individuals with smart phones and continuing expansion of Internet access. With health care equating to nearly 20% of our nation’s GDP, we can easily understand why investors view health IT companies as good investments.

In some respects, investments in health IT companies are no different than investments in companies in any other sector. Investors do their diligence to identify the strengths and weaknesses of the target company, evaluate the upside and downside potential, and decide whether and how much to invest and on what terms. In other respects, however, investments in health IT companies present new and substantial risks that deserve special attention. These risks center on privacy concerns and the security of the health IT platform developed or used by the target as well as the information transacted through or maintained therein. Again, you do not have to look any further than the headlines to understand the adverse impact that weak privacy or security protections could have on an investment:

- “Breaches Cost Healthcare \$6 Billion Annually”<sup>[6]</sup>
- “Cloud File Sharing Leads to \$250k HIPAA fine”<sup>[7]</sup>
- “Medical Record Breach Impacts 3.9 Million People Nationwide”<sup>[8]</sup>

To help mitigate the risk of your health IT investment becoming a headline, it is imperative that you carefully examine your target’s privacy and security practices prior to investing. While privacy and security diligence can be complex and difficult to accurately quantify, we offer the following tips to guide your diligence.

1. *Does your target understand the applicable laws and regulatory landscape in which they are operating?* As with most aspects of health care, privacy and security are regulated at both the state and federal level and the applicable laws depend heavily on the type of health IT platform the target has developed and how this platform is used by customers. Applicable laws could include the Health Insurance Portability and Accountability Act (“HIPAA”), the Federal Information Security Management Act (“FISMA”), the Privacy Act of 1974, and state privacy and security laws in the states in which they operate or do business. Once your target tells you which laws they believe to be applicable, independently verify the accuracy of their assertion. If the target was correct, you can check that box. If your target was incorrect, there is more work to be done evaluating whether they have been non-compliant with any applicable laws because they didn’t know about them, the risks associated with this non-compliance and the costs

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associated with coming into compliance.

2. *Does your target have effective privacy and security compliance programs in place?* While these programs may differ based on applicable law, health IT companies must have effective privacy and security compliance programs in place to mitigate the risk of breaches. Start by asking simple questions – Who is the privacy officer? Who is the security officer? Where are the target’s privacy and security policies and procedures? Assuming that the target can answer all of these questions with something more than blank stares, you can dig deeper. Review the policies and procedures to see whether they address compliance with applicable law in a meaningful way. Determine whether the policies and procedures are in keeping with best practices in the industry and are actually being followed. Ask questions about privacy or security incidents that have been identified and how they were resolved. Chances are, if the target’s program is effective, they will have identified some incidents and the speed and breadth of response could be a window into the soundness of their overall program.
3. *Are your target’s security practices technically sound and reflective of best practices?* While reviewing the target’s written privacy and security compliance policies is important, it is just as important to have a security specialist review the technical design of the platform to identify whether the proper security mechanisms are in place. The scope of this review may vary depending on the type and nature of the health IT platform in question and may include anything from a simple review of the platform and questions and answer session with the coders to penetration testing to identify vulnerabilities.
4. *What rights, if any, does your client have to the data transacted, maintained or collected through its health IT platform?* Big data can mean big dollars. To the extent that your target’s value is dependent on the value of the data it is transacting, maintaining or collecting, it is critical that you review the target’s rights to that data. In most cases, those rights will be contractual between the target and its customers, suppliers or licensors. Not only should you look at whether your target has rights to the data, but the scope of those rights. If the scope is too narrow, it may impair the target’s ability to convert the data into value for its customers, the company and ultimately the investors.
5. *Does your client have appropriate protections in its customer, supplier and subcontractor agreements?* Privacy and security provisions, indemnification for breach and limitations of liability in health IT contracts are some of the most heavily negotiated provisions of a health IT agreement. In each contract, the appropriate protections will be driven by the target’s role in the contract. For instance, in a contract between the target and its customers, the target is typically best served by very limited indemnifications following to the customer and a small liability cap. By contrast, in a contract between the target and its subcontractor, the target is typically best served by a broad indemnification flowing from the subcontractor to the target and a high liability cap for the subcontractor. Each contract should be reviewed in light of the target’s specific business model and relationships to determine whether the target is bearing the appropriate degree of risk.

In the current environment with the proliferation of health IT companies, there is no shortage of exciting start-ups and companies looking for investors. Doing thorough diligence on a health IT company’s privacy and security practices is critical to help ensure that private equity and venture capital companies are picking the right companies and mitigating some of the risks inherent in this market.

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[1] <http://medcitynews.com/2015/01/bazillions-vc-dollars-flowing-health/>

[2] <http://www.wsj.com/articles/health-care-startups-raise-record-3-89-billion-in-venture-capital-in-first-quarter-1429633713>

[3] <http://www.fiercehealthit.com/story/global-healthcare-it-market-projected-hit-66-billion-2020/2014-04-01>

[4] Allied Market Research, mHealth Market (Devices, Applications, Services & Therapeutics) Global Mobile Healthcare Industry Size, Analysis, Share, Growth, Trends and Forecast, 2012 – 2020

[5] <http://www.fiercehealthit.com/story/report-global-hie-market-reach-878-million-2018/2014-03-11>

[6] <http://www.healthitoutcomes.com/doc/breaches-cost-healthcare-annually-0001>

[7] <https://digitalguardian.com/blog/cloud-file-sharing-leads-250k-hipaa-fine>

[8] <http://www.esecurityplanet.com/network-security/medical-record-breach-impacts-3.9-million-people-nationwide.html>

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**Erin Whaley** is a lawyer with Troutman Sanders LLP in Richmond, VA in the Health Care practice. She represents hospitals and other health care providers in the full spectrum of health care legal issues and has co-authored many publications on health care related topics. Her corporate and regulatory experience includes advising providers on healthcare operational regulatory issues including Stark, Anti-Kickback and HIPAA; corporate issues such as physician contracting and joint venture opportunities; and compliance issues including the design and implementation of compliance programs as well as the investigation and resolution of compliance issues. Her health information technology experience includes assisting with the development of health information exchanges (HIEs) and advising these organizations on: (i) legal structure; (ii) governance; (iii) privacy and security frameworks; (iv) operational policies and procedures; (v) breach notification; and (vi) data exchange agreements. Erin assisted in drafting the Data Use and Reciprocal Support Agreement (DURSA) for the Nationwide Health Information Network (NwHIN) and provides expert advice to clients on e-health issues including HIPAA Privacy and Security, Health Information Technology for Economic and Clinical Health Act (HITECH), the development of electronic health record donation programs, and “meaningful use.”

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