

# De-Risking Emerging Market PE Investments: A Checklist for Investors

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## Emerging Market Risks

In addition to ordinary commercial risks, emerging market private equity (EMPE) investments are subject to those risks that arise across virtually all emerging markets: unenforceability of contracts, expropriation, discrimination against foreign investors, weak or corrupt local courts, corrupt government officials and regulators, poorly drafted or conflicting laws and regulations, and inefficient or inequitable tax regimes. It is not unusual for local partners to use home country weaknesses to disenfranchise PE investors or steal assets. However, these risks can be mitigated or avoided entirely, through structural arrangements or specific deal terms.

## Structural Arrangements

**Pick the Right Partner.** The wrong partner is a “gift that keeps on giving.” Picking the right local partner may not technically fall into the structural arrangements category, but it is a macro level decision that affects the risk profile of an investment for as long as it is owned by a fund. As is the case in developed markets, there are partners and managers in emerging markets for whom theft is an acceptable strategy and who are happy to use an EMPE investor’s capital when it suits them and push the EMPE investor out when it does not.<sup>1</sup>

Almost as important is picking the right counsel. Investing in emerging markets is a legally intensive business requiring more from investors’ international counsel (and local counsel) than investments in developed markets. However, the skillsets are scalable and can be applied across different jurisdictions. A savvy EMPE investor can minimize risk and achieve a measure of quality assurance by developing deal structure templates and model documents that are adaptable for use in different markets and by using the same international counsel for all transactions, regardless of the jurisdiction.

**Investment Treaty Protection.** The cavalry will never ride to the rescue when an EMPE investment goes wrong as a result of host country government action, but investment treaty protection is the next best thing. Investors and their counsel often forget to consider this when picking an investment vehicle. Investment treaties are intended to ensure fair treatment for foreign investors and a neutral forum for the arbitration of investment disputes. Many emerging market countries are party to bilateral investment treaties (BITs). If something goes seriously wrong with an investment—either as a result of direct action by a host country government or as a result of local courts or regulators failing to fairly and adequately protect a foreign EMPE investor—a BIT claim helps make the investor’s government an ally and can provide invaluable leverage

in negotiations with the host government.<sup>2</sup> If negotiations fail, the investor likely will have an arbitrable claim. The key is to ensure that the investment vehicle or, depending on the treaty terms, its EMPE fund owner, is incorporated in a jurisdiction that has benefits under the relevant BIT.

**Tax Treaty Protection.** In contrast to BIT protections, due to the involvement of accountants at an early stage, most EMPE investors do consider tax treaty protection when structuring their investments, though sometimes only in the context of working out whether there is a host country withholding tax on dividends or interest or whether host country taxes will be imposed on gains from transactions involving shares or immovable property. In assessing the benefits available under a tax treaty, investors should also consider the treaty’s limitation on benefits clause and whether it imposes additional residency requirements on a fund’s beneficial owners. Funds that are transparent for tax purposes sometimes consider only treaty benefits that run to them and forget to consider whether their limited partners might be able to use treaty benefits (including, for example, whether limited partners can benefit from permanent establishment protection under the relevant treaty in order to avoid host country tax return filing requirements and host country taxation on a net income basis).

**Investment Vehicle.** By investing directly in a company that is organized under the laws of a host country, investors also are directly subjecting their investment to the jurisdiction of the host country government and its courts, regulatory regime, bankruptcy laws and tax authorities. Where courts are weak, regulations poor, bankruptcy laws ineffective and/or tax authorities corrupt, layers of additional risk can result as a consequence of that one decision. Sometimes, by the time an EMPE investor arrives on the scene, a locally formed company is up and running and it is not practical for the investor to force all shareholders into a vehicle organized offshore. And in the case of regulated industries such as oil and gas, electric utilities, mining and mobile

<sup>1</sup> It has been suggested that when deals are successful local partners resent sharing the upside with foreign PE investors they regard as passive partners, and that when deals are not going well, local partners become difficult or resort to theft in order to avoid minority protections in shareholders agreements. See David Wilton, IFC’s *Experience in Emerging Markets Private Equity*, EMERGING MARKETS PRIVATE EQUITY Q. REV., Vol. VI, Issue 1, Q1 2010, at 6, 9. My experience has been that when an investment is going well, there is an increased risk a local partner will attempt to push the foreign PE investor out, and when things are not going well, there is a risk the local partner will carve-out the part of the business that is performing, leaving the foreign PE investor with the non-performing rump. One way to mitigate partner risk is to engage an investigative firm to carry out a thorough on-the-ground (as opposed to Internet or database only) investigation of a potential partner in advance of entering into a deal. It is also worth reviewing how a potential partner has treated its counterparties in other transactions.

<sup>2</sup> Many BITs can be found on the website of the United Nations Conference on Trade and Development (UNCTAD) at [http://www.unctadxi.org/templates/docsearch\\_\\_\\_779.aspx](http://www.unctadxi.org/templates/docsearch___779.aspx).

telecommunications, investors may have no choice but to invest directly in a local company. Where there is an upfront choice and a vehicle formed under the laws of a jurisdiction with a reliable legal framework can be used, investors can avoid risk by making their investment in an offshore entity.

**Governing Law and Dispute Resolution.** To mitigate the risks associated with unenforceability of contracts under host country laws, most sophisticated EMPE investors choose New York or English law as the governing law of their share purchase, investment or shareholders agreements, except where compulsorily required to accept local law, such as in the case of host country license or concession agreements. Local partners and entrepreneurs may try to sell EMPE investors on the benefits of local law and local courts. That path should be resisted at all costs, as choosing local governing law and submitting to the jurisdiction of local courts, no matter how noble, well-intentioned or necessary it might seem at the time, can significantly increase an investment's risk profile over its entire life.

The need for a neutral, independent forum in which disputes can be resolved and for decisions made in that forum to be enforceable at the local level would seem to be beyond debate. In my experience, the intensity of local entrepreneurs' arguments over the forum for dispute resolution correlates directly with the likelihood of future breach. Surprisingly, even experienced counsel often fail to consider the enforceability issue—for example insisting on submission of disputes to US courts (as opposed to arbitration) without taking into account whether those courts' decisions can be enforced in the relevant jurisdictions.

There are few relevant mutual enforcement of judgment treaties in force in emerging markets, meaning that one nation's court decisions may not be enforceable in the courts of another. As a consequence, the mechanism available to EMPE investors to protect their investments is international arbitration. Under the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, often referred to as the New York Convention, arbitration awards generally are enforceable—at least in theory—by the courts of signatory countries.<sup>3</sup> Assuming the host country is among the 146 states party to the Convention, the next decision to consider is where the arbitration will take place, or have its "seat." The law of the seat will, generally speaking, govern the procedural rules of the arbitration, and the courts of the seat will have jurisdiction over any disputes that occur before the arbitration starts or while it is ongoing. Investors also will likely turn to these courts to confirm or challenge an arbitration award.

When an EMPE investor commences an arbitration proceeding, the local partner or shareholder frequently will start a parallel proceeding in a host country court, arguing that, despite the agreed arbitration clause, the local court is the forum in which the dispute should be resolved. The local partner may even obtain an injunction purporting to stop the arbitration proceeding. It is at this point that the investor's choice of governing law and choice of seat become critical. Federal and state courts in New York generally have a pro-arbitration bias (due to the pro-arbitration bias of the

Federal Arbitration Act),<sup>4</sup> a more clear-eyed, less idealistic view of courts in emerging markets,<sup>5</sup> and are willing to issue anti-suit injunctions to stop parallel litigation in local courts and allow arbitration proceedings to go forward.<sup>6</sup>

English courts sometimes view arbitration proceedings as competitive with litigation in the English courts and, having been influenced to some degree by the continental European doctrine of "mutual trust", are generally more deferential to courts in emerging markets, making them somewhat less likely to issue anti-suit injunctions.<sup>7</sup> In addition, since the decision of the European Court of Justice in the *West Tankers* case,<sup>8</sup> English courts are no longer allowed to issue anti-suit injunctions to stop parallel litigation in courts of other EU member states, with the consequence that an investor can spend years engaged in frustrating parallel proceedings.

**Capital Structure.** Emerging market private equity is frequently described as having more in common with venture and growth capital investments than with traditional Western-style private equity. This distinction arises from the fact that EMPE investors often take minority equity stakes (as opposed to doing buyouts or control transactions) and seldom employ leverage.

As venture and growth capital investors in developed markets know well, from a risk perspective, there are benefits to being closer to the top of a target company's capital structure, because, in the event of a future bankruptcy or out of court restructuring, holders of common shares are more likely to suffer a complete loss in value and holders of debt or preferred shares are more likely to retain something. Accordingly, EMPE investors seeking to de-risk their investments—whether in an offshore entity or a company organized under local law—may make convertible loans or invest in preferred shares. Occasionally, investors will invest at every level of the capital structure – debt, preferred shares and common shares—thereby ensuring that they will have multiple seats at the table in the event of a future bankruptcy of the target company. Another tactic some EMPE investors employ is to create a separate class of common shares that enjoys special rights *vis à vis* other classes of shares.

## Deal Terms

**Governance Rights.** Because most traditional EMPE investments are minority stakes, the challenge for an investor

<sup>3</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, available at [http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII\\_1\\_e.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/XXII_1_e.pdf). A complete list of parties to the New York Convention can be found at [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

<sup>4</sup> See *IRB-Brasil Resseguros S.A. v. Nat'l Indem. Co.*, No. 11 Civ. 1965 (S.D.N.Y. Oct. 6, 2011).

<sup>5</sup> See, e.g., *Bridgeway Corp. v. Citibank*, 201 F.3d 134 (S.D.N.Y. Jan. 3, 2000).

<sup>6</sup> See *Telenor Mobile Communications AS v. Storm LLC*, 584 F.3d 396 (2d Cir. 2009); *Amaprop Ltd. v. Indiabulls Fin. Svcs. Ltd.*, 2010 WL 1050988 (S.D.N.Y. Mar. 23, 2010); *Storm LLC v. Telenor Mobile Communications AS*, No. 06 Civ. 13157 (GEL), 2006 U.S. Dist. LEXIS 90978, 2006 WL 6167978 (S.D.N.Y. Dec. 15, 2006).

<sup>7</sup> See Will Hueske, Rule, *Britannia! A Proposed Revival of the British Antisuit Injunction in the E.U. Legal Framework*, 41 GEO. WASH. INT'L L. REV. 433 (2009).

<sup>8</sup> Case C-185/07, *Allianz SpA and Generali Assicurazioni Generali SpA v. West Tankers Inc.*, 2009 E.C.R. I-663.

is to identify and negotiate a mix of rights that will ensure (a) its control over key decisions affecting the investment or the target company as a whole, (b) a flow of reliable information and (c) its influence over those decisions that it cannot control completely. To minimize risk, that mix should include:

- a share ownership percentage sufficient to block all key shareholder decisions, should the investor so choose;
- guaranteed board representation at a level that gives blocking power for all key board decisions and guaranteed participation in key committees of the board;
- the ability to hire and fire the CEO;
- minority protections (sometimes referred to as “veto rights”) in respect of the approval of any of the following, whether at the board or shareholder level: share issuances, borrowing, issuance of debt securities, creation of security interests, budgets and business plans, mergers, acquisitions, dispositions, dividends, asset sales, formation of new subsidiaries, bankruptcy, dissolution, hiring and firing of key officers and employees, hiring of a new auditor;
- pre-emptive rights in respect of share issuances at a price per share equal to the price offered to new investors;
- an obligation by the company to deliver periodic financial statements and to undertake an annual audit; and
- non-compete provisions applicable to local partners and other shareholders.

In most jurisdictions, for maximum effectiveness, these rights must be reflected in both the shareholders agreement and the target company’s memorandum and articles of association or by-laws.

**Planning for Exit.** A savvy EMPE investor will have at least three paths to exit on Day 1: (a) sale in a public offering; (b) sale to a strategic investor or another financial investor; and (c) a put right to a local partner or back to the target company. To ensure it has the ability to participate in a public offering, an investor should have both demand and piggy-back registration rights or their equivalent in the relevant jurisdiction. Some investors also insist on a unilateral right to force the target company to go public after a certain time period. To minimize any risk arising from a problematic new shareholder entering the picture, an investor should have a right of first refusal or right of first offer in respect of any share transfer by other shareholders, and share pledges and other transfers should be restricted. An investor may also wish to establish criteria for any future shareholders, such as a minimum credit rating and full disclosure of beneficial ownership.

To ensure it has the ability to force a sale to a strategic investor or another financial investor, as well as to participate in any sale that might be initiated by another shareholder, an investor should have both tag-along rights and drag-along rights. Finally, having the right to put its shares to a local partner or back to the company gives an investor an option in a worst-case scenario in which there are no strategic or financial buyers and a public market exit is unavailable.

**Security.** Just as positioning an investment at the top of a target’s capital structure provides some downside protection,

in the event of a bankruptcy or out of court restructuring of the target company, having a security interest in respect of the performance obligations of a local partner and/or the target company can help mitigate an investor’s risk. If a local partner knows there is a possibility a security interest in its shares will be enforced if it breaches a shareholders agreement or otherwise misbehaves, the likelihood of breach or misbehavior will be reduced. A security interest that secures a debt obligation or a put obligation of the target company may, depending on the relevant bankruptcy law, put an investor ahead of other creditors in the event of a bankruptcy proceeding. An ideal security interest is one that an investor can enforce without having to go through an arbitration proceeding and that cannot be frustrated by local court action. Pledges of offshore bank accounts and possessory pledges of shares in a foreign entity that can be appropriated upon the occurrence of a breach are the gold standard in this regard. It is important to put security interests in place on Day 1. Taking security midway through the life of a deal not only runs the risk of preference or fraudulent transfer claims that may lead to it being unwound, but it can also be difficult to negotiate with a local partner or the target company, who may at that point in time perceive themselves as having different interests.

## Conclusion

It is impossible to entirely de-risk an EMPE investment. And volumes can be written about the soft skills required to increase the likelihood of success of an EMPE investment. However, if investors carefully consider the relevant structural issues, pick the right local partner, avail themselves of applicable treaty protections, avoid involvement with local law and local courts, make careful choices with respect to governing law and seat of arbitration, and insist on deal terms that give them negative control, options for exit and a place near the top of the target’s capital structure, many of the risks commonly associated with emerging market PE investments can be mitigated and, in a few cases, avoided entirely. ●●

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*The author wishes to thank Nell Scott, Jamie Larkin and Susannah Nagle for their input and comments on this article, and his partner Bob Sills for introducing him to the mysteries of the arbitration world.*

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