

NAVIGATING A CHANGING REGULATORY ENVIRONMENT



From Brexit to the pandemic, recent geopolitical events have led to major legal changes throughout the UK and Europe. American firms are tasked with figuring out which reforms help and which hurt, writes *Kyle Campbell*

For US-based private equity firms, the UK and European markets present attractive opportunities for raising and deploying capital, but doing so entails navigating an evolving tapestry of legal and regulatory systems.

The region has long been a warren of independent and overlapping governing regimes, but recent years have seen a flurry of reforms impacting cross-border investment that have added new wrinkles to navigate, Aymen Mahmoud, a London-based partner at the law firm McDermott Will & Emery, says.

“They are different countries, each with their own specified legal systems, bankruptcy processes, regulatory overlay and so forth,” Mahmoud says. “Brexit made that more complex, then the pandemic made it still more complex because it forced a mass modernisation of the bankruptcy laws in all the major European financial centres.”

The campaigns resulted in a new learning curve for private equity firms and their legal teams, according to Mahmoud. But they also brought a level of “jurisdictional gamesmanship” with France, Germany and the Benelux regions, making strides to be more competitive with the region’s leading bankruptcy court system in the UK. He noted that similar modernisation efforts have been underway in Germany and Italy related to solicitation by lenders.

Other regulatory developments have thrown up new roadblocks for American private equity firms. Yet, those hurdles have not been enough to tame the growing interest from American firms seeking to plant their flag in Europe. Joerg Zirener, a Frankfurt-based partner at US-headquartered One Equity Partners, says he has seen a marked uptick in new private equity entrants from the US.

“The US remains by far the biggest PE market, but there is a lot of competition globally. To continue to generate attractive returns for investors, you have to look at new countries and jurisdictions,” Zirener says. “That is why Europe is playing such an important role for many firms currently.”

National interests

The most acute example of Europe’s evolving regulatory landscape is the new foreign direct investment regimes that have cropped up in recent years, which apply additional oversight to mergers and acquisitions involving companies deemed important to national interests.

The Council of the European Union implemented its Foreign Direct Investment (FDI) framework in 2019, modeling regulation on the Committee on Foreign Investment in the United States (CFIUS) protocol. But Vica Irani, co-leader of the corporate practice at the law firm Jones Day, says the oversight functions differently from other regulatory bodies in both Europe and the US.

Unlike antitrust regulation, which is handled at the European Union level, the FDI regime allows for screening both by the EU Commission and by individual member states.

“It is not a harmonised regime across Europe,” Irani says.

The framework has also deviated from CFIUS’ fairly narrow view of what constitutes a national security issue. Irani says special reviews were once reserved for investments in aerospace firms, defence contractors and similar entities, but the scope of scrutiny has expanded significantly in Europe and in the UK.

“They extend way beyond national security issues and will pick up deals in areas that you would not think would have a bearing on national security at all,” she says. “A deal may be reviewed because it is energy related, or it is healthcare related, or to investigate the security of the food supply. The list of sectors it applies to is vast.”

The FDI oversight frameworks have also encountered some growing pains. For example, a US-based firm operating a fund domiciled in Europe could be exempt from scrutiny, while a European-based fund that includes investors from outside the European Union could be flagged for further review.

Because the reviews are done on a deal-by-deal basis, even firms that are repeat transactors must go through the process every time they wish to acquire an asset deemed nationally important, Irani says. Establishing a rapport

with regulators can speed the process along, she says, but overall the framework remains “intrusive” and burdensome.

Yet, because the regime is so new, there is hope that it will improve over time. The commission is conducting a consultation to gather input on potential improvements and clarifications. In addition, while the additional oversight can be time-consuming and sometimes frustrating, it has not resulted in a surge of deals being derailed by regulators.

Regulatory headwinds

The overall regulatory picture has been discouraging for some international investors.

Foreign direct investment into the UK and Europe fell by 4% between 2022 and 2023, according to accounting firm EY, and was down 11% from 2019. The firm’s annual Europe Attractiveness Survey, which was conducted between February and March of this year and garnered responses from 500 global decision-makers, noted “regulatory burden” as the top concern about investing in the region.

The most concerning regulatory developments for the investors polled by EY include those related to sustainability, artificial intelligence and data protection, which respondents said could stifle business growth.

Still, Europe and the UK have long been the top international destinations for US private equity and venture capital deployment, and industry analysts expect that trend to carry through in 2024. A research paper from Silicon Valley Bank, a lender and service provider to American VCs and private equities, projects that a global slowdown will drag down emerging economies in Asia and the Americas, causing US firms to concentrate their cross-border activities in more mature markets.

Dan Oates, a partner with Ropes & Gray, said a growing share of his practice’s business has been focused on US-based firms transacting in the UK, a development he attributes to the US dollar’s relative strength compared to the British pound in the years since the UK withdrew from the European Union.

“For a dollar-denominated fund, you’ve probably got 20% more purchasing power than you had pre-Brexit,” Oates says. “That has definitely had an impact.”

American groups have also been drawn to the strong fundamentals in the tech, healthcare, life sciences and industrial sectors of the UK and Europe.

Specifically, recently depressed valuations of firms in these high-growth verticals have piqued the interest of many American firms as potential take-private targets, though these transactions have yet to take off in large numbers.

Cultural distinctions

Part of this reluctance centres on the companies themselves being unwilling to accept these lower valuations. But differing legal requirements and market practices between



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jurisdictions could also give pause to US buyers who are unfamiliar with the European approach.

Privatisations in Europe and the UK tend to be more “seller friendly” than those conducted in the US; Oates says this is because of the “locked box” method of setting purchase prices. In these constructs, parties agree to a fixed price and stick to it after a deal closes, with only small technical adjustments made.

Meanwhile, in the US the standard practice – sometimes referred to as the “closing accounts” approach – involves an estimated sale price based upon the target firm’s closing date balance sheet, as well as a post-closing “true up” in which discrepancies or unknown financial conditions are rectified. While this approach brings the final price closer to true value, it can often be costly and time-consuming.

Oates said much of his team’s time spent with US-based clients centres on explaining these types of nuances between the markets on either side of the Atlantic.

“The way we do a lot of things within legal documentation is slightly different. A lot – but certainly not all – of the concepts are the same, but much of the terminology is not,” he says. “Being fluent in both, and thereby able to translate between the two markets, is something that US-based clients in particular find enormously helpful.”

Overall, US-based firms have grown more accustomed to the nuances of the UK and European markets. Those with long track-records in the region know that each jurisdiction brings its own legal framework, and

the overall regulatory landscape is frequently in a state of flux.

Zirener says that helping companies expand their operations across borders, both within Europe and overseas, has been a fundamental part of One Equity’s strategy since it set up shop in Germany more than two decades ago.

“We have the experience, the track-record, the offices and the network to smoothly help companies expand internationally and execute transformative combinations. That is what we have been doing right from the start,” he says. “Over 75% of our transactions have involved combinations, including several transatlantic combinations.”

Still, the cultural distinctions run deeper than the legal systems and business protocols. Being able to communicate effectively is also critical, says Holger Ebersberger, a Munich-based partner for McDermott.

Therefore, even though technological innovations make investing from afar more feasible, Ebersberger says more US-based private equity firms – even midmarket groups – are focused on expanding their footprints in the region.

“Every European country has different ways of doing business. If you go to Italy, it is different compared to Germany or to the UK. The bigger the deal, the more similar it is, but in midmarket deals there is a lot of trust involved,” Ebersberger says. “Therefore, if you want to do deals within Europe coming from the US, it is always helpful to have local people on the ground.” ♦