KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

July 30, 2012

NDA Use Restrictions – Use With Caution

PENpoints

A recent New York court found that a "use restriction" in a confidentiality agreement prevented a private equity fund from pursuing an alternative transaction.

In the recent high-profile Vulcan/Martin Marietta decisions, the Delaware courts found that a "use restriction" in a confidentiality agreement (*i.e.*, a provision limiting the recipient's "use" of the disclosing party's confidential information to a specified purpose) could in certain circumstances preclude the recipient from later commencing a hostile offer for a target company even absent an explicit standstill. A recent New York decision refusing the defendant's motion to dismiss shows that "use restrictions" may also limit the ability of a recipient party to pursue an alternative opportunity after receiving confidential information under a non-disclosure agreement (NDA).

In the New York case (which in a motion to dismiss, the court accepts as true the plaintiffs' factual allegations), a private equity investor signed an NDA with a broker/advisory firm seeking financing for a corporate client in the cash management industry. In the NDA the PE firm agreed to use the confidential information shared by the broker only to explore a potential business transaction involving the broker and the broker's client. According to the broker, after the PE investor actively considered a number of transaction opportunities with the broker and its client, the investor later pursued and completed an acquisition of a target allegedly identified by the broker without including the broker and its client.

The broker alleged that the PE firm had breached the NDA by wrongfully using the confidential market insights about the cash management industry shared by the broker with the investor in order to pursue its own acquisition and thereby avoid a fee obligation to the broker. The PE firm argued that the NDA only covered a transaction that in fact involved the broker, and that the broker's proposed broad reading of the use restriction represented an "unreasonably indefinite obligation" on it not to enter the cash management industry.

The court rejected the PE firm's position and found that the NDA in fact imposes a very clear "definite obligation": not to use the broker's confidential information other than for the specific purpose stated in the NDA (*i.e.*, pursuing a transaction involving the broker and client).

The New York court's reasoning was notably similar to the reasoning in the Vulcan/Martin Marietta cases. Just as the Delaware court accepted that the NDA covering information shared in the consideration of a friendly deal did not by itself preclude a later hostile offer, the New York court did not find that the PE firm was necessarily prohibited from pursuing an alternative transaction in the cash management industry. However, in both cases, the courts found that in pursuing these permitted opportunities, the recipient of confidential information under the NDA could not violate its explicit agreement with the disclosing party not to use its confidential information for purposes other than those specified in the NDA.

While the New York decision was at a preliminary stage of litigation, was fact-specific and involved a damages claim for a fee (rather than injunctive relief), it still offers some cautionary lessons to parties entering into NDAs with use restrictions. Potential acquirers are usually asked to agree that they will only use the potential target's confidential information to explore a negotiated acquisition of the target. If the deal fails after the due diligence stage, the putative acquirer is exposed to the risk of claims that it "stole" and misused the target's confidential materials if it later pursues a similar opportunity through internal resources or via another acquisition.

The recent New York decision, coming on the heels of the Vulcan/Martin Marietta Deleware decisions, emphasizes the potential unforeseen consequences of broad "use restrictions" in NDAs. Parties asked to agree to use restrictions should consider drafting changes to

INSIDE KIRKLANDPEN

mitigate some of these unanticipated outcomes (*e.g.*, seeking express acknowledgment that the buyer may pursue similar deals or opportunities) while also taking steps (*e.g.*, internal firewalls) to buttress an argument that confidential information was not later misused in violation of the NDA.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

David Fox
http://www.kirkland.com/dfox
+1 212-446-4994

Yosef Riemer
http://www.kirkland.com/yriemer
+1 212-446-4802

Daniel Wolf
http://www.kirkland.com/dwolf
+1 212-446-4884

U.S. Regulators Penalize Fund Advisers

PENpoints

Recent enforcement actions against private fund advisers arising out of violations of the U.S. Foreign Corrupt Practices Act and U.S. Iranian Transaction Regulations demonstrate the value of effective compliance programs.

Recent enforcement actions against private fund advisers arising out of violations of the U.S. Foreign Corrupt Practices Act (FCPA) and U.S. Iranian Transaction Regulations (ITR) offer lessons for private fund compliance personnel.

FCPA: Lessons from Morgan Stanley's "Rogue" Employee

According to the U.S. Securities and Exchange Commission (SEC), former Morgan Stanley employee Garth Peterson made corrupt payments to a Chinese official to secure business for Morgan Stanley's real estate fund. In what the SEC described as "cross[ing] the line twice," Peterson then secured part of the investment for himself — so that he could profit personally from the corrupt payment to the Chinese official. Peterson and the SEC recently settled the charges against him as follows: Peterson is now permanently barred from working in the securities industry and must disgorge more than $3 million in cash and real estate allegedly obtained via violations of the FCPA.[1] In addition to these civil penalties, Peterson will appear for criminal sentencing in August, when he faces to up to five years in prison and $250,000 in fines.

Why wasn't Morgan Stanley charged, too?

The government took pains to note that Peterson was a "rogue" employee, based on Morgan Stanley's robust compliance program and cooperation with the U.S. government's probe. As the SEC noted in its press release, Morgan Stanley compliance personnel notified Peterson at least 35 times about his obligations under the FCPA. In fact, Peterson even was advised that the Chinese official was a foreign official under the FCPA.[2] Morgan Stanley terminated Peterson when they became aware of the FCPA violations and cooperated with the SEC and the U.S. Department of Justice by conducting its own extensive internal investigation. The U.S. Government and Morgan Stanley internal investigations revealed the extensive efforts by Peterson — a "web of deceit"— to evade internal controls which included:

- Frequent training, including in-person training by high-ranking persons within the organization;
- Customized advice regarding high-risk practices and even special events (such as the Beijing Olympics);
- Annual certifications of compliance;
- Annual disclosure of outside business interests of employees; and
- Due diligence of foreign transaction partners.

Notably, the government found no willful blindness on the part of Morgan Stanley. The U.S. authorities likely would have taken a different view of Morgan Stanley's actions had it ignored red flags and warnings.

What's next on the FCPA front?

This is the first FCPA enforcement action involving a private fund investment adviser and is likely a harbinger of things to come. A trend in FCPA enforcement is an industry-wide probe following an enforcement action against a company within that industry. Examples in the past five years include the enforcement cases against Bristol-Myers Squibb in the pharmaceutical and medical device industries, and Alcatel-Lucent and ITXC Corporation in the telecommunications industry.

When evaluating its FCPA compliance program, a private fund adviser should consider the following:

- When was the last time it assessed the effectiveness of its FCPA compliance program?
- Is the program designed to protect against the types of violations that can occur in today's business environment?
- Does the program provide adequate guidance and training to key employees?

Rigorous periodic review, including an independent audit, will help ensure that a private fund adviser's internal controls continue to prevent violations and identify, isolate and eliminate problems before they become violations.

OFAC: U.S. Party Penalized On Apparent Agency Theory

In contrast to the Morgan Stanley FCPA case, the U.S. Office of Foreign Assets Control (OFAC) recently held Genesis Asset Managers, LLP (GAM US) responsible for violations of the ITR by one of its foreign subsidiaries. GAM US agreed to settle by paying $112,500.

Of most importance to a U.S. private fund adviser, GAM US itself did not take any action with respect to Iran. GAM US, acting through a London-based subsidiary, provided investment advice to Guernsey-organized Genesis Emerging Markets Fund (GEMF). The London entity invested $3 million of GEMF's capital in First Pension Equity Fund, a Cayman Islands entity investing exclusively in Iranian securities. OFAC's apparent theory was that the London entity was acting as an agent of GAM US, leading to liability for GAM US.

Importantly, according to OFAC, GAM US (i) failed to "exercise a minimal degree of caution or care in the conduct that led to the apparent violation of the ITR," (ii) officers were "aware of the conduct giving rise to the apparent violations" and (iii) did not have an OFAC compliance program in place at the time the apparent violations occurred.[3]

The GAM US case shows that a U.S. private fund adviser can be liable under the ITR for the activities of one of its foreign subsidiaries. To avoid such liability, a U.S. firm should implement procedures to prevent foreign subsidiaries from acting on its behalf in transactions related to sanctioned countries or entities.

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1 http://www.sec.gov/news/press/2012/2012-78.htm

2 http://www.sec.gov/news/press/2012/2012-78.htm; http://www.sec.gov/litigation/complaints/2012/comp-pr2012-78.pdf

3 http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20120521.aspx

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If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Laurence A. Urgenson
http://www.kirkland.com/lurgenson
+1 202-879-5145

Laura Fraedrich
http://www.kirkland.com/lfraedrich
+1 202-879-5990

Joanna M. Ritcey-Donohue
http://www.kirkland.com/jritcey-donohue
+1 202-879-5980

Paloma Zepeda
http://www.kirkland.com/pzepeda
+1 202-879-5263

PENpoints

SEC Adopts Final Compensation Committee Independence and Related Rules

The SEC recently adopted final rules, required under the Dodd-Frank Act, directing national securities exchanges to set independence requirements for directors who sit on the compensation committee of a public company's board. Notably for private equity firms, the SEC rules do not require the exchanges to prohibit affiliates of the public company, such as a large shareholder, from serving on a compensation committee, although other facts affecting independence must be considered. To learn more, please see our recent Kirkland Alert.

PENnotes

NABE Transfer Pricing Symposium 2012
Arlington, Virginia
July 31 - August 2, 2012

The National Association for Business Economics' "Transfer Pricing Symposium 2012" will be held from July 31 to August 2 in Arlington, Virginia, to discuss and debate some of the most relevant economics topics in the field of transfer pricing. Kirkland partner Natalie Hoyer Keller will lead a workshop on "TP Audit Procedures and Adjustments — Mechanics." Click here for more information and to register for this event.

PLI's Hot Topics in Mergers & Acquisitions 2012
Chicago, Illinois - September 6, 2012
New York, New York - September 20, 2012

The Practising Law Institute will host its "Hot Topics in Mergers & Acquisitions 2012" seminar on September 6 in Chicago and September 20 in New York to explore the state of M&A and trends for the year ahead. Kirkland partner William Sorabella will participate as a panelist at the New York conference. Click here for more information or to register for this event.

PEVC in Brazil Forum & Showcase
New York, New York
September 11, 2012

The event will highlight the key issues for investing in Brazil as well as views from international Limited Partners on their own experiences in the country. During the Showcase, local fund managers will share their investment perspectives from the field and value creation strategies and techniques. Click here for more information.

7th Annual Kirkland Real Estate Private Equity Symposium
New York, New York
October 3, 2012

Please save the date for the upcoming "Kirkland Real Estate Private Equity Symposium." More information to come.

Chicago
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
Kirkland & Ellis LLP
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
Kirkland & Ellis LLP
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 300 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" for 2012 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm in the United States" at *World Finance*'s 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011*, and has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *The Legal 500*, the Practical Law Company and *IFLR*, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-2451