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The times for private equity and venture capital transactions are a-changin': 2024 challenges

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The last 18 months have been a challenging time for private equity and venture capital funds and their portfolio companies across the globe, impacting the availability and cost of capital, deal valuations and exit opportunities. High inflation, rapidly increasing interest rates, volatility in the public equity markets, the collapse of certain banks that support the PE and VC ecosystem and significant reductions in valuations of portfolio companies post-pandemic have led to massive economic challenges; U.S. and global political unrest has created uncertainty in the markets; and unions across the United States have led strikes driven in part by the current macroeconomic environment as well as innovative technologies that are changing the way that many companies do business.

Despite these challenges, moving forward to 2024, many are predicting some uptick in investment and mergers and acquisitions activity. The legal and compliance landscape is evolving in a way that must be considered in pursuing such transactions. U.S. laws are trying to adapt as rapidly as possible to an ever-changing environment to balance protection for workers, consumers and innovators with the need to allow the world and technological innovations to evolve and improve the way we live and do business.

The first of this two-part series explores key items that should be on the radar of private equity (PE) and venture capital (VC) funds and their portfolio companies for 2024 and beyond — including novel reporting obligations for U.S. and foreign businesses and a continued increase in antitrust enforcement.

CTA creates new reporting requirements

Historically, U.S. and foreign entities doing business in the United States had minimal, if any, legal compliance reporting obligations as to their ownership. Most states do not require any information at the time of formation or when filing annual reports regarding the owners, officers, or directors of an entity. This is in vast contrast to laws in other countries. Based on concerns over illegal activity such as money laundering, terrorism financing and other criminal activity engaged in through shell companies, the U.S. requirements are changing effective Jan. 1, 2024.

In 2021, the United States adopted the Corporate Transparency Act (CTA) as part of the White House's United States Strategy on Countering Corruption (https://bit.ly/41ifyDD). In September 2022, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule (https://bit.ly/47YgQGu) implementing the reporting requirements under the CTA. The FinCEN reporting system is set to go live on Jan. 1, 2024. This will be a secure non-public system available primarily to law enforcement agencies and financial institutions for limited purposes.

All U.S. entities formed by a filing with the secretary of state or similar office of a U.S. state, territory, possession, or tribal jurisdiction will be presumed to be reporting companies under the CTA unless exempt or excluded. Most foreign entities that register to do business in the United States will also be reporting entities under the CTA.

Any company that is a reporting company must report the identity of various individuals who are deemed to be its beneficial owners, which will include senior officers, directors to the extent they exercise substantial control, every individual who directly or indirectly controls 25 percent or more of the equity or voting interests in the reporting company, and every other individual who has substantial influence over important decisions (all as more fully defined in the CTA, regulations and various guidance documents issued by FinCEN).

In September 2022, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule implementing the reporting requirements under the Corporate Transparency Act. The FinCEN reporting system is set to go live on Jan. 1, 2024.

It is estimated that more than 30 million entities will need to report beneficial ownership information to FinCEN in 2024 alone. The most likely exemption available to existing companies will be the large operating company exemption for companies that have more than 20 full-time U.S. employees conducting business at a regularly established physical location leased or owned by such company and that have more than $5 million in reported U.S. sales or gross receipts in the prior year as evidenced by the filing of a U.S. tax or information return.

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This exemption may provide some solace for existing entities that have to file their initial reports with FinCEN by Jan. 1, 2025, but it does little for newly formed entities formed on or after Jan. 1, 2024, and before Jan. 1, 2025. These entities will have 90 days from notice of formation to file their initial report (with those formed from Jan 1, 2025, on having only30 days), but given the need for prior year tax returns, these newly formed entities will not be able to satisfy all of the requirements for this exemption even in the unlikely event that they could meet the other requirements within the time period prior to the filing deadline.

There are 23 exemptions in total with most relating to governmental or regulated entities or industries. Therefore, PE and VC funds and their portfolio companies will need to review both existing portfolio companies and any targets or new contemplated investments to ensure compliance with the CTA. Funds will also need to be prepared to comply with various obligations to their portfolio companies to report information necessary for the portfolio companies to comply with their obligations to the extent applicable.

Antitrust enforcement continues to ramp up

In addition to the general aggressive enforcement environment of the last few years, which has been a challenge to larger mergers and consolidation within certain industries such as health care and Big Tech, antitrust enforcement continues to ramp up. In 2022, the Federal Trade Commission (FTC) and U.S. Department of Justice (DOJ) filed 10 lawsuits to block deals they considered anti-competitive. This is a significant increase over prior years. There has also been a significant increase in the number of deals that have been the subject of antitrust review. This does not take into account the number of deals that are aborted during the exploration or negotiation phase due to anticipated challenges.

On the good-news front, under a new DOJ policy relating to mergers and acquisitions announced Oct. 4, 2023, the DOJ will decline to prosecute an acquirer for wrongdoing by a target company where the buyer on a timely and voluntary basis self- discloses the wrongdoing, cooperates with the government and remediates the wrongdoing. The self-disclosure must be within six months of closing the transaction whether the buyer has discovered the violation pre- or post-closing and the buyer must cooperate fully with the DOJ to remediate the misconduct within one year of the closing date.

However, on the flip side and potentially more important for PE firms focused on smaller transactions and particularly, industry roll-ups, the DOJ and FTC released draft merger guidelines (https://bit.ly/41mEBp5) in July that could have a significant impact on the number of deals that will be challenged by regulatory authorities. These proposed revisions lower the threshold at which deals are considered anti-competitive and broaden the types of deals that are subject to review.

The guidelines expressly note multisided platforms (platforms that provide products or services to two or more different groups who may benefit from each other's participation) and acquisitions that seek to take out potential competitors. This seems to take direct aim at Big Tech companies.

Perhaps, most importantly for the PE industry, the draft guidelines indicate a focus on situations where big companies or investors engage in a strategy of buying a series of small businesses or what the industry generally calls a "roll-up" or bolt-on strategy. Many of these deals have in the past avoided scrutiny because they fall below the threshold for review when viewed individually.

A shift in focus to looking at a platform company's overall roll-up strategy and pattern of multiple smaller acquisitions could put more PE deals on the radar of the FTC and DOJ.

Since the guidelines are clear that regulatory review will look at the strategy in hindsight, reviewing an acquirer's historical acquisition practices, as well as current strategy to determine if there is a pattern or strategy of pursuing consolidation through acquisition, there is presumably a risk that the government could try to undo past acquisitions by requiring post-closing divestitures. This could create more uncertainty for ultimate exits to and from these platforms.

It remains to be seen whether these guidelines will be adopted substantially as proposed, but there is no doubt that the current administration intends to remain aggressive in enforcing antitrust laws. As recently as Nov. 3, FTC Chair Lina Khan, in a letter to Congress (https://bit.ly/3TmsHJI), defended the agency's continued vigorous enforcement of the antitrust laws.

More to come for 2024

The second part of this two-part series will take an in-depth look at additional key items that PE and VC funds and their portfolio companies should keep in mind in 2024. Stay tuned.

About the author

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