THE DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT

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Estate Planning for Carried Interests

You are about to organize your next private equity fund. You're busy putting together a business plan, drafting a PPM and lining up investors and deals. You're trying to attract and retain talent. Why worry about estate taxes now? Who has the time or interest? Besides, isn't that tax going to get repealed?

Well, first of all, the odds of a real repeal of the estate and gift tax system are actually pretty slim. Even this year's vetoed bill would only have implemented the repeal in ten years – plenty of time for a revenue-hungry Congress to reinstate the tax. Most of the political heat on the issue can be handled by the alternative proposal to raise the exemption to, say, $5 million, which will limit the tax to the wealthiest one-half percent or so of estates. That type of tinkering is more likely to be the end result of the current machinations.

Under any foreseeable estate and gift tax system, your carried interest in a new Fund is an ideal candidate for estate planning: It starts with a low, speculative present value. Over time, the profits produced by the carried interest can be expected to amount to a major share of your net worth, which (if you do nothing) will eventually be subject to a tax in excess of 50% of your accumulated wealth. But with careful planning you can transfer a portion (or even all) of that future value to your beneficiaries now, while retaining investment control, at little or no tax cost. (The tax cost can increase substantially if you wait too long to implement the transfer.) What's more, you can leverage the transfer through debt arrangements and/or by paying the capital gains taxes yourself on the family's share of the profits, without any further taxable gift.

Due to a series of recent tax changes, as well as securities law restrictions, the mechanics of estate planning with carried interests must be handled with exceeding care. There are a number of decisions and trade-offs to be made, within a range of recommended approaches, that will affect the extent of your retained control over investment of the proceeds of the investment and carried interest, the amount of capital to be invested through the estate planning vehicle, your tax reporting and audit profile and even the extent to which you will have protection from future gift tax audits of the current transaction. Even more important, you will need to decide how much of the future gain to keep for yourself and how much to give away. Limited exit strategies can be built into the personal planning structure, which should be integrated into your overall estate plan.

If you want to discuss estate planning for your Fund interests, the sooner you start the more successful it is likely to be. ▢

— Jonathan Rikoon

What's Inside

"Dad, it's not that I don't appreciate the allowance, but why don't you transfer some of your carried interest to me now in order to avoid paying estate taxes down the road?"

letter from the editor

Welcome to the introductory issue of The Debevoise & Plimpton Private Equity Report, a publication for our clients and other friends in the private equity world. We hope it will focus private equity firms and their advisors on the ways in which recent legal developments impact private equity firms and their portfolio companies.

A special feature of each issue will be a guest column. To inaugurate our first issue, we are pleased to include excerpts from a recent talk that David Swensen, manager of Yale's endowment and an early proponent of private equity, gave at Debevoise earlier this fall. On a lighter note, another feature of each issue will be a specially-designed cartoon that only those in the private equity arena will understand.

We all know that private equity managers do well at managing other people's money. In this issue, Jonathan Rikoon, one of our Trusts and Estates partners, suggests ways in which they might manage their own wealth by putting portions of their most valuable asset – their carried interest – into trusts for the benefit of their heirs. David Schnabel, one of our Tax partners, reports on when it might be appropriate for U.S. sponsors to organize their funds offshore and Michael Harrell, one of the partners in our Investment Management Group, highlights recent trends regarding general partner clawbacks. We also focus on several new SEC pronouncements of particular interest to private equity firms and their public or quasi-public portfolio companies and on methods of doing deals in Europe without running afoul of financial assistance rules.

We welcome your comments on this new publication. We hope you find it provides practical guidance on matters of interest to private equity firms and their investors. We also hope that it reminds you of the breadth and depth of our private equity practice: we assist clients in structuring, organizing and investing in private equity funds; we advise our private equity fund clients in acquiring and financing public and private businesses; in a typical acquisition, we develop and implement compensation plans and ownership incentives for management teams; and ultimately, we implement sales or "going public" exit strategies.

Franci J. Blassberg
Editor-in-Chief

Financial Sponsor Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of
Debevoise & Plimpton
875 Third Avenue
New York, New York 10022
(212) 909-6000

www.debevoise.com

Washington, D.C.
Paris
London
Hong Kong
Moscow

Franci J. Blassberg
Editor-in-Chief

Ann Heilman Murphy
Managing Editor

Please address inquiries regarding topics covered in this publication to the authors or the members of the Practice Group.

All other inquiries may be directed to Deborah Brightman Farone at (212) 909-6859.

The Financial Sponsor Practice Group

All lawyers based in New York except where noted.

Private Equity Funds
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Should Your Next Fund Be Organized as a Cayman Islands Partnership?

One of the first legal issues that needs to be considered in establishing a new fund is whether to use a Delaware limited partnership or a limited partnership organized under the laws of a non-U.S. jurisdiction, such as the Cayman Islands. A Delaware limited partnership seems the order of the day if the fund has a U.S. sponsor or significant U.S. investors and will invest primarily in the U.S. However, if the fund expects to make significant investments outside of the U.S., the use of a non-U.S. limited partnership may result in substantial U.S. tax savings to a U.S. sponsor and U.S. investors.

If the fund expects to make significant investments outside of the U.S., the use of a non-U.S. limited partnership may result in substantial U.S. tax savings to a U.S. sponsor and U.S. investors.

Avoiding CFC Treatment

The tax savings arise primarily from the fact that a non-U.S. portfolio company is much more likely to be classified as a "controlled foreign corporation" (or CFC) if it is held by a Delaware partnership than if it is held by a non-U.S. partnership. If a Delaware partnership holds more than 50% of the stock of a non-U.S. portfolio company, the company will generally be classified as a CFC for U.S. tax purposes. An investment in a CFC usually results in several adverse tax consequences to the U.S. partners.

- Passive income earned by the CFC itself (e.g., dividends, interest, royalties and gains on stock sales) may be includable in income to the U.S. partners on a current basis, even if no distributions are made from the CFC. Certain types of "active income" earned by the CFC similarly may be includable in income of the U.S. partners.
- If the CFC invests in U.S. property (e.g., a U.S. sub), the U.S. partners may be treated as if they had received a taxable dividend from the CFC. The amount of the dividend is determined by reference to the basis of the U.S. property.
- Perhaps most importantly, a portion of any profit realized on the sale of the stock of the CFC may be recharacterized as ordinary income to the U.S. partners. In the case of a sponsor with U.S. individuals, the effect is to convert a portion of the override from long-term capital gain (subject to a 20% U.S. tax rate) to ordinary income (subject to a 39.6% U.S. tax rate).

The treatment of a non-U.S. portfolio company as a CFC can generally be avoided if the fund is organized as a Cayman Islands (or other non-U.S.) partnership. This outcome results from the fact that the "50% test" (and certain other tests) are measured at the "partnership level" in the case of a Delaware (or other U.S.) partnership and at the "partner level" in the case of a Cayman Islands (or other non-U.S.) partnership. Although the existence of a different rule for non-U.S. partnerships is well established and can lead to dramatically different tax results, there is no good explanation for the different rule. The rule for Cayman (and other non-U.S.) partnerships applies even if the partnership is managed and controlled in the U.S.

A non-U.S. portfolio company held by a non-U.S. partnership will generally only be treated as a CFC if the large U.S. partners of the fund (i.e., U.S. partners who own 10% or more of the capital or profits of the fund) collectively own or are considered to own more than 50% of the stock in the portfolio company. In applying this rule, the stock held by the partnership will be considered to be held proportionately by its partners.

Why the Caymans?

If a fund is going to use a partnership organized under a non-U.S. jurisdiction, the Cayman Islands is an excellent country to choose.

- Many countries allow for pass through of treaty benefits to the partners of a Cayman Islands partnership.
- The Cayman Islands has a stable government based on the British legal system.

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Jonathan J. Rikoon

guest columnist

Yale's David Swensen Speaks at Debevoise on Private Equity

David Swensen, Chief Investment Officer of the Yale Endowment, spoke earlier this fall to a group of 70 lawyers at Debevoise practicing in the private equity and mergers and acquisitions areas. David, an early and outspoken proponent of private equity, spoke about the investment philosophy Yale has employed since he joined in 1985. Yale's compound rate of return of 17% over that period is virtually unequaled by any other endowment. Joe Rice, Chairman of Clayton, Dubilier & Rice, who introduced David, referred to him as "a legend in his own time" and noted that the nicest thing about David is that "he doesn't even realize it".

David spoke initially about the three purposes of accumulating an endowment and the goals of the endowment:

One is to help an institution maintain its independence. In the early years of many private colleges, they were heavily dependent on subsidies from governmental bodies. When the colleges did something that the government didn't like, there were repercussions. In one case, Yale had six state senators put on the governing board to make sure that the college didn't stray from "appropriate" religious instruction of the students. The basic philosophy of an endowment is to provide an independent source of funds in order to give the institution more autonomy.

An endowment also provides stability to the institution. In the early years of Harvard, Yale and Princeton and others, there were extended periods where colleges weren't able to pay faculty salaries. As a matter of fact, perhaps America's greatest scientist, Josiah Gibbs, served without salary at Yale for years until Johns Hopkins offered him a salary to go along with his teaching and research responsibilities.

The third, perhaps more modern, reason is to provide a margin of excellence. If you were to identify the top world-class research universities in the United States, the list probably would include Harvard,Yale, Princeton and Stanford – these institutions also happen to be the four most well-endowed private institutions in the United States.

What are the goals of the endowment? First of all, to preserve the purchasing power of the institution in perpetuity. The second goal is to provide substantial contributions to the operating budget. It is useless to create a big pool of assets unless you are going to do something significant for the educational mission of the institution. That means spending money. From the Provost's perspective, the more money, the better.

I had my training as an economist. If you give an economist two goals, he will say there's a direct trade-off between those goals – you can't satisfy one without sacrificing the other. That's certainly the case with purchasing power, preservation and operating budget support. If you provide a heavy and stable stream of funds to the operating budget from the endowment, you endanger maintenance of the endowment itself; if you focus only on maintaining purchasing power of the endowment, you're likely to do a lousy job of providing funds to the budget.

So, what do you do to try and relax the tension between those two goals? You try to do a great job with your investments. At Yale, we have two fundamental tenets to our investment philosophy: first, an equity bias and the second is the importance of diversification.

David then described Yale's basic investment philosophy, as illustrated by its diversified portfolio:

So what did we do at Yale? We put together a portfolio, where we identified a number of asset classes that we thought would be fundamentally diversified because they would respond to drivers of returns in ways that were fundamentally different. If you look at Yale's portfolio today, marketable securities make up only 35% of our portfolio with a domestic equity allocation of 15%, a fixed income allocation of 10%, and foreign equities allocation of 10%. Our private equity allocation is 25%, our allocation to real assets, (real estate, and oil and gas) is 17.5% and our absolute return allocation is 22.5%.

David focused on Yale's private equity experience:

Private equity has been fabulous for Yale. We first invested in buyouts in 1973. The inception to date return for the University on its buyout portfolio is 36.4% per annum over a 27-year horizon. We first made a venture capital investment in March of 1976. Coincidently, the inception to date return on venture capital has been 36.4% per annum, but over a 24-year

horizon. One of the things that is most gratifying to me is that Yale's returns in the last decade – when we had a staggeringly large amount of money committed both to venture capital and buyouts – have been substantially higher than they were in the early years of the program. When you have more money at work, you would expect that returns would be dissipated by that fact alone. In fact, the opposite has occurred.

David outlined some learning from his recent book, "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment":
Yale's success with private equity has been quite unusual among institutional investors. One of the things that the book allowed me to do was to take some research assistants and test some of the ideas that I had assumed to be true. One of my favorite studies in the book is an analysis of buyout returns that we conducted over a period from 1987 to 1998. In that study, we took all the information memoranda that had been given to Yale over that period and reviewed all the deals that the general partners had sponsored.

We analyzed the realized transactions in this category, consisting of 542 transactions, 118 of which were sponsored by firms with which Yale invested. The gross returns on those deals on average were 48% per annum. The S&P 500 over that same period returned 17% per annum.

A 48% gross return relative to 17% for the S&P 500 is not bad. When the carried interest and management fees are factored in, our back of the envelope calculation suggests that the 48% gross return is reduced to 36%. That still makes a nice gap between the S&P 500 at 17% net returns and 36% net return to limited partners in those transactions. One of the complicating factors, however, is the leverage associated with the buyout transactions – far more leverage than you would find in the S&P 500. If you put the same degree of leverage on the S&P 500 that existed in the buyout deals, the S&P 500 return goes up to 86% per annum. By taking the same amount of risk in public securities you would have been left with an 86% per annum return versus a net return for these buyout deals of 36%. With the buyout deals, you end up 50 points a year behind a risk equivalent marketable security alternative.

Actually, the buyout transactions in which Yale participated have gross returns of 63% per annum and net returns of 48% per annum. The risk-adjusted S&P 500 return over that period on an equivalent basis was 41% per annum. The risk-adjusted S&P does not turn out to be quite as high a hurdle, because Yale managers tended to use less leverage than those we chose not to invest with. So the risk-adjusted number is 41% per annum relative to our actual returns of about 48% per annum. On that basis, Yale actually "made" 7 points a year on a risk-adjusted basis in its buyout transactions.

David analyzed the sharing of the risk-adjusted value provided by buyout transactions between the managers and the investors, noting the traditional carry of 20% is actually much higher if calculated against a risk-adjusted benchmark:
The general partners' interest tends to be an option-like reward. The general partners traditionally get 20% of the gains. If there are no gains, they continue to collect their management fees, and it doesn't cost them anything. A large portion of the returns in the buyout business come from the prevailing wind being at the investor's back. You have the wind at your back, because equity values over a period of time appreciate. It's been a very strong wind at the back over the last twenty years. A buyout firm has created no value just by being in the marketplace and should not be compensated just for being there. A much fairer starting point from an investor's point of view is to compensate general partners by giving them a profits interest only in the positive differential between their returns and what would have been created over that time period in the public equity markets.

David responded to a number of questions, undoubtedly asked by lawyers whose clients might be raising new funds from potential investors like David:

Q One of the things that we have used with our General Partner clients is a management fee offset mechanism to provide the co-investment. We have generally found that Limited Partners find this an acceptable approach. It is beneficial to the

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We love the combination of financial engineering and operating expertise. Firms with both skill sets care about the company's operations and probably, more than anything else, want to create something that five years from now is a more valuable enterprise.

European Financial Assistance Prohibitions: Just Another Challenge for Private Equity Firms

U. S. financial sponsors hoping to expand in Europe may initially be intimidated by explanations from their lawyers of the "financial assistance" rules which are applicable in all European Union jurisdictions. These rules generally prohibit targets from providing "financial assistance" in connection with the purchase of a target company's shares, which includes any borrowing by the target company to fund the acquisition price, as well as the use of the assets of the target to support (by upstream guarantee or otherwise) any acquisition debt. The rules impose significant penalties for violations, including civil and, in certain cases, criminal liability for the directors of the target company that approve the transaction.

If there were no exceptions to the financial assistance rules or no techniques for resolving the financial assistance issues, private equity firms would have a difficult time doing leveraged acquisitions in Europe. The good news is that there are exceptions in some countries and techniques in others for managing the financial assistance rules in order to effect leveraged transactions. As summarized below, however, each has its limitations or raises other corporate law issues (such as rules limiting dividends to distributable reserves) which do complicate, but should not undermine most transactions.

The financial assistance rules require careful consideration in leveraged transactions, but can usually be solved without unduly hampering a transaction's basic economics.

The U.K. and Ireland

In the U.K. and Ireland, there is an exception to the financial assistance rules commonly referred to as the "whitewash" procedure. If the conditions to the exception are met, the exception permits a target to provide financial assistance by guaranteeing the acquisition debt, advancing funds to the acquisition vehicle or otherwise providing credit support for the acquisition debt. To make use of the "whitewash" procedure in the U.K., the directors of the target must conclude that, after giving effect to the credit support, the target is expected to remain solvent for at least 12 months following the acquisition. The directors' statutory declaration must be accompanied by a report from the company's auditors that the directors' opinion is not unreasonable. Similar (but not identical) rules apply in Ireland.

The "whitewash" procedure, however, is not available in all circumstances. For example, it is not available for "public" companies. In the U.K. and Ireland, however, a public company, may be converted into a private company and then financial assistance may be given after compliance with the "whitewash" procedure. A 75% shareholder vote is required for the conversion for both countries. (In public tender offers in the U.K., the initial minimum acceptance condition is usually 90%, the threshold necessary for a squeeze-out, but this condition is often waived once the 75% threshold is met.)

Continental Europe

In continental Europe, "whitewash" procedures are generally not available, and other techniques to resolve the financial assistance issues must be used.

One technique is to place acquisition debt in an acquisition vehicle formed in the same country as the target. The target can then dividend profits (or other distributable reserves) to the acquisition vehicle in order to service the debt. Annual dividends to service acquisition debt generally do not raise any financial assistance issues. In some jurisdictions, however, large dividends immediately after the acquisition may raise questions under the rules.

Theoretically, financing an acquisition in this manner might be more costly, because the target may not provide upstream guarantees or other credit support for the acquisition debt without violating the financial assistance rules. However, a pledge of the target's shares is permitted under the financial assistance rules in continental Europe. Continental European banks have generally been willing to finance leveraged transactions despite these credit disadvantages.

This technique will not be tax efficient unless the applicable jurisdiction allows the acquisition company and the target to "consolidate" for corporate income tax purposes. Tax consolidation or its equivalent (subject to certain conditions) is possible in France, Germany and The Netherlands,

but not in Italy or Belgium. If tax consolidation or its equivalent is not available, the target must fund the interest expense with after-tax dividends, which is not efficient.

If tax consolidation or its equivalent is not possible, or if the additional financing costs of placing the acquisition debt at the acquisition vehicle level (without any upstream guarantee or other credit support from the target) are too high, a merger of the target and the acquisition vehicle after the acquisition may be an effective solution. After the merger, the cashflow of the acquired business is available to service the acquisition debt and the interest expense can be paid out of pre-tax income.

Downstream mergers (where the acquisition vehicle merges into the target) raise more difficult financial assistance issues in some jurisdictions than upstream mergers (where the target merges into the acquisition vehicle). In a downstream merger, the target assumes the acquisition debt and its assets therefore support the original acquisition debt, which raises a direct financial assistance issue. In an upstream merger, the acquisition vehicle is the surviving entity and the target's assets become assets of the acquisition vehicle, and the target's shares no longer exist. Thus, there is a good technical argument that this alternative does not raise a financial assistance issue. Moreover, an upstream merger immediately or shortly after the acquisition may raise financial assistance (or interest deductibility) issues in certain jurisdictions, including France and Italy. From a corporate perspective, various consents and approvals may need to be obtained in connection with an upstream merger in which the target does not survive.

The financial assistance rules require careful consideration in leveraged transactions, but can usually be solved without unduly hampering a transaction's basic economics. Our London and Paris offices have substantial experience in structuring transactions with due regard for these rules. □

— James A. Kiernan, III and Colin W. Bogie

Clawbacks: Protecting the Fundamental Business Deal in Private Equity Funds

This article briefly describes contractual "clawback" arrangements typically included in the partnership agreement or other constitutional documents of a private equity fund (a "Fund"). This article assumes that the Fund is a limited partnership governed by a limited partnership agreement, with (1) limited partners that invest the bulk of the capital and (2) a general partner that makes investment decisions for, and operates, the Fund and has unlimited liability for the Fund's debts and other liabilities to the extent that they cannot be satisfied out of the Fund's assets.

The fundamental 80/20 deal. The fundamental economic arrangement between investors in a Fund, the limited partners (the "LPs"), and the Fund sponsor, the general partner (the "GP"), is that, over the life of the Fund, (1) the GP is entitled to receive a "carried interest" equal to a specified percentage of the cumulative net profits from the Fund's investment program, and (2) the partners as a group are entitled to receive the remaining profits pro rata in accordance with their respective percentage interests in the Fund plus the return of their invested capital (often defined to include both capital used to purchase portfolio investments plus other capital contributions made to the Fund to pay organizational and operating expenses and to finance management fees). For purposes of discussion, I will assume that the GP of our Fund is entitled to a carried interest of 20%, and will describe the economic sharing between the partners as a group (the LPs, plus the GP to the extent that it invests capital in the Fund), on the one hand, and the GP, on the other hand, as "the 80/20 deal." The clawback provisions described below are included in the Fund's partnership agreement for the purpose of protecting the 80/20 deal, i.e., ensuring that the GP receives neither more nor less than 20% of the cumulative profit distributions from the Fund over its term.

"All capital first" versus "deal by deal" distributions. Historically in the United States (and today in Europe), in many private equity funds (particularly venture capital funds), proceeds from the disposition of investments were distributed on an "all capital first" basis. This meant that the investors

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The Impact of SEC Regulation FD on Portfolio Companies of Private Equity Firms

Recent legal and financial developments highlight the need for private equity firms to keep abreast of disclosure obligations imposed on their portfolio companies by the federal securities laws. The prevalence of high yield debt in acquisition financing has resulted in portfolio companies of financial sponsors having publicly-traded debt securities that impose reporting obligations on the company under the Securities Exchange Act of 1934. In addition, the desirability of leveraged recapitalization accounting treatment – which often is achieved by having the target company maintain public stock ownership (often referred to as the "public stub") – has resulted in public portfolio companies that are controlled by private equity firms. Finally, the appetite that private equity firms have shown in recent years for "PIPES" (private investments in public securities) has produced substantial minority investments in public companies that usually grant the private equity firm representation on the issuer's board of directors. These developments make it imperative that private equity firm employees serving as directors of their portfolio companies as well as senior management of those companies become familiar with disclosure issues under the federal securities laws.

Regulation FD

Under the aggressive leadership of Chairman Arthur Levitt over the last several years, the SEC has announced substantial changes to the public disclosure rules. One of the more far-reaching new rules became effective on October 23, 2000. The rule, known as Regulation FD (for "fair disclosure"), is already having a significant impact on communications among issuers, investors and financial analysts.

Regulation FD is intended to prevent selective disclosure between public companies and the financial community. The new rule requires issuers, or persons acting on their behalf (including directors), to make simultaneous disclosure of any material, non-public information that is intentionally given to specified outsiders. If the disclosure is unintentional (such as an inadvertent mention of a material event during an analyst call), the issuer must make public disclosure of that information "promptly," but no later than 24 hours after a senior officer of the issuer has become aware of the disclosure (or prior to the commencement of the next day's trading on the New York Stock Exchange, if later). Public disclosure can be made through filing or furnishing the information on Form 8-K with the SEC, or through a press release or any other method (or combination of methods) that is reasonably designed to provide broad public dissemination of the information, such as a press conference, conference call or webcast to which the public is granted access. Simply posting the material information on the issuer's website will not alone satisfy the new rule.

In its adopting release for the new rule, the SEC specifically encouraged the growing trend of opening up earnings announcements to the press and the public. It approved the practice, followed by many public companies, of announcing earnings through publication of a press release followed up by a conference call where investors are allowed, with adequate notice, to listen in either by telephone or through Internet webcasting. This practice is less prevalent among portfolio companies with publicly-traded debt (but not publicly-traded stock) and those with a thinly traded public stub.

Key targets of Regulation FD are the one-on-one sessions with financial analysts, industry conferences and other settings in which detailed company information is often shared with analysts and large investors. In particular, in adopting Regulation FD, the SEC is seeking to put an end to selective "guidance" from issuers regarding earnings forecasts. In the adopting release, the SEC explicitly stated that when an issuer official engages in a private discussion with an analyst seeking guidance about earnings estimates, the official "takes on a high degree of risk under Regulation FD." Selective disclosure that the company's anticipated earnings "will be higher than, lower than, or even the same as what analysts have been forecasting... regardless of whether the information about earnings is communicated expressly or through indirect 'guidance,'" will likely constitute a violation of the rule. The rule permits issuers to provide this guidance in an open earnings conference call, so long as there had been sufficient public notice of the call and of the issuer's intention to provide material non-public information during the call.

Overview of Regulation FD

The principal elements of the new rule are as follows:

- The rule will generally only apply to an issuer's communications with market professionals, including

financial analysts and large institutional investment managers, as well as with security holders who would reasonably be expected to trade on the information, and not to communications with the press, rating agencies, customers and suppliers.

- The rule will only apply to communications by the issuer and its senior management, its directors, its investor relations professionals and others who regularly communicate with market professionals and stockholders. The rule does not apply to communications by more junior managers and employees.
- To be in violation of Regulation FD, the selective disclosure must be intentional or reckless; that is, the individual making the disclosure must know (or be reckless in not knowing) that he or she was communicating information that was both material and non-public.
- For the public disclosure to be effective, it must be filed or furnished on Form 8-K or disseminated through another method, or combination of methods, of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public. If the information is "furnished" on Form 8-K, rather than "filed," it will not automatically be incorporated by reference into the issuer's Securities Act registration statements nor will it expose the issuer to liability for false or misleading statements in Securities Act or Exchange Act filings; although it would remain subject to general antifraud rules.

The SEC stated in the adopting release that acceptable alternative methods of disclosure include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public, after adequate notice, may attend or listen to either in person, by telephone or by other electronic means, such as a webcast. The public need not be allowed to ask questions. The SEC stopped just short of approving website disclosure as an acceptable alternative means of disclosure, noting that an issuer would, under certain circumstances, be able to demonstrate that website disclosure, in combination with other methods, designed to make the information public would satisfy the public disclosure requirements of the rule.

- An issuer's failure to make a public disclosure required solely by the rule will not be deemed to be a violation of Rule 10b-5, the antifraud rule, and thus will not alone give rise to a private right of action. Violations would be punished through SEC enforcement actions. A violation of the rule will also not disqualify a company from using Form S-3 or other short-form registrations, or preclude an investor from selling the company's securities under Rule 144. However, the rule would not affect any existing grounds for liability under Rule 10b-5 – such as for "tipping" and insider trading or for failure to make a public disclosure where there was a "duty to correct" or a "duty to update" or in cases where the issuer's contacts with analysts expose it to liability under "entanglement" or "adoption" theories.
- The rule excludes communications made in connection with most registered securities offerings; that is, road show disclosures made in connection with such offerings are not subject to the new rule. However, if the issuer already has publicly registered securities and is conducting a Rule 144A offering or other private placement (such as to managers purchasing equity), the new rule would apply. In a Rule 144A offering or private placement to management, however, potential investors would typically be required to agree expressly to keep the issuer's information confidential, and such a confidentiality agreement also provides an exemption from the rule.

Best Practices

Although "best practices" are still developing, issuers should consider the following guidelines for surviving under the new rule.

- Adopt a written compliance policy. As the SEC noted in its adopting release, the existence of a written policy for complying with the new rule may be relevant in determining a company's intent with regard to selective disclosure. Private equity firms whose members serve as directors of their portfolio companies are particularly well-positioned to require such policies throughout their companies. Such a policy should enable the issuer to:
  - Designate the corporate officers who are authorized to speak on behalf of the company with the financial community, shareholders and media.
  - Educate the authorized spokespersons about their obligations under the rule.
  - Caution other employees that they are not authorized to communicate with analysts, stockholders or the media and are subject to sanction or termination if they do so. There is a risk that

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The SEC's New Reporting Rules for Guarantors

The Securities and Exchange Commission recently issued new financial reporting rules for related issuers and guarantors of guaranteed debt securities under Financial Reporting Release No. 55. The new rules could apply to many portfolio companies of financial sponsors if their acquisition debt includes high yield securities with holding company or subsidiary guarantees. For the most part, the rules codify many of the positions taken by the SEC staff in interpreting prior SEC accounting policies under Staff Accounting Bulletin No. 53, which has been rescinded. The new rules are very detailed, and are intended to eliminate uncertainty that existed under prior practice and reduce the need for no action letters from the SEC.

Under the new rules, a reporting company will generally be required to include condensed consolidating financial information in its financial statements as a condition to omitting the separate financial statements of a subsidiary issuer or subsidiary guarantor in the registrant's filings and obtaining reporting relief for that subsidiary. This general result is broadly consistent with prior SEC practice, and in most cases should not require significant changes in the way issuers prepare their financial statements.

What's New

The new rules, however, are not simply a codification of existing practice. For example, under prior practice, a "shell" holding company that guaranteed the debt securities of an operating subsidiary could in effect file one set of periodic reports for both companies, using the parent's consolidated financial statements with narrative footnote disclosure generally explaining that the two companies' financial statements were not substantially different. While that practice still seems sensible, some major accounting firms have conflicting views on whether it can continue without modification under the new rules, at least where the issuer itself has significant nonguarantor subsidiaries. In this circumstance, some accountants believe that the new rules may require condensed consolidating financial information that breaks out the subsidiary issuer separately from its subsidiaries. If so, a company that voluntarily provided a parent guarantee to become eligible for parent-only reporting might now have to provide additional financial disclosure for the issuer on a stand alone basis, which was not previously required to be made public.

Under the securities laws, a guarantee is treated as a security separate from the security that is guaranteed. Generally, SEC rules require all issuers or guarantors of registered securities to file separate reports and include separate financial statements in their filings. However, the new reporting rules provide that, under certain circumstances, companies may present either modified financial information – condensed consolidating financial information in a footnote – or narrative disclosures instead of full financial statements, and subsidiary issuers or guarantors may be exempt from separate reporting requirements.

When It Applies

In all cases, the new rules require the subsidiary issuer or subsidiary guarantor to be wholly owned, and each guarantee to be full and unconditional. The new rules apply in the following circumstances: (1) a subsidiary issues debt securities that are guaranteed by its parent; (2) a subsidiary issues debt securities that are guaranteed by its parent and one or more other subsidiaries of its parent; or (3) a parent issues debt securities that are guaranteed by one or more of its subsidiaries. Where multiple subsidiary guarantors are involved, condensed consolidating financial information can be provided for the subsidiary guarantors as a group so long as their guarantees are joint and several – otherwise, individual condensed information must be given for each subsidiary that does not provide a joint and several guarantee.

The new rules allow a parent company to provide narrative disclosures instead of condensed consolidating financial information in four basic situations. In the first, the parent is the sole guarantor of securities issued by a finance subsidiary. In the other three, the parent has no independent assets or operations, and either (1) the parent is the sole guarantor, and all of its subsidiaries other than the issuer are minor, (2) the parent is the issuer, one or more of its subsidiaries guarantee the securities on a joint and several basis, and its other subsidiaries are minor, or (3) the parent guarantees securities issued by a finance subsidiary, and all of its other subsidiaries guarantee the securities on a joint and several basis.

A copy of Financial Reporting Release No. 55 can be found on the SEC's website at http://www.sec.gov/rules/final/33-7878.htm. ▢

— David A. Brittenham, Peter J. Loughran and Paul D. Brusiloff

- The Cayman Islands limited partnership law provides a lot of flexibility and allows for U.S.-style limited partnership agreements.
- The Cayman Islands law provides limited liability for the limited partners, which is respected by the U.S. and other developed countries.
- There is no tax in the Cayman Islands.
- The Cayman Islands is not considered a "tax haven" by the Organization of Economic Cooperation and Development. The OECD has indicated that it intends to recommend to its member countries that certain defensive measures be enacted to deal with investments made through tax havens (e.g., disallowing deductions, expenses and credits; requiring comprehensive information reporting; and enhancing audit and law enforcement activities).

Other popular jurisdictions include Bermuda, the British Virgin Islands and (in the case of funds investing in Eastern Europe) Cyprus.

Potential Drawbacks

There are, of course, a few downsides to using a non-U.S. partnership, particularly if the fund is going to make investments in U.S. companies.

- Although the U.S. market is generally open to foreign investment, various U.S. statutes and regulations restrict the ability of non-U.S. persons to invest in certain types of U.S. businesses. For example, under current law, a non-U.S. limited partnership is generally limited to holding minority positions (as little as 25% of the stock) in, and would not be permitted to control (through contractual rights or otherwise), media companies (including radio and television broadcast systems), U.S. airlines and U.S. intercoastal shipping businesses. U.S. law also restricts relationships by non-U.S. persons with defense-related industries, although it may be possible to take certain steps to avoid the application of these restrictions (e.g., insulating the non-U.S. partnership from access to classified information).
- A second potential downside relates to the application of the U.S. withholding tax rules. If a U.S. portfolio company pays a dividend to a Cayman Islands (or other non-U.S.) partnership, the company is generally required to withhold 30% from the dividend and pay the withheld amount to the U.S. IRS. The withholding is not an "incremental" tax, and the U.S. partners are generally entitled to claim a credit for the tax. However, the effect of the withholding is to require any tax exempt partners that are not subject to U.S. tax on dividends (and non-U.S. partners who are eligible to claim treaty benefits) to seek a refund for their share of the withholding. Under new rules that go into effect in January 2001, a non-U.S. partnership may avoid this "excess" withholding by providing detailed information about its partners to the portfolio company.
- A further potential downside is that U.S. partners who contribute cash to a foreign partnership are generally required to report the transfer to the IRS. Although compliance with this rule is straightforward, a U.S. person who fails to report a transfer is generally subject to a penalty equal to the lesser of $100,000 and 10% of the cash transferred. These reporting rules do not apply to transfers to U.S. partnerships.

The Best of Both Worlds

It is now fairly common to start with a Delaware limited partnership and include a provision in the limited partnership agreement of the fund that allows the sponsor to form a separate partnership (which may be organized outside of the U.S.) to make specific investments if necessitated by legal, tax or other considerations. One frequent issue with this provision is that the separate partnership may not be treated for tax purposes as a non-U.S. partnership if, in computing the override, a loss by one partnership must be made up by gains of the other partnership. As a result, the provision frequently permits the override of each partnership to be computed independently of the other partnership in cases where it is necessary to the tax (or other regulatory) analysis to do so. However, the ability not to integrate the economics is sometimes a sticking point in negotiations. Moreover, even sponsors who win the point are sometimes loath not to integrate out of investor relations concerns. □

— David H. Schnabel

were entitled to receive all distributions from the Fund until such time as they received an amount equal to the total capital contributed by them to the Fund. Only after the return to the investors of all capital contributed by them was the GP entitled to receive carried interest distributions. In the U.S. private equity market today, however, carried interest distributions are typically made on a "deal-by-deal" basis. This is universally true for LBO funds, and is the norm (although not always the case) for venture capital funds. It is this "deal-by-deal" distribution methodology that creates the possibility of "overdistributions" to the GP and has led to the inclusion in Fund partnership agreements of so-called "GP clawback" provisions.

GP Clawbacks

Why a GP clawback is needed. In a Fund with a deal-by-deal distribution scheme, when a portfolio investment is sold, the partners receive out of the proceeds: first, their capital invested in that portfolio investment (including, as noted above, expenses and management fees allocated to that deal); second, any capital invested in investments previously disposed of to the extent not previously returned; and third, the remaining proceeds (profits) from that portfolio investment are split 80/20 between the partners and the GP. This approach is favorable to the GP, because the GP receives carried interest payments earlier than would be the case with an "all capital first" distribution system. However, the deal-by-deal distribution methodology creates the possibility that the GP will receive more than 20% of the cumulative net profits on all portfolio investments over the life of the Fund, i.e., an "overdistribution" of carried interest. This is illustrated as follows:

Assume that the Fund makes five portfolio investments, A through E, each of which was purchased for $100. Assume that investments B, C, D and E are sold over a period of years for $200 each. Each time an investment is sold, the partners as a group will receive, out of the $200 of proceeds, distributions of $100 (equal to their capital contributed to that deal), plus $80 of the $100 of profit, and the GP will receive $20 of the profit as its carried interest. Thus, out of total proceeds of $800 distributed over time as these four investments are disposed of, the investors will receive a total of ($400 of contributed capital + $320 of profits =) $720. The GP will receive carried interest payments of (4 x $20 =) $80. Now assume that investment A, which had not been performing well and thus remained in the portfolio, files for bankruptcy and is written-off completely (i.e., deemed disposed of for $0). Looking at all five investments over the life of the Fund, we see that net profits were $300, because $500 was invested and resulted in total proceeds of $800 (= $200 + $200 + $200 + $200 + $0). The 80/20 deal agreed to by the LPs and the GP states that the GP is entitled to 20% of the cumulative net profits over the life of the fund, i.e., $60 (= 20% of $300). But the GP received $80 in carried interest distributions as deals B, C, D and E were realized. Thus, there has been an overdistribution of $20 to the GP. To protect the 80/20 deal, the Fund's partnership agreement should provide that this overdistribution amount is to be "clawed back" to the Fund from the GP, and then distributed to the investors.

Selected issues. Certain issues arise in implementing a GP clawback, including the following:

- The GP is typically a special-purpose vehicle with no assets (other than the right to receive distributions from the Fund) and no business other than acting as general partner of the Fund. Cash distributions received by the GP are typically immediately distributed out of the GP to its owners. Thus, isn't the clawback provision meaningless?
- To give the clawback teeth, shouldn't the owners of the GP (i.e., the ultimate recipients of carried interest distributions) be required to guarantee the GP's clawback obligation?
- If the owners do give such guarantees, should they be joint and several guarantees, or only several (and not joint) guarantees from each individual owner capped at the amount of distributions received by such owner?
- Joint and several guarantees could result in one of the individual fund sponsors paying more than his or her fair share of the clawback obligation if one of the guarantors defaults (and then having to seek contribution from his or her defaulting co-guarantor, who could be bankrupt, or from such co-guarantor's estate, if he or she is deceased). But several (and not joint) guarantees could leave the investors with a shortfall if a guarantor defaults.
- Should the GP's clawback obligation, even if guaranteed, be further secured by the holding in escrow of some percentage of distributions in a segregated reserve account? What percentage? Before or after tax?

- Most GPs will resist a holdback of distributions in a segregated reserve account – they want the cash to spend or invest as they please. Cash deposited in a segregated reserve account should be invested in safe, cash-equivalent type investments, which will not yield particularly attractive returns.
- Should the GP clawback be "net of taxes"? When the GP (or the owners of the GP) pay all or any portion of the clawback obligation, this typically creates a capital loss for the owners. However, under U.S. federal income tax rules, capital losses cannot be carried back by individuals (i.e., they can not be offset against prior year capital gains, which were taxed at that time). For this reason, the GP may offer only a GP clawback that is "net of taxes", i.e., a provision where the amount of the clawback obligation never exceeds the excess of (1) total distributions received by the GP over (2) total taxes paid or payable (usually at an assumed rate of tax) thereon.
- Timing: In principle, the GP could be required to make clawback payments from time to time over the life of the Fund, such as annually, if there has been an overdistribution. This is sometimes referred to as a "true-up" made during the life of the Fund. In the current private equity fund market, however, GP clawbacks almost always are given effect only at the time of dissolution of the Fund.

LP Clawbacks

Why an LP clawback is needed. In recent years, particularly in LBO funds, it is increasingly common for private equity fund sponsors to include in the Fund documentation a so-called "LP clawback". As with the GP clawback, the goal is to protect the 80/20 deal.

Here is one scenario where an LP clawback may be needed: The Fund disposes of the last investment in its portfolio (by negotiated sale or pursuant to a public offering of securities) and distributes the proceeds to the partners; the Fund has not yet been dissolved. Shortly after the disposition, the Fund is sued by a purchaser of the business or securities disposed of. The purchaser alleges a breach of representations and warranties in the sale agreement, or makes a securities fraud claim or some other claim. Even if the claim is without merit, it will need to be defended. Legal costs can mount quickly, but the Fund may not have sufficient assets to defend the claim or indemnify the GP if the GP defends the claim or incurs liability (as general partner) on behalf of the Fund. If the GP or the owners of the GP pay these Fund expenses out of its or their own pockets (which they might be required to do for a variety of reasons), then in fact the GP will have borne more than its share of the Fund's losses, and the LPs will have received a windfall. If the claim had occurred at an earlier point in time when the Fund had assets, the investors would have borne 80% of the loss (and the GP would have borne 20%, because profits would have been reduced by the amount of the loss), whereas in this scenario the GP bears 100% of the loss and the LPs bear none. Thus, the 80/20 deal becomes, let's say, an 82/18 deal. An LP clawback provides that the partners of the Fund are subject to having their distributions clawed back to the Fund in order to enable the Fund to indemnify the GP against losses. (Note that the term "LP clawback" is a misnomer because it is usually drafted as a clawback from all partners.)

Selected issues. Some issues that arise in connection with LP clawbacks include the following:

- Should there be a time limit on when distributions may be clawed back? In principle, no, if the goal is to protect the 80/20 deal. However, LPs want repose. After some period of time they want to know that distributions received by them are not subject to being clawed back.
- As is the case with the GP, shouldn't the LP clawback be "net of taxes"? In principle, yes, although many, and often most, Fund investors are tax-exempt. Also, see the next point below.
- Frequently investors negotiate for, and receive, a limit not only on the time period during which distributions can be clawed back, but also a limitation on the percentage of distributions that can be clawed back.
- Unlike GP clawbacks, LP clawbacks are virtually never secured or guaranteed, even though some LPs invest in the Fund through a special purpose vehicle. ▢

— Michael P. Harrell

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General Partner, because they don't have to be out-of-pocket after-tax dollars. What are your views? Is this "real money"?

DS It's probably very real money from the General Partner's perspective. This is money that General Partners view as belonging to them, and there is a downside to investing it. It satisfies some of my concerns about coincidence of interest between General Partners and Limited Partners. However, perhaps what's going on is the management fee is too high, and part of the management fee is being recycled into an ownership position for the General Partner. That could be viewed as a higher carried interest at the end of the day.

Q Are you still a proponent of buyouts and venture capital investing? Or do you think the world has changed and people should be focusing somewhere else?

DS I'm absolutely a proponent. We've got 25% of the portfolio in buyouts and venture capital. I've been very aggressive about selling every single public security that we get on the venture side. So, unlike some of our sister institutions, we've kept our venture exposure – both private and public – to less than 10% of the overall endowment. I think what you need to do is to work hard to find the people that are going to be able to succeed in the future.

At Yale, we have two fundamental tenets to our investment philosophy; first, an equity bias and the second is the importance of diversification.

Q We represent a lot of first-time funds. Their particular take on the market for 2000 is that there's just not money for them. And the mega-funds have soaked up everyone's allocation for the year, and they are having a hard time. Is their perception accurate?

DS I think it is. People are having a hard time raising first-time funds. We've seen that some very credible groups just cannot get the time of day from the institutional investment community. But if you look at the commitments that we've made around the world over the last year, it's been mostly middle-market funds that don't have ten years of audited investment performance numbers.

Q What are you looking for? What distinguishes a firm that you will invest with from one that you wouldn't invest with?

DS One thing we love is operating expertise. We love the combination of financial engineering and operating expertise. Firms with both skill sets care about the company's operations and probably, more than anything else, want to create something that five years from now is a more valuable enterprise.

Q To what extent when you are evaluating a fund do you pay attention to the General Partners' compensation structures? Do you care about vesting and similar issues? Do you ever get actively involved in suggesting ways to restructure those?

DS Yes, we care a lot about vesting. In a partnership that has immediate vesting, there is a potential for disaster. People can walk away and maintain their economic interests and then people who are not properly incentivized are the only ones paying attention to the asset. We care about the distribution of carry. These concerns can often times result in pretty delicate conversations. We don't like to see overly top-heavy allocations of the carry, but we're also not huge advocates of having a completely flat carry, because different people make different contributions. We do like to see a reasonable correspondence between the contribution that we think people are making and their incentives. So we do ask those questions, and we do care about it.

Q What terms and conditions do you most worry about in the funds in which you invest? Are you paranoid about UBTI, keyman provisions, and the like?

DS Ironically, sometimes we are more worried that certain terms and conditions that other investors propose will be adopted. For instance, we don't like situations where the Limited Partners can by majority vote or supermajority vote do this or that or the other thing to the General Partner. That's because at the end of the day we are more concerned that the other Limited Partners will gang up and do something that doesn't make sense. With respect to UBTI, we're happy to pay taxes if there's no way to structure around it, and our after-tax returns are adequate. A lot of people don't want to do it, and I don't understand why this is a hot button for them. Filing the form is not that complicated. On the keyman issue, we're realistic enough to recognize that often times you're depending on one or two key people, even in larger organizations. I think that's particularly true in the investment business. However, we recognize that there might be circumstances in which we're going to have to work things out, and an insurance policy isn't going to give us adequate recompense to deal with the loss. ▢

analysts, knowing they will have less access than in the past to senior officials for information about the company, may redouble their efforts to obtain such information by contacting less senior employees.

- Establish guidelines for one-on-one sessions with analysts or major stockholders. While it may not always be possible in practice, it would be preferable that senior officers meeting with members of the financial community be accompanied by a senior investor relations person or lawyer who can listen to the conversation and bring to the attention of the appropriate person any information conveyed in the meeting that might raise an issue under Regulation FD. Discussions with analysts or major stockholders covering non-material information or material information that has already been publicly disseminated would not present a problem under Regulation FD. Determining materiality, however, can be difficult and both a quantitative and qualitative analysis must be used.
- Prepare scripts, slides and other materials for speeches and presentations at industry conferences, which should be pre-cleared by a senior investor relations person or lawyer to ensure that no information that would create a problem under Regulation FD is included. If possible, likely questions should be anticipated and answers prepared and reviewed.
- When and where possible, request that analysts furnish in advance questions they would like addressed at an analyst meeting. Encourage company spokespersons to avoid responding when they are uncertain if the information that has been requested is material or non-public.
- Consider or re-examine "black-out" periods for analyst communications. Companies should consider establishing appropriate blackout periods when analyst communications are cut off. The later in the quarter that communication is made to analysts, the greater the risk of disclosure of material non-public information.

- Inform the directors that they are subject to Regulation FD. Regulation FD covers communications by directors. The general counsel's office or outside counsel should distribute to all directors a memo explaining Regulation FD and advising the directors that they are subject to its restrictions and should be circumspect in talking about the company's affairs with anybody outside the company, particularly anyone involved in the financial community or stockholders. Private equity firms should also caution their employees who serve as directors of companies where they are minority investors. Directors should be advised to call the general counsel or other designated person immediately if they think they have made an inadvertent disclosure of material, non-public information.
- Have a plan to respond to potential unintentional selective disclosure. Regulation FD not only covers intentional disclosures to analysts and others, but also unplanned, inadvertent disclosure of material information. In the event of an unintentional selective disclosure of material, non-public information, Regulation FD requires the company to make a public disclosure within the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange, in each case after a senior official learns of the disclosure.

Impact on Financial Sponsor Companies

The primary target of the SEC's "fair disclosure" initiative was what the SEC perceived to be a widespread practice among issuers of giving selective earnings guidance to market professionals. For financial sponsor portfolio companies with no public equity securities, the company's reported earnings are of less interest to the market. Nonetheless, high yield bonds trade more like equity than like investment grade debt and, in such a market, the kind of information that can move stock prices can also move bond prices. The federal securities laws make no distinction between companies with public debt only and those with both public debt and equity for purposes of the applicability of the disclosure rules. For these reasons, senior management and the finance and legal functions of financial sponsor portfolio companies need to be informed of the SEC's disclosure rules, of which Regulation FD is only the latest example. This requirement to be informed applies in spades to private equity firms that control or invest in public portfolio companies. □

— Paul S. Bird

alert

New SEC Rule Makes Trading Easier for Insiders

A new SEC Rule (Rule 10b5-1) is expected to make it easier for insiders like private equity firms and managers to sell securities. The new rule, effective in October, codifies the SEC's position that insider liability arises whenever an insider trades while in "knowing possession" of material nonpublic information and that proof that the insider "used" the information for trading is unnecessary. More importantly, for most insiders, the new rule provides an affirmative defense against liability for insider trading violations for trades made while the insider is aware of the nonpublic information, so long as the trade is pursuant to a plan made before becoming aware of the information.

The rule will make it easier for insiders to comply with securities laws. Insiders will be able to plan securities transactions when they are not in possession of material nonpublic information and carry out those transactions at a later time, even if they become aware of material nonpublic information in the interim. Since the rule may permit more frequent trading by insiders, it is of particular interest to companies where insiders such as private equity firms or management hold most of the equity. Senior executives whose wealth is tied up in stock and options will be able to use the rule to sell securities on an orderly basis.

Rule 10b5-1 will also make it easier for insiders to participate in employee stock purchase programs, invest in Company stock under their 401(k) plans and participate in other benefit plans funded through payroll deductions without worrying about insider trading liability. Issuers may wish to use the rule in connection with their open-market stock repurchase programs.

Elizabeth Pagel Serebransky has written a memo outlining the likely uses for the rule, what it does and does not permit and some practical steps for companies to consider taking in order to preserve the defenses to liability afforded by the rule. For a copy of her memo, please visit Debevoise's website at www.debevoise.com. ▢

Upcoming Speaking Engagements

December 1	Jeffrey P. Cunard, Michael J. Gillespie, Andrew M. Ostrognai and Christopher J. Smeall **Legal Issues Affecting Investment in the New Economy** Tokyo, Japan
December 4-5	Kenneth J. Berman **2000 Securities Law Development Conference** Washington, D.C.
December 13	Michael P. Harrell **Private Equity Fund Formation Conference** San Francisco, CA
February 12	Franci J. Blassberg **Strategies for Financing Acquisitions, Restructurings and Dispositions** New York, NY