THE DEBEVOISE & PLIMPTON
PRIVATE EQUITY REPORT

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Keeping Private Funds Private on the Internet

As the Internet becomes an increasingly important part of business life, private funds and their sponsors face a challenge: how to keep up with technology and take advantage of the vast public reach of the Internet, while maintaining their legal status as private entities exempt from registration under the securities laws.

Fund sponsors put a great deal of energy into keeping themselves and their funds private to avoid the regulatory burdens that come with registration under the Securities Act, the Investment Advisers Act and the Investment Company Act. In establishing an Internet presence, private fund sponsors need to bear in mind the network of exemptions on which they rely. This article addresses two ways in which fund sponsors' web sites can threaten an exemption: first, by holding the sponsors out to the public as investment advisers; and second, by facilitating a "general solicitation" that results in a "public offering" of private fund securities.

Don't Hold Out

Most private fund managers are not required to register under the Investment Advisers Act, thanks to an exemption for investment advisers with fewer than 15 advisory clients. Each private fund counts as one "client" for these purposes. (For a discussion of who counts as a client for registration purposes, see "Registration as an Investment Adviser: The More Successful You Are, The More Likely You Will Be Required to Register" on page 6 of this issue.) However, no matter how few clients an adviser has, it will not be eligible for the exemption, and will have to register under the Advisers Act, if it "hold[s] itself out generally to the public as an investment adviser." An adviser using its website to offer advisory products or services directly over the Internet – e.g., "Call or e-mail today to open an account!" – would clearly be holding itself out generally to the public as an adviser. Even describing the services a private fund manager provides to its funds should be avoided. Providing information on investments and general strategy is a closer call, and will depend on the facts. Although the SEC has never voiced its opinion on this issue directly, it has taken a conservative view on Internet use by advisers generally. Therefore, advisers should err on the side of caution.

Many private fund sponsors maintain web sites as a part of their general public relations strategy, including as a means of attracting deal flow. An adviser with a large investment pool will want to mention that fact in its web site. Here is where it gets tricky. While it may be appropriate to mention one's source of funds and to describe institutional goals and

continued on page 14

What's Inside

"OK, we won't put our IRR on our website. But can we hand out these tote bags at the annual Private Equity Analyst conference?"

letter from the editor

Welcome to the second issue of The Debevoise & Plimpton Private Equity Report, a publication for our clients and friends in the private equity world. As we noted when we introduced this publication late last year, we hope it will focus private equity firms and their advisers on ways in which recent legal developments impact private equity firms and their portfolio companies.

We are pleased that Michael S. Klein, Vice-Chairman, Co-Head of Global Investment Banking, of Schroeder Salomon Smith Barney, is the guest columnist for this issue. Michael has long been a leading adviser to private equity firms and was recently honored as Banker of the Year by Investment Dealers Digest. In his article titled "Do All Good Things Come to an End," Michael notes that 2001 will represent the strongest test of the private equity model in over a decade.

Notwithstanding the turmoil in the dot.com world, private fund managers have made doing business on the Internet part of their normal business practices. In this issue, Jennifer Burleigh, who practices in our Investment Management Group, cautions private fund managers on using websites in a way which will maintain their ability to offer their funds in private placements and without having to register as investment advisers. Also in this issue, David Schwartz, a counsel in our Investment Management Group, explains that registration as an investment adviser is not as onerous as many might expect.

With this issue we introduce a new feature, Trendwatch, which will identify various trends in the financial terms of private equity funds. We start with an analysis by Woody Campbell, a partner in our Investment Management Group, on fund management fees.

We also focus on some new legal developments of particular interest to private equity firms including recent changes to the Hart-Scott-Rodino filing regime and a new SEC pronouncement that will make it easier for portfolio companies to retain flexibility in raising capital. Drawing from a recent Delaware Supreme Court case, another article cautions private equity firms that are controlling shareholders in portfolio companies imposing an exit strategy without regard to board deliberation processes may be risky. We also offer some guidance on offering funds to European investors without running afoul of local legal restrictions.

We are pleased at the reception you have given to this publication. Please note that we are now offering delivery via e-mail. We welcome your comments on this issue and any guidance you might offer on ways in which we can offer practical guidance on matters of interest to private equity firms and their investors.

Franci J. Blassberg
Editor-in-Chief

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Caution to Controlling Shareholders: Process Matters When Selling a Portfolio Company

Every private equity fund manager knows that while acting as a controlling shareholder of a portfolio company, it needs to be mindful of the interests of and potential conflicts with minority shareholders. However, few controlling shareholders would doubt that they will be able to dictate the timing and process of a company's sale. After all, one of the primary advantages of being a controlling stockholder is being able to control the exit.

If the controlling stockholder isn't getting a disproportionate share of the "control premium," directors representing private equity firms would generally assume that minority shareholders will have no basis for complaining about how a sale was handled. A recent Delaware Supreme Court case, involving the sale of a public company that was 80% owned by Atlantic Richfield Company (ARCO), highlights the need to give special attention to the interests of minority shareholders at the time the business is sold.

A subsidiary is sold. After ARCO agreed to sell an 80%-owned subsidiary to a third party in a negotiated, all-cash, all-shares tender offer, a minority shareholder sued, claiming that the subsidiary's directors – a majority of whom were affiliated with ARCO – had breached their fiduciary duties in at least three ways: by failing to maximize value for all subsidiary shareholders, by delegating control of the sale process to ARCO, and by failing to disclose enough information for the minority shareholders to be able to decide whether to tender their shares or instead seek a judicial appraisal. Although a lower court dismissed these claims, the Delaware Supreme Court reversed that decision, holding that the claims could proceed.

Duty to maximize value. It is well established that directors of a company involved in a change of control transaction have a duty – often called a Revlon duty – to obtain the best value reasonably available. It's surprising, however, that a court would say that the directors of ARCO's subsidiary had a Revlon duty to the minority shareholders, because control was firmly held by ARCO – in other words, control was not an asset belonging to the other shareholders. The Supreme Court recognized that the subsidiary's board was not in a position to seek alternatives to the transaction negotiated by ARCO. It also recognized that ARCO, as a stockholder, was free to do what it liked with its 80% stake. But since the entire company was to be sold, the directors had an obligation to inform themselves as to whether the deal ARCO was proposing did in fact maximize value for all shareholders.

Even though the directors couldn't prevent the sale of ARCO's stock from going forward, they did have an obligation to assist the minority stockholders in determining whether to tender their shares or seek judicial appraisal rights. In many circumstances, the board of a public company will also have real leverage in the sales process and can make the acquisition more difficult for the acquiror by withholding consent to its acquisition of the controlling shareholder's stock, which, under Delaware's business combination statute, would prevent a merger with the acquiror for three years. In another recent Delaware case, the Board of a company with a controlling shareholder was found to have breached its fiduciary duties for failing to use that leverage effectively.

Delegation of the sale process. It seems ironic for a court to suggest that a professional manager or a controlling stockholder would have any goal in its exit strategy other than of maximizing value at the time of the sale. After all, that's why fund managers demand control over exit strategies. So why not leave to the fund managers the process of negotiating the sale? Aren't managers – with their market clout, and their motivation to maximize IRRs and raise subsequent funds – the ones best suited for this role?

According to the Delaware Supreme Court, the controlling shareholder – whether a large corporation or a fund manager – may in fact have a conflict of interests. In ARCO's case, the

continued on page 9

European Private Placements of Investment Fund Interests

Private placements of interests in investment funds in most European jurisdictions are subject to significant regulation. Although many fund sponsors are most familiar with the variation on the content of the legend that must be included in a fund's private placement memorandum (PPM) for use in foreign jurisdictions, the panoply of regulation can be far more intrusive.

Among the issues that need to be considered before initiating first contact with potential investors are the following: is the marketing of the fund on a private placement basis possible? What type of investors may be targeted? How must the marketing be conducted (e.g., can the PPM be mailed to potential investors, are there any restrictions on cold calls, can meetings be held in the home jurisdiction of potential investors?) Can the offering be done by any person (such as the general partner of the fund or a U.S. broker-dealer) or is the use of a locally licensed placement agent required?

Considering the rules applicable to a proposed private placement of interests in a fund to investors outside the United States as early as possible will make the process of establishing and marketing the fund go most smoothly. Although this article focuses on European countries, similar issues will need to be considered in connection with proposed private placements in other jurisdictions, such as Latin American, Middle Eastern or Asia Pacific countries.

Problem Jurisdictions

In most European jurisdictions, U.S.-style private placements of interests are well accepted practice. However, in a few jurisdictions private offerings are prohibited or are very difficult to effect, even if the offering is limited to institutional investors.

Most U.S. private equity sponsors would be surprised to learn that marketing their funds in Italy is prohibited. In Italy, an offering of interests in a closed-end private investment fund is not possible[1], because the marketing of interests in such funds is subject to the prior authorization of the Bank of Italy which, to date, has never been granted with respect to a non-UCITS fund.

Many U.S. fund sponsors with cross border investment objectives use non-U.S. partnerships as their investment vehicle of choice in order to maximize tax planning. Ironically, this structure may limit their ability to market to investors in Spain. An offering in Spain of interests in a fund established in a tax haven such as the Cayman Islands is currently problematic because the Spanish Securities Commission (the CNMV) has a policy of refusing to authorize any offering, even on a private placement basis, of interests in such funds.

Apart from very narrow "exemptions" (such as certain "passive sales" in Italy and offerings to a very limited number of offerees without "publicity" in Spain), the only way to place interests in most funds to investors in Italy and Spain is to keep all contacts with such investors outside those countries and sell the interests to them in another jurisdiction (subject to compliance with the laws of that jurisdiction).

Nature of the Fund: Delaware LP vs. Cayman Islands LP

The jurisdiction in which the fund is established may be relevant as to whether it can be offered in another jurisdiction and how its offering will be regulated. For example, the offering of interests in a Cayman Islands fund in France will be impossible, whereas a placement of interests in a closed-end Delaware fund will be quite routine. In the United Kingdom, a Cayman Islands limited partnership will be treated as an "unregulated collective investment scheme" because it is not considered a separate legal entity under Cayman Islands laws, and therefore, will be subject to a different set of regulations and private placement exemptions than would a Delaware limited partnership (which is considered a separate, legal entity).

Nature of the Investors: Who and How Many May be Targeted?

Except as noted above, one or several private placement exemptions are available in most European countries for private investment funds. Many jurisdictions, such as Belgium, France, Germany, the Netherlands and the U.K., have private placement exemptions available only for certain classes of investors (most frequently, professional or institutional investors). In such cases, contact with an unlimited number of investors will be permitted so long as it is limited to investors of the eligible class. In Germany, however, the interests in the fund should be offered only to investors with whom the general partner or the placement agent has existing investment relationships or who have expressly authorized such general partner or placement agent to contact them with respect to new investment opportunities.

As is the case in the United States, offerings in Europe to individuals generally will be subject to stricter regulations than offerings to institutional investors. In the Netherlands, for example, there is no private placement exemption for offerings to individuals, even high-net worth individuals, unless such individuals trade in securities in a professional capacity. French legislation provides for a private placement exemption when the offer is made to a "close circle" of individual investors acting for their own account. The concept of "close circle" is narrowly defined as personal family or professional acquaintances of the management of the issuer and would exclude other high-net worth individuals. In the U.K., any PPM and other offering materials sent to potential qualifying investors will be considered "investment advertisements" and, as such, will require approval by a person authorized to conduct investment business in the U.K. (a so-called "authorized person"), unless the offer is restricted to persons "sufficiently expert to understand the risks involved," a concept that covers most institutional investors and large companies and trusts, but not individuals, even high-net worth individuals.

In certain countries, private placement exemptions are available only if the offer is restricted to a limited number of investors (e.g., no more than 50 persons in the U.K., assuming the fund is a "body corporate") and/or the minimum investment required per investor exceeds a certain amount. Most private funds meet the minimum investment criteria which range, based on current exchange rates, from about $40,000 to $250,000 depending on the jurisdiction. Whereas such exemptions apply to offers to any type of investors, they will be most useful if the fund targets individuals. The reach of such exemptions may, however, be restricted by other sets of rules protecting individual investors. In the U.K., for example, although an offer to individuals can be made on the basis of such exemptions, the PPM and other offering materials will need to be approved by an authorized person.

Nature of the Offering: Restrictions on Marketing

Generally, the rules applicable to the distribution of the PPM and other offering materials and to the conduct of other marketing activities will be very similar to those for a private offering in the United States. In essence, interests in a fund should be marketed and sold in a manner that would not result in the offering being deemed a public offering. For example, there should be no advertising on television or radio or in newspapers of general circulation, no general solicitation or cold calling of potential investors, and no mass distribution of the PPM or other offering materials.

In addition, as discussed above, the number and kinds of investors to whom the PPM and other offering materials may be distributed is restricted by local law. In France, for example, it is further recommended that the offering materials be sent only at the written request of the investor.

One-on-one meetings and roadshows with prospective eligible investors will generally be permitted. In Belgium, however, visits to prospective investors, whether individuals or legal entities, to offer the interests are prohibited except if made to banks and brokers (but not other professional investors covered by the "professional investor" exemption). In the U.K., the restrictions on "investment advertisements" referred to above will apply equally to materials distributed at those meetings and to any oral presentation. Therefore, an authorized person should be involved in those meetings unless the only attendees are the so-called "expert" investors referred to above. Furthermore, U.K. law prohibits "unsolicited calls"except in particular circumstances from certain "overseas persons" (i.e., a person who does not have a permanent place of business in the U.K.).

Locally Licensed Placement Agents

In all E.U. member States, only licensed investment services providers may provide investment services (such as placement services) with respect to financial instruments (such as interests in private funds). Therefore, if a placement agent is used to market a fund in a E.U. jurisdiction, such placement agent must be licensed as an investment services provider in that jurisdiction. Generally, an investment services provider that is licensed in one E.U. member State and who has complied with the required notification procedure is considered to be so licensed in the other E.U. member States. There are, however, particular exceptions to this licensing requirement in certain jurisdictions. In Germany, for example, placement agents will not need a license if they market the interests to qualifying investors from outside Germany. The Dutch Securities Board takes the position that a foreign broker dealer acting as a placement agent in the Netherlands will not need to be licensed as long as it does not actively solicit the Dutch market and the first contact was initiated by the investor. In the U.K., an "overseas person" may carry on investment business in the U.K. (including selling interests in a fund) without being authorized to do so in the U.K., provided that it does not solicit investors in the U.K. in a way which contravenes U.K. regulations on "investment advertisements" and "cold calling." Finally, in certain countries, such as France and the

continued on page 13

1 *Only interests in a UCITS (Undertaking for Collective Investment in Transferable Securities), which are open-ended funds established in a E.U. jurisdiction in compliance with the requirements of E.U. Directive 85/611 relating to UCITS, are permitted in Italy.*

Registration as an Investment Adviser – The More Successful You Are, the More Likely You Will Be Required to Register

Most managers and general partners of private investment funds are exempt from registration under the Investment Advisers Act of 1940 because they have had fewer than 15 clients in the preceding 12 months and do not hold themselves out to the public as investment advisers. However, long before raising Fund XV, a manager may no longer qualify for this exemption. This article discusses certain of the requirements imposed on registered investment advisers - and concludes that registration is not as onerous as often presumed.

General Rule

Managers and general partners of private equity funds are considered to be investment advisers under the Investment Advisers Act of 1940. However, an investment adviser who during any 12 month period has had fewer than 15 clients and who does not hold itself out generally to the public as an investment adviser is not required to register under the Advisers Act. (Have you checked your Web page lately? – While you may have had fewer than 15 clients, you may be inadvertently holding yourself out to the public as an investment adviser. See "Keeping Private Funds Private on the Internet" elsewhere in this issue.)

Who is a client?

Each fund –as opposed to each individual partner of a fund – will be counted as one client if the advice given by the manager is based on the investment objectives of the fund rather than the individual investment objectives of its partners. Accordingly, while a manager or general partner may raise capital from dozens of investors, the determinative question is generally: how many separate funds does the adviser manage? Even though a manager may only be raising Fund III or IV, if it has set up several parallel funds, sector funds, entrepreneur's funds and employees' securities companies in connection with those funds, it may reach the 15 client limit long before raising Fund XV. Also, funds which are fully invested but not dissolved continue to count as clients since the manager will advise on dispositions.

An investment adviser does not need to count itself as a client. In addition, the general partner of a fund or a side-by-side co-investment fund for the senior employees of the manager generally do not need to be counted as clients.

Substantive Requirements

While the Advisers Act imposes significant substantive requirements on a registered investment adviser and the conduct of its business, most fund managers should be able to comply with the requirements of the Advisers Act without materially altering the way they do business. Fund managers on the borderline should note that the penalties for willful violations of the Advisers Act include monetary fines, imprisonment for up to five years, or both. In addition, any contract made in violation of the Advisers Act or performance of which would violate the Advisers Act is void as to any person violating the Advisers Act.

The following are areas of significant substantive regulations imposed by the Advisers Act and the rules thereunder on registered investment advisers:

1. *Performance-Based Fees.* Investment advisers may generally not charge "carried interest" fees based on capital appreciation. However, the prohibition against performance fees does not apply with respect to fees charged to, among other things, (i) "qualified purchasers" (natural persons owning at least $5 million in investments and entities which in the aggregate own and invest on a discretionary basis at least $25 million), (ii) sophisticated clients (generally persons with a minimum net worth of $1.5 million or more or a minimum of $750,000 of assets under management with the investment adviser), (iii) knowledgeable employees (employees involved in the investment activities of the adviser but not in a purely ministerial capacity) and (iv) clients that are non-U.S. residents. Other than perhaps investors in a fund for employees (which mostly do not charge a carry in any event) and an entrepreneur's parallel fund, the typical investor in a private equity fund falls within the above categories.

Even if a fund manager is not currently required to register as an investment adviser, it should consider only permitting "qualified" and "sophisticated" purchasers to invest in its funds so that it will be able to register in the future if its business model changes without jeopardizing its ability to charge performance fees.

2. *Anti-Fraud Provisions.* Generally, the anti-fraud provisions of the Advisers Act broadly prohibit any fraudulent conduct on the part of any investment adviser. The courts have interpreted the Advisers Act's anti-fraud provisions as imposing an affirmative duty of utmost good faith with respect to their clients and a duty to make full and fair disclosure of all facts that are material to the advisory relationship, particularly where the adviser's interest may conflict with its clients. In addition to these general duties, the Advisers Act and SEC anti-fraud rules include a number of specific requirements:

- *Advertising Restrictions:* Generally, the Advisers Act prohibits registered advisers from distributing any advertisement that, among other things, contains untrue statements of material fact or that is otherwise false or misleading. The term "advertisement" is defined broadly and certainly includes the offering memorandum for a fund. In particular, the SEC staff takes the position that track record disclosure for registered advisers generally must present IRRs on a net (and not just a gross) basis. (Many unregistered fund managers already disclose net IRRs in response to investor requests.) In addition, the advertising rules specifically prohibit a registered investment adviser from using testimonials in its advertisements and contain restrictions on the use of prior investment recommendations in advertisements.
- *Insider Trading; Codes of Ethics:* Although the Advisers Act requires an investment adviser to establish, maintain and enforce policies and procedures tailored to prevent the misuse of material non-public information by the investment adviser or any person associated with such adviser, many non-registered investment advisers, either as a matter of prudence or because of requirements contained in their fund agreements, effectively adopt personal trading policies that would comply with the requirements of the Advisers Act. Many registered investment advisers also maintain codes of ethics governing the personal trading activities of their employees. These codes of ethics are designed to assure that employees do not trade in a manner that is inconsistent with the adviser's fiduciary duties. In addition, the registered investment adviser must keep a record of the personal securities transactions of certain of its personnel.
- *Principle and Agency Cross Transactions:* A registered investment adviser who sells securities to or purchases securities from a client (either as a principal or broker) must disclose in writing to its client the capacity in which it is acting and obtain the consent of the client prior to the transaction. This is of particular concern for funds sponsored by or associated with investment banks.

3. *Books and Records.* Generally, a registered investment adviser must maintain books reflecting its financial affairs and describing transactions for and communications with its clients. A registered adviser must also maintain all accounts, books, internal working papers and any other documents necessary to form the basis for, or demonstrate the calculations of, the performance information used in advertising.

4. *Custody Regulations.* A registered adviser who has custody or possession of securities of clients must keep additional records, segregate the securities, mark them to identify the client who has a beneficial interest in the securities and hold them in safe keeping in some place reasonably free from risk of loss or destruction. In addition, all funds and securities of clients must be verified by an independent public accountant by actual examination at least once each calendar year at a time chosen by the accountant without prior notice to the adviser. An adviser is deemed to have custody of client securities or funds when it has direct or indirect access to such securities or funds. Accordingly, a manager of a fund may be deemed to have custody if it has the authority to direct the custodian to disburse partnership assets to, for example, pay advisory fees or partnership expenses.

continued on page 15

Although the Advisers Act requires an investment adviser to establish, maintain and enforce [insider trading] policies... many non-registered investment advisers, either as a matter of prudence or because of requirements contained in their fund agreements, effectively adopt personal trading policies that would comply with the requirements of the Advisers Act.

Do All Good Things Come to an End?

2001 will represent the strongest test to the private equity business model since the collapse of the high yield market and resulting moratorium on leveraged buyouts in 1990. Last year witnessed records broken in most private equity categories as the industry expanded into a robust asset class driven by the demand for flexible capital from both mature and early stage businesses. Industry leading firms were recognized for the first time as highly profitable and as growing asset managers, not simply sponsors or promoters. As a result, not only were billion dollar funds raised, but the leading private equity firms were themselves valued in the billions of dollars. However, by years' end the public equity market correction, dramatic reduction in the availability of leveraged credit and the U.S. economic slowdown erased sizeable gains in portfolios and questioned private equity investment strategies. At the same time, as the size and investment diversity of funds grew, historic measures of industry performance have failed. Limited partner investors have been left unclear about their exposures and appear to have paused to await the outcome. The results will be telling.

Lessons Learned

In the end, returns will continue to prove attractive as the flexible nature of private equity will allow firms to migrate rapidly, as in the past, to undervalued asset classes. By year end, portfolios will be marked to market and winners and losers in our industry will be more clearly defined. Several major lessons will be learned.

The most important lesson that has emerged is that venture capital has far greater and different risks than later stage investing. Fundamentally, later stage investing allowed the top private equity firms to achieve a successful investment outcome on nearly 90% of capital invested from the industry's inception until 1998. In the past year, private equity firms adopted a model of total life cycle investing by aggressively attacking the growing technology and telecommunications venture capital market. A roaring public market and lightning quick exits conferred Midas status on dozens of otherwise unknown financiers. Early successes, however, were met by equally notable failures. The diversion of funds to early stage investing will be felt less in absolute returns than in success ratios, and the resulting high profile failures will continue to undermine limited partners confidence.

The reasons for the incredible batting average historically are clear. Other than individual operating risks and macroeconomic factors, later stage transactions have one principal risk, excess leverage. Offsetting that risk are the multiple exit options available for more mature companies including most notably sale, IPO, recapitalization and growth through acquisitions. Later stage control investing provides an imbedded control premium to investors. Private equity firms learned after the junk bond market collapse that the only way to lose money was to actually hand the company to the creditors. That lesson (plus a bit of restraint from lenders) has caused far lower leverage and, as a result, long-term optionality to play a major factor in the success ratio of funds. Venture investing, as many firms have known for some time, and others have only recently learned, has two much more fundamental risks: early stage operating issues and the constant need for growth capital. In a market where high yield growth capital evaporated (the market declined by 80% in 2000) and growth stocks imploded (the NASDAQ was off over 50%) growth capital was virtually unavailable. As a result, many investments have suffered a triple witching hour as valuations have been reduced, operations are at risk and capital to provide time to fix the problems is not available.

"The Best of Times and the Worst of Times"

What a difference a year makes. In 2001, market participants will relearn the historic benefits the private equity model provides for later stage, control investing. While the venture capital landscape has been forever changed by the advent of multibillion dollar funds, the increased risk from new venture investing will again demand its required rewards.

In the current year, sizeable investments will fail, select portfolios will face further material markdowns, and many firms will not reach announced fundraising targets. At the same time, certain firms will rest on the sidelines and work their existing portfolio assets to preserve or enhance returns. Still other firms will have extraordinary successes, find significant undervalued investment opportunities and raise large new funds. With European buyouts at record levels, Japan opening for the first time to foreign private capital, distressed equity investments emerging and over 70% of the U.S. public markets trading at below buyout multiples, private equity firms will see a revival of more traditional opportunities. As financing markets stabilize, the lessons of 2000 will crystalize into a significant rise in activity.

Fund returns will be driven both by the soundness of the nonpublic control investing business model and the capabilities of each individual manager to weather diverse market conditions. In short, Private Equity, like its public sister, has matured into a large, diverse \$2 trillion asset management market whose principal specialists operate with distinct core competencies and strategies sharing only similar financial access, selected core investors and consistent risk/reward expectations. As a result, best performers will continue to grow their already sizeable asset complexes. ▪

— Michael S. Klein, Vice Chairman, Co-Head of Global Investment Banking, of Schroeder Salomon Smith Barney

Caution to Controlling Shareholders (continued)

Delaware court found the conflict was the result of ARCO's desire to sell quickly, and only for cash, in order to raise money to pay down acquisition debt. According to the plaintiff, the subsidiary directors violated their fiduciary duties by delegating the sale process to a conflicted majority shareholder – although the court agreed that the board could properly rely on ARCO to conduct "preliminary negotiations." We would hate to see that theory applied by a court to determine that a private equity sponsor "forced" a sale to help raise its next fund!

In the ARCO case, the court was not favorably impressed by the sale process. Although the subsidiary had formed a special committee of independent directors, the committee had no role in the sale. Moreover, the full board met only once to consider the transaction. The court noted that time constraints may "compromise the integrity" of a board's decision-making process.

Duty of candor. The court also held that the plaintiff had stated a viable claim that the board had violated its duty to provide shareholders with all information material to the action being requested of them. In particular, the plaintiff alleged that the directors failed to disclose to the minority shareholders how indications of interest from other potential acquirors were handled, what restrictions were placed by ARCO on the terms of any sale, and the information and valuation methodologies used by the subsidiary's financial adviser. Although the minority shareholders in the ARCO case were public shareholders, a similar situation could arise in any context where appraisal rights are available – basically, in any transaction in which the merger consideration is cash or non-public securities.

Lessons. The most important lesson of this case is that process matters, even if it isn't apparent how having a "good" process will have any effect on the transaction. Fund sponsors should take care to keep portfolio company directors involved in the sales process and provide ample information to minority shareholders, especially public shareholders. Taking these steps should not interfere with a fund's objectives for a sale transaction, but can add significant protection in the event of litigation by disgruntled shareholders and the class action bar.

(For those so inclined, the cases referred to in this article are *McMullin v. Beran*, C.A. No. 16493 (Del. Sup. Nov. 20, 2000) and *In re Digex, Inc. Shareholder Litigation*, C.A. No. 18336 (Del. Ch. Dec. 13, 2000).) ▪

— Franci J. Blassberg and William D. Regner

Fund sponsors should take care to keep portfolio company directors involved in the sales process and provide ample information to minority shareholders, especially public shareholders. Taking these steps... can add significant protection in the event of litigation by disgruntled shareholders and the class action bar.

SEC Makes Switch Between Public and Private Offerings Easier

Portfolio companies trying to raise capital in dynamic capital markets have traditionally been faced with a difficult choice. Should they try a public offering or pursue a private placement? If the first choice turns out not to be the right choice, how can they change course without running afoul of the U.S. securities laws?

The SEC has recently announced the adoption of a new rule (to become effective March 7, 2001) that will permit portfolio companies more flexibility in raising capital. The rule will give companies hunting for equity financing greater ability to quickly change gears and pursue a private offering if a planned IPO generates insufficient interest or to commence a public offering if the initial response to a planned private placement is overwhelmingly positive or if the condition of the public equity markets improves.

The new rule provides "safe harbors" that allow companies to undertake a private placement following an abandoned public offering and also to change course and undertake a public offering following an abandoned private placement. By complying with new Rule 155, a company can switch to a private offering from an abandoned public offering and vice versa without concern that the transaction may violate the registration requirements of the Securities Act of 1933 because of the SEC's "integration" doctrine. If securities offerings are "integrated," they need to comply with the U.S. securities laws when considered part of a single offering, a result which is often impossible to achieve.

Through rules and staff policy statements, the SEC has established various "safe harbors" from integration for securities offerings in a number of different circumstances. For example, the SEC staff has indicated in a no-action letter known as *Black Box* that a private placement that is limited to qualified institutional buyers and no more than two or three large institutional investors can be completed concurrently with a registered public offering without the two offerings being integrated. Until the adoption of Rule 155, however, the question of whether the SEC would integrate certain public or private offerings that occur within six months of an abandoned offering could only be determined with reference to a five-factor test (or possibly by reference to the *Black Box* limited offering exception described above). As might be imagined, applying a five factor test does not always yield a definitive answer and many companies in today's marketplace cannot wait six months before receiving a cash infusion.

Private offerings following abandoned public offerings. The new rule permits a company to undertake a private offering beginning 30 days after the effective date of the withdrawal of its registration statement. (The rule regarding registration statement withdrawal has also been modified to provide that withdrawal is effective upon filing a withdrawal notice unless the SEC objects within 15 days of the filing.) A "private offering" is an offering that is exempt from registration under certain specified provisions of the Securities Act under Rule 506 of Regulation D. The company will be required to make certain disclosures to the private placement offerees that are designed to ensure that the offerees do not rely upon information in the withdrawn registration statement and to inform the offerees of the legal consequences resulting from the change to a private offering. For example, the offerees must be informed that the privately placed shares will be "restricted securities" under the U.S. securities laws and therefore may not be resold unless they are registered or an exemption from registration is available. Any disclosure document used in the private offering will also need to disclose any changes in the company's business or financial condition occurring after the filing of the registration statement that are material to the investment decision in the private offering.

Public offerings following abandoned private offerings. Under the new rule, a company that terminates its private offering before selling any shares may thereafter undertake a public offering 30 days following the private offering's termination. This 30 day waiting period can be disregarded and a registration statement for the public offering can be filed immediately following termination of the private offering if all of the private offering participants were reasonably believed to be accredited investors or sophisticated investors (in that they have knowledge and experience in financial and business matters as specified in Regulation D). The company will be required to make certain disclosures in its registration statement regarding the abandoned offering, including the size and nature of the offering, the date on which it was terminated and any indications of interest or commitments received prior to termination. The company would also need to indicate that the prospectus delivered in the registered offering supersedes any selling materials used in the private offering.

New Rule 155 is a non-exclusive safe harbor from integration. Existing SEC rules and policies remain in effect, including the five factor integration test mentioned above. In light of the vagaries of the capital markets, the new rule is welcome news and should provide important flexibility to portfolio companies in an important area that has been plagued by uncertainty.

— Peter J. Loughran and Kevin M. Schmidt

Important Changes to Hart-Scott-Rodino Notification Requirements

Recent amendments (effective February 1, 2000) to the Hart-Scott-Rodino (HSR) Act will affect the antitrust filing obligations of private equity funds in several ways. The amendments have eliminated the need to file for smaller transactions ($50 million or less) but will require filings for some transactions that were previously exempt. In addition, filing fees have been substantially increased for transactions valued at $100 million or more.

The New Filing Requirements

A filing is now required for any acquisition that results in the acquiror's holding more than $200 million of voting stock of the target (including stock acquired in prior transactions), regardless of the size of the parties. (Exemptions still apply to acquisitions made solely for the purpose of investment and certain non-U.S. acquisitions.) This change will have an impact in two circumstances. First, because the "size of person" test was based on the book value of assets and the prior year's revenues, some large acquisitions (in dollar value) of voting securities of technology and other companies did not have to be reported but now will. Second, most funds were able to make their first acquisition – no matter how large – without a filing because the assets that counted in determining the size of a newly formed fund did not include the cash being used to make the acquisition. Since most funds' first call involves only the cash necessary to pay for the first acquisition and incidental expenses, the fund did not meet the size of person test. While this test will still apply to acquisitions valued between $50 million and $200 million, larger acquisitions will require a filing.

Increased Filing Fees

Transactions newly reportable under the revised rule will subject the acquiror to a double whammy. Not only will a filing be required, but the filing fee, payable to the Federal Trade Commission by the acquiror, has been increased for acquisitions involving $100 million or more. Transactions valued from $100 million to $500 million now require a $125,000 fee, while those involving $500 million or more are subject to a fee of $280,000. The filing fee remains at $45,000 for acquisitions valued at $50-100 million.

Other Changes

The new legislation and rules have made several other changes in the HSR procedures:

- Notification thresholds will be set at $50 million, $100 million, $500 million, 25% of an issuer's voting securities if valued above $1 billion, and 50% of an issuer's voting securities.
- Any waiting period that would end on a weekend or public holiday shall end on the next business day.
- The usual waiting period after substantial compliance with a second request will be increased from 20 to 30 days; the 10-day period in a cash tender offer or bankruptcy acquisition is unchanged.
- The new HSR form places greater emphasis on valuation of the transaction (because of the sliding fee scale) and no longer requires information as to vendor-vendee relationships.

Summary

The following table provides a quick guide to the new filing requirements and fee schedule:

Notification Thresholds	
$50 million or less	No filing required
>$50 million to $200 million	Filing required if size of person test satisfied
>$200 million	Filing required regardless of size of persons
Filing Fee Schedule	
<$100 million	$45,000
$100 million – $500 million	$125,000
$500 million or more	$280,000

— Daniel M. Abuhoff and Gary W. Kubek

This portion intentionally omitted.

European Private Placements (continued)

Netherlands, the general partner, being the representative of the issuing fund, could market the interests without being licensed.

Legends

In the majority of the European countries where the fund can be placed on a private placement basis, specific customized legends in the PPM or a supplement thereto are either required or recommended.

Although the hurdles to marketing private investment funds to European investors can initially appear daunting, understanding the specific regimes in applicable jurisdictions can make the process less intimidating for fund sponsors. Debevoise & Plimpton has built and maintains a survey for its fund clients of securities law and limited liability issues relevant to the offering of interests of private investment funds in over 35 countries.

— Ann G. Baker and Sylvie Deparis-Maze

Keeping Private Funds on the Internet (continued)

processes as a means of courting potential deal sources, any mention of investment in the funds, their performance or marketing status may be viewed as an invitation to prospective investors to use the adviser's services.

Web site content should be aimed specifically at potential sources of deal flow rather than potential fund investors, and should avoid any marketing slant aimed at investors. For example, IRR data should not be shown, and the contact person listed should be involved on the manager's transactional side, not the marketing or investor relations side. In addition to screening for "holding out" language generally, fund sponsors should include a specific statement on their web sites to the effect that the fund manager does not provide services to the public and that the site is intended only to provide information to potential deal sources.

Keep the Offering Private

Private fund interests are offered to limited numbers of sophisticated investors in offerings that are exempt from Securities Act registration, usually in reliance on the safe harbor provided by Regulation D. One key element of Regulation D is its prohibition against offering securities by "any form of general solicitation or general advertising." Generally speaking, the SEC will find a "general solicitation" where an offer is made to an investor with whom there is no pre-existing substantive relationship.

In 1995, the SEC first clearly stated that the offering of securities on a publicly accessible web site would constitute a "general solicitation," inconsistent with a private offering. Then, in two no-action letters issued in 1996 and 1997 (and updated in 1998), the SEC staff seemed to suggest that private funds could be offered to previously unknown investors over the Internet, so long as (among other things) they filled out a questionnaire indicating that they met the financial sophistication requirements of Regulation D. Passwords could then be assigned and the investors could view offering materials, despite the lack of a pre-existing relationship. In an April 2000 release, however, the SEC retreated from that stance, stating that while private fund securities could be offered to prospective investors via password-protected Internet sites consistent with Regulation D, passwords may be given only to investors with whom there is a pre-existing substantive relationship. In other words, the Internet can be used as a means of distributing information and documents quickly and efficiently in a private offering under Regulation D, but it cannot be used to expand the universe of offerees.

...[F]und sponsors designing websites and selecting materials to be included on the sites should be mindful of the need to vet the sites' content thoroughly in order to avoid risking making an unanticipated general solicitation or inadvertently holding themselves out as investment advisers.

Private fund sponsors that are currently marketing (or planning to market) a fund should not mention that fact - or discuss the new fund at all - on their publicly accessible web pages. This includes sponsors who plan to post offering materials, as discussed below. They should also steer clear of other kinds of information that may be viewed as conditioning the market for interests in the fund. This would include track record information relating to a sponsor's previous funds, statements of targeted returns, or other information that might be construed as being intended to attract investor interest. Again, formulating the site to target deal flow sources rather than investors should be the guiding principle.

In posting offering materials on the Internet, sponsors should be careful not to tip off uninformed readers that a fund is being marketed – which would be tantamount to a general solicitation. One way would be to set up a separate website and give that URL to selected investors together with their password. Another option is to create an innocuous link (for example, "password holders click here") from the sponsor's main website that will take investors to the password-protected page.

A note on liability for Internet offerings: Advisers who choose to post password-protected offering materials on their web sites should consider carefully the materials they provide. Not only will the fund and its advisers be liable for statements and omissions made in documents posted together with offering materials (under the antifraud rules of the Securities Act), but the SEC has also taken the position that any information contained on a website that is hyperlinked with the offering website can be deemed to be statements of the issuer, making the issuer responsible for the content of those sites as well. If a fund posts more than its official private placement memorandum and subscription documents, the sponsor should vet the content of all additional documents and links as if they were part of the fund's offering memorandum.

A Word of Warning

While the Internet provides a useful tool for private fund sponsors to serve the informational needs of existing investors and attract deal flow, it also exposes them to heightened risk of losing their exempt status as private entities making private offerings. The rules governing private offerings are relatively straightforward, but they evolved long before the advent of the Internet and their application to the Internet by the SEC has proven unpredictable.

Therefore, fund sponsors designing websites and selecting materials to be included on the sites should be mindful of the need to vet the sites' content thoroughly in order to avoid risking making an unanticipated general solicitation or inadvertently holding themselves out as investment advisors.

— Jennifer J. Burleigh

Registration as an Investment Adviser (continued)

5. Disclosure Requirements. Registered investment advisers must provide advisory clients with a copy of a written disclosure statement–generally Part II of Form ADV. In addition, contractual arrangements with placement agents must be disclosed.

Registration Process

Investment advisers with 15 or more clients and more than $25 million in assets under management must complete Form ADV. Part 1 of Form ADV, which requires general identifying and financial information about the adviser and its business, including its control persons, whether it maintains custody of client assets and information regarding the disciplinary history of the adviser and its employees and their affiliates, must be filed (electronically through the new Investment Adviser Registration Depository) with the SEC. Part II of Form ADV, which requires more detailed information about the adviser's business and employees, including information regarding the types of clients the adviser provides services to and the advisory services provided, the basis of compensation, the adviser's investment strategies, the adviser's policies and procedures (including those regarding brokerage allocation and personal securities transactions by advisory employees), and disclosure regarding the educational background and employment history of the adviser's owners and executive officers, as well as anyone else who provides investment advice, is not currently required to be filed with the SEC, but must be maintained by the adviser with its records. A registered adviser has a continuing obligation to amend its Form ADV to reflect certain changes that may occur in the course of the year.

Because registration usually becomes effective within 45 days after filing and the substantive requirements described above must be complied with from and after the date the registration is effective, we generally recommend that the adviser not file Form ADV until the adviser has adopted appropriate written policies and procedures and is operating in compliance with the requirements of the Advisers Act.

The SEC periodically inspects investment advisers to ensure compliance with the foregoing restrictions and generally inspects within 18 months of the initial registration. The inspection most likely will focus on the accuracy of the Form ADV and the rules and regulations discussed above.

Most fund managers will eventually have more than 14 clients and be required to register under the Investment Advisers Act. While there are many substantive requirements, compliance with the Advisers Act should not be overly burdensome. In fact, many non-registered investment advisers, either out of prudence or the requirements of the marketplace, are already in compliance with many of the provisions of the Advisers Act.

— David J. Schwartz

Upcoming Speaking Engagements

March 8	Stuart Hammer **Environmental Risk in Corporate Transactions** New York, NY
March 8-9	Franci J. Blassberg, Co-Chair **16th Annual ALI-ABA Seminar on Corporate Mergers & Acquisitions** San Francisco, CA
March 24	Gregory V. Gooding **Marketable Securities in Public Company Mergers** Philadelphia, PA
March 26-27	Kenneth J. Berman **Effective Private Equity Fundraising Techniques** New York, NY
May 7	Andrew N. Berg **Partnership Taxation** New York, NY

For additional details on speaking engagements, contact Deborah Brightman Farone, Director of Client and Public Relations, at 212.909.6859.

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