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Without Pooling, Are Recaps Doomed?

Everyone in the "deal business" knows that after June 30, pooling transactions may be only of historical interest, but few have focused on what the new proposed accounting rules relating to the elimination of pooling and the amortization of goodwill mean for recapitalizations. Recapitalizations have traditionally been one of the financial sponsor's most valuable tools in competing for deals against strategic buyers who could utilize pooling in stock for stock transactions.

When the Financial Accounting Standards Board announced in December of 2000 that it was proposing to eliminate the pooling of interest method of accounting and to simultaneously revise the way goodwill would be amortizable under GAAP, most of the M&A community, particularly strategic buyers and their advisors, breathed a sigh of relief.

True, the bad news was that the proposal would give effect to the FASB's long stated goal of eliminating pooling – an accounting technique favored by strategic buyers because it allowed them, subject to satisfying a somewhat Byzantine set of rules, to combine their balance sheet with a target's balance sheet and to thereby avoid any asset write up or goodwill on the opening balance sheet (and any need to amortize those assets in subsequent P&L's).

But the good news was that the FASB also proposed, quite surprisingly, to effectively revise purchase accounting to provide that any goodwill created in a deal (i.e., the excess of the purchase price over the fair value of the target's assets) would thereafter be amortizable only to the extent of any asset impairment of the goodwill in subsequent periods. (The existing rule requires all goodwill to be amortized on a straight line basis over 40 years.) This change would allow one of the principal benefits historically associated with pooling – eliminating the charge to earnings associated with amortizing goodwill – to thereafter be realizable in deals accounted for as a purchase, at least to the extent of no subsequent asset impairment. Based largely on the view that the new rules governing the impairment of goodwill would allow strategic buyers to avoid recurring amortization of goodwill without having to navigate through the treacherous qualifying requirements under the pooling rules, strategic buyers and their advisors have generally expressed support for the FASB proposal, including its elimination of pooling, although they have expressed concern over the implementation of the impairment model.

But what do the impending rule changes mean for recapitalizations, the financial sponsor's answer to poolings? (Recapitalizations are similar to poolings in that they allow a financial sponsor, subject to a different set of qualifying conditions, to acquire a controlling interest in a business without having to restate any of the target's assets or to recognize any

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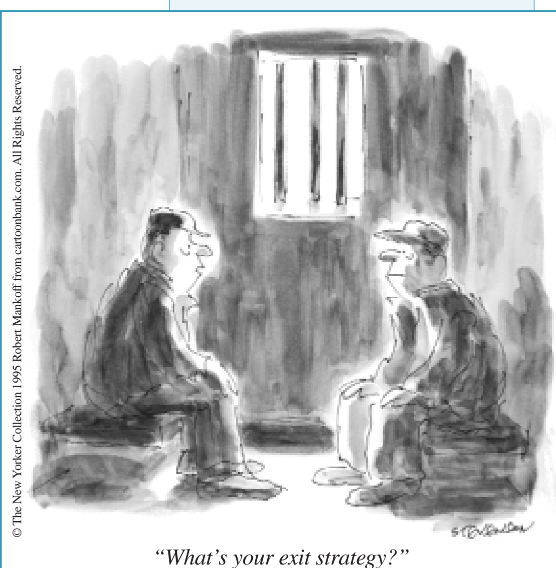
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"What's your exit strategy?"

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letter from the editor

As we publish the third issue of the Debevoise & Plimpton Private Equity Report, a publication for our clients and friends in the private equity world, the private equity environment is far less robust than it has been in many years. Although the private equity fundraising environment remains challenging and the performance of many private equity firms' portfolio companies reflects the uncertainty of our current economic times (as highlighted in this month's cartoon), we hope to focus private equity firms and their advisors on some good news for private equity firms and their portfolio companies.

Our guest columnist for this issue is David Webb, head of Merrill Lynch & Co.'s Financial Sponsors Group and a member of its Investment Banking Operating Committee. David's article reminds private equity firms of the "Advantages of Identity." David has been a leader in providing investment banking services to private equity firms for many years and shares some of his thoughtful guidance on how private equity firms can distinguish themselves in today's competitive environment.

The FASB's anticipated elimination of pooling and its changes in accounting for goodwill are the result of significant input from the business community. In this issue, we analyze the impact that those proposed changes will have on recapitalizations as a deal structuring tool for financial sponsors. Because today's uncertain equity markets may result in LBO firms re-engaging in going private transactions, we offer some thoughts on how termination fees in public transactions affect LBO funds. In light of the more robust investment climate for private equity firms abroad, Gary Friedman, one of our Tax partners, helps to simplify the Byzantine rules that U.S. private equity firms investing in foreign portfolio companies can face. Also in this issue, Bill Beekman, a partner in our Finance practice, reports on the simplification of UCC filings required to perfect securities interests in leveraged acquisitions as a result of revisions to Article 9 of the UCC. In addition, in this issue we explain how private equity portfolio companies can create broad-based stock option plans without subjecting themselves to SEC registration.

In this issue's "Trendwatch," we follow up on our recent analysis of fund management fees by focusing on run-off management fees.

As always, we welcome your comments on this issue and any thoughts you might have on ways we can offer practical guidance on matters of interest to private equity firms and their investors.

Franci J. Blassberg
Editor-in-Chief

Private Equity 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.

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The Private Equity Practice Group

All lawyers based in New York except where noted.

Private Equity Funds
Ann G. Baker – *Paris*
Woodrow W. Campbell, Jr.
Sherri G. Caplan
Michael P. Harrell
David J. Schwartz
Andrew M. Ostrognai – *Hong Kong*

Mergers & Acquisitions/ Venture Capital
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A Brave New World: Revised Article 9 Due to Hit July 1, 2001

If you've participated as a purchaser in the closing of a leveraged acquisition, you probably remember that after signing multiple copies of multiple security documents, some haggard young lawyer presented you with a mountain of forms with little boxes on them (maybe even with carbon-paper multiples, like from the fifties) to keep signing. Those forms are called UCC-1's, and under Article 9 of the Uniform Commercial Code as currently in effect they need to be filed in specified locations as a notice of the lender's lien on personal property. Now, a revised version of Article 9 of the Uniform Commercial Code, due to become effective nationally on July 1, promises to make your life as a signer (and the haggard young lawyer's life as a preparer) of UCC-1 forms much easier.

Article 9 of the UCC governs security interests in personal property, and it is a key underpinning of any secured loan transaction. As the name implies, the UCC is promulgated to be enacted in each state as a *uniform* statute, though the drafters may provide a menu of options for certain key provisions. The original version of Article 9, introduced approximately 50 years ago in much the same form as it survives today, provides a system for filing notice of a non-possessory security interest in personal property on a simple form in one or more state filing offices, whereupon the security interest is "perfected." (Article 9 also codified the old practice of possessory liens.) Thereafter, a competing creditor can search the record for notice of the lien (and if it fails to search, it will nonetheless be deemed to have constructive notice, provided that the filing was correctly made). Upon compliance with Article 9, a secured creditor will have a "valid" and "perfected" security interest, the priority of which is governed by the time of filing of the UCC form.

Article 9 has been amended from time to time, but Revised Article 9, slated to become effective July 1, is a thorough overhaul that was ten years in the making. The stated purpose of the drafters of Revised Article 9 was to address problems that had evolved due to a lack of clarity in the old statute, leading to confusion among lawyers and (more importantly) judges in interpreting the law. This confusion resulted in clients having to sign piles of additional UCC-1's because the lender's lawyers wanted to ensure that the lender would be protected in all events where the facts or the law were even slightly ambiguous. The drafters also sought to up-date the statute to help cover transactions (e.g., sales of financial assets other than customer accounts receivable) and types of collateral (e.g., deposit accounts) that did not exist or had previously been carved out of the scope of Article 9. Finally, the revision was intended to modernize the statute, such as by introducing the concept of "authentication" in lieu of signature.

Revised Article 9 is in fact quite different from the version currently in effect (last up-dated in 1994 to bring "investment property" in as a new class of collateral). Perhaps the most widely noted (and potentially problematic) change is in the place where UCC filings are to be made in multi-state transactions. Under the old law, the general rule was that for tangible property, you filed where the property was located, while for intangible property you filed where the debtor was located. Thus, for a sales business with inventory in 49 states, you filed in 49 states (and, in some states, maybe in county offices as well).

But where was such a company "located?" The UCC said it was located at the location of its chief executive office. Assuming that your borrower had its inventory in all states but Hawaii and its chief executive office in Hawaii, you had to file in the other 49 states to perfect a security interest in all of its tangible personal property, and you had to file in Hawaii to perfect a security interest in all of its intangible personal property. For a borrower with less than a national presence, failing to file a UCC-1 in a particular place could mean that the lender was unperfected in some of the physical collateral located in that place or, if the lender chose the wrong place as the "chief executive office," in *all* of the intangible collateral. Lawyers being cautious (and UCC filings being relatively cheap and easy to make), UCC-1 filings multiplied. Hence, the proliferation of UCC-1 forms to be prepared and signed at, or prior to, closing.

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James C. Swank – *Paris*
John M. Vasily

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Craig A. Bowman – *London*
David A. Brittenham
Paul D. Brusiloff
A. David Reynolds

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Employee Compensation & Benefits
Lawrence K. Cagney
David P. Mason
Elizabeth Pagel Serebransky

Estate & Trust Planning
Jonathan J. Rikoon

guest column

The Advantage of Identity

The private equity industry is now well-established, which is quite an accomplishment in an industry not much more than 25 years of age. Just ten years ago, there were only two private equity firms with as much as $1 billion of capital. Five years ago the number of $1 billion firms had grown to eleven. Today there are upwards of 75 private equity firms with over $1 billion of capital; a third of that number with $2.5 billion or more. There are nearly 100 additional firms with $250 million to $1 billion of capital. In short, we now have a large number of well-capitalized firms competing for attractive investments and funding.

The implications of this to two important constituencies of private equity firms – potential investors and corporate managers – are profound. Recently, I met with the CEO of one of my firm's corporate clients who was considering an acquisition that he believed would transform his company. He needed a financial partner to accomplish this, and wanted our advice. This type of request has become almost commonplace when public capital markets are unsettled as they are now. The CEO had specifically asked that I bring a comprehensive list of the private equity firms that would be comfortable investing the $100 million he required.

He told me that he wanted to meet with potential partners and make a decision within three weeks. Well, the list of private equity firms with the wherewithal to make such an investment extended to over 50 firms, an impossible number for him to consider. He looked down the list and said, "I haven't even heard of most of these firms, David, how does one decide even whom to interview?"

A second example which illustrates the competitive environment that private equity firms now face comes from my partner, Kevin Albert, who runs our firm's equity private placement department. Early each year, many of our largest institutional private equity investors ask to get together with Kevin to discuss their private equity investment allocations for the year, and which private equity firms are coming to market and in what size. And this year more than ever, there are more demands than the institutions can possibly fulfill. One important investor told Kevin recently, "not only can I not satisfy all the requests I have received for 're-ups', I don't even have the time to monitor the results of the 58 firms in which I have invested... I've got to cut back." These institutional investors are faced with the same dilemma, how does one decide?

This decision will be significantly influenced by how each private equity firm defines itself.

At my firm, we are fortunate to have an extensive franchise with private equity firms and over a number of years have developed a clear sense of how many of them are distinctive. As investment bankers, we can then knowledgeably introduce those investment opportunities – and many of these opportunities of necessity may only be discussed with a limited number of private equity firms – which would be most interesting to a particular firm. Armed with this knowledge, we are also better able to direct investors to the private equity firm that best suits their objectives.

But it is here in this issue of identity where I believe that private equity firms, themselves, can take the lead in communicating their specific identity; take the lead in establishing a strong awareness of the individuality of their firm. Corporate executives and institutional investors will ultimately select a private equity firm based upon personal chemistry, performance and other factors. But they need a place to start. A strong identity is an advantage in what has become a large, well-established and perhaps even crowded industry. ▫

David Webb is head of Merrill Lynch & Co.'s Financial Sponsors Group and a member of its Investment Banking Operating Committee.

Private equity firms, themselves, [should] take the lead in communicating their specific identity; take the lead in establishing a strong awareness of the individuality of their firm.

SEC Staff Loosens Standards for No-Action Relief for Broad-Based Stock Option Plans

Incentivizing employees of private companies with options has just become easier. The SEC staff recently loosened the standards under which it will permit private companies to grant options to more than 500 employees without registration. This will permit financial sponsors' private portfolio companies to issue stock options without having to register their equity securities under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") and become reporting companies.

Because companies that have a class of outstanding securities (including options) held by more than 500 security holders and more than $10 million in assets at the end of any fiscal year are required to register their securities, it has been difficult for private issuers to grant stock options to more than 500 employees, absent an exemption.

Although the SEC staff has been willing to grant no-action relief exempting private companies from the registration and reporting requirements for options granted to more than 500 employees, the onerous conditions imposed by the SEC made adopting plans that met those conditions too burdensome for many companies. In a recent update to the SEC's Division of Corporation Finance Current Issues and Rulemaking Projects Outline, the staff indicated that they will now consider granting no-action relief to private companies with more than 500 option holders under far less onerous conditions.

Any relief granted will apply only to stock options. Once a company has 500 holders of record of any other security (such as common stock, including stock received on exercise of options), it would be required to register.

The conditions for relief are as follows:

- the options may be granted solely to employees of issuer or its wholly-owned subsidiaries and consultants who meet the requirements under Rule 701;[1]
- options may only be issued without consideration, for purposes of incentivizing employees (and consultants);
- options must be non-transferable, except in the case of death or disability;
- grantees must be under no obligation to acquire the stock underlying the options;
- vesting may not be subject to individual performance objectives, only company-wide performance objectives;
- holders of options may not be entitled to vote or to receive any dividends with respect to the options;
- options may be exercised, but shares received on exercise may not be transferred, except back to the issuer, or on death or disability;
- holders must have no right to receive compensation in respect of their options or exercise shares, other than in a change in control or on death or disability;
- the company must distribute to holders of options on a continuing basis materials similar to that which would be provided if the company were registered, including annual and quarterly financial statements and such other information as is provided generally to all of the Company's unit holders. In addition, the company must make its books and records available on request and, where options terminate upon termination of employment, distribute, prior to such termination, all relevant information with respect to the options that is material to the decision whether to terminate employment and forfeit the options.

Any options or stock incentives granted under the company's other equity incentive plans must be sufficiently different in terms of eligibility, exercisability, vesting, transferability, repurchase provisions and other features that they will not be part of the same class of securities as options for which no-action relief is requested.

The no-action relief will not be granted for an indefinite period of time. Accordingly, companies seeking no-action relief will need to commit to register the options (or cash them out) by a specified date in the future (generally seven or eight years after grant).

The SEC's new policy for granting no-action letters to private companies' option plans will permit financial sponsors to offer equity based incentives to a broader group of employees without having to register with the SEC or agree to burdensome conditions.

— Elizabeth Pagel Serebransky

1 Consultants are natural persons, provide bona fide *services to the company that are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.*

Termination Fees, Expense Reimbursement and the LBO Fund

The termination (or "breakup") fee, and what triggers its payment, are often some of the more highly negotiated provisions in a public company merger agreement. The buyer's desire to protect the deal must be balanced against the seller's need to protect its directors from breaching their fiduciary duties. On the other hand, buyers must be mindful that courts may not enforce overly generous termination fees, and sellers must recognize that a generous fee may sometimes be necessary to convince a reliable buyer to sign a merger agreement.

When a private equity fund sponsor negotiates a termination fee, the relevant questions are not significantly different than those that a strategic buyer would consider: How badly does it want to protect its deal? What is reasonable compensation for the time, effort and costs (including, for instance, financing commitment fees) expended in the structuring and negotiation of the deal? How much "idiot" insurance does it want in the event its publicly announced deal is displaced by a superior offer?

In some cases, this insurance may be marginally more important to a private fund than a strategic buyer, since it is a fund's business to close its deals. On the other hand, acquisitions by private funds are often significantly more conditional than strategic acquisitions, principally due to the financing contingency. A target may argue that its board's fiduciary duties are unduly strained when a high termination fee could ward off bidders who may promise not only a better price but also greater certainty of completion. (On the other hand, a financial buyer probably raises fewer antitrust impediments than a strategic buyer.)

The conventional wisdom is that fund sponsors are more concerned about expense reimbursement than termination fees because they are required to share termination fees and not expense reimbursements with limited partners. Our analysis, based on a sample of the 297 leveraged buyout funds in our database that have closed since 1997, suggests that the situation is far more complex. Termination fees received by the fund manager are typically "shared" with the limited partners through a reduction in management fees. The fee-sharing percentage is typically 50%, but can be as high as 100%. Based on a sampling from the Debevoise & Plimpton proprietary database, approximately 32% of the funds require an equal sharing of termination fees, 28% call for the management fee to be reduced by the entire amount of the termination fee, and only 8% allow the manager to keep the entire fee. The remaining 32% provide for some other type of sharing.

The fact that termination fees are shared reveals only a small piece of the puzzle. Even managers who share all or a large portion of termination fees with their limited partners can be highly motivated to negotiate an aggressive termination fee. Not only does the manager have a positive obligation to look out for the best interests of the fund and protect the deal, but there are also sensitive investor relations issues to be considered. To the extent management fees are "paid" by third parties through this reduction mechanism rather than by capital contributions from the limited partners, it can boost the fund's IRR. In addition, reducing management fees generates goodwill among the limited partners, especially when a publicized deal has been lost. A reduction in the management fee will also free up a corresponding portion of the fund's capital for investments.

Broken-deal expenses are typically considered fund expenses that are borne by the limited partners (although in some instances they are borne by the manager instead). However, even if the manager does not have to pay these expenses, amounts paid by the limited partners for broken-deal expenses ultimately have an impact on the fund sponsor. All capital contributions, including amounts contributed as expenses, have to be returned before the fund sponsor is entitled to its 20% carried interest (which means that the fund sponsor effectively bears 20 cents of every dollar of broken-deal expenses). However, if broken-deal expenses are paid by the proposed target rather than by capital contributions from the limited partners, it is better for the fund's IRR. Also, fund sponsors generally do not like to be in the position of reminding their limited partners through a capital call for broken-deal expenses that their efforts to bring in an investment has failed.

Thus, if a fund is asked to trade termination fees for reimbursement of expenses in negotiating a merger agreement, the sponsors may want to analyze not only which approach will result in more cash flow to the manager, but also which approach will have the least negative impact on the fund's IRR and the best impact on investor relations. Fund sponsors

should also determine the impact in situations where there is only an expense reimbursement provision and not a termination fee. In situations where there is both, but the expense reimbursement is capped, the termination fee provision will probably provide for any unrecovered expenses to be deducted from amounts attributable to the termination fee before the termination fee sharing is implemented.

Below are a number of frequently asked questions about termination fees and expense reimbursement. The answers should be taken with a grain of salt, because courts have not – and cannot – set firm rules regarding termination fees, which are only part of the fiduciary story. In determining the propriety of the amount and the triggers of a termination fee, courts will often ask a variety of related questions: Was the target in "Revlon mode?" Was it trying to defend against an unsolicited offer? Was there a market check? An auction? Are there are other bidders? What other "defensive" provisions are there? Did the termination fee enhance stockholder value by encouraging the original bidder, or did it impermissibly hinder a fair and spirited bidding process to the detriment of stockholders? These and other factors will color a court's decision as to the enforceability of a challenged termination fee.

Q ***What do the Delaware courts deem to be an enforceable termination fee?***

A Delaware courts generally uphold termination fees up to 3%. One court has recently upheld a 3.5% termination fee, stating only that it was at the high end of what Delaware courts have approved. On the other hand, the Court of Chancery recently found that a 6.3% termination fee "seems to stretch the definition of... reasonableness... beyond its breaking point."

For the purpose of this article, we undertook an unscientific study of termination fees in public deals struck in 2000. The following chart summarizes the results:

	Value of Transaction ($ millions)			
	$25 - $100	$100 - $500	$500 - $1,000	> $1,000
Average Fee	4.4%	3.3%	3.0%	2.7%
Range of Fees	1.0% - 10.3%	0.1% - 7.0%	1.2% - 4.4%	0.3% - 5.3%
Number of Transactions	75	108	31	93
Average Fee for Fund Acquirors	9.0% (1 deal)	3.9% (8 deals)	—	1.7% (2 deals)

Source: Securities Data Corporation

As the results suggest, it is generally thought that higher termination fees (as a percentage of deal value) are more defensible the lower the value of the transaction. The theory is that 3 or 4% of a small deal is unlikely to deter competing bidders in the way 3 or 4% of a large deal might.

Of the more than 300 public transactions covered in the chart, only 11 involved private equity funds (including venture capital funds). Termination fees in those transactions varied significantly, and it is difficult to draw any meaningful conclusions.

Q ***What is a termination fee calculated as a percentage of?***

A Generally, the courts think of a termination fee as a percentage of aggregate purchase price, not enterprise value. It is probably appropriate to consider fully diluted equity to the extent options, convertible securities and the like will be converted into merger consideration in the transaction, although again the courts have not spoken definitively to this point. Please note that in a leveraged transaction, the termination fee will be a much higher percentage of the sponsor's equity commitment. This explains why lending sources often feel entitled to "share" in the sponsor's termination fee.

Q ***To whom should a termination fee and expense reimbursement be paid?***

A Generally, these would be paid to the disappointed buyer. However, when the buyer is a private equity fund, receipt of these payments by the fund itself could generate an unrelated business taxable income problem for some limited partners. The payments are therefore generally directed to the fund manager, but in most cases are shared with the limited partners through a management fee reduction.

Q ***Is a termination fee or an expense reimbursement provision more likely to be upheld by a Delaware court?***

A Generally, although courts have not addressed this directly, the more a payment to a disappointed buyer can be viewed as compensation or reimbursement of expenses rather than as a defensive or protective measure, the easier it will be to defend in court. In a 1996 case, a Delaware court noted that a termination fee together with

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The conventional wisdom is that fund sponsors are more concerned about expense reimbursement than termination fees.... [o]ur analysis... suggests that the situation is far more complex.

Key Issues in Reviewing Confidentiality Agreements

A private equity firm will be asked to sign a confidentiality agreement ("CA") for each "blue book" it receives. As a result, financial sponsors with robust deal flows may need to review several such agreements a week. Often, the most efficient process will be to review the agreement in-house, produce a limited mark-up, initial the changes and return the signed agreement to the seller or its banker. Here is a checklist of key issues that may facilitate such a review.

What's Covered. The CA will prohibit disclosure of "Evaluation Material," except to the bidder's employees and representatives and except for legally required disclosures. When reviewing a CA, be sure that "Representatives" includes financing sources and their counsel and co-investors, if applicable. In the exception for legally required disclosures, delete any obligation to obtain written advice from counsel.

The standard exceptions from the definition of Evaluation Material include information that (i) is publicly available, (ii) the bidder already possesses or obtains from sources other than the target or (iii) the bidder develops independently. The CA will also usually limit these exceptions so that they will not apply to information that is subject to another confidentiality obligation. You should insert that it is only information that the bidder does not know to be the subject of another confidentiality obligation, or you risk inadvertently breaching this provision.

Who's Covered. You will need to advise your representatives of the confidentiality restrictions, but, absent special circumstances, you should resist a requirement to obtain written acknowledgements from all of your representatives since that is generally impractical. Obviously, you should try to avoid being liable for your representatives' breaches, but that may not be realistic. As a compromise, you might offer to use commercially reasonable efforts to assure that your representatives will comply or agree to be responsible for any breach by a representative.

Apart from the auction context, you may be able to negotiate for the confidentiality provisions to apply to both parties. This may prevent the seller from using the bidder as a "stalking horse" to attract other bidders.

Return of Information. If the sale process is terminated, sellers will want all the Evaluation Material returned. You should ask instead for the ability to destroy rather than return documents, since this requirement will be easier to fulfill and you may not want other parties to obtain the notes, analyses or projections that you have prepared based on the Evaluation Material. As a compromise, you could offer to certify the destruction of Evaluation Material in writing or limit the right to destroy Evaluation Material to what you developed internally.

Non-Solicitation. Sellers want to restrict bidders, particularly competitors, from using the sale process to identify and poach key employees of the target. Although a financial sponsor is unlikely to solicit or hire a target company's employees, that may not be true of its portfolio companies. Because many financial sponsors would find it impractical to enforce such a restriction on their portfolio companies, the mark-up of the non-solicitation provisions should explicitly exclude affiliates and portfolio companies. Other customary limitations on the non-solicitation provisions are that they (i) expire after one or two years, (ii) exclude non-targeted, general solicitations (e.g., newspaper advertisements) and (iii) apply only to executives, officers and/or technically trained employees first met during the sale process.

Standstills. Public companies usually seek to preclude bidders and their affiliates from making unsolicited bids (including public pressure on target management) and open market purchases of the target company's securities. Although many financial sponsors view standstill provisions as acceptable since their business practices do not include either of these activities, other sponsors, especially those affiliated with investment banks or hedge funds, may have significant issues with these provisions. In any event, it is advisable, and usually expected, for the standstill to expire after a fixed time period.

Auction Process. CAs often prohibit the bidder from contacting the target company or any of its employees without the written consent of the seller or its investment banker. However, since financial sponsors will often want to negotiate employment and equity terms directly with management, it is a good idea to liberalize this requirement by providing that consent can be obtained orally from either the investment banker or the seller.

Termination. CAs should terminate after two or three years, thereby limiting the need to monitor use of the Evaluation Material, particularly if you are likely to make future acquisitions in the target's industry.

Antitrust. If you have a portfolio company that operates in a similar business to the target company, particularly in a concentrated industry, you should agree to follow the special

procedures proposed by the seller to avoid any appearance of using the sale process to share sensitive information (e.g., product prices) and to create a record of compliance from the time of early contacts. Generally, you should consult outside antitrust counsel for guidance on typical procedures.

Although most CAs are relatively "plain vanilla," they can present onerous obligations on a financial sponsor. The key issues discussed above should facilitate an in-house review of a plain vanilla agreement. In other circumstances, it is advisable to consult with experienced counsel.

— Timothy S. T. Bass

A Brave New World: Revised Article 9 Due to Hit July 1, 2001 (continued)

The filing rules change drastically under Revised Article 9. After July 1, in the case of a borrower that is a statutory entity such as a corporation or a limited partnership, the place to file for almost *all types* of UCC collateral is in the state office of the state where the entity is organized. For a Delaware corporation, that is Delaware. Under Revised Article 9, there is no guessing (or multiple filing) to deal with the uncertainty of location (whether of chief executive office or physical collateral).

But there's a catch that could prove troublesome. As we go to press, Revised Article 9 is currently enacted (and due to become effective July 1) in 36 states and the District of Columbia, and has been introduced in all the remaining states (including New York). Sounds like we're in pretty good shape? Not necessarily. If Revised Article 9 is not timely enacted everywhere, chaos could ensue for those lenders and borrowers having contacts with the tardy states.

Suppose Revised Article 9 is not timely enacted in New York. Section 9-103 of the current New York UCC would still provide the old rule for whose law governs perfection of a security interest in a multi-state transaction, i.e. the place where the tangible collateral is located and the location of the borrower's chief executive office with respect to intangible collateral. But what if the borrower's chief executive office is located in Delaware and the physical collateral is located in California, both of which have enacted a version of revised Article 9? Under 9-103 of the New York UCC, we look to the UCC of Delaware and California. What do they say? Section 9-307 of Revised Article 9 tells you to look to the law of the place where the borrower is incorporated. The borrower is a Delaware corporation? That will work. The borrower is a *New York* corporation? Revised Article 9 sends us back to New York, which sends us back to California and Delaware, which sends us back to New York... Lawyers call this problem "renvoi", and it can be ugly. If renvoi should arise because Revised Article 9 has not been timely enacted in a relevant jurisdiction, borrowers should expect to continue signing multiple UCC's as a precautionary measure until Revised Article 9 has been adopted.

In addition to worrying about renvoi, the finance attorneys are all fretting about how to re-write the forms of their security documents and legal opinions to accommodate Revised Article 9, and what (if anything) they might need to do for the billions of dollars worth of deals that were done under current Article 9. For lawyers who spend all of their time representing secured lenders, these problems make Y2K look like a picnic in the park. Our prediction is that certain lenders (including of course the ones with the most cautious counsel) may want to refile in the jurisdiction of the borrower's incorporation, even though the transition rules for Revised Article 9 generally provide that the original filings remain good for up to five years after July 1. The good news is that it should be easy enough for borrowers to indulge such lenders by making these extra filings (and in any event, borrowers are most likely obliged to do so under a "further assurances" or similar type of clause in the existing security documents).

But the best news for clients is that the first acquisition closing you attend after July 1, 2001 should require fewer UCC-1's to be signed. Maybe you can get some real work done that day.

— William B. Beekman

The filing rules change drastically under Revised Article 9... [I]n the case of a borrower that is a statutory entity such as a corporation or a limited partnership, the place to file for almost all types of UCC collateral is in the state office of the state where the entity is organized.

Investing in a Foreign Portfolio Company: Call 1-800 Tax Lawyer

Secretary of the Treasury Paul O'Neill recently called the U.S. Tax Code an "abomination" and "not worthy of an advanced society." Although Mr. O'Neill obviously chose his words for political effect, when it comes to the provisions of the Code dealing with investment in foreign companies, his descriptions seem almost appropriate. The U.S. tax rules dealing with U.S. investment abroad are among the most counter-intuitive, and in many ways arbitrary, rules in the U.S. tax system.

Example 1

A U. S. private equity fund ("PEF") buys 100% of a German manufacturing company. The German company sees an opportunity to expand into the U.S. and invests $20 million of its retained earnings in the stock of a U.S. distributor. Result: Each U.S. investor in PEF must include a pro-rata share of $20 million in income even though neither they nor PEF receives any cash.

Example 2

PEF buys 100% of the stock of a French manufacturing company. Over the next two years, the French company earns $20 million, which it reinvests in the business. At the end of the two years, PEF sells the French company, realizing a $50 million profit. Result: Only $30 million of the profit qualifies for long-term capital gains treatment. The remaining $20 million is taxable as ordinary income to PEF's partners.

Example 3

PEF buys 100% of a Dutch manufacturing company. The Dutch company sells its Italian subsidiary at a $20 million profit and reinvests the proceeds in a new manufacturing plant. Result: Each U.S. investor in PEF must include a pro-rata share of $20 million in income even though neither they nor PEF receives any cash.

The U.S. tax rules dealing with U.S. investment abroad are among the most counter-intuitive, and in many ways, arbitrary, rules in the U.S. tax system.

Example 4

The partners of PEF are all corporations, except for one individual, who owns 1% of PEF. PEF forms a Swedish start-up company, which temporarily invests the cash received from PEF in U.S. Treasury securities. The Swedish company has no significant earnings for the year other than interest on the Treasury securities. Result: Each U.S. investor must include in income a pro-rata share of the Swedish company's earnings even though neither they nor PEF receives any cash.

Example 5

PEF is organized outside of the U.S. On January 1, PEF invests in a Swedish start-up company organized one month earlier. The start-up invests the proceeds received from PEF in U.S. Treasury securities. On July 1, the Treasury securities are sold and the proceeds are used to buy machinery. Two years later, PEF sells the Swedish company at a $20 million profit. Result: The entire profit will be treated as ordinary income (not long-term capital gain), and each U.S. investor in PEF will owe a substantial interest charge to the IRS on its share of the resulting tax.

The results in Example 1 through 3 above arise because the portfolio company is a **controlled foreign corporation** (a "CFC"). The result in Example 4 arises because the portfolio company is a **foreign personal holding company** (an "FPHC"), and the result in Example 5 arises because the portfolio company is a **passive foreign investment company** (a "PFIC").

Each of these regimes was enacted by Congress with good intentions, namely to avoid giving U.S. taxpayers an incentive to invest abroad rather than in the U.S. Because profits realized in the U.S. are subject to current U.S. tax, Congress feared that U.S. taxpayers would favor offshore investments because of the opportunity they present to defer U.S. tax. To place U.S. and foreign investment opportunities on a level playing field, Congress sought to end the ability of U.S. taxpayers to defer tax on foreign investment in most cases. As the above examples illustrate, however, the rules are written so broadly that they sweep up a variety of legitimate transactions that are not motivated by a desire to escape or defer U.S. taxation.

Despite the breadth of the CFC, FPHC and PFIC rules, it is generally possible to avoid them, or at least minimize their effect, in most transactions. In Examples 1 through 3 above, forming PEF as a non-U.S. partnership (for example, as a Cayman partnership) would generally make it possible to

avoid the CFC provisions. A CFC is a foreign corporation owned more than 50% by 10% or greater U.S. shareholders. If PEF is a U.S. partnership, any majority investment it makes in a foreign corporation will cause the CFC rules to apply, because PEF is a U.S. shareholder. If PEF is instead a foreign partnership with no U.S. partners with a 10% or greater interest, the CFC rules generally can be avoided.

In Example 4, the portfolio company is a FPHC, which is defined as a foreign corporation that (a) earns mostly passive income for the year and (b) is owned more than 50% by five or fewer U.S. individuals. For purposes of the stock ownership test, an individual is deemed to own all the stock owned directly or indirectly by his partner. Under this rule, the individual who directly owns a 1% interest in PEF is deemed to own 100% of the portfolio company because he is attributed all of the stock owned (or treated as owned) by the other partners of PEF. The solution here is to require any individual desiring to invest in PEF to do so through an entity, such as an S corporation. Only an individual is deemed to own stock owned by his partner, so the attribution will not occur if PEF has no direct individual partners.

In Example 5, the portfolio company is a PFIC, which is a foreign corporation 50% or more of whose assets for the year are held for the production of passive income. The solution here is to cause the portfolio company to buy the machinery June 30, rather than on July 1, so that the assets for the year, on average, are mostly machinery, not passive investment securities. Alternatively, the solution is for the PEF partners to file an election to include the portfolio company's net income currently in any year in which the company is a PFIC. If the portfolio company is a start-up, chances are good that the election will be painless because the company will have no positive net income at the early stages. In later years, when the portfolio company is profitable, it will be unlikely to have the same high proportion of passive assets, and hence it will no longer be a PFIC.

...[W]ith a bit of advance planning, the worst of the CFC, FPHC and PFIC rules can be avoided.

So with a bit of advance planning, the worst of the CFC, FPHC and PFIC rules can be avoided. Alternatively, fund managers can write to Congress and Secretary O'Neill urging repeal of the anti-deferral rules. We think that working with tax lawyers is easier than working with politicians.

— Gary M. Friedman

Termination Fees, Expense Reimbursement and LBO Funds (continued)

reimbursement of expenses would be "only" 4.8% of the offer value; the termination fee alone was 2.8%. The implication is that courts are likely to be more willing to uphold higher payments to disappointed buyers if a portion clearly reflects the reimbursement of quantifiable expenses.

Q ***What types of triggers are permissible or impermissible?***

A Merger agreements can and do contain a broad variety of termination fee triggers. Courts have been wary of triggers that could be viewed as coercing the target's stockholders into voting in favor of the buyer's merger proposal. For instance, requiring the payment of a fee if the stockholders simply voted down the deal without another offer on the table is often rejected as being coercive (though at least one court seems to have upheld this type of trigger). Often, the determination of appropriate triggers is based on considerations of fairness (requiring a fee upon an unintentional breach of representation may not be fair) and pragmatism (requiring a fee upon a material adverse change may not be practical).

Private equity firms contemplating going private transactions should recognize that the way termination fees and expense reimbursements are handled in their partnership agreements and in deal negotiations are an important part of the risk calculus of such deals.

— Andrew L. Bab and Sherri G. Caplan

goodwill.) Put another way, if the new rules have effectively allowed strategic buyers to view poolings as dispensable, will they also eliminate or significantly blunt the advantages to a financial sponsor of structuring a transaction as a recapitalization?

We believe the answer to that question is a qualified no, for the following reasons:

1. Avoids Write-up of Identified Intangibles and Fixed Assets.

While the proposed new rules would require buyers to amortize goodwill only to the extent of any impairment, the rules keep in place the existing requirement that all fixed assets and identified intangible assets of a target must be written up to fair value on the opening balance sheet. As a result, buyers utilizing purchase accounting will still have to take an incremental charge against earnings in periods subsequent to the acquisition to reflect the amortization and depreciation relating to the write up of these assets. Conversely, in a deal structured as a recapitalization, these types of charges would not flow through any subsequent P&L since there is no restatement for financial accounting purposes of any of the target's assets (and hence no subsequent amortization or depreciation of these assets). This difference will obviously preserve a significant advantage of the recap structure, particularly in deals where there would be a significant write-up of the target's fixed assets (such as property, plant and equipment) or identified intangibles (such as specific patents) under purchase accounting. We understand that accountants are finding it virtually impossible to advise clients on the appropriate amortization period for many identifiable intangibles such as routes, customer lists and the like.

2. Preservation of Treatment.

Another likely continuing advantage of the recap structure is that the avoidance of goodwill in a qualifying recapitalization is permanent, whereas the continued avoidance of goodwill under the new FASB rules will be dependent on the absence of any impairment to that goodwill in subsequent periods. While FASB has yet to specify what standards will apply under the new rules to determining whether any impairment to goodwill has occurred, an acquiror in a transaction accounted for as a purchase will run the risk that it might have to record substantial and possibly recurring amortization charges in subsequent P&L's if and when the target's goodwill declines in value. For example, if these rules were in effect 12 months ago, many companies which acquired high tech or Internet businesses 24 months ago would presumably have seen the goodwill associated with those businesses impaired in light of the market turmoil in the technology sector. To the extent the same transaction is structured and accounted for as a recapitalization, however, the acquiring party would run no such risk because under recapitalization accounting no goodwill is recorded on the target's balance sheet to begin with (it is all retained at a level above the target) and hence there is no possible impairment charge relating to that goodwill in the future.

3. Alignment of Incentives.

A final reason why recapitalizations are likely to remain attractive to financial buyers is that the principal condition that needs to be satisfied to achieve a qualifying recap – the retention of equity by one or more of the existing stock holders of target – usually enables a financial buyer to achieve independent commercial objectives as well as to realize the accounting benefits associated with a recapitalization. For example, the retention of enough stub equity by a corporate divester, a private seller or by a target's management to qualify for a recap, may also provide extra insurance to the financial buyer about the condition of the business it is buying since the former owners are retaining some "skin in the game." This alignment of underlying commercial objectives with the preferred accounting result inherent in a recapitalization likely ensures the continued utility of the recap structure. It also contrasts sharply with poolings, where the conditions that needed to be satisfied to achieve a qualifying pooling often defeat important commercial objectives of the parties. This may explain why strategic buyers now seem prepared to accept the elimination of pooling in favor of the new rules governing the amortization of goodwill.

Because recaps, unlike deals accounted for as a purchase, will afford the benefits described above, we believe they will continue to be attractive to financial buyers even after the new FASB rules take effect. We should note, however, that the FASB, which has previously indicated its interest in reviewing recap accounting, may be pressured to do so sooner rather than later by strategic buyers who have no option to avoid the write-up of identified intangibles and fixed assets or to be faced with potential goodwill impairment. However, the gap between the accounting benefits associated with a recap under the new rules, on the one hand, and purchase accounting, on the other, will be

narrowed significantly. As a result, we believe that financial sponsors will use recapitalizations more selectively than has been the case historically and only in circumstances where the incremental benefits of the structure in a given deal from a P&L and overall deal perspective are likely to outweigh the added transaction costs associated with achieving a successful recapitalization.

— Franci J. Blassberg and Stephen R. Hertz

Ten Issues to Keep in Mind in Structuring a Recapitalization

Structuring a recapitalization can be tricky. Here is a brief overview of some key issues to keep in mind.

- The *sine qua non* of a recap is the retention by some or all of the target's existing stockholders of at least 5% of the equity in the recapitalized company. Generally, stock options, warrants and similar securities are ignored in determining the percentage of ownership by the new and continuing stockholders.
- A recap can be structured as a purchase of primary shares by an investor, coupled with the simultaneous repurchase or redemption of a portion of target's outstanding shares. This will generally be the preferred structure in deals involving private targets with a manageable number of stockholders.
- Recapitalizations involving private companies with a large number of stockholders or public companies can be structured as a merger, so long as the "merger subsidiary" is transitory and has no business operations other than signing the merger agreement and consummating the merger. The merger subsidiary should not be a party to any of the financing arrangements.
- Some states permit "disparate treatment" mergers, which facilitate a financial sponsor's ability to ensure that the requisite continuing equity in a recapitalization is retained only by existing management. A disparate treatment merger is a merger in which holders of the same class of securities of a company (e.g., Common Stock) receive differing forms of consideration for their shares. It can be used to ensure that a certain percentage of target's shares are retained by management, whereas all other shares are converted to cash. Some states do not permit "disparate treatment" mergers. Delaware generally allows disparate treatment mergers, but subjects them to an "entire fairness" test.
- If a "disparate treatment" merger isn't available, a cash-election merger is another viable alternative. But in deals involving the recapitalization of a public company, this structure may result in public stockholders continuing to hold a small equity interest (or stub) in the target. This may result in the target continuing to be subject to public reporting obligations and may force some financial sponsors to "mark to market" their investment in the recapitalized company.
- A recap cannot be structured as a third-party tender offer because of the requirement that the merger vehicle be as transitory as possible. In theory it could be structured as a self-tender, but this structure is not attractive due to the application of "illegal dividend" and similar statutes to the target's purchase of shares in the self-tender.
- If the target has publicly traded debt securities that will remain outstanding after the consummation of the acquisition, recapitalization treatment may be available even if there is no continuing common stock ownership. This structure usually has little practical benefit for financial buyers, however, because the terms of the target's public debt normally preclude the leverage needed to implement the recapitalization. In addition, the moment the public debt is retired – often at the time of an IPO – the target's assets and liabilities need to be restated, and goodwill relating to the original investment needs to be recognized.
- A typical sponsor's form of stockholders agreement should be modified to comply with recapitalization rules. Specifically, the retained equity should generally not be subject to transfer restrictions (other than rights of first refusal or rights of first offers) or calls upon termination of employment. Drag-along rights are acceptable.
- Because the target's assets are not written-up in a recapitalization and no goodwill is created, a leveraged recapitalization can often result in the target having substantial negative equity on a GAAP basis. This can have important collateral consequences for the target, particularly if it operates in a sector where a strong balance sheet is critical to commercial success.
- Finally, early and continuing coordination between legal counsel and accountants is critical in order to avoid inadvertent "trip-ups" over the rules.

— Franci J. Blassberg, Stephen R. Hertz and Joshua L. Targoff

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Private Equity Funds and Financial Holding Companies

What do financial holding companies ("FHCs"), investors in the private equity funds they sponsor and fund sponsors hoping to attract investment from FHCs have in common? They should all be aware of the merchant banking rules recently issued by the Federal Reserve Board and the Treasury Department.

FHCs, which were created by the Gramm-Leach-Bliley Act of 1999 ("GLB Act"), are basically bank holding companies whose depository institution subsidiaries are well-managed and well-capitalized and who elect to be an FHC under the GLB Act, thereby avoiding the restrictions on merchant banking activities and provision of non-banking financial services and products applicable to bank holding companies.

The GLB Act opened the door to FHCs becoming full participants in the private equity business by eliminating the restrictions on their equity ownership of nonfinancial companies, i.e., portfolio companies. Instead of the prior approach of limiting the percentage interests of portfolio companies that can be held by FHCs, the GLB Act distinguishes between permissible and impermissible investments by FHCs based on the concepts of "control" and "routine management or operation."

Under the GLB Act, an FHC can control and routinely manage and operate a qualified private equity fund. In addition, an FHC and its controlled funds can also invest any amount in equity of a portfolio company (even more than 50%) and control it. However, neither an FHC nor a fund controlled by an FHC can routinely manage or operate the portfolio company.

The new rules provide guidance and some clarity on what constitutes control of a fund by an FHC and how FHCs and their controlled funds can participate in the governance and management of portfolio companies. In general, board representation and similar supervisory authority (including approval rights over actions outside the ordinary course of business), and provision of financial and advisory services are permissible control of a portfolio company. Involvement in day-to-day operations, such as the FHC's personnel acting as officers or employees and approval rights over routine business decisions, constitute routine management activities and are generally prohibited. Investors should note, however, that if the portfolio company needs new management, the FHC can have its personnel manage the company only on an interim basis.

In addition, the new rules set limits on the percentage of an FHC's Tier 1 capital that can be invested in private equity funds and require the implementation of certain policies, procedures and systems to manage risks associated with merchant banking activities.

Upcoming Speaking Engagements

Date	Engagement
May 7	Andrew N. Berg Getting Out of a Deal – Creative Exit Strategies New York, NY
June 4-5	Raman Bet-Mansour Special Issues in Acquiring Divisions or Subsidiaries of Large Corporations New York, NY
June 11	Sherri G. Caplan Negotiating Key Issues: Real Estate Opportunity Funds Santa Fe, NM
June 25-26	Adele M. Karig Examining the Critical Tax and Accounting Issues Surrounding the Private Equity Market New York, NY

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