THE DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT

Volume 1, Number 4 | Summer 2001

Germany – A Prime Target for Private Equity Funds

Private equity firms are excited about Germany for good reasons. Germany is increasingly attractive to private equity firms as a result of an unusual confluence of factors, including the unprecedented availability of investment opportunities as well as the increasing interest of German institutional investors in diversifying their portfolios to include alternative asset classes. In the case of public corporations, the German market has demanded that "shareholder value" be maximized, creating a renewed focus by major corporations on their core businesses and resulting in the proposed divestiture of numerous non-core businesses. This trend will accelerate as a result of recent tax reform legislation which will exempt the corporate gain on such sales from taxation. See, "German Tax Reform: A Primer for Fund Managers" elsewhere in this issue.

Demographic trends and political stability have also contributed to the increase in the number of investment opportunities for private equity. The founders of a significant number of German family-owned enterprises are reaching retirement age, and their heirs are simply not able or willing to inherit the mantle. In addition, the unprecedented duration of peace and prosperity in Germany has created a phenomena not replicated in over a century. Founders are focused on the need to monetize their family businesses rather than being forced to watch them be devalued by political and economic instability. The advent of new high-tech enterprises in need of expansion capital is yet another factor contributing to the panoply of investment opportunities available for private equity.

The exit scenarios for private equity in Germany are robust, although perhaps not at their historical peak. The development of the financial markets and emergence of a stock culture in Germany have created exit opportunities that simply did not exist a decade ago. Private equity firms have already begun to take advantage of these opportunities and will undoubtedly continue to do so for the foreseeable future. The German private equity market, while more crowded than a few years ago, is less crowded than in the United States and the United Kingdom – at least for now.

Players in the German private equity field need to be conscious of the special features of the German business landscape that impact transactions involving German companies. While many of these special features are evolving, others remain as a stable part of the business scene.

Structuring a Leveraged Acquisition of a German Business

The most common corporate forms for German commercial businesses are the corporation (Aktiengesellschaft or AG), the limited liability company (Gesellschaft mit beschränkter Haftung or GmbH) and the limited partnership with an AG or GmbH acting as the

continued on page 16

Global private equity investor addressing the opening of Debevoise & Plimpton, Frankfurt: "Ladies and Gentlemen, Ich bin ein Frankfurter."

What's Inside

German Tax Reform: A Primer for Fund Managers — page 3

Guest Column: The Potential and Challenge of Private Equity in Germany — page 4

Trendwatch: The German Market — page 6

Is the Insurance Industry Any Place for Private Equity Firms? — page 8

Avoiding "Phantom Income" When Buying Preferred Stock — page 10

What's the Buzz About Privacy? — page 12

Alert: Options and Capital Gains – The Best of Both Worlds — page 14

letter from the editor

With the publication of this fourth issue of the Debevoise & Plimpton Private Equity Report, we are pleased to remind you of two major developments in the life of the firm: As many of you know, our New York office will move to 919 Third Avenue on July 9th. We're excited about our new space, which not only has vastly expanded conference facilities, but is designed to permit us to manage technology to practice law even more efficiently. Even more important, however, is the news that the firm will be expanding its global presence in Europe with the opening of an office in Frankfurt, Germany on July 16, 2001. Hans Bertram-Nothnagel (from our New York office), Marcia MacHarg (from our Washington office) and David Hickok (from our Paris office) are the founding partners of the new office and will be joined by two new German partners, Dr. Friedrich Hey and Dr. Thomas Schürrle. Dr. Schürrle was previously a corporate partner at the Munich-based firm of Nörr Stiefenhofer Lutz where he focused on international M&A, and Dr. Hey, a tax partner, joins the firm from the New York office of Oppenhoff & Rädler/Linklaters & Alliance advising on cross-border transactions.

In celebration of our new German presence and capabilities, we focus in this issue on the climate for private equity in Germany and address some of the legal issues that transacting business in Germany raises. Our guest columnist for this issue is Donald J. Gogel, President and C.E.O. of Clayton, Dubilier & Rice, Inc. which has made major investments in Germany over the last several years. Don's article highlights the potential that private equity holds for the transformation of corporate performance in Germany. This month's Trendwatch also has a German focus and analyzes the geographic focus of private equity firms in Germany and compares the terms of German funds with those in other markets.

For those not yet focused on the German market, we also offer articles of more generalized interest. While most private equity firms appreciate the commercial benefits of making preferred stock investments in portfolio companies, many have not taken into account the tax risk that holders of such preferred stock may have imputed income on accrued dividends before any cash is actually distributed. David Schnabel and Peter Furci offer several suggestions on how to avoid this "phantom dividend income." Another article discusses whether the insurance industry is a fertile ground for private equity investment. We also offer guidance reminding equity firms to focus on the use of personal customer information by potential acquisition targets as part of their business and legal due diligence. In addition, we propose structuring equity incentivization programs using LLCs.

We hope you have enjoyed these first issues of the Debevoise & Plimpton Private Equity Report and welcome your continued input on how we can offer practical insight into matters of legal 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
919 Third Avenue
New York, New York 10022
(212) 909-6000

www.debevoise.com

Washington, D.C.
London
Paris
Frankfurt
Moscow
Hong Kong

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.

All contents © 2001 Debevoise & Plimpton. All rights reserved.

The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

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
Marcia L. MacHarg – *Frankfurt*
Andrew M. Ostrognai – *Hong Kong*
David J. Schwartz
Rebecca F. Silberstein

Mergers & Acquisitions/ Venture Capital
Hans Bertram-Nothnagel – *Frankfurt*
E. Raman Bet Mansour
Paul S. Bird
Richard D. Bohm
Franci J. Blassberg
Margaret A. Davenport
Michael J. Gillespie
Gregory V. Gooding
Stephen R. Hertz
David F. Hickok – *Frankfurt*
James A. Kiernan, III – *London*
Antoine Kirry – *Paris*
Marc A. Kushner
Robert F. Quaintance
Thomas Schürrle – *Frankfurt*
Andrew L. Sommer – *London*
James C. Swank – *Paris*
John M. Vasily

German Tax Reform: A Primer for Fund Managers

Tax reform is at the heart of Germany's recent business-friendly initiatives. Below is an overview of the most important tax reform provisions relevant to U. S. fund managers. All of the provisions discussed below will be fully phased in during 2002.

Capital Gains Exemption

This is the centerpiece of the tax reform legislation. It is aimed at permitting German corporations to unlock the value of their appreciated holdings without incurring the prohibitive tax costs they formerly faced. Under the legislation, German corporations will enjoy full exemption from capital gains tax on a disposition of shares in German or foreign corporations. There are no minimum holding period or investment size requirements that must be met for the exemption to apply. Formerly, capital gains were subject to German tax at a rate of approximately 59% (except in the case of dispositions of foreign subsidiaries when treaties applied). It is expected that the capital gains exemption will likely prompt German corporations to shed many of their non-core businesses, thereby presenting a large number of investment opportunities for private equity funds.

For German individuals, the reform legislation is somewhat more complicated. Formerly, German individuals enjoyed a full exemption in the case of stock gains provided their level of equity ownership in the company sold was under 10% at all times during the five years preceding the sale. Under the reform legislation, this threshold for full exemption has been reduced to 1%, meaning a great many more individuals will be subject to capital gains taxation than in the past. On the positive side, however, only 50% of any non-exempt capital gain realized by an individual will be subject to tax.

Rate Reduction

The highest corporate income tax rate will be reduced from 42.20% to 26.375%. The reform legislation does not affect the German trade tax, which is roughly analogous to state income tax in America. The trade tax ranges generally between 17% and 22%, depending on location. Because the trade tax is deductible for corporate tax purposes, in very general terms the effective overall rate of German income tax will be approximately 38.9% to 42.6% (as opposed to 52 % to 54.9% prior to the reform). The reduction in tax rates will be particularly important for private equity investors because, under the American foreign tax credit system, there is rarely any opportunity for U.S. partners to claim a credit against U.S. tax for corporate-level income taxes paid by a portfolio company.

Depreciation

Counteracting to a certain extent the income tax rate reduction is a tightening of the rules regarding depreciation. In general, the recovery period for many assets has been extended and the accelerated methods of tax depreciation have been scaled back. On the positive side, however, the rules regarding the amortization of intangibles, including goodwill (15 years, straight line), have not been affected.

Debt Equity Rules

The tax reform legislation tightens the rules on related-party indebtedness. Formerly, a safe harbor existed for debt equity ratios as high as 9:1. Under the reform legislation, the safe harbor has been reduced to 3:1 and, in certain cases, to 1.5:1. Despite the new restrictions, significant opportunities still remain for highly leveraged structures. For example, German partnerships are not subject to any debt to equity limitations. When this rule is combined with the American "check the box" rules (permitting great flexibility in the American classification of foreign entities), opportunities abound for stripping earnings out of German companies on a tax deductible basis without adverse American consequences.

Adoption of a "Classic" Corporate Tax System

Under the reform legislation, Germany will adopt the American-style "classic" system of corporate-level and shareholder-level tax. Formerly, Germany had an "imputation" system under which German shareholders received a (refundable) credit for corporate-level taxes. Under the reform legislation, however, dividends paid by a German corporation to another German corporation, regardless of the size of the holding, will be exempt from German

continued on page 19

Acquisition/High Yield Financing
William B. Beekman
Craig A. Bowman – *London*
David A. Brittenham
Paul D. Brusiloff
A. David Reynolds

Tax
Andrew N. Berg
Robert J. Cubitto
Gary M. Friedman
Friedrich Hey – *Frankfurt*
Adele M. Karig
David H. Schnabel
Peter F. G. Schuur – *London*

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

Estate & Trust Planning
Jonathan J. Rikoon

guest column

The Potential and Challenge of Private Equity in Germany

The following remarks are adopted from a speech delivered to the Handelsblatt Venture Capital and Private Equity Conference in Frankfurt, Germany in May, 2001 by Donald J. Gogel, President and CEO of Clayton, Dubilier & Rice, Inc. ("CD&R").

I would like to discuss the potential – and to some extent the risks – that private equity holds for the transformation of corporate performance in Germany. In doing so, I will focus my comments on the segment of private equity traditionally called "buyouts" and exclude the very different dynamics of venture capital, though these terms are often used interchangeably in Europe.

Private equity can be a critical catalyst in the transformation of many traditional or "old economy" businesses. It is a form of "transitional capital" that can provide an orderly transfer of underperforming assets into the hands of investment firms willing, ready and able to transform those assets into more productive enterprises. Under the right conditions, private equity firms can be a source of revitalization, new investment, higher employment and value creation.

[W]e expect conditions [in Germany (and Europe)] will...support strong and constructive private equity activity. But that opportunity will be realized only if private equity firms have the resources, the will and the energy to bring about the necessary changes in their portfolio companies.

Those are the premises under which our firm is operating on a large scale in Germany today. CD&R has made 3 investments in this country beginning with the purchase of Schulte GmbH from Tyssen in 1998 and most recently our $1.2 billion commitment of growth capital in Fairchild Dornier. This last investment was made jointly with Allianz Capital Partners. Altogether, the funds we manage have invested over $500 million in equity in companies that employ more than 7,000 German workers.

We have been pursuing private equity investment opportunities in Germany since 1995, and during this period, we have observed increasing acceptance of the role of private equity in reshaping German businesses. This follows a trend in the U.S. that began 20 years ago in which business and economic conditions became receptive to private equity as an important factor in facilitating business transformations. Even recognizing that Germany (and Europe) will evolve in a distinctive manner, we expect conditions here will be similar and will support strong and constructive private equity activity. But that opportunity will be realized only if private equity firms have the resources, the will and the energy to bring about necessary changes in their portfolio companies.

Conditions For Private Equity To Thrive

Developments in the United States set a framework to understand the conditions under which private equity can thrive:

Shareholder pressure for improved financial performance. There is no doubt that shareholder pressure spurred merger and acquisition activity in the United States in the past 20 years. The particular source of that pressure is less important than the realization that the demand for better performance from influential, outside, constituent shareholders will be persistent and will only increase over time. In the United States, the threat of hostile takeover made this pressure real, even though hostile takeovers represented only a tiny fraction of overall merger and acquisition activity. Today, the threat is more to top management as turnover in the executive suite is the ultimate price paid by management for poor performance. The average tenure for U.S. corporate CEOs is now between 4 and 5 years.

In Germany, major corporations are under considerable pressure to improve performance. The globalization of financial markets and competition within and outside the European Community is creating some of the most demanding conditions ever faced by Germany's major companies. Despite the current debate over the EU directive on takeovers, it is inevitable that shareholder pressure will continue to force more radical restructuring –

opening the door to transactions that are best suited for private equity.

A closely-related development is the trend toward "disentanglement" of cross ownership holdings that have occurred in Germany. The result of disentanglement, of course, is that it effectively lessens the influence of big friendly shareholders and opens the door to the pull of market influences.

Healthy capital markets for acquisition finance. The emergence of a strong market for both syndicated bank debt and high yield securities provided the basis for private equity to fund investment activity. At its peak, these markets were willing to finance acquisitions with up to $8 of debt for every $1 of equity, often with historical cash flows that barely covered interest expense.

Capital markets in Germany and Europe today may not be as aggressive in lending practices, but acquisition finance is a healthy and growing part of the total market. Total European syndications for leveraged loans exceeded $34 billion in 2000 and $10 billion so far this year. High yield bond offerings for buyouts last year were at $3 billion and are $1.8 billion year-to-date.

Aggressive corps of advisors and M&A professionals. Bankers, lawyers and accountants alone do not create M&A activity, but they are essential to encourage this activity. Several thousand highly paid and motivated M&A professionals in the U.S. have a big stake in keeping M&A activity high, and a similar group is now established and growing in Germany. The merger of major law firms in Germany and London (not to mention the opening of a Debevoise office in Frankfurt) as well as the big buildup of investment banking teams in Germany are good indications that the intermediaries expect a significant amount of deal flow.

Generally positive tax and regulatory environment. U.S. government policy in the 1980s was not wholly favorable (for example, the Tax Reform Act of 1986 eliminated favorable tax treatment of divested divisions), but provided a reasonably benign environment.

In Germany, tax reforms are expected to unleash a wave of restructuring, as divested properties will escape punitive taxation. See,"German Tax Reform: A Primer for Fund Managers" elsewhere in this issue. Other reforms are equally encouraging of improvements in corporate governance and productivity, including new legislation on squeeze-out mergers. See, "Germany – A Prime Target for Private Equity Firms" elsewhere in this issue for a discussion of the proposed German Securities and Tender Offer Act.

Social acceptability of high performance corporate cultures. U.S. buyouts have worked in part because managers and employees have been willing to embrace high standards of performance and innovative practices. With our employees at Schulte and Fairchild Dornier, we have experienced a similar willingness to try new management techniques, as well as a fresh entrepreneurial spirit. These attitudes are captured in comments from a Fairchild Dornier shop steward that were quoted in *Die Welt* recently: "Skepticism against the Americans on board has dissipated.... They practice an open-door policy. In 90 percent of the cases a consensus is reached...." Because of the modern management style, "the worker feels just as important as the gentlemen in management. That is especially important in periods of change."

Several thousand highly paid and motivated M&A professionals in the U.S. have a big stake in keeping M&A activity high, and a similar group is now established and growing in Germany.

With these conditions in place now in Germany, private equity can start to fulfill its promise of facilitating changes in ownership and improving financial performance. These changes can be as significant for privately held and middle market companies as they can be for large industrial enterprises. However, this promise will only be realized if private equity firms show the fortitude to press for changes in management practices.

What Private Equity Firms Must Do To Succeed in Germany?

Specifically, what must private equity firms do to succeed in Germany? More than anything else, they must shake-up the culture of under-performing businesses. As a private equity firm makes an investment, there is an expectation of change. Excitement and fear may mix equally in people's minds, but there is certainly an expectation of change. Private equity firms must take advantage of this expectation and press quickly for needed changes in several areas.

continued on page 15

Is the Insurance Industry Any Place for Private Equity Firms?

Growth of Private Equity Funds as Acquirors of Insurers

Private equity investments in the insurance industry have grown steadily over the past decade. While the dramatic success of the 1992 AmRe transaction was one catalyst for this growth, a number of other factors have attracted private equity firms to participate in the ongoing consolidation in the insurance industry:

- The perception that there are under-managed assets in the insurance industry has generated interest in potential gains based on operational improvements.
- The opportunities for smaller, focused management teams to meet consumer demand for better service, expanded and more cost-effective product offerings and new methods of distribution has also spurred interest in the sector.
- The potential for unlocking value based on increasing insurance investment portfolio yields has attracted financial buyers.

Insurance regulations create a number of issues for insurance industry private equity transactions and require that special care be taken in structuring these transactions. These issues include a variety of restrictions limiting the amount of debt that can be utilized, as well as informational requirements for obtaining regulatory approval of insurance company acquisitions that financial sponsors may find challenging.

Regulatory Approvals for Change of Control Transactions

Acquisition of "control" of an insurer requires the prior approval of the domestic state insurance regulator of the insurer and the state insurance regulator of any state in which the insurer is "commercially domiciled." "Control" is usually defined as the possession, direct or indirect, of the power to direct or cause the direction of management and policies, whether through the ownership of voting securities, by contract or otherwise, and is presumed if any person, directly or indirectly owns, controls, holds with the power to vote or holds proxies representing 10% or more of the voting securities of a person.

The application for approval, a Form A, requires disclosure of the buyer and all its controlling persons, directors and executive officers. In addition, the application requires provision of financial statements of the buyer and its controlling persons and of a description of the buyer's plans for the acquired insurer, including detailed financial projections. Because this information must be provided for the acquiror's ultimate controlling person on the basis of the definition and presumption described above, private equity sponsors may be required to provide detailed information for their individual general partners, including personal financial statements. Some states also require that directors and executive officers of the buyer and its controlling persons submit biographical affidavits and fingerprints. Although confidential treatment for non-public information provided during the Form A process is typically available upon application to the insurance department, many sponsors nevertheless find these information requirements to be intrusive.

Other key factors considered by insurance regulators in considering a change of control application include:

- As more fully described below, the amount of leverage contemplated in the transaction is a critical issue for regulators.
- The insurance expertise of the financial sponsor or its proposed management team. A financial sponsor can enhance the prospects of approval by securing services of experienced insurance professionals as directors and officers of the insurance company.
- The proposed business plan for the insurance company. Insurance regulators are principally concerned with safeguarding insurance company assets for the benefit of policy holders and not with maximizing shareholder value. A business plan which reflects too rapid revenue growth may therefore create a problem or at least result in heightened scrutiny of the insurer's post-transaction capitalization. Senior insurance regulators are also political appointees and as such concerned with preserving jobs within their states, and therefore may not be enamored with a plan that emphasizes synergies through headcount reductions.
- Most state insurance laws require that all material transactions between the insurance company and its affiliates be properly notified to the insurance department and receive prior approval. Although the management consulting and indemnification agreements private equity firms typically have with the holding company would not need to be filed with the regulator because the insurance company is not a party, the insurance operating company's ability to make dividend payments to the holding

company to meet the parent's obligations under such agreements will be subject to the dividend restrictions discussed below.

Debt Restrictions

Insurance regulations in a number of states impose restrictions on the amount of debt that can be placed on an insurance holding company and its insurance subsidiaries, the debt security package, and the availability of funds to service debt. Although lenders can take some comfort from the fact that insurance deals are typically less leveraged than conventional deals, the structural anomalies which result from these regulatory impediments generally make the cost of financing insurance leveraged buyouts higher than conventional leveraged buyouts. (Part of the premium paid for debt financing in insurance LBOs is also attributable to the smaller pool of mezzanine investors in the market for these transactions, even in a more robust mezzanine market than we have recently seen.)

Restrictions on Debt Placed Directly on the Insurance Company. Insurance laws in a number of states prohibit debt from being placed directly on the insurance company, even on an unsecured basis, unless the loan proceeds are received and retained by the insurer.

Insurance laws may also restrict pledges of the assets of the operating insurance company. For example, New York domestic insurers may not, without prior regulatory approval, pledge more than 5% of their admitted assets. Other states prohibit pledging assets to secure another person's debt or guaranty or otherwise limit asset pledges in order to ensure that there are sufficient unencumbered assets to pay policyholder liabilities.

Limitations on Holding Company Debt. Accordingly, in leveraged buyouts of insurers debt is typically placed at the holding company level. Senior lenders may receive a pledge of the insurance company's stock, the holding company's principal asset. Foreclosure on the pledge would be conditioned on insurance department approval of the acquisition of control of the insurer by the purchaser at the foreclosure sale. Because debt is at the holding company level, both structurally and legally, policy claims rank senior to lenders' claims, in the event of receivership of the insurer (a proceeding that is governed by the law of the insurer's state of domicile, as an insurer cannot be a debtor under the federal Bankruptcy Code). Insurance regulators' concerns about protecting policyholders interests may result in significant limitations on the debt to equity ratio at the holding company, which rarely exceeds 1.5 to 1.0.

Insurance Company Dividend Restrictions. Insurance company dividend restrictions, limit the amount of cash available to service holding company debt and also limit the amount of debt that can be placed on the holding company.

Typically, an insurer may not pay any dividend other than from "earned surplus." This usually equates with "Unassigned Funds (Surplus)" as reported on the insurer's statutory financial statement. An insurer with a prior history of losses may have a negative "earned surplus" which may be a barrier to payment of any dividend (or, in some states, require a prior domestic state insurance regulatory approval).

Under the law of most states, an insurer may not make an "extraordinary dividend" without the prior

> *Leverage does not play as large a role in providing investment returns in insurance company leveraged buyouts as it does in other industries.*

approval of the domestic state insurance regulator. An "extraordinary dividend" is usually defined as dividends which in a twelve month period exceed the greater of (i) 10% of the insurer's policyholders' surplus, or (ii) the net income of the insurer.

Tax Sharing Agreements. In addition to servicing debt through dividend payments, tax sharing agreements also provide a source of funds to service holding company debt.

Under a tax sharing arrangement, an insurer that is included in a consolidated tax return with the holding company (and possibly other affiliated companies) can make payments based on its share of the group's tax liability. In any one year, these payments can actually be more than the amount the group is required to pay to the taxing authority. If, for example, taxable income generated by the insurance company is sheltered in the consolidated return by deductions generated by other group members, and the tax sharing arrangement is structured so that the insurance company pays what it would have paid if it had filed on a separate return basis, the tax sharing arrangement will provide net positive cash flow to the holding company.

A tax allocation agreement may be subject to review by the insurer's domestic state insurance regulator

continued on page 18

Avoiding "Phantom Income" When Buying Preferred Stock

Preferred stock investments have become increasingly popular among private equity funds in recent years. Many traditional LBO funds have made significant preferred stock investments in portfolio companies. Other LBO funds have purchased preferred stock either as mezzanine financing of a leveraged acquisition or, as venture funds have for years, purchased preferred equity, rather than common, in start-up or relatively high-risk companies.

The commercial benefits of convertible preferred stock are well known. They provide downside protection by giving the holder a preference (ahead of the common stock) if the issuer's fortunes decline. In addition, the ability to convert the preferred into common stock of the issuer provides significant upside potential. In cases where the preferred stock includes a "pay-in-kind" dividend (or the equivalent), the conversion feature can become exponentially more valuable the longer the preferred stock is held.

In most cases, the preferred stock includes a fixed dividend rate (say, 10% per year). Sometimes the dividend is payable in the form of additional shares (a so-called PIK dividend); in other cases the dividend accrues and is added to the stock's liquidation preference. For example, if a holder starts with 100 shares, the holder would receive a dividend of 10 additional shares at the end of the first year and a dividend of 11 additional shares at the end of the second year. Thus, at the end of the second year, the holder would own 121 shares.

The taxation of preferred stock is an area full of lore but low on actual law. As a result, there is a benefit to "staying with the pack" – that is, following what other investors are doing in the market. However, the quirky nature of the rules governing preferred stock make it quite easy to inadvertently fall outside of the pack.

While most investors appreciate the commercial benefits of buying preferred stock – particularly with the slowing economy – many investors do not realize that preferred stock can result in unwelcome tax consequences. Specifically, the holder may be currently taxed on either the PIK dividend or the accrued dividend before the holder actually receives cash. Many fund investors loathe this "phantom" dividend income. The phantom income is made especially unpleasant because it is taxed at an almost 40% rate for individual holders (vs. 20% rate for long-term capital gains) and a 30% rate for non-U.S. holders (vs. a 0% rate for capital gains). Fortunately, with a degree of tax planning, private equity fund investors can avoid the phantom dividend income by taking advantage of one of three commonly-employed strategies.

The No Earnings and Profits Exception

First, phantom dividend income arises only if the issuing company has current or accumulated "earnings" (or, in tax parlance, "earnings and profits" or "E&P"). Since companies receiving early-stage financing generally do not have E&P, most preferred stock investments in start-up companies do not generate phantom dividend income. However, a company can have E&P if it has earnings in any given year – even if those earnings are far less than the company's accumulated losses from prior years. Thus, while the lack of E&P often works in the early years, it is not necessarily a long-term solution. Of course, the Internet economy has shown that the "early years" can last a very long time.

The Participation Exception

A second way of avoiding phantom dividend income, which works even if a company has E&P, is to add a "participation feature" to the terms of the stock. This works because stock that "participates in corporate growth" to a significant extent is considered "common stock" for tax purposes, and the tax rules provide that a holder of "common stock" generally does not have phantom dividend income upon the receipt of a PIK dividend.

When this structure is used, the questions for the tax lawyer are what types of participation count in determining whether stock is considered "common stock" for tax purposes and how much participation is required. The right to participate in current dividends actually paid on the regular common stock and the right to participate on liquidation generally count. Surprisingly, however, conversion rights are ignored in determining whether stock is considered "common stock" for tax purposes.

The question of how much participation is required is more difficult. Tax practitioners generally believe that stock will be treated as common stock if, *in addition* to the liquidation preference and stated dividend rate, the stock participates on an as–converted basis with the common stock in the event that the company liquidates or there is a dividend paid on the company's outstanding common stock. Lesser participation can also work, but it is more risky and requires a more fact specific analysis. Frequently, the appropriate solution is to provide that the holder is entitled to receive the *greater* of the stock's liquidation preference and the amount that would be received if the stock were actually converted.

Since venture companies don't normally pay dividends (and no one expects any company to liquidate), venture companies are often willing to add participation features to the terms of the preferred stock, even where it was not really part of the original business deal. However, in the public context, some issuing companies actually pay regular common stock dividends or believe that they may pay regular common stock dividends in the future. As a result, public companies are often less willing to add a participation feature to the terms of the stock. In that case, the special rule for PIK dividends on stock treated as "common stock" for tax purposes is not available.

Unfortunately, the participation features described above will not work if cash dividends are paid on any other class of stock or interest is paid on convertible debt. If that happens, a PIK dividend paid to the holder of convertible preferred stock will give rise to current dividend income to the extent of the company's E&P, regardless of the participation features written into the terms of the convertible preferred stock.

The Undeclared Dividend Exception

The third way that phantom dividend income can be avoided - which also works whether or not the issuer has E&P – is to provide for an accumulating, compounding cash dividend that is payable only if it is declared by the board. Normally, a holder of preferred stock is not considered to receive a taxable dividend until the dividend is actually declared and paid by the issuing company. Even if dividends are allowed to accumulate and compound when not declared, the holder of the preferred stock generally is not considered to have current dividend income until the holder actually receives a cash dividend (or the preferred stock is exchanged for common stock). If the dividends are not actually paid in cash but are instead added to the investor's liquidation preference, the holder is generally in the same economic position as a holder of PIK preferred since the amount of common stock received by the holder upon conversion of the preferred stock will typically be based on the increased liquidation preference.

Once again, however, there is an exception. Many tax practitioners believe that if the issuing company is actually prohibited from declaring the cash dividend (either pursuant to a debt covenant or an agreement with the holder), and the preferred stock provides for mandatory redemption on a given date or gives the holder the right to put the stock to the issuer, then the accrued dividend may be taxable to the holder on a current basis. This is known as the so-called "redemption premium" exception. Public companies (and companies acquired in LBO transactions) are much more likely to have debt covenants restricting their ability to pay current dividends than companies in the venture capital context, which do not rely as heavily on bank debt. In light of the uncertainty surrounding the application of the redemption premium exception, tax practitioners will often recommend adding a participation feature (as described above) to the terms of the convertible preferred stock.

While most investors appreciate the commercial benefits of buying preferred stock... many investors do not realize that preferred stock can result in unwelcome tax consequences.

The taxation of preferred stock is an area full of lore but low on actual law. As a result, there is a benefit to "staying with the pack" – that is, following what other investors are doing in the market. However, the quirky nature of the rules governing preferred stock make it quite easy to inadvertently fall outside of the pack. For example, people often forget that the "participation" alternative described above generally does not work if the issuer has convertible debt outstanding. Accordingly, even when the terms of the stock are designed to mirror what has been done elsewhere, it is always a good idea to run them by a tax lawyer. ▫

—David H. Schnabel and Peter A. Furci

What's the Buzz About Privacy?

We've all thought about personal privacy issues on the Internet and applauded regulatory initiatives to protect the use of our personal information. That perspective changes dramatically in connection with an acquiror's increasing need to consider the privacy practices of its acquisition targets as an important issue in business and legal due diligence.

While few would question the need for environmental and intellectual property audits to analyze the compliance history of an acquisition target, many acquirors have yet to recognize the importance of a privacy audit as part of the diligence process. Recent legislation, including the Gramm-Leach-Bliley Financial Services Modernization Act (G-L-B Act), which requires banks, insurance companies and other financial institutions to adopt privacy protection policies, as well as the Bush Administration's plans to implement privacy regulations relating to medical records have created a "buzz" about privacy issues. In addition, corporate violations of their own privacy policies have highlighted the cost of announcing but not following a policy. For example, Amazon.com reportedly paid $2 million in settlements of class action suits filed after the FTC announced that it was looking into whether Amazon's privacy policy was deceptive. Toysmart.com, the now-defunct Internet toy-retailer, found that its most valuable asset, its customer list, could not be sold during its bankruptcy due to the limits of its previously posted privacy policy.

While few would question the need for environmental and intellectual property audits to analyze the compliance history of an acquisition target, many acquirors have yet to recognize the importance of a privacy audit as part of the due diligence process.

New state laws and regulations and international regulatory schemes have added to the complexity surrounding privacy matters. In conducting a privacy audit, you might consider the following:

What are the regulatory schemes applicable with respect to the acquisition of the target business?

For example, if the business operates in Europe, it will need to comply with the European Union's 1995 Directive on the Protection of Individuals with Regard to Processing of Personal Data (the "EU Directive"), which mandates that entities must protect privacy when processing personal data (broadly defined to include any information through which an individual can be identified), both online and offline. More importantly, the EU Directive restricts the transfer of personal data outside the European Union except to those countries deemed to ensure an "adequate level of protection." Because the EU does not consider the U.S. to provide an adequate level of protection, the U.S. Commerce Department and the EU recently negotiated a set of privacy principles; U.S. companies that voluntarily comply with those principles will be entitled to a presumption that they comply with the EU principles. An obvious question in the course of a privacy audit for companies operating in or hoping to expand into Europe is whether the target complies with the privacy principles negotiated between the U.S. Commerce Department and the EU.

Is the target subject to U.S. regulations as a bank, insurance company or other financial institution and therefore subject to the G-L-B Act?

Does it plan to share consumer financial information among affiliates or third parties? If so, sharing that information with affiliates and third parties may be prohibited under the GLB Act regulations unless the consumer has been notified of the privacy policies and not objected. In some cases, sharing such information among affiliates is also regulated by state law. Although the level of enforcement of these rules is not yet clear, acquirors ought to understand the potential

business risk, especially if one of the target's most valuable assets is consumer financial information.

Does the target have an Internet site visited by children under the age of 13?
Under the Children's Online Privacy Protection Act (COPPA), operators of websites directed at children or having actual knowledge of use by children are required to provide notice of data protection policies, obtain parental consent prior to collecting information from a child, provide access to all information collected, tailor information gathering and maintain security and confidentiality. In the spring of 2001, the FTC settled charges against the operators of girlslife.com, bigmailbox.com, and insidetheweb.com for illegally collecting personal identifying information from children under 13 years of age without parental consent in violation of COPPA. In settling the charges, the website operators agreed to delete all of the information that had been collected and used in violation of COPPA and to pay civil fines.

Does the target have any insurance operations?
The obligations of insurance companies with respect to protection of consumer health and financial information seem to be expanding. Under the G-L-B Act, the actual implementation of privacy rules for insurance companies is delegated to the states which are expected to adopt requirements that are even more stringent than the G-L-B Act required. New federal and state regulations are also being adopted that are intended to prevent insurance companies and others from disclosing patient medical histories and other non-public patient information. Any business plan involving the sharing of consumer information with or from an insurance company will need to take these regulations into account.

Although the level of enforcement of these rules is not yet clear, acquirors ought to understand the potential business risk, especially if one of the target's most valuable assets is consumer information.

Although this list of issues to consider in the course of a privacy audit is hardly exhaustive, it should highlight the many ways in which privacy issues affect businesses and the need for acquisition teams to consider the impact of privacy regulation on both the existing and potential operations of a target's business.

— Sarah A.W. Fitts and Sheri Rabiner-Gordon

Fund Alert

We would like to remind our private equity fund clients and friends whose limited partners include individuals of the following: As outlined in our memorandum sent to friends and clients on June 1, 2001, private funds with individual limited partners are required to send to those limited partners by July 1, 2001 a privacy notice concerning their rights with respect to disclosure of non-public information. If you do not have a copy of our June 1 memorandum, a copy can be found on our website, Debevoise.com, or by calling Ken Berman, a partner in our Washington, D.C. office at (202) 383-8000.

alert

Options and Capital Gains – The Best of Both Worlds

Private equity funds are under increasing pressure to come up with management equity incentive plans that will be taxed at capital gains rates. For years, private equity funds have used option plans with one or more components: service options, which vest over time, and performance options, which vest depending on the extent to which the portfolio company meets annual earnings or other performance-based targets or which vest upon exit, in some cases, depending on the return received by the private equity sponsor in the sale. While options provide tremendous flexibility in incentivizing management, the spread between the exercise price and the fair market value of the underlying shares is taxed at ordinary income rates. Given that the federal ordinary income rate is 39%, whereas the federal long-term capital gains rate for individuals is 20%, there is a meaningful economic impact on employees if the private equity firm can deliver equity incentives that are taxable at capital gains rates.

Although LLCs were once considered by many to be too complicated or difficult to be used for employee incentive plans, we have encountered much broader acceptance in recent times.... We should caution, however, that this approach may be most appropriate for very senior executives with significant equity interests or for broader based plans designed for very sophisticated employee groups.

For years, private equity firms have delivered capital gains treatment by using restricted stock, especially with start-up companies, where the buy-in price for the shares is relatively low. With more mature companies, however, the buy-in price may be prohibitively high. The portfolio company can arrange for, or provide loans to, the managers to fund their purchases of stock, but the loans must be recourse (at least in substantial part) to the managers' personal assets. Although requiring "skin in the game" is appealing, if the stock declines in value from the buy-in price, this can lead to significant economic hardship for the managers. It is also difficult to mimic performance options with restricted stock grants.

We have recently designed an LLC structure which incorporates all the provisions of a standard private equity shareholders agreement (e.g., puts and calls on termination) and a private equity option plan, including both service and performance options. This structure should provide capital gains treatment to key managers, in many cases with minimal capital investment required. The underlying operating company remains a corporation, thereby addressing concerns of tax-exempt and foreign investors. However, by layering an LLC holding company at the top of the structure, more flexibility is provided in designing attractive equity incentives.

Although LLCs were once considered by many to be too complicated or difficult to be used for employee incentive plans, we have encountered much broader acceptance in recent times. There seems to be a broad movement to use LLCs in designing incentive tools. We should caution, however, that this approach may be most appropriate for very senior executives with significant equity interests or for broader based plans designed for very sophisticated employee groups. For example, we have been involved in the establishment of employee co-investment plans as recruitment and retention vehicles for employees throughout large investment banks. We should point out that the explosion of the use of warrants and convertible interests in LLCs has resulted in intense study by the IRS over the past year, resulting in an IRS official being quoted earlier this month as saying that this is a "blockbuster issue;" obviously, we will be tracking the IRS' interest. Please feel free to call either of us, or any of the members of our employee benefits group, if you would like to talk about this further. ◻

— Andrew N. Berg and Margaret A Davenport

First, private equity firms must attract new and more talented leaders and managers into a business. Old economy companies are at a huge disadvantage in competing for the best and the brightest. Slow-to-react businesses that provide minimal opportunities to create rewarding intellectual and monetary cultures do not attract the high-energy leadership needed to champion corporate revitalizations. Private equity firms typically bring in at least several new managers with world-class functional and leadership skills and provide very generous compensation packages that are directly linked to performance. Think about the impact of hiring Lothar Matthaeus for your football team. When CD&R invested $300 million (along with $100 million in equity from Allianz Capital) in Fairchild Dornier, we moved quickly to bolster the management team, starting with the recruitment of a new Chief Executive, Lou Harrington, formerly Vice Chairman of McDonnell Douglas. We also established a world class Main Board that included, among others, Brian Rowe, formerly the Chief Executive of General Electric's aircraft engine business.

Second, private equity firms must build new businesses on top of old ones. Building a new business model through new or better services, products and channels will typically require three to five years, new capital investment, and a willingness to accept losses from some or all operations. Public stock market investors generally cannot stand to watch the tedious process as new businesses struggle mightily to increase revenues and profits in new lines of business as their old lines of business deteriorate. Fortunately, private equity investors can and should absorb the short-term pain of such dislocations.

In the case of Italtel, CD&R recently made another $300 million investment as part of a $1 billion transaction to purchase the equipment-manufacturing arm of Telecom Italia. With management and co-investors, Cisco and Telecom Italia itself, CD&R will have the opportunity to transform Italtel from a voice-switching manufacturer to a leading provider of data and voice over data telecommunications equipment.

Third, private equity firms must establish a performance culture. Many large companies, in the U.S., as well as Germany, do not have performance-oriented cultures. "Doing a little bit better" is often the norm, even though the standard for success may well be much higher. Private equity firms are experienced in "raising the bar" for performance. By setting higher standards for sales, productivity, quality and profitability – and motivating employees to meet them through very generous incentive compensation programs – firms like ours can introduce a major cultural shift in favor of performance.

We believe we have already had such an impact at Fairchild Dornier.

[W]hat must private equity firms do to succeed in Germany? More than anything else, they must shake-up the culture of under-performing businesses.

Our large, complex model 728 development program has met every scheduled milestone in the first year of our ownership. There is the expectation at Fairchild that development schedules will be met.

These changes are relatively simple to describe. But they are very difficult to implement. That is the reason that private equity firms – at least those with the experience and operating capability – have significant work to complete in the years ahead.

Financial leverage and rising stock market prices will not lead to superior financial returns for private equity investors. The test for CD&R and other private equity firms in Germany in the next decade is whether we can sustain the energy and maintain the edge necessary to bring about the business transformations.

The barriers to success are high, but we are optimistic about the prospects for private equity to help build stronger more competitive businesses that will be valuable for employees, customers and investors.

— Donald J. Gogel

managing partner with unlimited liability (Kommanditgesellschaft). In the case of all three types of companies, it will usually be desirable to structure an acquisition so that acquisition debt is ultimately placed at the same level, in terms of the group holding structure, as operating revenues and assets. This is particularly important in Germany because there are a number of restrictions on the timing and amount of dividend payments by German corporations and limited liability companies. Dividends may only be paid from profits and distributable reserves shown on the company's audited accounts and, in the case of a corporation (AG), interim mid-year dividends are not permitted, so that cash flow generated by a business may not always be immediately available for distribution to the acquiror to service its acquisition debt.

In the case of German corporations, financial assistance rules further prohibit upstream loans, guaranties or pledges of assets to repay or secure indebtedness incurred to acquire the corporation's own shares. While this rule does not apply to limited liability companies, upstream loans or guarantees by such companies must generally be limited to amounts which could be paid out as dividends of profits or distributions of other free reserves so as not to impair the company's capital. In the case of all three types of German legal entities, distributions of profits to non-EU shareholders to service acquisition debt incurred by such shareholders will also be subject to German withholding tax. Placing debt on the German operations avoids dividend withholding tax and also enables interest deductions to reduce taxable profit in Germany.

The most common structure for a German acquisition is the creation of a German acquisition vehicle (typically a German limited liability company to avoid the more constraining corporate procedures required for a corporation) to acquire the German target or its assets using a combination of equity and acquisition indebtedness. In the case of an asset acquisition or the acquisition of a limited partnership, operating cash flow can then be applied to service acquisition debt free of the corporate law constraints on dividends and other distributions applicable to corporations and limited liability companies. In addition, interest on the acquisition debt will directly offset operating profit for tax purposes. In the past, these advantages often led acquirors to cause German targets in corporate or limited liability company form to be converted into limited partnerships either before or after the acquisition. This had the additional benefit of permitting a tax free step-up in the basis of the assets of the target company for tax purposes. Under the tax reforms to take effect on January 1, 2002, however, this tactic will be of practical interest in only limited cases, since capital gains on sales of shares in a German corporation or company (as opposed to sales of assets or partnership interests) will be exempt from German corporate taxation and a tax free step-up in basis will no longer be permitted.

As opposed to an asset acquisition or the acquisition of a limited partnership, in the case of the acquisition of a German corporation or limited liability company by a German acquisition vehicle, dividends and other distributions and upstream loans and guarantees are still restricted under German company law. Moreover, under the new German tax reform legislation, the acquisition vehicle's interest deductions would not be available to offset the target's operating profits in the absence of tax consolidation and also would be disallowed to the extent of dividends paid by the target in any year.

However, the traditional limitations on applying leverage in acquisitions of a German corporation or limited liability company are now surmountable. One possibility may be for the German target and acquisition vehicle to merge, so that interest expense may be serviced from operating revenue without the payment of a dividend. Such mergers may be made on a tax-free basis. At least to date, the German courts have not followed the reasoning of French or Italian courts in holding that, in some circumstances, such a merger constitutes an abusive end-run around financial assistance or other corporate rules. Another possibility is for the target and the acquisition vehicle to enter into a Profit and Loss Absorption Agreement, whereby the acquisition vehicle assumes the profits and losses of the target and therefore obtains the equivalent of tax consolidation, so that its interest deductions reduce taxable operating profit for German federal tax purposes (and partially (to the extent of 50%) for German "trade" tax purposes).

Partially Public Companies

During the late 1990's and the first half of 2000, Germany experienced an unprecedented boom in capital market activity, particularly in the new economy, biotechnology, telecommunications and media sectors, but also in more traditional sectors. As stock prices rose, numerous companies or controlling individual shareholders made public offerings of minority share interests in their subsidiaries or portfolio companies

while retaining controlling equity stakes. With the slowdown in capital market activity this year, many of these shareholders are now seeking alternate sources of capital for their subsidiaries or portfolio companies or to realize on their investments through sales of the partially public company.

Under a new German Securities and Tender Offer Act which will almost certainly be passed into law by the beginning of 2002, acquisitions of substantial equity interests in these partially public German companies (as well as wholly public companies) will be subject to mandatory regulation in line with the draft European Union Tender Offer Directive, which is also expected to be adopted this year. (Germany had previously developed a voluntary takeover code similar to the English City Code which did not, however, gain a comparable level of widespread adherence.)

Under the new German Takeover Act, any acquiror of shares representing 30% or more voting power of a company having its seat in Germany and listed on a German exchange, whether in a privately negotiated transaction or through exchange trades, will be required to launch a mandatory tender offer for the company's remaining shares. The offer must be for cash or securities listed on an EU exchange. In the case of both mandatory and voluntary tender offers, the price and other terms of the offer and the offer documentation will be subject to prior review and approval by the Federal Supervisory Office for Securities. In the case of mandatory offers and voluntary tender offers intended to establish control, the new Takeover Act and the draft implementing regulations stipulate minimum offer price formulas based upon the prices for shares paid by the offeror during the three month period preceding the offer (or the acquisition of the 30% stake). In no event may the offer price be less than the average share price during such three month period. These regulations are designed to prohibit two tier offers that were once common in the United States.

The new scheme will be similar in many ways to the approach followed in the U.K. In the case of both mandatory and voluntary offers, a financial institution must sponsor the offer and confirm that sufficient committed funds are available to consummate the offer. Transactions will not be permitted to go forward subject to financing conditions. This will require private equity firms to have their financing arranged or bridged before they announce an offer. In addition, even in the case of a voluntary tender offer, conditions to the offer will only be permitted to the extent the conditions are outside the control of the bidder. This means, among other things, that the "material adverse change" condition will be interpreted very restrictively – more like it is in the U.K. than in the U.S.

Squeeze-Outs – Finally Possible

At present, German company law does not provide any satisfactory mechanism equivalent to the Delaware squeeze-out merger for eliminating minority shareholders. A German parent corporation (AG) (but not a foreign corporation as a German GmbH) can elect to "integrate" a 95% or more owned subsidiary in corporate form (AG) and thereby obtain 100% of the subsidiary's shares, but the minority shareholders in the subsidiary must receive an offer to receive either cash or shares in the parent company, at their election. The adequacy of the offer (and hence the valuation of the subsidiary) is subject to review by a Regional Court in a special proceeding (the so-called "Spruchstellenverfahren"), which often lasts for years. In the case of a highly leveraged German acquisition vehicle, minority shareholders, if they accept the offer to acquire shares, may well obtain a stake in the acquisition vehicle which is significantly larger, in percentage terms, than their original stake in the target.

The exit scenarios for private equity in Germany are robust, although perhaps not at their historical peak. The development of the financial markets and emergence of a stock culture in Germany have created exit opportunities that simply did not exist a decade ago.

The new German Takeover Act will provide a far more acquiror-friendly squeeze-out mechanism. Once 95% or more of the shares of a German corporation (AG) are held by a single shareholder (whether German or foreign and regardless of corporate form), a shareholders' meeting may be held to resolve that such shareholder will acquire all remaining shares against cash payment only. Most significantly, if the squeeze-out is made at the offer price and follows a mandatory or voluntary tender offer in which 90% or more of the offeree shareholders accepted the offer, the squeeze-out price will not be subject to court review. The new squeeze-out rule will not apply to limited liability companies (GmbH's), but there may be a possibility in some cases to transform a GmbH into an AG and then apply the squeeze-out rules. ▫

— David F. Hickok and Thomas Schürrle

under state insurance holding company regulations since it is a transaction between affiliates in a holding company system.

Administrative Service Agreements. It may also be possible to move money up to the holding company through administrative service agreements.

Administrative agreements between an insurer and its holding company parent are usually subject to review by the insurer's domestic state insurance regulator under state insurance holding company laws since they involve transactions between affiliates in a holding company system.

New York, for example, limits the amount of money that may be upstreamed through an administrative services agreement by typically requiring that services provided by a parent or affiliate be provided at cost. Other states may be more flexible, for example by allowing services to be provided at arm's-length market prices (including a profit component).

Acquisition of "control" of an insurer requires the prior approval of the domestic state insurance regulator of the insurer.... The application for approval... requires disclosure of the buyer and all its controlling persons... [,and] private equity sponsors may be required to provide detailed information for their individual general partners, including personal financial statements.

Alternatives to a Traditional Leveraged Buyout Model in Insurance Company Investing

For the reasons described above, leverage does not play as large a role in providing investment returns in insurance company leveraged buyouts as it does in other industries. Financial sponsors therefore need alternative investment rationales to generate leveraged buyout returns.

- *Minority Investing.* A common form of private equity investment in insurance transactions is a minority investment, usually in partnership with a strategic buyer. The strategic buyer may be a foreign firm that is relying on the private equity firm for more in-depth knowledge of the particular insurance products in the target company's sector and for the firm's financial expertise, knowledge of U.S. compensation and benefit programs and understanding of U.S. market culture.

  Public market validation is also a factor that leads strategic buyers to partner with a financial sponsor, which necessarily measures each investment opportunity against a high return-on-equity hurdle.

  To enhance the return of the private equity firm's investment, a minority equity stake may come with warrants. To ensure a minimum return, investments frequently take the form of convertible debentures, with or without common stock investments.

- *Leveraged Build-ups.* Leveraged build-ups involve an initial investment in a platform insurance company which subsequently engages in acquisitions of other insurers. Investment returns are generated by synergies and operating efficiencies achieved in connection with such acquisitions. This form of investment strategy is similar to that employed by major strategic consolidators, like Conseco, in the early days of their acquisitions and is now being employed by private equity firms that initially invest in a platform company. In such cases, the follow-on acquisitions may be financed with additional equity from the private equity firm, stock in the platform company, debt or some combination of all three.

- *Investment Arbitrage.* Another alternate investment strategy being used by private equity firms involves no leverage and focuses on what a private equity firm perceives to be under-managed assets. In these transactions, the private equity sponsor purchases an insurer that is in "run-off", that is, no longer issuing new policies.

  This type of transaction typically involves a stock acquisition of the target company, combined with a purchase of reinsurance by the target company to support the assets available to meet the target's liabilities. The acquiring company then attempts to generate a private-equity level return by more actively and aggressively managing the target company's investment portfolio, subject, however, to applicable regulatory constraints.

Note that some state regulators may require a stronger showing that the liabilities of a target company in "run-off" will be adequately provided for, and others may have an informal policy prohibiting the sale of a company in run-off.

- *Investments in Related Industries.* Private equity funds are also investing in unregulated or less heavily regulated portions of the insurance sector that may permit a more conventional leveraged buy-out structure, such as the 1998 acquisition of Willis Corroon Group plc, a global insurance broker.

The ongoing rationalization of the insurance sector should continue to provide fertile opportunity for private equity sponsors. Although regulation often adds an additional layer of complexity to transactions in this sector, the regulatory framework can be accommodated if care is taken in structuring insurance transactions. ▫

— Paul S. Bird, Wolcott B. Dunham and Andrew L. Sommer

German Tax Reform: A Primer for Fund Managers (continued)

tax in the hands of the recipient corporation; in the hands of individuals, only 50% of the dividend income will be subject to tax.

Disallowance of Expenses

As a consequence of the exemption of capital gains and inter-corporate dividends, certain formerly deductible expenses, notably acquisition-related interest, will be disallowed in any year to the extent of any exempt gains or dividends realized during that year. This restriction, however, only applies to expenses of a German parent with respect to stock it holds in German companies. Furthermore, the restriction can generally be circumvented by, for example, merging operating companies into a German parent or by causing German companies to file income tax returns on a consolidated basis (an "Organschaft"). In the case of a foreign subsidiary, expenses remain fully deductible against German income; dividends received from a foreign subsidiary, however, are not fully exempt – 5% of such a dividend is subject to German tax.

Step Up in Asset Basis

The reform legislation significantly curtails the ability of acquirors to step up the basis of the assets of a target company. Prior to the reform legislation, a tax-free step up in basis could be obtained even in a stock acquisition by virtue of a simple conversion of the target into a limited partnership. Under the reform legislation, this technique will generally not be economically attractive because the target is now required to recognize gain in connection with such a conversion. In some cases, however, the technique will still be viable, for example, where the target has significant loss carryforwards that can absorb the gain triggered upon a conversion.

In summary, the reform legislation will permit German corporations to sell off unwanted subsidiaries without facing any corporate-level tax, thereby presenting new opportunities for private equity investors. Furthermore, with proper structuring, the rates of return achieved by private equity funds on German portfolio company investments should be considerably enhanced by virtue of reduced tax rates and earnings-stripping financing structures. ▫

— Gary M. Friedman and Friedrich Hey

Under the legislation, German corporations will enjoy full exemption from capital gains tax on disposition of shares in German or foreign corporations.... It is expected that the... exemption will likely prompt German corporations to shed many of their non-core businesses, thereby presenting a larger number of investment opportunities for private equity funds.

On July 16, 2001
we are opening
a new office in
Frankfurt, Germany:

DEBEVOISE & PLIMPTON

Börsencenter
Taubenstrasse 7-9
60313 Frankfurt am Main
Tel 011-49-69-209 75 000
Fax 011-49-69-209 75 555

The Debevoise & Plimpton Private Equity Report AVAILABLE ONLINE!

Did you know that you can receive
The Debevoise & Plimpton Private Equity Report
by email?

Simply send your name, telephone number
and email address to Rowena Lui
at rlui@debevoise.com
to begin your electronic subscription.