Debevoise & Plimpton

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Can You Sandbag?

When a Buyer Knows that One of the Seller's Representations or Warranties is Untrue

A buyer of a business generally assumes that if a representation or warranty made by the seller in the purchase agreement survives the closing and is untrue, the buyer will have a right to recover damages (subject to any materiality standards, deductibles, caps, etc. provided for in the agreement). However, in some situations, a buyer may not be able to recover damages for a breach of the seller's representation if the buyer was aware of the breach before closing. The relevant case law is confusing, but the purchase agreement can provide buyers (and sellers) with greater certainty.

Four Troublesome Situations

You are a frequent buyer of privately-held businesses. Here are four situations in which your knowledge of misrepresentations by the seller may limit your ability to recover damages, and recommendations for preserving your rights.

The Last-Minute Dump. After you sign the purchase agreement and just before closing, the seller's lawyer hands you a letter listing ten ways in which the seller's representations are not true. The purchase agreement does not contemplate updating of the seller's representations. You ignore the letter and, relying on your ability to recover for the breaches of the representations pursuant to the indemnification provisions of the purchase agreement, close the transaction. Under the law of some jurisdictions (including New York), unless you have expressly reserved your rights (with the concurrence of the seller), you may not have a claim for the breaches of the representations.

A buyer should always include in the purchase agreement provisions reserving the buyer's rights. Otherwise the seller can argue that because the buyer closed, notwithstanding its knowledge that a representation was untrue, the buyer could not have relied on such representation and that by closing the buyer waived its right to be indemnified. Typical rights-reserving provisions include a provision to the effect that the seller's representations and the seller's obligation to indemnify the buyer for breaches thereof will not be affected by any investigation by or on behalf of the buyer or by the buyer's knowledge that any such representation is or might be untrue, and a provision to the effect that any waiver of the buyer's rights under the purchase agreement must be express and in writing.

Sandbagging. Before the purchase agreement is signed, your environmental consultants inform you of a potential material liability uncovered in the course of their investigation of the business. Your lawyer wants to bring this liability to the attention of the seller and negotiate for either a purchase price reduction or a special indemnity. You are reluctant to raise the point. The seller is touchy, and you do not want to rock the boat. You also do not want to scare your lenders. Your lawyer confirms that the liability would constitute a

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"Would everyone check to see they have an attorney? I seem to have ended up with two."

letter from the editor

Happy New Year from The Debevoise & Plimpton Private Equity Report. 2002 should prove a challenging year for private equity firms seeking to strike the right balance between fundraising, investing and operating priorities. We have great faith that the private equity industry will meet those challenges.

As busted deals become more common, Robert Quaintance, one of our Corporate Partners, explains what buyers can do when they discover prior to closing that one of the seller's representations is untrue and cautions against the dangers of sandbagging. Our Guest Columnist for this issue, Eric W. Doppstadt, Director of Private Equity at The Ford Foundation, outlines several guiding principles that have characterized the most successful U.S. private equity firms over the last 15 years and should be considered by any firm hoping to create value in the current environment of excess capital, sluggish stock markets, lower returns and reduced leverage.

David Mason and David Lebolt, of our Compensation and Benefits Group, highlight the risks sponsors face in negotiating compensation terms with target management in advance of a tender offer and offer guidance on how to structure such arrangements to avoid running afoul of the All Holders/Best Price Rule. In this issue's Trendwatch, Woody Campbell focuses on advisers, analyzing the extent to which the choice of law firms and placement agents can affect deal terms. In addition, Stuart Hammer warns potential buyers of businesses why Phase 1 Environmental Assessments may not be adequate to analyze environmental risk.

Beth Pagel Serebransky and Kenneth Berman explain that, notwithstanding the current environment, now may be exactly the right time for financial institutions with private equity operations to develop employee leveraged co-investment plans. The advice offered by Richard Hahn and Harold Neu to private equity professionals serving on the boards of their firm's troubled portfolio companies is particularly timely in the current economic environment.

As the German acquisitions that have been widely predicted are beginning, David Hickok and Thomas Schürrle, Partners in our new Frankfurt office, remind U.S. investors more accustomed to U.S.-style takeover protections of the distinct features of the new German Takeover Law. Ann Baker of our Paris office also explains the Fonds Commun de Placement à Risque (FCPR), the most common private equity investment vehicle in France.

As technological advances and other developments in the securities markets have increased the number and types of persons involved in marketing securities, the SEC has made it more difficult to avoid being a broker. Marcia MacHarg, Kenneth Berman and Rachel Graham answer some FAQs about how efforts to place interests in private equity funds can implicate U.S. broker-dealer regulation and offer guidance on how private equity firms can avoid becoming subject to registration and reporting as a broker/dealer.

As usual, we welcome any comments you may have on how we can focus the publication on subjects of practical interest to private equity firms and their investors.

Franci J. Blassberg
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The SEC's "All Holders/Best Price Rule" Can Complicate Management Arrangements in Tender Offers

Nearly every sponsor's negotiated acquisitions will involve reaching agreement with the future portfolio company's management team. If the acquisition is structured as a tender offer, however, great care must be taken at all stages of the process to try to minimize the risk that an aggressive plaintiff lawyer could claim that the agreements violate the so-called "All Holders/Best Price Rule" (Rule 14d-10 under the Williams Act provisions of the Securities Exchange Act of 1934).

What Agreements with Management are Typical?

At a minimum, the sponsor and the management team will usually reach agreement on the broad parameters of the equity incentive plan that the sponsor will put in place after the acquisition. Often, however, the discussions with management will be much more specific and can cover a much broader range of topics, including the terms of new, post-acquisition employment agreements for key members of management (including severance), annual bonus plans, etc. If the acquisition involves a "roll-over" of option gains or other similar items, the terms of the equity (or deferred equity right) that management is to receive in the roll-over will be agreed to as well.

None of these agreements are generally improper or inappropriate. They are disclosed to the target board and to the public, and are necessary for both the sponsor and the target company. If the discussions with management cannot start until after the sponsor has already acquired the company, the management team may well try to extract some hold-up value from the sponsor. An understanding of the post-acquisition compensation and other incentive arrangements will also help minimize management concerns during the crucial period before the consummation of the acquisition, thus helping to avoid a melt-down of target management before the acquisition is completed.

What's at Stake?

The "All Holders/Best Price Rule" imposes two requirements on tender offers that are meant to prohibit discrimination among holders of the shares that are subject to the tender offer:

- the tender offer has to be open to each holder of the class of securities for which the tender offer is being made ("**All Holders**"); and
- the consideration paid to every security holder pursuant to the tender offer must be the highest paid to any holder during the tender offer ("**Best Price**").

If a court determines that the person making the tender offer violated this rule – for example, by paying one shareholder more for his shares than was being paid to the public – the result would be an order to pay the "extra consideration" to all of the other shareholders.

The risk here – in so far as it relates to a sponsor's arrangements with management – is that some item(s) in the sponsor's agreements with the management team are re-characterized as disguised payment for shares held by management, and that "extra" payment must then be paid to the public shareholders. Perhaps more technically, the risk to keep in mind is that this issue might get to a *jury*, although this risk can sometimes be reduced somewhat with proper planning.

For example, let's say that someone purchased a company through a tender offer and, in connection with that tender offer agreed with the Chairman of the target (who was also a shareholder) that he would receive $5 million for a non-competition agreement. A jury subsequently determines that $2.3+ million of this was actually a payment for the tender of his shares. Assuming there are 2,300,000 shares outstanding, this would translate into an additional $1.00 per share that the other shareholders had not received in the tender offer, and the purchaser would be ordered to pay that additional $1.00 to the other shareholders, plus interest. Something like this actually happened. (*Gerber v. Computer Associates*, on appeal)

It is easy to see how this area can send visions of BMWs and vacation homes dancing in the minds of plaintiff lawyers (and give acquirors, and their lawyers, nightmares).

The Legal Landscape

Until the SEC clarifies how the All Holders/Best Price Rule should apply in the area of management compensation arrangements or until the Supreme

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Surviving in Private Equity's Brave New World

The U.S. private equity industry has grown to a staggering size in recent years. From 1995 through 2000, annual fundraising by U.S. buyout funds multiplied almost fourfold, from $19 billion to $74.1 billion, with the amount of capital raised in the year 2000 almost double the annual average of the prior five years. Over the same period, annual fundraising by domestic venture funds rose an astonishing sixteenfold, from $4.7 billion to $75 billion. More than 500 buyout firms, and over 1,500 venture firms, operate in the U.S. today. And, as the industry's investment pace has slowed, its uninvested capital has soared, and is now estimated by some sources to be as high as $100 billion in buyouts, and $50 billion in venture capital. Private equity has truly become a full-fledged capital market in its own right, comparable in size and complexity to many segments of the liquid capital markets.

Despite private equity's explosive growth, however, there is little or no evidence to date that the industry's ability to create value has grown in proportion to the growth in its assets under management. Almost all of the most successful U.S. buyout and venture investments of the last fifteen years were made when average fund size, and capital under management, in those sectors was a fraction of what it is today. Competition for transactions is as intense as ever, with most transactions now involving auctions or multiple bidders. And with many U.S. industries having been consolidated or rationalized, the flow of attractive opportunities may even be smaller today than it was five years ago. All this suggests that the venture and buyout sectors may be facing a problem of excess capacity, the consequence of an "overbuilding" spree fueled by cheap and readily available investor capital.

In light of this excess capacity, it is not surprising that returns on capital are falling throughout the industry. U.S. buyout returns have fallen steadily for much of the last decade, and, in the aftermath of the Internet-telecom-tech bubble, the U.S. venture industry is facing its steepest losses ever. There is also a growing realization that the way many private equity firms create value – through investment structuring and financial leverage in the buyout industry, and through public market – momentum investing in venture – are likely to yield still lower returns in the future, as leverage declines, product markets become more competitive, and product lifecycles grow shorter.

All this suggests that the coming decade is likely to be a much more difficult operating, investing, and fundraising environment for U.S. private equity firms. Firms that succeed in this new world are likely to be those that follow some key principles that have made the industry's best firms successful over time:

Size is usually the enemy of performance. As average fund sizes have ballooned in recent years, many firms in both the buyout and venture sectors have adopted an asset-gathering business model, patterned after those of other large money management firms. The key driver of such businesses is steady fee income, spread over an expense base that grows more slowly than assets under management. For the managers of private equity funds that follow this "asset maximization" model, the annuity-like fee stream that is generated as new funds are layered on top of prior funds dilutes the incentive effect of the general partner's carried interest. Over time, such managers become less concerned with achieving significant outperformance than with avoiding significant underperformance. Since the success of a private equity firm is highly dependent on the idiosyncratic skills of its investment professionals, however, it is difficult to scale such firms without eroding returns. Thus, firms that have scaled ambitiously may find it increasingly difficult to produce the results needed to keep their asset base growing, particularly without the levitating effect of a bull market. A more sustainable strategy would be to ensure that the firm's assets under management do not grow faster than its ability to deploy those assets at consistently high rates of return.

Focus on company-building, not financial engineering. Relatively few private equity firms possess the kind of operating expertise that enables them to build fundamentally better and more valuable assets, as opposed to relying on financing structures, or rising market multiples, to generate returns. In today's financial world, however, financial engineering and market momentum are weak factors, unlikely to generate acceptable investment returns in isolation. Financial engineering skills are now widespread, but are less and less important to buyout returns as debt availability declines. And venture capitalists following a market momentum strategy offer little of value in today's equity markets. The key to superior performance in the future is likely to be operating expertise that enables investors to fundamentally improve the cash flow generating power of the assets in which they invest. Thus, every private equity firm should

place top priority on enhancing its operating skills, no matter what sector the firm invests in.

Find your niche, and stick to it. The rising tide of the 1990s bull market enabled many private equity firms to pursue undifferentiated, generalist investment strategies, or even to switch strategies from time to time, without suffering adverse consequences. But "plain vanilla" investment strategies (such as the generic "middle market buyout firm") are likely to generate increasingly disappointing results in an environment in which deals are hotly competed for, leverage is often unavailable, and market multiples may shrink, rather than expand. A more effective approach in this environment is, instead, likely to be based on a deep familiarity with a particular strategy (such as turnarounds of underperforming businesses) or sector (such as financial services or consumer products) that enables an investor to identify value-added opportunities not obvious to others.

Avoid the "fallacy of composition." In classical economics, the "fallacy of composition" describes a situation in which otherwise rational investors pursue opportunities without considering the effects of similar investments by others. Recent instances of this phenomenon at work in the private equity markets include the massive overinvestment in Internet retailers, telecom service providers, communications equipment companies, movie theater chains, and, more recently, biotechnology companies (it has been reported, for example, that 12 anthrax-related biotech firms have been funded since September 11). These episodes make clear that it is insufficient to look at a prospective investee's potential market; evaluating the activities of competitors is equally important.

Low cost capital is a dangerous illusion. A phenomenon closely related to the fallacy of composition is the lure of cheap capital. At the height of the speculative froth of 1999-2000, seemingly limitless capital from limited partners, and from the IPO and merger and acquisition markets, caused many private equity firms to lower their risk perceptions and to make investments based on little more than market momentum. In retrospect, that artificially cheap capital was a trap, luring firms into making investments that far overran economic rationality, as more companies got funded in each sector than there were employees to manage them or customers to buy their products.

Be a thoughtful contrarian. It is widely accepted that in public market investing, a "good company" is only a good investment if the investor's view of the company's prospects is not yet reflected in the market consensus. Likewise, in today's competitive private equity environment, investing on the basis of the consensus view of a company or sector's prospects is unlikely to produce superior returns, because the consensus view is likely to be already incorporated in the price. Private equity firms that can, instead, develop a view apart from the market consensus, based on specialized knowledge of a company or an industry sector, can create opportunities for significant returns.

Diversify across market cycles. Private equity is a cyclical business, and multiple funds managed by the same private equity firm have performed very differently, based on the time period in which those investments were made. For this reason, spreading investment dollars across various economic and market cycles is the most important form of diversification in private equity investing. Within reasonable bounds, private equity firms should thus seek to invest consistently at each part of the cycle. The drastic acceleration in the industry's investment pace during the last few years, particularly in much of the venture industry, was in retrospect a form of market timing, the dangers of which have become all too apparent.

Treat your investors like partners, and your partners like investors. As the financial world becomes ever more transaction-driven, private equity remains one of the few areas that is still largely driven by long-term relationships between firms and their investors. The most successful private equity firms will be those that treat their investors like long-term partners, by creating fund terms that maximize transparency and alignment of interests between the firm and its investors. One very important way to align interests is for private equity fund managers to make significant personal investments in their own funds, alongside their limited partners.

Following these principles cannot guarantee investment success. But ignoring them is riskier. In today's post-"bubble" environment, the building blocks of limited partner asset allocations to private equity – its expected returns, estimated risks, and anticipated correlation with other assets – have all become less favorable than they might have appeared in recent years. Thus, private equity firms that ignore these principles are very likely betting their future on their investors' continued willingness to accept falling returns, and flawed fund terms, at a time when investor allocations to private equity may be shrinking. For private equity firms focused on risk and return, the principles above offer a surer route to success.

— Eric W. Doppstadt
Director, Private Equity,
The Ford Foundation

Caveat Investor: Phase 1s May Not Be Adequate For Analyzing Environmental Risk

This article is Part 1 of a two-part series on environmental issues of critical importance to private equity investors. In this article, we address the inadequacies of traditional Phase 1 Environmental Site Assessments as a due diligence tool. In Part 2, we will analyze shareholder liability under environmental laws.

Over the past 18 months, as numerous dot com, telecom and other "new economy" businesses have faltered, many private equity firms have recalibrated their investment mix in favor of traditional, "old economy" businesses. The resurgence in old economy investments has prompted a need on the part of private equity firms to evaluate the greater environmental risks often inherent in these more traditional businesses, particularly in the case of distressed companies that may lack the cash flow necessary to address environmental concerns.

In analyzing environmental risk, private equity firms have come to rely heavily on the findings of a Phase 1 Environmental Site Assessment ("Phase 1"). Where a Phase 1 reveals no significant environmental issues, private equity investors often mistakenly assume that there are no environmental liabilities or obligations impacting the subject facility. As discussed below, we believe this reliance is misplaced. Phase 1s may not address important elements of environmental risk that can significantly undermine a private equity investment.

Overview of Phase 1s. Phase 1s have been part of the lexicon of investors since the 1980 passage of the federal Superfund law, which empowered the federal government and private parties to recover costs incurred in cleaning up contaminated facilities. Confronted with the prospect of environmental liability that is retroactive, strict, joint and several, investors have routinely commissioned Phase 1s as the cornerstone of their environmental due diligence.

Phase 1 reports are prepared by an outside environmental consultant and generally consist of the following:

- A review of relevant federal and state environmental databases to determine whether the facility at issue has been the subject of a cleanup order or for which regulators are proposing cleanup. These databases will also reveal other potential environmental issues, including the generation of hazardous waste, the presence of underground storage tanks and reported releases of hazardous materials. In addition, these databases can identify environmental concerns at nearby facilities that could affect the target property.
- Interviews with knowledgeable site personnel and a review of on-site environmental documentation in order to identify any environmental concerns. The consultant will also review aerial photographs and fire insurance maps, which provide information on historical usage of the property.
- An inspection of the facility to determine whether there are any indications of potential contamination, such as discolored soil or distressed vegetation. Particular attention will be paid to possible sources of contamination, including lagoons, settling ponds, landfills, storage tanks and waste disposal areas. When matters of environmental concern are identified, the consultant may recommend a subsurface investigation (commonly referred to as a "Phase 2" environmental investigation).

Limitations of a Phase 1. While a Phase 1 is an important tool for identifying potential contamination issues, it does not address other important elements of environmental risk that may bear upon a potential private equity investment:

- Phase 1s generally do not include an analysis of environmental compliance issues. Costs associated with environmental compliance can sometimes exceed costs associated with contamination. Compliance is a particularly important issue for distressed or highly leveraged companies that have lacked the capital necessary to purchase pollution control equipment and address other compliance issues. Costs necessary to bring a facility into compliance with environmental regulations, particularly those associated with the federal Clean Air Act, can be millions of dollars.
- Phase 1s do not identify environmental liabilities or obligations associated with formerly owned or operated facilities. A target company may have assumed (whether by contract or by operation of law) environmental liabilities associated with prior operations or facilities that it no longer owns or operates. Remediation

obligations associated with former facilities may be significant.

- Phase 1s generally do not identify liabilities associated with the target's off-site disposal of hazardous wastes. Where cleanup of an off-site disposal facility is ordered, the target could be required to contribute to cleanup costs. These costs could be significant, particularly if the target is one of the largest generators of hazardous waste at the facility.
- Most Phase 1s do not address pending or threatened environmental litigation. Not surprisingly, environmental litigation can significantly undermine a private equity investment. Toxic tort claims and asbestos exposure lawsuits can result in multi-million dollar liability verdicts. Actions brought by regulators or environmental protection groups could expose the target not only to expenses, but also to negative publicity.
- Phase 1s do not address certain substantive environmental issues that could affect an investment decision. For example, Phase 1s do not estimate the costs necessary to remove asbestos at a facility. Asbestos removal projects can be costly, particularly if removal is required at multiple locations. Similarly, Phase 1s do not address issues associated with wetlands, which can be important, particularly if future development of the wetlands areas is planned.

Relying on a Seller's Phase 1. In auction situations, it is fairly common for sellers to commission Phase 1s of the target's facilities in order to facilitate the bidders' due diligence. Private equity firms should be cautious before relying on these reports, which can often understate environmental problems at a facility. In some seller-commissioned Phase 1s, consultants may not be provided with all relevant environmental documentation. Similarly, for confidentiality purposes, consultants may not be given access to knowledgeable facility personnel. Moreover, some sellers retain inexpensive and often unqualified consultants whose reports are inadequate for assessing environmental risk.

To alleviate concerns associated with a seller-commissioned Phase 1, the scope of work for the Phase 1 should be reviewed in order to assure that no significant limitations were imposed on the consultant's review. In addition, the private equity investor should obtain a "reliance letter" from the seller's consultant, which provides the investor with recourse against the consultant for certain deficiencies in the Phase 1.

Additional Investigation. Rather than merely commissioning a traditional Phase 1 report, private equity firms should consider commissioning a more comprehensive environmental due diligence assessment that evaluates all relevant environmental risks, including risks not ordinarily identified in a Phase 1. The scope of this assessment will depend on several factors, including (i) the structure of the transaction (e.g., stock purchase vs. asset purchase), (ii) the nature of the business (e.g., whether the business typically has significant environmental issues), (iii) the extent to which the seller is retaining liability for environmental matters, (iv) the time and funds available for performing the investigation, and (v) the level of environmental risk the private equity investor may be willing to accept.

Rather than merely commissioning a traditional Phase 1 report, private equity firms should consider commissioning a more comprehensive environmental due diligence assessment that evaluates all relevant environmental risks, including risks not ordinarily identified in a Phase 1.

Depending upon these factors, the environmental assessment commissioned for a private equity investment may need to address the following issues:

- regulatory compliance, including an estimate of the costs necessary to bring the target company's facilities into compliance with environmental laws;
- the impact of any impending environmental regulations and, in certain instances, the impact of any proposed environmental regulations;
- liabilities associated with off-site waste disposal practices, including an understanding as to which off-site facilities used by the target are expected to require clean-up;
- environmental obligations related to former facilities and discontinued operations;
- pending or threatened environmental litigation, including complaints by regulators, private parties and environmental protection groups; and
- health and safety issues, including complaints raised and compensation

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Employee Leveraged Co-Investment Plans: Should You Have One?

Employee Leveraged Co-Investment Plans have become an increasingly popular and attractive recruitment and retention (and wealth creation) vehicle for many financial firms involved in private equity investing. These plans give employees – including those not directly involved in the employer's private equity business – the opportunity to use part of their compensation to invest in private equity opportunities with leverage provided by their employer. Even in the current economic climate, the availability of such a plan is often a major consideration for prospective employees who may have other opportunities where they can participate directly in a carried interest. Most of the larger investment banks and many other financial institutions and consulting firms have implemented Leveraged Co-Investment Plans or similar plans for their key employees.

The funds can also help to focus private equity employees on long term returns, align the interests of employees with both their employer and its investors, increase the potential for referrals to the private equity group from participating employees outside of the private equity group and increase the sources of capital available for private equity investment.

Notwithstanding a somewhat unfavorable private equity environment, there is another reason to consider implementing a Co-Investment Plan. The SEC has recently given sponsors the opportunity to open up the plan to a greater number of employees. Under current law, funds with 500 or more participants may become subject to the public periodic reporting requirements. We recently obtained SEC no-action relief (in many respects the first of its kind) for a group of co-investment funds exempting them from these public reporting requirements.

Implementing a Co-Investment Plan raises many of the same issues involved in setting up any private equity fund, as well as numerous special issues due to the involvement of employees.

In most plans, employees invest after-tax funds directly into a co-investment vehicle structured to provide flow-through tax treatment to the employee. You can also structure a fund to permit investment of pre-tax dollars, although it is more difficult to achieve flow-through tax treatment in that structure.

This article focuses on plans for U.S. employees. (The tax and securities law considerations are substantially different in each country, and implementing a multi-country fund can be done, but raises complex structuring issues and can substantially increase the costs of implementing a plan.)

1. Which Employees Should Participate?

There are four primary factors that drive employee selection – the desired fund size, how much capital the employer is willing to invest in the fund, the overall compensation levels desired for employees, and legal and related cost factors.

Offering U.S. employees the opportunity to invest in a co-investment vehicle, like any fund offering, is subject to compliance with the U.S. securities laws. The registration requirements of the Securities Act of 1933 (the "33 Act"), the requirements of the Investment Company Act of 1940 (the "40 Act") and, if the fund is sufficiently large, the reporting requirements of the Securities Exchange Act of 1934 (the "34 Act"), as well as state blue sky laws, are all potentially implicated by the fund offering.

If you expect 100 or more participants, the co-investment vehicle will generally need to be structured as an "employee securities company" (or ESC) and the employer will need to apply for the 40 Act exemption available for ESCs. The application for exemption must be filed with the SEC prior to closing the co-investment fund (and the ESC must operate as described in the application), but the order need not be obtained until after the fund closing.[1]

Many Co-Investment Plans are limited to accredited investors (employees with at least $200,000 in annual income or $1 million of net worth) to fit within the ESC precedents and the exemption from 33 Act registration provided under Regulation D. Regulation D permits sales to an unlimited number of accredited investors and up to 35 non-accredited investors.[2]

1 The order will generally not provide a blanket exemption from all of the provisions of the 40 Act. For example, certain transactions with the employer or its affiliates which would otherwise be prohibited by the 40 Act are permitted subject to compliance with safeguards designed to protect employees. The books and records of the ESC will be subject to SEC inspection.

2 The SEC's ESC orders generally require the 35 non-accredited investors to satisfy other conditions relating to income level, education or business experience. It is possible to structure a co-investment plan that includes more non-accredited investors and may avoid the need for a 40 Act exemption and 34 Act registration through a fund in which the employer has a very significant (i.e., majority) equity interest or through a deferred compensation or phantom plan arrangement. However, unless the investing employees also provide services directly to the fund, or the fund is consolidated on the employer's balance sheet, the deferred compensation and phantom plans would not permit a direct investment in the co-investment vehicle and distributions to employees participating in those plans would be taxable at ordinary income rates.

Under current law, co-investment funds with 500 or more participants may become subject to the reporting requirements of the 34 Act and be required to publicly file annual and quarterly reports as to the fund's activities. Because of the costs involved in public reporting, as well as the strong desire of sponsors to keep confidential the terms of the plan, its investments and its investment performance, most employers try to structure the plans to avoid reporting. This is not always possible, particularly for larger financial institutions. We recently obtained SEC no-action relief for a group of co-investment funds exempting them from these public reporting requirements. The employer was required to fully describe the plan in its request for no action relief and the relief was subject to a number of conditions. For example, employees may not transfer their interests in the fund to third parties. The funds must provide annual and semi-annual reports to investors. In addition to financial statements that funds generally provide as a condition to obtaining 40 Act exemptions, the reports will contain additional information concerning fund investments, the factors that materially affected the fund's performance and certain other information.

2. Employer Leverage. Most employers enhance the investment potential to employees from the co-investment vehicle through employer-provided leverage, either through recourse and/or non-recourse loans to the employee or the co-investment vehicle or a preferred equity investment in the co-investment vehicle. The employer-provided leverage substantially enhances the potential returns from a successful co-investment vehicle (but increases the risk for unsuccessful investments).

The amount of leverage provided and the amount of employee recourse on the leverage varies. Leverage to investment ratios are generally within a range of 1:1 to 5:1. Leverage and interest charges (or preferred equity returns) are repaid through investment earnings. Leverage is frequently recourse to the employee (i.e., the employee is personally liable to repay the leverage or contribute additional funds to the investment vehicle if investment returns are not sufficient to do so), with greater recourse where there is greater leverage.

3. Vesting and Forfeiture. Most plans contain vesting provisions, whereby the employee's right to the earnings on the leveraged amount of the investment is subject to vesting, generally based on continued employment.

Unvested amounts are usually forfeited if employment terminates (with some exceptions in the case of death, disability or retirement). In addition, "bad leaver" provisions are frequently provided under which the return on the leveraged amount of the investment (either the unvested amount or all vested and unvested amounts) is forfeited if the employee joins a competitor, solicits employees or is terminated for cause.

4. How Large Should the Fund Be? The size of the fund is primarily determined by the business concerns relating to the number of employees selected to participate, their compensation levels and the amount of leverage the employer is willing to provide. The fund also needs to be large enough to be able to participate in the intended investments. The size of the fund may be particularly important for a co-investment fund of funds.

Funds of funds typically invest in other fund vehicles that are exempt from the 40 Act under either Section 3(c)(1), the exemption for funds with 100 or fewer investors, or Section 3(c)(7), for funds owned exclusively by qualified purchasers. These exemptions contain attribution provisions that require the exempt fund to "look through" investing entities and count the investing entity's security holders in certain circumstances. To avoid the attribution rules, co-investment plans that intend to invest in 3(c)(7) funds must have more than $25 million in investments[3] and cannot be formed for the specific purpose of acquiring the 3(c)(7) fund. To avoid attribution standards contained in the 40 Act or developed by the SEC staff, co-investment vehicles structured as 3(c)(1) funds (rather than employee securities companies) cannot own more than 10% of the voting securities of a 3(c)(1) fund, or invest more than 40% of their capital in a single 3(c)(1) fund.

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3 Investments means investments and capital commitments net of any loans. Leverage provided through a preferred equity investment would not be considered a loan.

Notwithstanding a somewhat unfavorable private equity environment, there is another reason to consider implementing a Co-Investment Plan. The SEC has recently given sponsors the opportunity to open up the plan to a greater number of employees.

Troubling Times for Directors of Portfolio Companies

Serving as a director of its portfolio companies is central to a private equity sponsor's task of actively managing its fund's investments. In good times, concerns as to personal liability for one's actions as a director remain peripheral. In difficult times, such as these, directors of troubled companies naturally seek to right their foundering enterprise, but must do so with a careful eye on potential sources of personal liability. When a storm appears on the horizon, directors should seek advice concerning the scope of their legal duties and consider how best to aid in the recovery without unduly exposing themselves to liability.

While those who have served as a corporate director will be familiar with these principles, it is helpful to review the basic ground rules under Delaware corporate law. (Of course, other jurisdictions may follow different principles. In particular, the insolvency law of many foreign jurisdictions differs markedly from the U.S. framework.)

Back to Basics: Duties of Care and Loyalty

Directors of a corporation have two primary fiduciary duties: the duty of care and the duty of loyalty. The duty of care requires that each director exercise the degree of care that an ordinary careful and prudent person would use in similar circumstances. This entails informing oneself of all material information reasonably available and acting with the requisite care. The duty of loyalty demands that a director act in good faith in the best interests of the corporation and its shareholders and prohibits self-dealing and exploitation of corporate opportunities to personal advantage.

Standards of Review: Business Judgment and Intrinsic Fairness

Generally, in exercising these duties, directors are protected by the familiar "business judgment rule," which establishes a presumption that in making a business decision the directors acted on an informed basis, in good faith, and in the honest belief that the decision was in the best interests of the corporation. In practice, the business judgment rule establishes a high bar for potential plaintiffs to recover from directors personally.

Participation of "interested" directors in the Board's decision making, however, strips directors of the protection of the business judgment rule and results in the application of a higher standard of review known as the "intrinsic fairness" test. Of course, the intrinsic fairness test is not unique to troubled companies, but it may be more relevant to directors of troubled portfolio companies because of the likelihood that a restructuring transaction will render investor directors "interested."

Intrinsic fairness requires that the Board's actions must be both substantively and procedurally fair. Substantive fairness inquires whether the terms of the transaction were fair (i.e., was the price, fee, asset valuation, etc. fair to the corporation). Procedural fairness necessitates a fair decision making process in which material information is adequately disclosed, and the transaction is negotiated by disinterested directors properly counseled by qualified advisors in an environment free from inappropriate time and other pressures.

In contemplating a follow-on investment to shore-up a portfolio company that has unaffiliated investors, consideration should be given whether to form a special committee of independent directors to review and negotiate the terms of the investment. The special committee should have separate counsel and financial advisers, and the process should be run formally with careful attention paid to establish a record of procedural and substantive fairness. In particular, transaction fees and on-going monitoring fees should be reviewed for continuing appropriateness. In addition, it may be appropriate to approach outside sources of capital as a market check for the proposed investment.

To Whom are Fiduciary Duties Owed?

For solvent companies, director's duties run to the shareholders of the corporation. Creditors are only entitled to the benefit of their contractual rights. When a corporation becomes insolvent or approaches the "vicinity of insolvency," the directors' fiduciary duties shift from the corporation's shareholders to its shareholders and creditors. With respect to many decisions that come before the Board, this shift in duties is insignificant, and directors should simply think in terms of the best interests of the "community of interests" constituting the corporation rather than the interests of the shareholders exclusively. In some instances, however, the interests of the corporation's shareholders and creditors will diverge. In such cases, the Board need not slavishly follow the demands of the corporation's creditor constituencies. However, the directors of a troubled company cannot subject creditors to undue risk in the pursuit of a recovery for the shareholders.

How are Insolvency and the Vicinity of Insolvency Defined?

Courts define insolvency in two ways: an equity test and a balance sheet test. The equity test inquires whether the corporation is able to pay its debts as

they become due in the ordinary course of business. The balance sheet test finds insolvency when the liabilities of the corporation exceed the reasonable market value of the corporation's assets. Because each company's circumstance will vary, court decisions provide no bright line test and directors should assume that their duties have shifted when the corporation has entered the "vicinity of insolvency."

Should I Stay or Should I Go?

Each director of a troubled company will need to weigh the advantages and disadvantages of continuing to serve versus resignation. For individual directors representing a controlling stockholder, remaining in control of the board is critical to maintaining any value in the fund's investment. The choice is less clear if the Board seat is tied to a minority interest in the troubled company.

Advantages of Continuing. Once the restructuring process has commenced and counsel and financial advisers have been retained, the risk of liability generally is lessened. The Board's actions are subject to heightened scrutiny from creditors and in some cases a bankruptcy court. As a practical matter, however, this enhanced review tends to shield the directors from liability. In addition, a continuing director is in a better position to orchestrate a consensual plan of reorganization. In consensual restructurings, continuing directors often benefit from releases of liability by the company's institutional lenders.

Disadvantages. Continuing as a director of a corporation in financial stress will require devotion of a great deal of time and energy. In addition, while the risk of additional liability is lessened, there is a limited possibility of incurring new liability for actions taken or omitted after commencement of the restructuring.

Protections for Directors

Directors of all corporations benefit from certain protections against personal liability. The impact of financial trouble and bankruptcy on these protections should be carefully assessed.

Indemnification. Generally directors are entitled to indemnification from the corporation under statute, the charter or bylaws of the corporation or pursuant to contractual indemnification rights. In addition to state law principles that may limit indemnity payments to directors, bankruptcy imposes limitations on a director's ability to collect, including an automatic stay of claims against the debtor, a requirement to share pro-rata with other unsecured claims and a disallowance of contingent indemnification claims. In addition, in some circumstances, indemnification claims may be equitably subordinated if the director engaged in inequitable conduct injuring creditors or giving himself an unfair advantage. Similarly, indemnification claims relating to securities law claims can be subordinated to a level below the underlying security.

Indemnification Trusts. An irrevocable trust can be established to fund indemnification claims against directors to avoid potential impediments to successful recovery for directors' indemnification claims. However, indemnification trusts must be structured carefully to avoid the reach of the Bankruptcy Code and may be subject to attack in bankruptcy court as a fraudulent conveyance or preference.

D&O Insurance. Whether directors and officers insurance will protect the directors adequately will be a function of the specific policy terms. Some policies combine D&O coverage with coverage for the company, which can raise an issue as to whether the policy is an "asset" of the debtor's estate and, therefore, not available to the directors. Policy terms also may raise issues as to advancing defense costs, applicability of the deductible to directors and officers' claims, coverage in the event of bankruptcy or insolvency and exclusions for claims of fraud.

Common Issues

As a liquidity crisis nears, officers and directors of troubled companies often confront a variety of issues outside their previous experience. For example, if the company's stock is publicly traded, what should be said in the MD&A of the Form 10-Q or Form 10-K, which requires disclosure of known trends and uncertainties about the business? Oftentimes, corporate officers and directors will find themselves struggling to balance concerns as to compliance with the securities laws and fears that poor disclosure will make a difficult situation worse by impairing relations with employees, customers and suppliers.

Similarly, the company's revolving credit facility likely requires that representations and warranties be repeated prior to each draw, which raises the question whether the company can meet the conditions to borrowing. If the company likely will need covenant relief, what is the best way to approach the lending group? If the company needs cash, can it fully tap its revolver without first discussing with its lenders that it may need an accommodation, or will borrowing under those circumstances poison relations with the company's lenders?

As these examples demonstrate, managing a distressed company can be expected to raise many challenging issues for its directors. At the same time, the fiduciary duties remain the same. As such, with sound judgment and the assistance of experienced legal and financial advisers, these challenges can prove to be a remarkable opportunity to save an enterprise and create value for a portfolio company's many constituencies, including the fund's investors.

— Richard F. Hahn and Harold A. Neu

The New German Tender Offer Law

On the heels of extensive tax reform legislation and as previously predicted in our Private Equity Report last summer, a new German Tender Offer Law came into force on January 1, 2002. We believe that this legislation will be of interest to private equity firms interested in the acquisition of German-listed companies and will have a significant impact on mergers and acquisitions of or by listed companies.

Germany, one of the first EU countries to enact a new tender offer law, has been eager to pre-empt several other European member states and the European Commission, who have been haggling for nearly a dozen years over more aggressive reforms aimed at levelling the takeover playing field in Europe by means of an EU directive concerning takeover bids. As of January 2002, it appeared that the EU debate over takeover reform might be rekindled by the publication of an extensive report by a "High Level Group of Company Law Experts" mandated by the EU Commission to draft proposals for modernizing the company law statutes of the member states and creating pan-European takeover rules. While such an EU directive is almost certain to clash with (and may ultimately trump) certain provisions of the new German Tender Offer Act, Germany and a number of other member states will likely continue to oppose the adoption, or at least delay the transposition and application, of any wide-sweeping EU takeover directive for at least a few years. In the interim, investors interested in Germany should understand the new German Tender Offer Law (the "New Law").

The New Law also requires bidders to make an offer to all remaining shareholders once a controlling interest of at least 30% has been acquired, regardless of whether such stake has been acquired privately or on the open market.

Private equity investors and others familiar with Delaware law will applaud the advent of an effective mechanism to squeeze out minority shareholders following an acquisition. However, investors accustomed to U.S. practice will be struck by a number of features of the New Law, including the right of government agencies to review the price and other terms of each offer and the requirement that bidders launch a compulsory offer for all remaining shares once a controlling interest (defined as 30% of the voting power) has been secured.

The New Law applies to target companies domiciled in Germany whose stock is traded on an EU stock exchange or regulated markets. Bidders are now required to publish a tender offer announcement before submitting a draft offer statement to the Supervisory Authority for Securities Trading (Bundesaufsichtsamt fuer den Wertpapierhandel) for review of its terms. If the Supervisory Authority does not object to the offer, the bidder will have 10 days in which to make an offer to shareholders that must generally remain open for at least 4 weeks but no more than 10 weeks. Additionally, a qualified financial institution must certify that financing sufficient to consummate the offer is in place, and the offer may not be subject to conditions that are within the bidder's control.

The target board is obliged to act in the interest of the target generally but certain defensive measures may be permitted if previously authorized by the general assembly of shareholders at least 18 months prior to the offer.

Investors accustomed to U.S. practice will be particularly struck by the Supervising Authority's mandatory review of the terms of all takeover offers in which the bidder expects to acquire at least 30% of the target's equity or voting rights. In particular, the Supervisory Authority will have the power to review the offer price for "adequacy." Although the criteria defining the "adequacy" of a given purchase price are to be defined in more detail in forthcoming regulations, their current draft form the regulations generally require that the offer be based on the average trading price of the target shares and take into account previous tender offers.

If a shareholder so requests, consideration must be payable in cash or securities which may be traded in the EU. This may mean that U.S. offerors proposing a share-for-share exchange may find it beneficial to be listed on an EU stock exchange prior to making an offer. In order to prevent a bidder from gradually acquiring a material interest, the New Law provides that the offer price must be paid in cash if the bidder has acquired more than 5% of the target in the 3 months preceding the offer. The New Law effectively prevents a control premium by providing that the price paid for a privately sold stake of 30% or greater will be the floor price for further purchases in the year

following acquisition of such controlling interest.

The New Law also requires bidders to make an offer to all remaining shareholders once a controlling interest of at least 30% has been acquired, regardless of whether such stake has been acquired privately or on the open market. The requirement to make an offer to remaining shareholders would also appear to apply where a German public company exchanges 30% or more of its shares or voting shares for shares of the target. In such case, if a former shareholder of the target acquires 30%, such shareholder will be required to make an offer to the remaining shareholders of the acquiring public company. This is expected to complicate transactions involving reverse take-overs and mergers of privately held companies into listed stock corporations insofar as the acquisition of more than 30% of the shares of a listed stock corporation may now require the controlling shareholders of the merging company to make an offer for all the shares of the receiving corporation – a result clearly not intended by the legislature.

As part of the New Law, the German Stock Corporation Act will be amended to provide for a minority squeeze-out mechanism once 95% of the outstanding shares has been acquired. The squeeze out will be effected by obtaining the approval of the AG shareholders to a cash-only buyout. While such consideration will still be subject to court review, some of the uncertainty will be eliminated by the New Law insofar as a squeeze out purchase price which is equal to or greater than the consideration offered to 90% of the other shareholders may no longer be contested.

While the New Law may fall short of U.S.-style takeover legislation and does not necessarily dove-tail with the investment invitation afforded foreign investors by recent German tax reform, it is clearly a major step in the right direction. It remains to be seen if the New Law will make life easier for those investing in the German market. ▫

— David F. Hickok and
Dr. Thomas Schürrle

Are Your Fund Marketers “Brokers”?

Private fund sponsors generally understand that certain marketing techniques, including press releases and website postings, may endanger the exempt status of their funds under the Securities Act of 1933 and the Investment Company Act of 1940, and the sponsor’s exempt status under the Investment Advisers Act of 1940. They may not, however, be accustomed to thinking that their efforts to place interests in their funds can implicate U.S. broker-dealer regulations.

Sales efforts by fund sponsors, even in private placements, can trigger broker-dealer registration requirements, depending largely on the activities of the sponsor’s employees in marketing interests in the fund and how those employees are compensated. This is an area in which the SEC staff has leaned toward regulation rather than deregulation. Set forth below are some questions frequently asked by fund sponsors concerning U.S. broker-dealer regulation.

FAQ #1: Who is a broker for purposes of the U.S. federal securities laws?

It is a somewhat common misperception that only firms involved in the sale of publicly traded securities need to worry about broker-dealer registration. In the broker-dealer context, the law does not distinguish between privately placed securities and registered securities.

Section 3(a)(4) of the Securities Exchange Act of 1934 (the “Exchange Act”) defines the term “broker” to include “any person engaged in the business of effecting transactions in securities for the account of others.” Factors indicating that a person is “engaged in the business” include, among others, receiving transaction-related compensation; holding oneself out as a broker, as executing trades or as assisting others in completing securities transactions; and participating in the securities business with some regularity.

If employees of a private fund sponsor receive commissions for the sale of fund interests, they will be deemed “brokers.” If employees of a fund sponsor are “brokers,” they must be “associated persons” of an entity that is a registered broker-dealer – and in the absence of a registered placement agent, the signs may point to the fund sponsor as the entity that needs to be registered because it is exercising control over the activities of the brokers. (The private fund itself, like any issuer, is not a broker because it is not selling securities for the account of “others” but rather selling interests in the fund for itself.)

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FAQ #2: What can a sponsor's personnel do and be compensated for without becoming brokers?

There is a safe harbor rule that most fund sponsors rely on to avoid characterizing their fund marketing personnel as brokers, and exposing the firm itself to registration as a broker-dealer. Rule 3a4-1 under the Exchange Act permits the partners, officers, directors or employees of a private fund or of its general partner to avoid regulation as brokers if they satisfy several conditions. An employee engaging in selling efforts:

- must not have been associated with a broker or dealer during the preceding twelve months;
- must not participate in selling an offering of securities for any issuer more than once every twelve months;
- must primarily perform substantial duties for the sponsor other than selling efforts; and
- must not be compensated for his or her activities by "the payment of commissions or other remuneration based either directly or indirectly on transactions in securities."

This last condition often creates some confusion. What constitutes transaction-based compensation is not always obvious. For example, would a bonus scheme not directly tied to sales efforts but reflecting the overall success of the sponsor in raising capital be viewed as transaction-based compensation? Not all bonus schemes implicate transaction-based compensation. If bonus programs are implemented, it is best that they not have any elements that might be seen to be a form of disguised commission, such as a stated component tied to the amount or size of the investment commitments obtained or facilitated by the individual.

The rule is a "safe harbor;" there may be other means to establish that a person is not a broker. Because demonstrating that an employee who engages in selling efforts is not a broker requires a detailed analysis of the relevant facts, sponsors prefer to rely on the safe harbor, if possible.

Assuming that the safe harbor is not available, another common issue is the extent to which employees of the fund sponsor can be involved in presentations to prospective clients that are designed to solicit investment in a private fund. As long as the sponsor's employees are present to discuss the investment objectives and policies of the fund and leave to others (preferably registered personnel) the tasks of delivering offering documents and subscription agreements, negotiating and accepting subscriptions and making direct solicitations, fund sponsor employees would not be considered brokers. Of course, compensating fund sponsor employees based on their "success" in bringing in specific commitments is likely to be seen to be a form of transaction-based compensation.

A private fund sponsor that is offering a number of funds and is regularly engaged in marketing activities may wish to explore having those activities conducted by a registered broker-dealer. One avenue is to market shares through an already registered broker-dealer.

While fund sponsors may rightfully seek to save placement fees, they need to be careful; instead it may be appropriate to work with established private placement agents that specialize in serving as brokers for fund sponsors. Another alternative is to form an affiliated broker and employ as registered representatives those individuals responsible for selling the fund's shares. The advantage to this approach is that those individuals can be rewarded with transaction-based compensation. The major disadvantage is the burden imposed by additional regulation, discussed in detail below.

FAQ #3: Isn't there a third alternative? Can't we use a finder that is not a registered broker to identify fund investors?

Private fund sponsors may be able to identify potential investors with the help of a "finder" – that is, a person who assists a sponsor in identifying potential investors and receives compensation from the sponsor for doing so. However, the SEC has recently limited further the activities in which a finder may engage without being considered a broker.

As with Rule 3a4-1, the scope of activities in which a finder may engage without becoming subject to broker-dealer registration and regulation has always been narrow. For example, in one no-action letter, the staff of the SEC's Division of Market Regulation concluded that registration as a broker was not required where the activities of the finder (Paul Anka – yes, that Paul Anka) were limited to furnishing an issuer (a partnership that was acquiring the Ottawa Senators hockey club) with the names and telephone numbers of persons with whom he had a bona fide, pre-existing business or personal relationship and whom he believed would be interested in purchasing partnership units. The letter contains a litany of

activities in which Mr. Anka would not be involved (e.g., negotiations between the Senators and any potential investors and the preparation of any sales or analytical materials).

In more recent no-action letters, the SEC staff has narrowed the scope of the "finders" exception. The SEC staff is concerned that, because of technological advances and other developments in the securities markets, "more and different types of persons [have] become involved in the provision of securities-related services." Making introductions to persons personally known to the solicitor without any further participation in negotiations or in structuring the private placement may pass muster if it is not part of an ongoing pattern of such activity for a sponsor.

If the sponsor believes that it will require a concerted and broad marketing effort by a third party and that commission-based compensation will motivate successful sales persons to solicit investors for a private fund, the sponsor should retain a registered broker-dealer or bite the bullet and register itself or a subsidiary as a broker-dealer and qualify its sales persons with the National Association of Securities Dealers, Inc. (NASD).

FAQ #4: How tough can it be to register as a broker?

Pretty tough, although a motivated fund sponsor can achieve registration and employee qualification if it has patience and a willing "sales force." Moreover, registration is something that a private fund sponsor with a dedicated in-house sales force and plans to offer a number of funds must consider.

For a private fund sponsor accustomed to minimal regulatory requirements, the process of registering as a broker, which generally takes several months, is typically viewed as very burdensome. In general, a broker must register with the SEC, the NASD and the securities commission in each state in which the broker will operate. The SEC and NASD maintain web sites that provide useful information concerning the registration process and other matters. *(http://www.nasd.com/membinfo/fr_MBR_1.html* for the NASD and *http://www.sec.gov/divisions/marketreg/bdguide.htm* for the SEC)

While the registration requirements differ among these regulators, each requires the filing of Form BD, the Uniform Application for Broker-Dealer Registration. Form BD seeks information about the applicant's business, its regulatory and disciplinary history, its direct and indirect owners and its executive officers and its affiliations with certain entities (e.g., securities or investment advisory firms, banks). The SEC may deny registration to any applicant that has been subject to certain disciplinary proceedings.

The NASD registration process is much more involved and requires the applicant to submit a variety of materials for NASD review. In addition to the Form BD, the NASD requires background (including disciplinary) information with respect to each of the firm's partners, officers and directors and each employee who effects transactions in securities. The applicant must also submit, among other things: a detailed business plan; copies of agreements relating to its securities business; information concerning the nature and source of the applicant's capital; and descriptions of its financial controls, communications and operational systems, supervisory system, written procedures and recordkeeping system.

Private fund sponsors may be able to identify potential investors with the help of a "finder" – that is, a person who assists a sponsor in identifying potential investors and receives compensation from the sponsor for doing so. However, the SEC has recently limited further the activities in which a finder may engage without being considered a broker.

A registered broker and its associated persons are subject to fairly broad regulatory requirements, including antifraud rules, the NASD's Conduct Rules and detailed reporting and recordkeeping obligations. The Conduct Rules, for example, require the broker to have reasonable grounds for believing a security is suitable for a particular investor before making the sale. Brokers must comply with net capital requirements, although the requirements are fairly *de minimis* for brokers that do not carry customer accounts. The sponsor's offices and employees must pass exams administered by the NASD, a prospect that many might find unappealing. Finally, brokers are subject to inspections by regulators. ■

— Marcia L. MacHarg, Kenneth J. Berman and Rachel H. Graham

breach of the seller's representation regarding environmental matters. You decide not to raise the issue. Under the law of some jurisdictions (including New York), you may not have a claim for the breach of the representation.

If a buyer knows prior to the signing of the purchase agreement that one of the seller's representations is untrue, the buyer should seek a purchase price reduction or indemnification for the specific event or circumstance that causes the representation to be untrue. If the buyer depends on its ability to recover for the breach, the buyer could be found not to have relied on the seller's representation when the buyer struck the bargain and therefore be unable to sustain one element of its indemnity claim. If for any reason a buyer does not want to or cannot obtain a purchase price reduction or specific indemnity, it should make sure that the purchase agreement includes the rights-reserving provisions described above. It is not certain, however, that these provisions will preserve the buyer's rights where its knowledge of the breach was acquired prior to signing; none of the New York cases presents this fact pattern, and the relevant cases provide ambiguous guidance.

If a buyer knows prior to the signing of the purchase agreement that one of the seller's representations is untrue, the buyer should seek a purchase price reduction or indemnification for the specific event or circumstance that causes the representation to be untrue.

Anti-Sandbagging. The seller requests that a provision be included in the purchase agreement to the effect that you will not be entitled to be indemnified for any breach of the seller's representations if you are aware of such breach before closing – a so-called "anti-sandbagging" provision. Sometimes a seller is motivated to demand the anti-sandbagging provision because of suspicions raised by the buyer's request to include the rights-reserving provisions described above. If you agree to a broad anti-sandbagging provision, you will be limiting your rights more than even the most seller-favorable cases, and you will create an extra element of proof (or give the seller a potential defense) on every indemnity claim.

Buyers should always strongly resist "anti-sandbagging" provisions. They limit the buyer's rights more than the most unfavorable New York cases (principally because they limit the buyer's rights even when the buyer acquired knowledge of the breach after signing from a source other than the seller – see "The Cases" below). They create an extra element of proof (lack of buyer's knowledge) or a potential defense for the seller in connection with every indemnity claim. They encourage the seller to play games – such as giving the buyer information the significance of which does not become clear until the buyer seeks indemnity, or withholding information until just before the closing when the buyer is so committed to the transaction that exercising its walk-away right is difficult. A buyer who compromises on this provision should insist that the seller bear the burden of proof of the buyer's knowledge and that the buyer's rights only be limited if the buyer has actual knowledge of the breach.

Updating. The seller wants to include a provision in the purchase agreement entitling it to update, between signing and closing, the disclosure schedule setting forth exceptions to the seller's representations. The updated disclosure will not affect the conditions to closing – if any such updated disclosure is materially adverse you will not have to close – but if you do close, you will not be indemnified for the updated matters. You successfully resist this provision on the grounds that limiting your rights to the ability to walk away from the deal does not guarantee you the full benefit of your bargain. Under the law of some jurisdictions (including New York), unless you have expressly reserved your rights, your rights could be limited anyway.

Whether a buyer accepts a provision permitting a seller to update its disclosures is a matter of taste and, accordingly, can be handled in different ways. A buyer who feels that "a deal is a deal" and that if one of the seller's representations is untrue – no matter what the reason – the buyer should have the option of walking away from the deal or closing and seeking indemnity should resist any such provision (and make sure that the purchase agreement includes the rights-reserving provisions described above). Other buyers may wish to compromise by allowing updating to reflect events that occur after signing (perhaps with the further limitation that the occurrence of such events not be attributable to the fault or breach of the seller) but not to correct errors – such an approach keeps

pressure on the seller to get its representations right in the first place. A buyer who accepts a version of this provision should make sure that if it walks away it retains the right to recover damages for representations that were untrue at the time the original contract was signed or that became untrue through fault or breach of the seller.

The Cases

In the leading New York case, *CBS Inc. v. Ziff-Davis Publishing Co.* (1990), CBS entered into an agreement to purchase certain businesses of Ziff-Davis. The agreement provided that each party's representations would "survive the closing, notwithstanding any investigation made by or on behalf of the other party." After signing and prior to closing, CBS concluded, on the basis of its due diligence investigation, that one of Ziff-Davis's representations was untrue. The purchase agreement excused CBS from its obligation to close the transaction if Ziff-Davis's representations were not true at closing. Ziff-Davis did not agree that the representation was breached, and, after negotiation, the parties agreed that they would close the transaction but that closing "would not constitute a waiver of any rights or defenses." Following the closing, CBS brought suit for breach of the representation. Ziff-Davis argued, among other things, that because CBS had knowledge of the alleged breach prior to closing CBS could not have been relying on the truth of the representation when it closed and that the absence of such reliance doomed CBS's claim.

New York's highest court, the Court of Appeals, said that "[t]he critical question is not whether the buyer believed in the truth of the warranted information..., but 'whether [it] believed [it] was purchasing the [seller's] promise [as to its truth].'" The Court of Appeals found that the inclusion of the representation in the purchase agreement "as part of the bargain between the parties" evidenced the required reliance and that "the right to be indemnified... does not depend on proof that the buyer thereafter believed" the representation. Accordingly, the court decided (on this point) in favor of CBS. Although the court mentioned in its statement of facts the survival provision in the original purchase agreement and the "no waiver" provision in the agreement subsequently entered into between the parties, neither provision was cited in the court's presentation of the rationale for its decision. The court emphasized that the knowledge of the breach arose after signing and that the issue was *not* whether the buyer was relying on the seller's representation when the buyer decided to enter into the purchase agreement.

Three subsequent cases, each decided by federal courts applying New York law, limited the *Ziff-Davis* rule and held that a buyer was not entitled to recover for breaches of representations of which it was aware prior to closing.

In *Galli v. Metz* (1992), Galli and Metz simultaneously signed a purchase agreement and closed the sale of Galli's business to Metz. Galli made one or more representations in the purchase agreement that were untrue. Metz sued. One of Galli's defenses was that he or his agents had told Metz of the facts giving rise to the breaches prior to closing (and therefore prior to signing). Metz cited *Ziff-Davis* and argued that his knowledge was irrelevant. The United States Court of Appeals for the Second Circuit distinguished *Ziff-Davis* on the basis that in *Ziff-Davis*, unlike in *Galli*, there was a dispute about the accuracy of the seller's representation. The court said "where a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach. In that situation, unless the buyer expressly preserves his rights under the warranties (as CBS did in *Ziff-Davis*), we think the buyer waived the breach." Apparently Metz had not expressly reserved his rights.

> *Buyers should always strongly resist "anti-sandbagging" provisions. They limit the buyer's rights more than the most unfavorable New York cases (principally because they limit the buyer's rights even when the buyer acquired knowledge of the breach after signing from a source other than the seller...).*

In *Rogath v. Siebenman* (1997), Siebenman sold a painting, supposedly by Francis Bacon, to Rogath. In the bill of sale, which was presumably delivered upon the closing of the sale, Siebenman represented that he had no knowledge of any challenge to the authenticity of the painting. This was untrue. However, Siebenman maintained that he had told Rogath the relevant facts. Although the

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sale of a painting, unlike the sale of a business, is subject to the Uniform Commercial Code article governing sales of goods, the court (again the United States Court of Appeals for the Second Circuit) purported to follow the law established in *Ziff-Davis* and *Galli* and held that if Siebenman had told Rogath, Rogath was not entitled to recover. The court elaborated on its analysis of *Ziff-Davis* set forth in *Galli* by stating that if the buyer's knowledge of the inaccuracy of the seller's warranties comes from the seller, "it cannot be said that the buyer – absent the express preservation of his rights – believed he was purchasing the seller's promise as to the truth of the warranties." Apparently Rogath had not expressly reserved his rights. Although the court suggests that a buyer who knows that a representation is untrue does not need to reserve its rights if the source of its knowledge is not the seller, none of the cases actually presents those facts. Accordingly, buyers should assume that they have to reserve their rights, whatever the source.

Finally, in *Coastal Power International, Ltd. v. Transcontinental Capital Corporation* (1998), the United States District Court for the Southern District of New York held that a buyer of a business that learned of breaches of the seller's representations from the seller, after signing and before closing, but closed without expressly reserving its rights, had waived its right to recover for those breaches. The purchase agreement in *Coastal* required the seller to inform the buyer if any of the seller's representations became untrue and conditioned the buyer's obligation to close on the continued accuracy of the seller's representations, but apparently did not contain any rights-reserving provisions.

> *Ziff-Davis, which was decided by New York's highest state court, was a good decision for buyers....Unfortunately for buyers, the federal courts that have been subsequently called upon to interpret Ziff-Davis have distinguished it by reference to facts that may not have mattered to the Ziff-Davis court.*

Analysis and Conclusion

Ziff-Davis, which was decided by New York's highest state court, was a good decision for buyers. It stands for the principle that a buyer who knows that one of the seller's representations is untrue may close the transaction and still recover, so long as the buyer believed it was buying the right to recover when it signed the purchase agreement and so long as it acquired its knowledge that the representation was untrue *after* signing. Unfortunately for buyers, the federal courts that have been called upon to interpret *Ziff-Davis* have distinguished it by reference to facts that may not have mattered to the *Ziff-Davis* court. In *Galli*, the seller did not dispute that the representation was untrue; in *Rogath*, the buyer learned that the representation was untrue from the seller, not from a third party; and – probably the controlling factual difference – in each of the three cases the buyer did not reserve its rights. Until the three federal court decisions were handed down, one might reasonably have predicted that the *Ziff-Davis* court would also protect a buyer's rights if the buyer acquires its knowledge *before* signing (i.e., if it sandbags), but the narrow interpretations in *Galli*, *Rogath* and *Coastal* leave considerable doubt that a court – at least a federal court – would reach the same conclusion.

Buyers have to live with, and be guided by, all the cases. So: (1) Sandbag before signing at your peril – you may not have a claim. (2) Do not accept an anti-sandbagging clause just because you do not intend to sandbag – you do not want to have to prove what you do not know, and you do not want knowledge acquired after signing to interfere with your rights. (3) Above all, reserve your rights!

— Robert F. Quaintance, Jr.

5. Taxation. A Co-Investment Plan involves complicated tax issues, including both compensation tax and tax issues generally applicable to all private equity funds. Like most investors, employees want capital gains (or flow-through) tax treatment on their investment; and employers will often accommodate their desire. This is easier to achieve when employees invest their after-tax dollars. Where pre-tax dollars are used, ordinary income treatment (with corresponding employer deductions) is more typical.[4]

Whether pre-or-post-tax dollars are used, Section 83 of the Internal Revenue Code will generally govern the tax treatment because the plan interests are being offered as a compensation tool. Under Section 83, whenever an employee receives "property" in connection with his or her performance of services, the excess (if any) of the fair market value of the property over the purchase price paid is taxable to the employee as ordinary compensation income, and the employer has a corresponding deduction and withholding obligation. The tax is payable (and fair market value determined) on the later of the date of acquisition and the date any forfeiture or transfer restrictions lapse (i.e., at vesting).

An employee may be able to elect to be taxed at the time of acquisition rather than at vesting by filing what is known as an "83(b) election" with the Internal Revenue Service at the time of the initial investment. In most cases, the market value at acquisition will be the same as or close to the amount paid, and no or minimal tax will be due as a result of the election.[5] The 83(b) election may, however, only be made if the employee is sufficiently at risk for his or her investment (including the non-recourse leverage) to be considered the owner for tax purposes. If the non-recourse leverage constitutes too high a proportion of the total investment, the employee's investment may not be substantial enough to qualify.

Because vesting and forfeiture provisions are typical in co-investment plans, employees who do not or cannot make an 83(b) election may have a taxable event upon vesting. Until that time, the employer would be considered the owner of the property, income and losses on the investment would be recognized by the employer and any distributions made to the employee would be considered compensation (taxed at ordinary income rates). To avoid the complications of such delayed income recognition, many employers require all U.S. employees who purchase fund interests to make the 83(b) election, and structure their funds accordingly.

Employee Leveraged Co-Investment Plans are complicated to implement but, with the enhanced investment potential provided by leverage, together with the vesting and forfeiture provisions, such plans can be a powerful incentive for your key employees.

— Elizabeth Pagel Serebransky and Kenneth J. Berman

4 It is possible to structure a hybrid plan funded with pre-tax dollars where gains in excess of the initial investment and the returns on the leveraged amount receive flow-through tax treatment. Implementation of such a plan is complicated and creates an additional administrative burden for the employer.

5 Certain action, such as appreciation in value of any investments made by the fund prior to the date an employee receives his or her interest, transferring appreciated warehoused investments to the fund at their original cost or below-market interest rates on the leverage, may cause the fair-market value to exceed the amount paid by the employee. Careful planning can reduce the risk of employee tax recognition.

Under current law, funds with 500 or more participants may become subject to the public reporting requirements. We recently obtained SEC no-action relief... for a group of co-investment funds exempting them from these public reporting requirements.

alert

Alert: Removal of the U.K. 20 Partner Limit

The U.K. Government recently announced its intention to eliminate the 20 partner limit for partnerships and limited partnerships. The prohibition on the formation of partnerships with more than 20 partners dates back to 1856. The original justification for the limit, namely the difficulty of suing a fluctuating body of partners at a time when it was necessary to join all the partners in an action, has long since disappeared.

Most professional partnerships are already exempt from the 20 partner limit. In investment partnerships, this restriction is commonly avoided by establishing a series of parallel partnerships, each of which has no more than 20 partners. Private equity sponsors and their investors will now be relieved of the administrative burden and costs of running a large number of parallel partnerships.

The U.K. Department of Trade and Industry proposes to remove the restriction by way of a Regulatory Reform Order made under the Regulatory Reform Act of 2001. This new parliamentary procedure is designed to fast-track the removal of red tape in business. The abolition of the 20 partner limit is likely to become law in mid-Summer 2002.

— Colin Bogie and Sherri G. Caplan

Caveat Investor (continued)

claims filed by workers concerning exposure to hazardous materials.

Because only limited information may be available in the initial stages of a private equity investment, private equity firms (and their representatives) may be unable to narrow the scope of the environmental assessment. In most instances, for example, little will be known at the early stages of a transaction about how environmental risk will be allocated among the parties. In such instances, a broad assessment that accounts for all types of environmental risk may be necessary.

However, certain information about the transaction may allow the private equity firm to narrow the scope of the assessment. If, for example, the parties agree early in the sales process that the transaction will be structured as an asset sale, there generally will be a lesser need for the private equity firm to analyze environmental issues associated with former facilities. Similarly, if the seller agrees early in the sales process to take responsibility for all pending litigation (which it might do in order to make it easier for bidders to price the deal), less analysis of pending environmental litigation will be necessary.

In preparing a comprehensive environmental assessment, certain investigative functions will be more suited to the skills of an environmental consultant, while other functions will be more suited to the skills of an environmental attorney. For example, estimating costs necessary to bring a facility into compliance with environmental, health and safety laws (including the cost of pollution control equipment) and investigating the use of off-site waste disposal facilities are functions more suited to the environmental consultant. Other tasks, such as evaluating environmental, health and safety litigation exposure and analyzing environmental indemnification obligations (such as those that may be associated with former operations), are more suited to an environmental attorney (who may be able to “smoke out” useful information through carefully drafted environmental representations).

Comprehensive environmental assessments can be significantly more costly than traditional Phase 1 reports. A comprehensive assessment will generally add approximately 50% to the cost of a traditional Phase 1, though such additional costs will vary by transaction. In heavily regulated industries in which environmental compliance is a major concern, a comprehensive evaluation can double the cost of a Phase 1.

In sum, a comprehensive evaluation of the environmental risks posed by a contemplated investment, rather than a traditional Phase 1 report, will be the best way for a private equity firm to protect against unanticipated environmental costs.

— Stuart Hammer

Court weighs in on this topic (if they were to choose to do so), we are faced with some starkly different guiding principles under the All Holders/Best Price Rule, depending on which Federal Circuit's law applies to the particular case. Because the plaintiff will often be able to pick the Federal Circuit in which the suit is brought, plaintiffs will almost assuredly try to bring suit in a Circuit where the law is more favorable to the plaintiff. Therefore, it is not really practical to try to structure the arrangements solely in order to comply with the laws of a particular Circuit that might be more favorable to the purchaser in the hopes of having litigation end up there. However, at a minimum, one would be well advised to work within the guidelines of that more favorable law.

Bright Lines

The All Holders/Best Price Rule by its terms applies only to consideration paid in connection with a tender offer and "during a tender offer." Reaching the conclusion that the statute means what it says, and no more, some courts have found that additional consideration will violate the Rule only if it is paid literally during the tender offer. Customary management agreements will almost certainly not run afoul of the All Holders/Best Price Rule under this interpretation. Special retention bonuses that are intended to help retain employees through the closing of the acquisition would, however, be troublesome if paid upon completion of the tender offer, even under this most favorable reading. (In this regard, payment following completion of the back-end merger would seem more sensible.)

Courts in the Second and Seventh Circuits, as well as the Fourth and Eleventh Circuits, have followed this bright line approach, although the line is the brightest in the Seventh Circuit.

Blurry Lines

Courts in the vast Ninth Circuit – which includes California and many of the Western States – and the Third and Sixth Circuits reject a bright line approach to the All Holders/Best Price Rule. These courts instead direct the inquiry to whether the additional consideration paid was an "integral part" of the tender offer. A payment might be viewed as an "integral part" of the tender offer if the amount of the consideration was tied to the final tender offer price or whether the payment was contingent on successful completion of the tender (or support for the tender offer). Not surprisingly, a payment in exchange for actually tendering the shares in the tender offer would also be a violation of the Rule.

This approach will, of course, create far greater opportunities to argue that payments made outside the tender offer are nevertheless a violation of the Rule. Indeed, a few bad facts and an adept plaintiff lawyer can probably bring almost anything into the fray.

Some courts have not gone quite so far as the courts that have adopted the "integral part" test, and instead have found that only payments that are intended as an "inducement" to the recipient to tender his or her shares or to support the tender offer is a violation of the Rule. This test is somewhat narrower than the "integral part" test, looking only at the intentions of the purchaser, but still open to considerable latitude as to what payments may or may not in fact be brought under scrutiny.

Keep in Mind

As a practical planning matter, if an acquisition is to be structured as a tender offer, it may be easy to avoid certain obviously problematic payments for management (such as a payment to tender shares in the tender offer – a definite "NO"). Beyond that, given the legitimate needs for the sponsor and management to have some level of understanding and agreement on certain post-acquisition compensation-related matters, it may not be possible to structure the arrangements with management in a manner that is invulnerable to attack under the All Holders/Best Price Rule, given the potentially all-inclusive reach of the "integral part" test. Through awareness of the issue and attention to all of the various and nuanced structuring, timing and other factors, it is possible to reduce risk significantly. ▢

— David P. Mason and David S. Lebolt

The risk here – insofar as it relates to a sponsor's arrangements with management – is that some item(s) in the sponsor's agreements with the management team are re-characterized as disguised payment for shares held by management, and that "extra" payment must then be paid to the public shareholders.

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