Debevoise & Plimpton

Private Equity Report

Volume 3 | Number 2 | Winter 2003

Questions to Ask Before You Join a Club

Despite the recent flurry of large transactions in which a consortium of private equity firms have teamed up to make joint bids and acquisitions, "club deals" themselves are not breaking news. In fact, they have been a staple of small- and middle-sized private equity M&A transactions for years. Recently, however, there has been a growing trend toward large club deals with enterprise values over $1 billion.[1] Due to their size, complexity and, often, international dimension, these transactions have generated considerable attention in the business press and have prompted much discussion among private equity professionals and the limited partners whose money they manage.

The increased number of very large club transactions arises from a number of factors, including the tremendous growth in the availability of private equity capital and the popularity of auctions in the sales process. Even more importantly, perhaps, because of difficulties in the debt markets, the percentage of equity needed to complete transactions has increased to such a degree that in the largest transactions even large private equity firms cannot complete a transaction without running afoul of the diversification limitations in their limited partnership (fund) agreements. (Most buyout funds limit the amount that can be invested in any portfolio company to 20% or 25% of the fund's committed capital.) Therefore, a club deal may be the only way to raise the required equity to finance a very large transaction.

Club deals offer private equity firms:

The Chance to be a Winner, Especially in Very Large Transactions. By participating in a club deal, a private equity firm may increase its chances of acquiring an interest in a "prized property" that it would otherwise not have sufficient equity to obtain. In addition, sharing judgments about valuation and limiting the other number of competitors are added benefits of being part of a club bid.

Diversification and Risk-sharing. Club transactions are also a way of spreading investment risk by permitting firms to use their available equity to participate in a larger number of transactions and to spread the risk of a single transaction among similarly situated private equity firms.

Greater Leverage with Financing Sources. Teaming up with another private equity firm may well make it easier for club members to get the best financing terms available. Financing sources would generally find club deals attractive, especially since they will be able to serve more than one client in a single transaction.

Running on the "Inside Track" and Breaking New Ground. Club deals might also permit a private equity firm to benefit from the industry (*e.g.*, telecom) expertise or prior relationships (*e.g.*, with management or the seller) of its co-bidders.

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1 Notable recent examples include: the acquisition by Texas Pacific Group, Inc. (the lead investor), Bain Capital, Inc. and Goldman Sachs Partners, LP of Burger King Corporation from its British parent, Diageo plc for $1.5 billion in December 2002; the acquisition by The Carlyle Group, LP (50% equity) and Welsh, Carson, Anderson & Stowe (50% equity) of QwestDex, a subsidiary of Qwest Communications International, Inc. for $7.05 billion in August 2002; and the acquisition by funds managed by Providence Equity Partners Inc. (49% equity and lead investor), Soros Private Equity Partners, LP and Goldman Sachs of Eircom plc for $2.5 billion in June 2001.

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"I never said it was the world's most exclusive club."

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letter from the editor

In this, the first issue of the *Debevoise & Plimpton Private Equity Report* for 2003, we focus on new and proposed legal developments that impact the private equity industry – from tax laws to takeover defenses. We also highlight several key respects in which U.S. private equity firms operating in Europe need to get accustomed to different ground rules.

In our cover story, we outline the issues that private equity firms participating in club deals ought to consider – both vis-à-vis the private equity firms with whom they partner as well as their own limited partners. We also report on a recent Delaware Supreme Court case that may potentially limit private equity investors' exit opportunities from public transactions. On the tax front, we describe how the most recent version of President Bush's tax proposals to eliminate taxes on corporate dividends may impact private equity.

Jim Kiernan, who heads our European practice, explains how serving on the boards of a fund's European portfolio companies can expose a sponsor's employees to civil and criminal liabilities that would be unlikely in the U.S. and suggests how to protect against that liability.

Also from the European perspective, Geoff Kittredge describes the basic differences between private equity funds organized as English versus Delaware limited partnerships – most of which relate to form rather than substance. We believe that the elimination of the 20-partner limit for English partnerships should allow UK private equity funds and their sponsors to move closer to the administratively simpler U.S. fund model that uses parallel vehicles less frequently and relies on a single, integrated partnership agreement for both U.S. and non-U.S. investors. In our private funds formation practice in both London and New York, we are pleased to be participating in this transition.

In that connection, we are happy to announce the arrival of our newest partner in London, Marwan Al-Turki, a leading English fund formation and financial services regulatory lawyer. The addition of Marwan to our international practice further strengthens the firm's commitment to European private equity clients and U.S. funds seeking to organize and invest abroad.

In our Guest Column, Steven Millner, a managing director at DML, a specialist in accounting, administrative and advisory services for the private equity industry, cautions that institutional investors are focusing the due diligence spotlight on private equity fund managers and proposes guidelines to help fund managers develop the infrastructure, processes and controls that investors expect.

The Trendwatch column is taking a brief hiatus this issue as we update our database in order to provide you with the most current analysis of trends in the financial terms of private equity funds.

We continue to strive to make the *Debevoise & Plimpton Private Equity Report* a useful and informative resource for our private equity clients and friends and welcome any suggestions you might have on topics of interest to you and your colleagues.

Franci J. Blassberg
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Shark Repellents That Can Bite

When private equity firms use IPOs as exit strategies (as they sometimes have, and might again, in better market conditions), the portfolio company going public often includes a full complement of "shark repellents" – that is, charter and by-law provisions intended to guard against unwanted or abusive takeover attempts. Private equity sponsors should review these provisions carefully, because some of them can limit a fund's flexibility to cause a sale of the public portfolio company or, under the right circumstances, obtain a control premium that is not shared with other stockholders.

The array of shark repellents implemented for a new public company might include, among other things, a staggered board, elimination of shareholders' ability to act by written consent or call special meetings, adoption of a shareholder rights plan (a "poison pill"), and advance notice requirements for shareholder proposals and director nominations.

There are two reasons these provisions often are added at the time of the IPO. First, they have proven effective in improving the board's leverage in the event of an unsolicited takeover attempt, strengthening the company's ability to do the best possible job for the shareholders. Second, for whatever reason, IPO investors just don't seem to be bothered by them. That's odd, because institutional investors tend to disfavor antitakeover devices – to the extent that it is often impossible to obtain shareholder approval for measures such as a staggered board after a company has gone public. But underwriters have frequently advised that including a normal set of shark repellents – including a poison pill – will not harm the marketability of the IPO shares.

The private equity sponsor that will continue as a major shareholder of a public company should think twice about whether some shark repellents are really in its best interests – specifically, business combination statutes, such as Delaware's Section 203, and poison pills.

Section 203 imposes a three-year moratorium on business combinations with any 15% or greater stockholder unless the business combination or the crossing of the 15% threshold receives prior board approval, the bidder reaches the 85% threshold in the same transaction as it crosses the 15% threshold, or the combination is approved by the board and by holders of two-thirds of the shares not owned by the bidder. A Delaware company can opt out of applicability of Section 203 by so providing in its charter, but that's really a one-shot opportunity for the private equity sponsor to decide whether or not Section 203 will apply.

A poison pill works in a similar manner by making it prohibitively expensive for a bidder to cross a specified ownership threshold – often 15% – without prior board approval. If a bidder crosses the threshold without prior board approval, all poison pill rights other than those held by the bidder become exercisable to buy stock in the target company at half price. At the same time, the bidder's pill rights become void – thereby causing massive economic and voting dilution. A poison pill is stronger than a business combination statute because a pill punishes any unauthorized crossing of the threshold, not just one followed by a business combination.

Private equity sponsors should seriously consider having a portfolio company opt out of Section 203 at the time of its IPO. Even if Section 203 wouldn't directly apply to the private equity sponsor – either because it has owned its shares for at least three years or because it has received board approval – it would apply to any person to whom the sponsor wants to transfer its shares. That means that the private equity sponsor's decision to sell its shares becomes, in part, a board decision – and the board will be looking after the interests of all shareholders, not just the sponsor. The same is true if the company has a poison pill, which is why private equity firms should also consider whether they want the IPO company to adopt one.

Here's an example of how Section 203 or a pill can chill dealmaking:

A private equity sponsor takes PortfolioCo public and, after some secondary sales, is left with a 35% interest. Two years later, BuyerCo would like to acquire PortfolioCo, but will go forward only if it is sure that PortfolioCo's biggest shareholder – the private equity sponsor – is committed to the deal. If PortfolioCo has a poison pill or is subject to Section 203, any lock-up agreement between the sponsor and BuyerCo will require

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Private Equity and the Proposal to Exclude Dividends from Income

In early January, the Bush Administration proposed to exclude corporate dividends from the taxable income of individual shareholders. Although it appears unlikely that the 100% exclusion proposed by the President will survive as the proposal wends its way through Congress, even a lesser exclusion (say at the 70% or 80% level) would significantly alter the tax strategies employed by private equity funds.

Under current law, most exits are structured as sales so as to permit individual investors, including the partners of the sponsor, to enjoy the benefits of long-term capital gains taxation (currently at a maximum tax of 20%). In addition, foreign investors in a fund are generally exempt in the U.S. with respect to capital gains (except for those involving real estate companies). Since dividends are taxed to individuals at a rate of 38.6% and foreigners are potentially subject to a 30% U. S. tax on dividends, payment of dividends is not currently a desirable method of delivering value to shareholders upon exit. Under the Administration's proposal, however, the incentives will be reversed, at least in connection with U. S. investors. If, for example, Congress were to enact an 80% dividend exclusion, the tax on individual investors (including partners of the sponsor) upon receipt of a dividend would be only 7.72% (20% of 38.6%) as opposed to 20% with respect to a capital gain.

The Administration's proposal would also cause leverage recapitalizations prior to final exit to become a more popular method of delivering value to investors. This is of particular importance in today's market where many private funds are holding equity investments that have appreciated in value but that are not in a position to be sold in light of the general state of the market and the absence of strategic buyers. To deliver value to investors prior to final exit, a fund could cause a portfolio company to borrow and use the proceeds to declare substantial dividend to the fund. Whereas under today's law the tax rate for individual investors would be 38.6%, the tax rate on a dividend paid under an 80% exclusion regime would be the 7.72% rate discussed above. Indeed, even a 50% exclusion regime would make this exit strategy desirable; under a 50% regime, the tax rate would be just under 20%.

One group of investors that will not be enthusiastic about receiving dividends is foreign investors. The Administration's proposal does not call for an elimination of the 30% withholding tax on dividends paid to foreigners. Accordingly, foreigners will continue to favor receiving value through sales transactions. Unlike the current state of affairs where the tax interests of U.S. individuals and foreign investors are aligned, the Administration's proposal would cause those interests to diverge.

If the Administration's proposal is watered down in Congress – for example, if Congress enacts a capped exclusion (similar to the $100 per year dividend exclusion that existed prior to 1987) – the effect on private equity will be unimportant. Any sort of substantial exclusion, however, will cause private equity funds to rethink in fundamental ways their tax planning strategies. ■

— Gary M. Friedman
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Upcoming Speaking Engagements

March 6-7

Franci J. Blassberg, Program Chair and Panelist
ALI-ABA Conference on Corporate Mergers and Acquisitions
Special Problems When Acquiring Divisions and Subsidiaries
and
Negotiating the Acquisition of a Private Company
San Francisco, CA

April 1-3

Adele M. Karig
Annual Private Equity and Venture Capital Markets Summit 2003
Mastering Effective Tax Practices for Venture Capital and Private Equity Funds
New York, NY

How to Ensure That Your Special Committee is Special

Companies that are controlled by private equity funds often find it useful to establish "special committees" to approve transactions between the company and the fund. In some cases, this is because the company has debt instruments, such as high-yield bonds, that require that transactions between the borrower and its affiliates be approved by non-affiliated directors. In other cases, particularly where there are minority shareholders whose interests may be different from that of the fund, the use of a committee of independent directors can limit the risk of liability for breach of fiduciary duty under the laws of the state in which the company is incorporated.

However, the benefits to be gained through the use of a special committee in these circumstances can be realized only if the members of the committee are truly independent, and the committee is given the freedom to do its job without interference from the controlling shareholder. This article briefly outlines the basic requirements of a properly organized and functioning special committee of independent directors, in the context of a public company that is controlled by a private equity fund.

Independence of Committee

The members of the special committee must be truly independent. Naturally, this means that any affiliates of the fund, such as employees of the fund's management company, cannot be on the committee. It also means that directors who are employees of financial organizations or other companies that have commercial relationships with the fund should be excluded. Likewise, the committee should not include officers or employees of the company, such as the CEO, since their continued employment and compensation arrangements are ultimately within the discretion of the directors appointed by the fund.

In general, the special committee should not include any director who could be viewed as being beholden to the fund or its affiliates or as having a similar interest as that of the fund in the transaction that is being negotiated.

Number of Members

It is possible for a special committee to have only one member. However, committees with two or more members are to be preferred. Courts may give a transaction particularly careful scrutiny where there is only one member of the Committee. (See, for example, *Kahn v. Dairy Mart Convenience Stores, Inc.* (Del. Ch. Mar. 29, 1996).)

The Committee's Charter

The resolutions that are adopted by the full board in establishing the special committee should clearly set forth the responsibilities of the committee. Ideally, these should be as broad as possible. For example, it is better if the special committee is specifically authorized to negotiate, rather than merely to approve or disapprove the initial proposal of the controlling shareholder. Likewise, it is better for the Committee to be authorized to explore alternatives, assuming that an alternative transaction is a realistic possibility.

On the other hand, the special committee need not be given the power to block the proposed transaction (*e.g.*, to prevent the fund from going "over the heads" of the committee and taking its proposal directly to the public shareholders). In the recent case of *In Re Pure Resources* (Del. Ch. October 1, 2002), the court held, in the context of a proposed going-private transaction, that it was not a breach of the fiduciary duty of the board not to give the special committee the power to block the transaction by adopting a poison pill, and that the independent directors of the board did not have any duty to seek such a power.

Even if this instance, though, where a proposed transaction is structured in a manner that does not require any action by or approval of the company – for example, a tender offer by a controlling shareholder, which is made directly to the shareholders – Delaware law may mandate the use of a special committee to assist the shareholders in evaluating their options. Again in the case of *In Re Pure Resources*, the Delaware Chancery Court has held that a controlling shareholder who proposes to make a going-private tender offer to the public shareholders owes a duty to those shareholders to permit the independent directors of the board of the target company "free rein and adequate time" to evaluate the proposal (including with the assistance of independent financial and legal advisors), make a recommendation to the shareholders as to such offer, and provide the shareholders with adequate information with which to make an informed judgment.

Selection of and Independence of Advisors

The special committee should be given the power to hire advisers, the costs of which would be borne by the company. For a complicated matter, such as a going-private transaction, these would typically include both independent legal counsel and a financial advisor.

The committee should hire its advisors without interference from

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A Comparison of U.S. and UK Private Equity Funds

In this article, we review the basic differences between private equity funds organized as Delaware and English limited partnerships and find that most are differences in form, not substance. The notable exception is an economic one – U.S. sponsors generally receive carried interest distributions before their UK counterparts.

Delaware and English Limited Partnerships

The Delaware limited partnership is the fund vehicle of choice among U.S.-based private equity fund sponsors. Of the more than 700 hundred U.S. private equity funds listed in Debevoise & Plimpton's proprietary database, more than 80% are Delaware limited partnerships. The Cayman Islands exempted limited partnership is also a popular investment fund vehicle among U.S.-based private equity sponsors, but is still less commonly used than the Delaware limited partnership.

As popular as they are with U.S.-based sponsors, neither Delaware nor the Cayman Islands has succeeded in becoming the preferred jurisdiction for organizing private equity funds sponsored by European firms. In Europe, the English limited partnership has emerged as the European counterpart to the Delaware limited partnership and the favored fund vehicle of the UK's, and to some extent Europe's, private equity industry. Of the approximately 70 private equity funds in our database that are focusing on European investment, about half take the form of English limited partnerships. Other popular jurisdictions include Jersey and Guernsey in the Channel Islands.

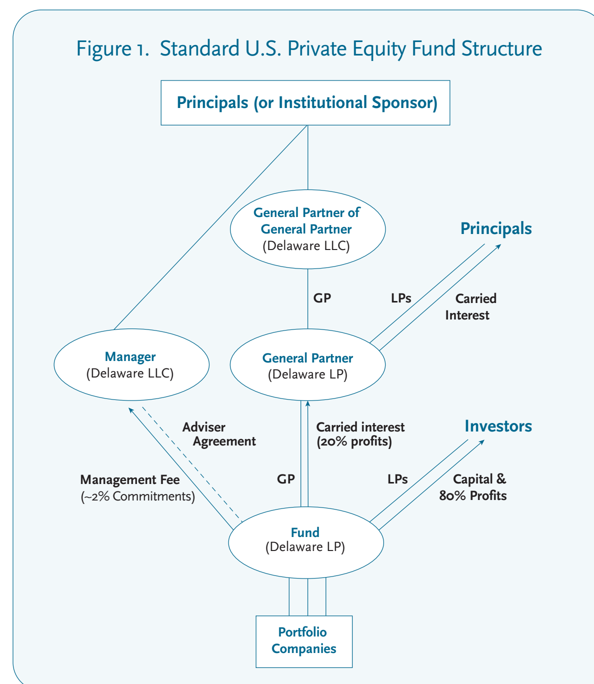
At first glance, U.S. private equity funds organized as Delaware partnerships and UK private equity funds organized as English partnerships look rather similar. But there are certain differences between the two that sponsors and investors should be aware of, including (1) the use of loan commitments instead of capital commitments in an English partnership, (2) the market practice of distributing the carried interest later in a UK fund than in a U.S. fund, (3) tax-driven structuring of UK management fees and (4) the legacy of England's old 20-partner rule – numerous parallel partnerships.

For the most part these are differences in form, not substance (although from a legal and tax perspective they are critical to a properly documented UK fund). The timing of the carried interest distributions is a notable exception and economically impacts fund sponsors, but represents a commercial difference between the U.S. and UK private equity markets. We do not expect either the U.S. or UK market on carried interest distributions to change significantly in the near future. We do expect U.S. and UK funds to move closer together on structure, as UK fund sponsors going forward reduce the number of parallel partnerships they manage.

Typical U.S. Structure

Figure 1 (below) presents a typical but simplified U.S. private equity fund structure and Figure 2 (below) presents a typical but simplified European private equity fund structure based on an English limited partnership.

Figure 1. Standard U.S. Private Equity Fund Structure



Limited Partners (Investors)

In Figure 1, the private equity fund itself is a Delaware limited partnership that invests in one or more portfolio companies. The fund's investors are limited partners that make capital commitments to the partnership and agree to meet those commitments by making cash contributions to the fund as and when the general partner determines that such contributions are needed for the fund to make portfolio investments or pay partnership expenses. As Figure 1 indicates, limited partner investors receive a return of their capital contributions, plus 80% of the profits thereon, as cash and other proceeds from the fund's investments become available for distribution after payment of expenses.

General Partner (Sponsor Affiliate)

The general partner of the fund is also a Delaware limited partnership (other forms or jurisdictions are possible) and makes a capital commitment to the fund equal to about 1%

of the fund's total commitments, although the precise percentage may vary for tax reasons or based on commercial negotiations between the sponsor and investors. (In Figure 1 we ignore the general partner's capital contribution.) In addition to receiving a return of its own capital contributions and any profits thereon, the general partner receives a carried interest equal to 20% of the profits generated by the fund's investments (frequently subject to a hurdle or preferred return). The sponsor's investment professionals (in Figure 1, the "Principals"), if they share in the carried interest and/or help fund the general partner's capital commitment to the fund (as is typically the case), are limited partners of the general partner and receive cash distributions from the general partner. Participation in the carried interest by the Principals can also be structured one level up, through the general partner of the fund's general partner, or may involve additional entities and more complex structuring to accommodate sophisticated personal tax and estate planning.

Manager (Sponsor or its Affiliate)

In a standard U.S. private fund structure the manager of the fund is neither a general nor limited partner of the fund. Instead, the manager usually is a separate but affiliated entity that is organized as a limited liability company instead of a partnership. Although the management company may also be organized as a Delaware entity, and many are, it is also common for a U.S. fund sponsor to organize the management company in the state where its principal offices are located and business activities take place.

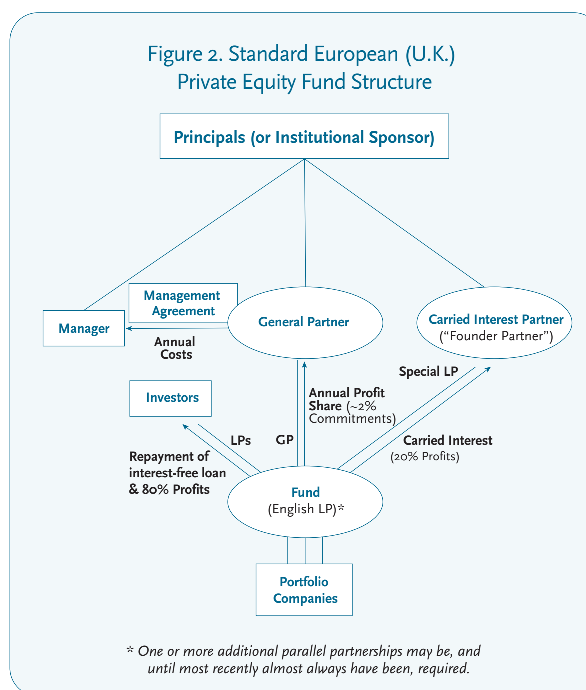
If the manager is a private equity "boutique," it is controlled by one or more of the Principals and is referred to as the sponsor. Alternatively, if the manager is a subsidiary of a large financial institution, such as a bank or insurance company, then the financial institution is generally viewed as the sponsor and in most cases maintains ultimate control of both the fund manager and the general partner. In either situation the manager acts as an adviser to the fund, providing investment advice and administrative management services to the fund pursuant to a services contract that is approved by the general partner and the fund's limited partners. In exchange for the services that it provides the fund, the manager earns an annual management fee that is paid by the fund as a routine operating expense.

Typical UK Structure

Figure 2 represents a generic UK private equity fund organized as an English limited partnership.

The structure is generally similar to the U.S. model in Figure 1: (1) investors are limited partners in the fund and are entitled to 80% of the profits from their investments, (2) a 20% carried interest on the profits generated from the limited partners' investments is distributed to a special purpose vehicle under the control of the fund's sponsor (although in this case it is not the general partner of the fund) and is eventually distributed to the sponsor's Principals and (3) a fixed annual amount is paid out by the fund, which covers the actual costs of providing investment advice and managerial services. Nevertheless, there are certain differences in the way that the commitments, carried interest distributions and management fee work together in an English limited partnership.

Figure 2. Standard European (U.K.) Private Equity Fund Structure



* One or more additional parallel partnerships may be, and until most recently almost always have been, required.

Commitments: Capital and Loans

One difference between UK and U.S. private funds is that investors in English limited partnerships are required to make capital (equity) commitments and loan (debt) commitments to the fund, whereas investors in Delaware limited partnerships make only capital commitments to the fund. Why?

Under Section 4(3) of the English Limited Partnership Act of 1907, no part of a limited partner's capital contribution can be irrevocably returned to the limited partner prior to the dissolution of the partnership. If capital contributions are returned to the limited partner earlier, the limited partner loses its limited liability status to the extent of the capital returned and any capital contributions distributed to a limited partner prior to the fund's dissolution may, as a matter of English partnership law, be required to be re-

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guest column

What's Good for the Goose...
Turning the Due Diligence Spotlight on Sponsor Infrastructure

Private equity sponsors are obviously familiar with the importance of appropriate due diligence into management and business continuity systems at potential targets when they make their own investment decisions. What may not be so obvious is that institutional investors are increasingly shining the due diligence spotlight on the private equity fund sponsors themselves before committing capital. Interestingly, many sponsors are challenged when faced with formulating their responses to these inquiries.

The turmoil created by Enron, WorldCom and Tyco coupled with the terrorist attacks of September 11, 2001, have dramatically demonstrated that businesses must reexamine their financial reporting, governance and business continuity plans. Private equity firms are not exempt. Restive LPs and increased media attention almost certainly guarantee that the market will demand major changes. There is simply too much capital exposed in the private equity asset class and growing, though not necessarily accurate, perceptions of "murky valuation standards," "portfolio company melt downs," "fund downsizing," "lack of transparency" and sponsors with "mom-and-pop" back offices.

Our experience in dealing with a large number of U.S. and European private equity firms reveals that many senior executives at private equity firms today are, in fact, concerned about the quality of their firm's internal infrastructure. This should come as no surprise given the dramatic growth in private equity. From 1999 to 2001 alone, there were a record 528 new funds closed that raised $214 billion of capital.

As in many other growth industries, investment in infrastructure oftentimes lags revenue growth (in the case of private equity – the "build-out" of the asset base). The private equity business has grown from a cottage industry to a mainstream asset class. This growth and the renewed focus on governance and quality of financial reporting has led to increased scrutiny and expectations on the part of institutional investors. There is also a concern of increased regulation. Harvey Pitt, the outgoing Chairman of the Securities and Exchange Commission, revealed in a recent speech that the private investment arena was under review by the Commission.

While certain aspects of private equity, like deal structuring and financing, are highly complex, the operations of a private equity fund are actually fairly straightforward. It is easy to understand why private equity managers seem to associate their business more closely with the operations of a small business, than with a multimillion/billion dollar investment asset manager. Most firms have traditionally been highly entrepreneurial organizations driven by the vision and skills of their founders. However, the significant fiduciary responsibility associated with investing substantial amounts of third-party capital creates a difference between the private equity fund sponsor today and a small business.

While sponsors are increasingly recognizing the need to institutionalize their organizations, including re-examining the infrastructure and business continuity plans for their own operations, progress has been slow. This progress has been impacted by concerns about costs, trepidation regarding the ability to close future funds and the need to justify an appropriate return on investment, the current economic climate (including softer market conditions for new fundraising), more time spent tending to the needs of portfolio companies, reduced carried interest distributions to sponsors and LP pressure on management fees.

In our capacity as private equity fund administrators, we have noted a substantial increase in the number of inquiries from the institutional investor community regarding processes, procedures and business continuity planning. Not surprisingly, requests on behalf of our new fund clients to complete gatekeeper checklists addressing reporting policies, procedures and infrastructure are on the rise.

Identifying, assessing and implementing change to a sponsor's infrastructure is not unlike those processes a sponsor employs when vetting a potential acquisition. In fact, many of the resources necessary to improve a sponsor's infrastructure substantially are often readily available within its organization.

The key to moving forward is to accept the fact that infrastructure

issues and business continuity planning should be a key concern of senior private fund management. At an implementation level, it is important to identify an individual or team of individuals with the proper level of authority who, while not involved in day-to-day operations, have significant operating experience. The individual or team must be empowered to make an assessment of business operations.

The following simple set of guidelines will help ensure that a fund sponsor's infrastructure has the requisite fundamental processes and controls in place to meet the core needs of institutional investors.

Identify critical processes:

- Fund raising
- Investor relations
- Investment identification, monitoring and harvesting
- Financial and investor reporting
- Risk management
- Technology

Take inventory of what you currently have in place. You should have:

- An organization chart
- A well-documented policy and procedures manual
- Documentation regarding your technology platform
- Business continuity plan
- Job descriptions
- Market-standard financial reporting processes and practices

Assess what you currently have:

- Is the organizational structure appropriate for your business model?
- Do your policies and procedures adequately address high-risk areas?
- Is there a formal escalation policy?
- Is compliance being maintained with your policies and procedures?
- Is the technology system you are using well supported and backed up at a secure location?
- Do you have the most up-to-date version of the technology being used?
- Is knowledge of the technology and access to key information limited to only one employee?
- Make an honest assessment of your team.
- Benchmark financial and investor reporting with other funds.

Reach out for accessible help:

- Meet with your auditors. Inquire of them as to their views on your internal controls and financial reporting.
- Speak to your professional team. Legal counsel and placement agents can be insightful.
- Borrow professionals from your portfolio companies. By way of example, we know of a fund sponsor that enlisted the help of a portfolio company's risk manager to develop the fund's business continuity plan.
- Consider outsourcing
- Speak to colleagues

Utilize the Multiple Resources

There has been a concomitant growth in the number of available resources to serve private equity fund sponsors as the industry has grown. Industry groups are cropping up to enable private equity managers to have a forum to share ideas and experiences.

When I started in private equity, Lotus 123 was the industry standard for private equity fund accounting and administration. Now, there are readily available software packages designed specifically for private equity fund administration. The expanded pool of advisors specializing in the private equity arena, including executive search firms as well as legal, accounting, communications and fund administration providers can be tremendous resources. Increasingly, outsourcing is being embraced as a best-practice solution for private equity fund administration.

As private equity fund administrators, we have noted a substantial increase in the number of inquiries from the institutional investor community regarding processes, procedures and business continuity planning.

Now Is the Ideal Time to Act

This is the time of year that funds close out their year-end accounts and the independent auditors commence their work. That makes it an ideal time for private equity sponsors to assess their internal infrastructure. The investment community is demanding action on these issues to ensure that sponsors and their portfolio companies are prepared for a range of formerly unthinkable scenarios. Firms with an institutional vision, will exercise leadership and heed their call.

— Steven Millner, Managing Director of New York-based DML, a BISYS company.

Minority Equity Investments in German Companies

2002 was a tough year for private equity investors in Germany, as in almost every other jurisdiction. "Total write-off" was the leading exit channel by volume for members of the German Venture Capital Association during the first half of the year, according to its managing director. The reasons for this result include the typical litany – differences in valuation expectations of buyers and sellers and difficult debt financing conditions made it harder to close deals, deteriorating economic conditions led to a number of restructurings and insolvencies of German portfolio companies backed by private equity funds and the capital markets remained essentially closed to IPO activity (six IPOs in 2002, as compared to 150 in each of 1999 and 2000).

But the mood among private equity professionals and their advisors in Germany is not sullen. As one might expect, investment bankers are even more optimistic[1]. Ninety-four percent of German investment bankers surveyed are confident that cheaper assets represent an opportunity for private equity firms. There is also a dramatic rise in the expectation of increased going-private transactions.

For many private equity firms, the main issue at the moment, however, is how to ensure an exit from current or new investments. The general view in Germany is that the IPO market is unlikely to warm up again before 2004. But even then, European markets may not be as vibrant as some are hoping. Strategic buyers are showing lukewarm interest – they often have their own issues to sort out.

Nevertheless, there is deal activity in Germany. In our own practice we have seen an increasing number of private equity firms effecting partial exits or restructurings by selling minority participations in portfolio companies. We expect this trend to continue – at least until strategic buyers and the public markets show more interest in the investments currently held by private equity firms. This article outlines some of the issues that have arisen in a number of recent of minority investments by private equity (and particularly venture capital funds) in German companies.

1 *In a survey (the Cinven Index) published in December 2002, nearly four out of five (78%) bankers expect private equity participation in the overall M&A market to increase across Europe (Germany 65% versus UK 89% and France 80%).*

Investment structures and Instruments

Minority investments in German companies by private equity/venture capital funds involve investment structures and investor rights very similar to those in the U.S. Typically, the fund will seek limited shareholder rights to protect its investment, such as supervisory board representation and information rights, assurance of equal economic treatment through such mechanisms as a tag-along right (a right to participate *pro rata* in any sale of securities by the controlling shareholder), pre-emptive rights to subscribe for new shares, and less commonly, rights of first refusal in respect of sales of shares by the controlling shareholder or shareholders.

However, in continental Europe, company laws and contractual rights, are quite different from those in the U.S., so that a number of typical U.S. private equity/venture capital investment structures or investor rights need to be adapted to local law or, in some cases, simply do not work.

German Structures

By way of background, the most common company forms in Germany are the limited liability company (*Gesellschaft mit beschränkter Haftung, "GmbH"*), the stock corporation (*Aktiengesellschaft, "AG"*) and a form of limited partnership with a GmbH as general partner (*GmbH & Co. KG*). In the case of a GmbH or a GmbH & Co. KG, it is possible to tailor financial, voting and other shareholder rights attaching to any equity interest or class of equity interests very much as the parties desire, whereas the rules governing an AG are more restrictive.

Equity investments in either an AG or a GmbH can take the form of either ordinary or preferred shares. Non-voting preferred shares are often used, but non-voting preferred shares may not constitute more than one half of the share capital of an AG. Minority investments in a GmbH & Co. KG typically take the form of non-voting limited partnership interests with such economic rights as are provided in the partnership agreement; the majority investor or sponsor then holds 100% of the GmbH acting as general partner, which often only has nominal economic rights.

In Germany, important features of securities that are standard and self-executing in the U.S., such as conversion or redemption rights, can only be implemented by means of shareholder voting agreements. While shareholder voting agreements are enforceable in Germany, there may often be a substantial delay in obtaining a judicial remedy in the event of breach and the need to hold a shareholders' meeting is in itself cumbersome. For example, in order to provide issuance of options or warrants to minority stockholders or to provide them with the benefit of conversion or subscription rights, a shareholders agreement must provide that the controlling shareholder will vote in favor of the required corporate action, which requires a 75% vote of

shareholders present at a shareholders' meeting at the time of issuance.

The role of pre-emptive rights in Germany, as in many continental jurisdictions, is far more problematic than in the U.S. Depending on the terms of the company's Articles, existing shareholders may have compulsory pre-emptive rights or pre-emptive rights that can only be eliminated by supermajority vote. The articles of association of an AG may provide for a greater or a lesser lower majority vote to issue common shares and, within certain limits, the management may issue shares in amounts and on conditions set forth in a shareholder resolution.

Convertible preferred stock does not exist in Germany. Conversion of preferred shares into common shares also requires 75% shareholders' approval and a separate 75% majority vote of the holders of the preferred shares, which could also be provided for in a shareholder's agreement.

Only an AG can issue convertible bonds. Otherwise conversion of a loan into equity can only take the form of a contribution in kind of the loan to the capital of the AG/ GmbH. A contribution in kind requires a valuation of the loan by a qualified auditor to ensure the loan is worth at least the nominal value of the shares issued as well as a shareholder vote. Again, as in most cases, the only enforceable mechanism for providing for such a contribution upon request of an investor would be a shareholder's agreement to vote in favor of a capital increase.

Corporate action to give effect to changes approved by shareholders also does not occur as swiftly in Germany as in the U.S. The issuance of new securities often takes up to four to six weeks (and occasionally even longer in Germany) because of the need to file with the local commercial register an amendment to the articles in the form of a notarial deed.

Trade Sales to Minority Investors. In the absence of access to capital markets, tag-along rights – whereby minority investors are granted the right to participate *pro rata* in trade sales by the controlling shareholders – currently constitute the principal means of ensuring an exit for minority shareholders. The clause is typically enforced by an irrevocable power of attorney authorizing the controlling shareholder to transfer legal title to shares of the other shareholders. In a number of recent transactions on which we have worked the minority investors have sought (without success) the right to sell all of their shares before the controlling shareholders can make a sale.

Controlling shareholders often seek a prohibition on sales by the minority investor for a specified period. While prohibitions on transfer for extended periods are not permitted under German law, prohibitions of reasonable duration (one to three years) should be enforceable. It is more common, however, for controlling shareholders to permit minority investors to make sales to third parties, but to retain rights of first refusal over such sales. Less frequently, minority investors seek first refusal rights in respected sales by other minority or controlling investors.

Drag-along clauses – whereby minority investors can be obligated to participate *pro rata* in sales by the controlling shareholders – are also standard in Germany. The clause is also typically enforced by an irrevocable power of attorney authorizing the controlling shareholder to transfer legal title to shares of the other shareholders. As an alternative, some investment agreements in Germany have required a shareholder resisting a drag-along to surrender some or all shares to the investor benefiting from the drag-along as a contractual penalty. However, this solution is less secure, since the sale would be delayed until the dispute is resolved and a contractual penalty may be set aside or reduced by a court.

Redemption. One common means to seek to provide exit from an investment in the U.S. is the use of redeemable preferred stock. Unfortunately, German company laws place extensive limitations on redemption. Although in some cases it may be possible to negotiate the equivalent of a redemption right through complex shareholder agreements, in most cases such contractual rights provide little real assurance of an exit by way of redemption and may also be subject to enforcement delays.

In Germany, redemption can take the form of a repurchase of shares (essentially a put option), or a reduction in stated capital (the aggregate nominal value of all shares issued) or a combination of the two. (There are other possibilities for withdrawing shares that are not relevant to this discussion).

Unless shares are to be cancelled following repurchase, an AG may only purchase its own shares pursuant to a specific shareholders' resolution passed no more than 18 months prior to purchase. A put option with a longer exercise period would require a share-

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In Germany, important features of securities that are standard and self-executing in the U.S., such as conversion or redemption rights, can only be implemented by means of shareholder voting agreements.

You're Not in Delaware: Directors' Liabilities in Major European Countries

You are a principal of a U.S. private equity firm, and you have been asked to sit on the boards of directors of several of its European portfolio companies. Before you make up your mind, you should know how companies in these jurisdictions are governed, as well as the extent of your duties and liabilities in these jurisdictions.

You are probably familiar with Delaware corporate law on these matters. You understand that a director of a Delaware corporation is subject to both civil and criminal liability for breaches of his/her duty of care or duty of loyalty, as well as for failing to comply with other applicable legal requirements, such as the federal securities laws. Nevertheless, you are comfortable that your personal liability is relatively limited in practice, through the application of the business judgment rule and the use of indemnification agreements and insurance policies.

It would be incorrect, however, to assume that company law in Europe is similar to Delaware law or even that a uniform approach exists among European countries. Although the rules in England may generally be similar (though not identical) to those in the U.S., the rules in France and Germany are quite different. Directors in a one-tier board structure (a single board of directors), or members of the management board in a two-tier structure (management board and supervisory board), face civil and even criminal liability in situations where liability would be unlikely in the U.S., including violations of certain provisions of corporate law, such as unlawful dividend distributions and "financial assistance."[1]

In view of these differences, we would recommend that, in France and Germany, where two-tier board structures are possible, they should usually be chosen and that representatives of private equity firms should generally serve on the supervisory board. Of course, if, through provisions of the articles of incorporation or a shareholders agreement, all or many of the ordinary course of business decisions generally made by members of the management board are in fact made by members of the supervisory board, there is a risk that the members of the supervisory board may be found to have assumed the responsibilities (and, accordingly, the liabilities) of the management board.

England

How are English Companies Governed?

As in Delaware, the management of English companies is vested in a single board of directors. The board of directors of an English company usually has extensive rights and responsibilities. Although the British government has expressed a commitment to reforming company law as a whole, including the law with respect to governance, this is still at the discussion stage. As in the U.S., English law is a composite of statutory and case law.

What are the Sources of Directors' Liabilities?

Directors' liabilities in England can arise from breaches of three categories of duties: (1) statutory duties, (2) the duty of skill and care and (3) fiduciary duties.

A director's statutory duties are principally contained in the Companies Act 1985 and the Insolvency Act 1986, both of which can impose personal as well as criminal liability in certain cases.

For example, violations of the financial assistance rules in the Companies Act 1985 can result in criminal liability, but, so long as certain "whitewash" procedures are followed, financial assistance can often be given in leveraged acquisitions. In addition, the Companies Act 1985 contains detailed provisions concerning fair dealing by directors that supplement and overlap with the common law rules.

In practice, the provisions of the Insolvency Act 1986 are likely to be of greater concern as they can impose personal liability on a director (or former director) to contribute to a company's assets upon liquidation where the director has been involved in wrongful or fraudulent trading. "Wrongful trading" is broadly interpreted and essentially means allowing a company to continue to do business when there is no reasonable prospect of avoiding an insolvent liquidation.

A director's duty of skill and care, set forth in case law, is owed to the company as opposed to its individual shareholders. Whether a director is meeting his or her duty of skill and care is determined by the higher of an objective standard (that of a reasonably diligent person having the knowledge, skills and experience that may reasonably be expected of a person carrying out the same functions) and a subjective standard (that of the actual general knowledge, skill and experience of the director involved).

1 Under an EU directive, it is illegal for the assets of an issuer to be used to provide financial assistance (directly or indirectly through loans or guarantees) in support of the purchase of shares of that issuer. There are exceptions to the rules on financial assistance in some EU countries, particularly in England, but it should be borne in mind that financial assistance issues almost always arise in leveraged acquisitions by private equity funds.

It is not common for a company to sue its directors for breach of the duty of skill and care, and there are fewer lawsuits brought against directors in England than in the U.S. The lower volume of litigation may also be the result of a lack of a clear form of derivative action. A law commission report on company law reforms in England recommended the establishment of a new and clearer form of derivative action, but that recommendation has not yet been acted upon.

The fiduciary duties of directors in England are also derived from case law. Except in limited circumstances, fiduciary duties are owed to the company as opposed to its individual shareholders. However, as a company approaches financial difficulties the interests of creditors become increasingly important. Examples of fiduciary duties include: (1) a duty of loyalty (to act in the best interests of the company), (2) a duty of independence (to exercise independent judgment in the best interests of the company) and (3) a duty of fairness (to act fairly as among shareholders). If a director breaches his fiduciary duty, the director may be liable to the company for any loss incurred and will be accountable to the company for any benefit received.

How can a Director be Protected from Liability?

In general, an English company may indemnify and insure its directors against liability. Liability insurance policies may cover the director's "neglect, omission or error," but only to the extent any loss incurred is not a result of the director's fraud or criminal act. Directors' liability insurance is increasingly common in England, and we would recommend its purchase for private equity firm principals (and others) serving on any boards in England.

France

How are French Companies Governed?

Significant French companies, including portfolio companies of private equity funds, are usually organized as stock corporations (SAs). A majority of these corporations have a single board of directors similar to the unitary board structure of a Delaware or English company.

French company law also permits French companies to have a two-tier board structure, consisting of a supervisory board and a management board. In this case, the supervisory board oversees the activities of the management board and the management board is responsible for the ordinary course business of the company.

In our experience, private equity firms are increasingly adopting two-tier board structures for their French portfolio companies and appointing their representatives to the supervisory board. We generally recommend this alternative because it means that the private equity firm principals (and others) are less exposed to potential civil and criminal liability (because their responsibility is limited to supervising the management board), while still allowing the private equity firm's representatives to exercise an oversight role.

What are the Sources of Directors' Liabilities?

Members of the board of directors of a French corporation (in the case of a one-tier board structure) or the management board (in the case of a two-tier board structure) are subject to both civil and criminal liability. Directors are subject to civil liability in connection with acts or omissions: (1) committed in violation of statutory or regulatory provisions, (2) violating any provision of the corporation's articles of incorporation or bylaws or (3) attributable to "errors" in management. Directors are also subject to criminal liability in

> *In France and Germany, where two-tier board structures are possible, they should usually be chosen, and... representatives of private equity firms should generally serve on the supervisory board.*

various circumstances (including not only what U.S. lawyers would view as breaches of fiduciary duty, for example, using corporate funds or assets in a manner known to be contrary to the interests of the corporation, but also for violations of certain provisions of corporate law, such as unlawful dividend distributions, financial assistance and the requirements with respect to the issuance of shares).

In the early 1990s, Nasa Electronique S.A., a French company whose investors included a well-known English private equity fund, was involved in a leading French case concerning directors' liabilities. The French court found that the board of directors (Nasa had a one-tier board structure) was aware of questionable management decisions and did nothing to prevent them. Subsequently, Nasa and its subsidiaries declared bankruptcy. The French court held all the directors jointly and severally liable for an amount in excess of FF 400 million (approximately $53 million), but did not find criminal liability on the part of the board members. The English private equity fund had only a 5% shareholding in Nasa and had appointed only one of its seven directors.

In contrast to members of a management board, members of a French supervisory board are only subject to civil liability for acts or omissions

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Ability to Penetrate Foreign Markets. Joining a local firm in a transaction based in a foreign market might provide a good introduction to that market for a private equity firm that has not previously (or regularly) invested in that market. Collaborating with a local private equity firm could reduce the risk of investing in a new geographic area.

Before participating in a joint bid or joining a "club," private equity investors should understand the complications involved – both at the bidding stage and if the bid is ultimately successful.

Preliminary Deal Matters. Before joining a bidding process, each party should consider the following issues:

- ***Exclusivity.*** What holds the bidding group together? Will they be exclusively tied to each other? Until the auction is over, or only until a certain date, or until they disagree on fundamental terms or strategy? Can they switch partners mid-stream? Who decides to admit a new member?
- ***Bidding strategy.*** How should the bidding be handled? Should the indication of interest range include a stretch price, dependent on due diligence findings? Do the club members agree on the highest price that they are willing to pay?
- ***Role of management.*** What opportunities and incentives are the bidders willing to offer to management to work with them in the selection process?
- ***Negotiating control.*** Who will control the bidding process? Should there be a "lead" investor? Should it necessarily be the firm that will contribute the most equity or that initiated the transaction, or perhaps another club member with a strong relationship with management? Private equity firms tend to operate by consensus. Should one individual at each firm be responsible for making decisions for that firm so that the process works smoothly?

Before participating in a joint bid or joining a "club," private equity investors should understand the complications involved – both at the bidding stage and if the bid is ultimately successful.

Relationships with advisors, including the investment banker (if any), the accountants, outside counsel, etc. How will advisors be selected? Often each member of the group selects one of its traditional advisors, such as accountants or counsel, although sometimes "neutral advisors" are chosen so that each member of the group has the same degree of relationship with the advisors. In choosing outside counsel, we have found that the club is best served by selecting counsel not only with private equity M&A experience, but also with an understanding of the special requirements of the private equity funds (*e.g.*, tax, ERISA, partnership agreement investment restrictions) and their investors, which will be providing the equity in the transaction.

Financing structure. While determining the amount of equity that each club member commits to should be fairly easy, other aspects of the financing structure can be more problematic. For example, some club members may be prepared to "bridge" some of the purchase price from their funds, while others may not be permitted to do so or may prefer other alternatives. Determining the overall financing structure, including the debt sources, is something the club members should carefully review. Are the co-bidders in agreement on the degree of financing certainty that is acceptable for their bid? Are club members willing to pay for commitments from financing sources, or can they rely on historical relationships to obtain the requested commitment letters?

Allocation of expenses. If the transaction is not successful, how will the club members allocate the "dead deal" costs?

Allocation of any break-up fees. If the transaction is not successful, how will the club members share in any break-up fees?

Participants in a joint bid also need to have tackled a number of other issues before submitting their bid in order to feel confident that they will have a good working relationship with the co-investors if the bid is successful.

Governance Rights. Among the most important issues to be addressed are governance rights. The allocation of governance rights among the club members will be a function of, among other factors, their relative equity stakes in the company, their relative bargaining positions, their expertise in the business or some combination thereof. Matters to be covered in allocating governance rights among club members include:

- ***Board representation and committee membership,*** including chair positions, replacement procedures and adjustments to board representation when investors' equity stakes change. Jointly selected independent directors should be considered to round out the Board. If the company is going to issue public debt, care should be taken to have directors that will meet Sarbanes-Oxley requirements. Investors that are

private equity funds may be required to obtain rights to board seats to satisfy the venture capital operating company (VCOC) exemption from the plan asset regulations under ERISA.

- ***Supermajority voting rights and veto rights.*** The club members should first decide the matters, if any, that will require a supermajority vote of the Board. Items for consideration might include new equity issuances, payment of dividends or other distributions, sales or purchases of significant assets, extraordinary corporate transactions such as mergers or joint ventures, CEO hiring and firing, transactions with affiliates (including deal and management fees), and exits from the investment. Veto rights may also be appropriate in some transaction but, particularly in a club with three or more members, might tend to create logjams. In 50/50 club deals, the club members should devise mechanisms for dealing with deadlock, perhaps by having independent directors on the Board.
- ***Anti-dilution protection: preemptive rights, warrants and convertible stock.*** In order to provide dilution protection, private equity firms typically consider preemptive rights, convertible securities and/or veto rights over new security issuances by the company. In some instances, participants will not know if they will be able to provide additional capital to maintain their *pro rata* interests when new equity infusions are required because they are close to completing the investment of a fund's capital or are in jeopardy of running up against diversification limits. In those circumstances, the private equity firm might want to put the investment in a new fund (subject to limited partner approval) or permit its prior fund's limited partners to participate directly. Because participants in a club transaction may have different abilities to provide additional capital and/or may require limited partner approval for follow-on investments, these constraints should be analyzed when the transaction is structured initially.
- ***Information and observation rights.*** A minority investor that is unable to secure board membership should insist upon having information rights – the right to inspect the company's books and records and the right to receive financial reports and other periodic disclosures, for example – and/or observation rights for purposes of satisfying VCOC requirements.
- ***Allocation of deal and management fees among the club members.*** This issue is close to the hearts of private equity investors and should be resolved early in the process. Many private equity firms charge investing banking, origination, directors and monitoring fees to their portfolio companies. If the transaction is successful, which firms may charge which fees? When? How much? Because different investors will hold different percentages of the equity post-closing (and thus effectively bear different percentages of fees charged), and because some private equity firms share larger percentages of fee income than others (and thus may be less anxious to charge transaction fees, for example) this can be a contentious issue.

Portfolio Company Management, Exit Strategy, etc. Once a transaction is completed, participants in a club deal may face challenges because of the nature of joint ownership. To enhance the likelihood of a smooth working relationship, club members should discuss operating philosophies at the outset of the deal. That means, for example, sharing a common understanding of the company's business and growth plans and the appropriate strategy for achieving such goals. Among the items to be considered are:

- ***The company's strategic plan.***
- ***The management team.*** The club members should focus on the management team: Is it strong? Does it need supplementing, especially if the transaction is a divestiture?
- ***The optimal management incentive mechanisms.*** The club members should agree on the various incentivization approaches (stock purchase, options, warrants, bonuses, etc.) that most closely align managers' incentives with the club members' financial objectives.
- ***The courses of action to follow if the company starts performing poorly.*** For example, is there someone at one of the participants' firms who could run the business on an interim basis if a management change is required?
- ***Exit strategy.*** The club members should determine whether they have roughly similar time horizons and target rates of return on the investment.

Limited Partner Reaction. In deciding whether to participate in a club deal, a private equity firm should consider the potential reactions of the limited partners in its funds. Limited partners that are investors in funds that jointly acquire a business may take issue with the way the transaction impacts them, regardless of the merits of the transaction.

- ***Anti-diversifying effect.*** For limited partners, club deals may have an anti-diversifying effect by increasing their risk exposure when multiple private equity firms in which they are investors invest in a single portfolio company. Limited partners may find themselves "over-invested" in a transaction in which several of their private equity managers have jointly participated.

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Questions to Ask Before You Join a Club (continued)

- ***Control investing.*** Some limited partners expect (by agreement or otherwise) the private equity firms in which they invest to participate primarily in control investments. If a private equity firm engages in more than an occasional club deal in which it is a minority player or 50/50 investor, it might fail to satisfy the expectations of its limited partners who anticipate that it will engage mostly in control transactions.
- ***Cross-ownership problems.*** Limited partners that are invested in a single transaction through multiple private equity firms may be subject to unanticipated tax treatment in certain exit transactions unless sponsors carefully monitor the situation. In addition, such cross-ownership issues may limit exit alternatives.
- ***Management fees.*** Limited partners may feel that private equity firms that participate primarily in club deals should receive a lower management fee because such limited partners may view participation in club deals as devaluing what the "deal finders" bring to the table.

Put and Call Rights. If a strategic investor is participating with private equity firm(s) in a club deal, the parties should consider whether to include put and call rights in the shareholders' agreement. Such rights could be structured to enable the private equity firm(s) to require the strategic partner to buy out the private equity firm(s) at an agreed upon multiple or to permit the strategic investor to acquire a larger stake (through exercise of a call right) at an agreed-upon IRR. Such arrangements are much less typical in club deals solely among private equity firms.

Large club deals appear to be a permanent part of the private equity landscape. Private equity firms that anticipate participating in such transactions should do some careful planning in order to structure those investments in a way that avoids surprises and conflict between both club members and their limited partners.

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Shark Repellents That Can Bite (continued)

PortfolioCo board approval, because otherwise either BuyerCo will trigger the pill or be forbidden from completing an acquisition of PortfolioCo for three years.

The board approval requirement is not just ministerial. Based on recent case law (see "Goodbye to Lock-Ups?" in this issue), the board of a Delaware company will likely be unable, on fiduciary grounds, to approve the lock-up agreement if it would, as a practical matter, preclude a higher bid by a third party. But if PortfolioCo has no pill and is not subject to Section 203, BuyerCo could freely enter into a lock-up agreement with the sponsor and then launch a tender offer for all of PortfolioCo's shares – without any involvement by PortfolioCo's board other than its need to make a recommendation about the offer.

Foregoing a poison pill and applicability of Section 203 should not seriously compromise the ability of a company to defend against a coercive takeover attempt. The board could always decide to adopt a poison pill down the road, once a specific threat materializes – and if a company has a pill, it shouldn't also need Section 203.

We looked at a selected group of 21 IPOs by U.S. portfolio companies of private equity sponsors over the period May 1996 to January 2003. Of that group, at the time of the IPO, eight companies (or 38%) opted out of Section 203 and did not adopt a pill. Another eight companies were subject to Section 203 but did not adopt pills, and five companies were subject to Section 203 and adopted pills – meaning that 62% were subject either to a pill, to Section 203 or both. Down the road, it is possible that at least some of those firms will wish their companies did not have those particular shark repellents.

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the company or the controlling shareholder. In one case, *Kahn v. Tremont Corp.*, 694 A.2d 422, 426 (Del. 1997), the Delaware Supreme Court concluded that even though the going-private transaction was approved by an independent committee, the controlling shareholder still had the burden of proving that the transaction was "entirely fair," in part because the committee member with the closest ties to the controlling shareholder chose the advisers, and the target company's general counsel, who was also general counsel to the controlling shareholder, suggested the committee's legal advisors. In another case, the Delaware court characterized as "not helpful" the fact that the special committee's investment banker was recommended by the controlling stockholder's counsel.

Similarly, the advisors to the special committee should be independent of the company and the controlling shareholder. In selecting its advisors, the special committee should inquire into whether a prospective adviser has done business for, or is otherwise beholden to, the controlling shareholder. Often the financial adviser will be part of a multi-function financial services organization, in which case the special committee should consider ties and business relationships of affiliates of the financial adviser (for example, banking relations, underwritings or other advisory relationships). Past or even present business relationships between the advisor or its affiliates and the controlling shareholder need not necessarily disqualify the advisor, but such relationships should be carefully scrutinized by the special committee and, if the transaction is subject to shareholder approval, will need to be disclosed.

Recordkeeping

To establish that the special committee has done its work carefully, a careful record of the meetings of the Committee, including telephonic meetings, should be kept, with appropriate minutes reflecting the members' knowledge of Target's business and their careful consideration of the issues. The courts will consider whether the members of the special committee were diligent in reviewing and negotiating the transaction and may give little weight to the determination of the special committee if it concludes that the committee did not do its job properly. For example, in Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997), the Delaware Supreme Court noted the lack of attendance and diligence by some committee members as part of the basis for its conclusion that the defendants retained the burden of showing the entire fairness of the transaction, despite the use of a special committee.

There are many benefits to be gained to negotiating a transaction with a special committee of independent directors: It can serve to shift the burden of proof on the question of "entire fairness" under Delaware law. It can help convince shareholders to vote in favor of the transaction or to tender their shares. It can be used to deflect public criticism that the transaction is coercive or unfair. However, these benefits can be obtained only if the special committee is established and functions appropriately, including by giving proper attention to the matters outlined above.

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UPDATE: Removal of the UK 20-Partner Limit

As a follow-up to the Alert in our Winter 2002 issue, the UK government, acting through the Department of Trade and Industry, abolished the 20-partner limit on general and limited partnerships effective December 21, 2002. This amendment, which came sooner than anticipated, removes the need to establish and operate a series of parallel partnerships, each containing no more than 20 partners. This should considerably reduce the administrative complexity and cost of establishing and operating English partnerships for investment purposes.

contributed to the partnership to satisfy the partnership's liabilities and obligations. For example, capital contributions returned to an investor in the fourth year of a fund's 10-year term are subject to recall for six more years, or longer if the fund's term is extended for one or two additional years, as partnership agreements commonly allow. (Note that it is the amount of the limited partner's returned capital contribution, plus any capital commitments still uncontributed, that the limited partner is liable for prior to the dissolution of the partnership, not the amount of any gains or profits received in connection with the returned capital.)

As a commercial matter, U.S. and European private equity funds have traditionally negotiated limits on the amount of distributions to investors that may be redrawn by the fund to satisfy the fund's liabilities (the so-called "LP clawback"). LP clawbacks are relatively common in U.S. private equity funds, subject at times to limitations on the duration of the provision and/or the amount or percentage of distributions that may be recalled or clawed back. LP clawbacks are relatively uncommon in UK and other European private equity funds.

If investor commitments to English limited partnership funds were structured as they are in the U.S. (*i.e.*, as capital commitments), English limited partnership law would frustrate the commercial agreement negotiated between the sponsor and the investors – namely that distributions to limited partners are not subject to recall or being clawed back except as specifically provided in the partnership agreement.

European private equity funds organized as English limited partnerships solve this problem by splitting an investor's fund commitment into two components: a large loan commitment coupled with a small capital commitment. Loan commitments make up more than 99% (often 99.999%) of an investor's total commitment to a private equity fund. The remaining 0.001% of the investor's commitment is in the form of a capital commitment contributed at or soon after closing. In accordance with the terms of the partnership agreement, this nominal capital contribution is not returned to the investor until the fund's final, liquidating distribution and dissolution. Therefore, at no time during the life of the fund is the investor liable for returning even this nominal capital contribution because it has not yet been distributed by the partnership.

Loan commitments are drawn down from time to time in accordance with the terms of the fund's partnership agreement in the same way that capital commitments are drawn in a U.S. fund. These contributions, in the form of loan advances, are made to the fund on an interest-free basis and all distributions of investment proceeds made by the fund to its investors are treated as a repayment of the principal amounts of the loans advanced or as a distribution of profits realized from gains on the sale of portfolio investments.

If an investor making a loan commitment to an English private equity fund is a U.S. taxpayer, the investor must treat the loans to the fund as equity for U.S. tax purposes. Sponsors of such UK private equity funds are advised to include a covenant in the partnership agreement requiring U.S. investors to report the loans as equity for U.S. tax purposes.

Carried Interest Distributions: Where and When

Another difference between UK and U.S. funds is where the carried interest is distributed. The standard practice in the U.S. is for the general partner to receive the carried interest (*see Figure 1*). In an English limited partnership structure the carried interest vehicle is a limited partner, often called the "founder partner" (*see Figure 2*).

When the English partnership is first established, and then at each closing with the fund's investors, the founder partner contributes to the partnership 20% of the capital commitments of the fund (i.e., 20% of the 0.001% equity), but not 20% of the loan commitments. In exchange for contributing 20% of the "equity," the founder partner receives 20% of the profits (the carried interest). For example, if the fund's total commitments are £500 million (£499,995,000 loan commitments and £5,000 capital commitments), the founder partner contributes £1,000 (20% of £5,000). If the fund's cumulative profits equal £400 million, then the founder partner receives carried interest equal to £80 million on an investment of £1,000.

Note that the timing of the distribution of the carried interest tends to be different in UK and U.S. funds. In the UK and elsewhere in Europe, private equity funds usually make distributions by returning all contributions made by investors (plus the hurdle/preferred return) before making any carried interest distributions. In the specific context of an English limited partnership, amounts returned first include the return of all loan advances, but not the small capital contribution that is returned at dissolution.

In the U.S., LBO funds and, to a lesser extent, venture capital funds, often make distributions to investors on a net "deal-by-deal" basis. Net deal-by-deal distribution arrangements allow for the possibility of distributing carried interest earlier in a fund's term because distributions of carried

interest with respect to gain on the disposition of a particular portfolio investment may be made at the time that such portfolio investment is realized, provided that realization proceeds are sufficient to return to investors the cost basis of such investment, plus related expenses and the hurdle thereon, plus any prior shortfall not already returned to investors.

The timing of carried interest distributions is the principal economic difference between UK and U.S. private equity funds; however, this difference between the two markets is purely commercial and is not related to any inherent legal differences between Delaware and English limited partnerships.

General Partner Profit Share (Management Fee)

The form of the management fee also distinguishes UK private funds from their U.S. cousins. In a U.S. fund, the fund pays the management fee to the manager pursuant to a management contract. In a UK private equity fund, the equivalent of the annual management fee is structured as an annual guaranteed profit share (in addition to the carried interest) drawn periodically by the general partner. Even in the early years of the fund's term, when there may not be any profits, the general partner's profit share is distributed and recorded as a charge against the fund's future profits.

The reason is tax-related: structuring the distribution to the general partner as a guaranteed share of the fund's profits reduces the risk that UK value-added-tax (VAT) of 17.5% is imposed on this annual amount distributed by the fund. Because private equity funds do not engage in any business other than investing, they do not provide services to anyone and therefore cannot charge VAT to offset any VAT that they must pay out. Given the amount of the general partner's profit share over the life of a fund – somewhere between 10% and 20% of commitments – it is important to minimize the amount of unrecoverable VAT. The absence of a VAT regime in the U.S. makes it unnecessary for U.S. private equity funds managed from within the U.S. to adopt a similar structure with respect to amounts paid by the fund as management fees.

Although the general partner of a UK private fund receives the annual profit share, it does not generally retain such profits. The cash from the profit share is used for the same purposes as the management fee received by the manager of a U.S. fund – to pay the overhead and other expenses of the fund sponsor or manager, including rent and salaries of the firm's investment professionals. Those salary and other overhead costs and expenses are incurred largely by the UK manager, which is appointed by the general partner as the fund's manager. Pursuant to a services agreement between the general partner and the manager (*see Figure 2*), which is similar to the services agreement between a U.S. fund and its manager (*see Figure 1*), the UK manager charges the general partner a fee for providing managerial, advisory and administrative services. The general partner's payments to the manager are not generally subject to VAT because the general partner and the manager are part of the same VAT group.

Parallel Partnerships and Elimination of the 20-Partner Limit

One of the cumbersome aspects of UK funds and the English limited partnership structure has been the long-standing prohibition (dating back to 1856) against having more than 20 partners in an investment partnership. Although the limitation was recently removed (see the "Update" elsewhere in this *Report*), many UK funds and their sponsors have not yet taken advantage of the removed ceiling and continue to operate their funds as a series of parallel partnerships, each with no more than 20 partners. U.S. fund sponsors also structure their funds using parallel vehicles on occasion, but only when necessary to address tax, regulatory or other issues related to specific investors or portfolio investments.

UK fund sponsors traditionally used the parallel partnership structure not only to comply with the 20-partner rule, but also to channel certain categories of investors into the same partnership vehicle and then customize the relevant partnership agreement to accommodate the unique requirements of the particular investor group. For example, UK funds organized as a series of parallel English partnerships often establish a single partnership dedicated to U.S. investors with a partnership agreement that includes specialized terms (*e.g.*, VCOC covenants and ERISA withdrawal rights for U.S. pension plans; transfer clauses tailored to U.S. tax rules on publicly traded partnerships; limitations on UBTI for U.S. tax-exempt investors).

Documenting and administering multiple parallel partnerships adds unwelcome complexity to managing a fund: (1) a co-investment agreement among the various parallel partnerships to ensure *pro rata* participation in investments is needed, (2) "true ups" within each partnership and between partnerships to take into account expenses and portfolio investment dilution related to subsequent closings with fund investors can be complicated and (3) going forward, the fund is burdened with a more difficult drawdown and portfolio acquisition process.

Elimination of the 20-partner limit for English partnerships should allow UK private equity funds and their sponsors to move closer to the administratively simpler U.S. fund model that uses parallel vehicles less frequently and relies more on a single, integrated partnership agreement for both U.S. and non-U.S. investors.

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holders' agreement to periodically vote upon a new resolution approving repurchasing. The shares acquired and any other shares already acquired and still held by an AG also may not exceed 10% of AG's company's share capital. (There is no such limitation if an AG acquires its own shares on the basis of a shareholders' resolution in connection with a subsequent redemption of such shares through a reduction of share capital, but a reduction of share capital can be a burdensome, time-consuming process and is not always practicable.)

In the case of a GmbH, a repurchase at above market value pursuant to a put option may possibly be deemed to be an illegal dividend that must be repaid by the shareholder.

In the case of both a GmbH and an AG, a share repurchase or a reduction in capital out of accrued profits and free capital reserves may only be made to the extent that there is shareholders' equity which exceeds stated capital (the aggregate nominal or par value of outstanding shares) and legal reserves—in other words only to the extent there are accrued profits and premiums on share issuance on the company's books. In the case of a start-up or a loss-making company, there very often will be insufficient shareholders' equity to satisfy this requirement, so that a "put option" has little real practical value as a means of ensuring exit.

A redemption of shares of either a GmbH or AG by way of reduction of share capital also requires a resolution of the shareholders' meeting. The shareholders can commit themselves in a shareholders' agreement to pass a resolution on the cancellation of an investor's shares upon request by the investor or upon occurrence of certain objective events, such as specific revenue targets being met.

However, an ordinary reduction of share capital of an AG or GmbH from nominal capital (as opposed to profits and free capital reserves) is quite cumbersome and generally takes more than six months.

Shareholder Agreements

As noted above, in many cases minority rights which would normally be embedded in the organizational documents of a U.S. portfolio company must, in the case of German companies, be set forth in a shareholder or investment agreement. However, care must be taken to structure these agreements to avoid having them characterized as partnership agreements. In such a case, each shareholder would have the right to terminate the partnership without notice unless the agreement is entered into for a fixed period of time. It is therefore preferable to avoid a mutual undertaking by all shareholders to cooperate to achieve a specified exit or other goal, which might suggest that a partnership exists.

A different tax concern in this context has arisen in connection with the recent German tax reforms: the non-deductibility of interest under the amended anti-thin-capitalization rules pursuant to Section 8a Para. 3 sentence 3 KStG (Corporate Tax Act). Those rules apply to shareholder-lender loans provided that the shareholder holds directly or indirectly more than 25% of capital. Separate minority investors bound by mutual shareholder obligations under a shareholder or investment agreement may possibly be viewed as a single, greater then 25% investor, for this purpose.

In addition, dividend withholding taxes may be created because German law treats disallowed interest under the new rules as "constructive dividends" to which dividend withholding tax applies. In the absence of a tax treaty, the withholding rate would be a little above 21%. Tax gross-up clauses in investment agreements may provide relief, but are obviously not tax efficient. It is preferable to avoid the issue altogether through careful drafting of shareholder and investment agreements.

Management Rights Agreements

An AG has a two-tier management structure, with a management board that is responsible for the operations and a supervisory board that oversees the activities of the management board. The supervisory board elects the members of the management board. A GmbH is only required to have a supervisory board if it has more than 500 employees or if provided for in the articles of association.

Private equity funds that receive a significant portion of their capital from U.S. pension plans typically seek to operate as a venture capital operating company (VCOC) in order to qualify for exemption from certain requirements of the U.S. Employee Retirement Income Security Act of 1974 (ERISA). One of the requirements for funds to qualify as VCOCs is that at least 50% (by cost) of their investments include the right to participate substantially in the management activities of the portfolio company, which is often most easily satisfied by the fund obtaining the contractual right to appoint a member of the company's Board of Directors. In the case of German companies, the appropriate board would be the Supervisory Board rather than the Management Board. Management Board members are responsible for day-to-day operations and face significant risks of personal liability for a number of corporate

actions, such as delay in declaring bankruptcy upon an insolvency or over-indebtedness or making interest, royalty or other payments to shareholders that are later found to be disguised dividends.

Under the German worker co-determination law and the works constitution laws, respectively, half of the members of supervisory board must be workers' representatives if a company has more than 2,000 employees, and a third if the company has less than 2,000 but more than 500 employees. In such cases, controlling shareholders are usually unwilling to give a board seat to minority investors. However, contractual rights to participate as observers in Board meetings, to obtain information on the company's business and to meet and consult with management should usually be sufficient to qualify for VCOC status.

IPOs

Only securities (shares or bonds) issued by an AG may be listed on a German stock exchange. Thus, if an initial public offering is planned, an investment vehicle organized as a GmbH or a GmbH & Co. KG must be converted into an AG prior to the offering. In the case of a GmbH, this requires a 75% majority vote of the shareholders present at the shareholders' meeting. It is not possible to evade the 75% voting majority requirement by delegating the decision to convert into an AG to the directors or by providing for a contingent automatic future transformation. However, shareholder agreements to vote in favor of a transformation proposed by one of the shareholders are enforceable (although, as previously noted, judicial enforcement can involve substantial delay).

In Germany (and Europe generally), there is no "registration" of shares with the securities authorities. Instead, an entire class of shares (common or preferred, for example) are simply listed by application to the relevant exchange accompanied by an approved prospectus. Minority investors therefore do not require registration rights unless an offering on the U.S. is contemplated.

Most observers expect the German capital markets to return to life sometime in 2004. However, one permanent casualty of the current downturn has been the once glamorous Neuer Markt, which had served as the platform for the initial public offerings of numerous telecommunication, media and technology companies, among others in 1999 and 2000. On November 19, 2002, the Exchange Council of the Frankfurt Stock Exchange (FSE) approved the merger of the Neuer Markt into the FWB and a new segmentation of the FWB equity market of the FSE. As of January 1, 2003, the FSE is divided into established two new market segments, the Prime Standard and the General Standard. The Neuer Markt and Small cap (SMAX) segments will be discontinued by the end of 2003.

The Prime Standard includes companies that wish to target international investors. Companies listed in the Prime Standard must meet high international transparency criteria, over and above those set out by the General Standard, such as quarterly reporting, application of international accounting standards or U.S. GAAP, analyst conferences and English language for current reporting and ad hoc disclosures. The General Standard segment is aimed at smaller and mid-sized companies that predominantly attract domestic investors and are interested in an inexpensive way of being and staying listed.

In general, this change in market structure will have little impact on the ability of private equity funds to exit by initial public offering, although a return to the heady heyday of the Neuer Markt is unlikely. Most existing Neuer Markt companies will be listed in the Prime Standard Segment and private equity/venture capital sponsors seeking maximum returns are also likely to apply for the Prime Standard segment. Whereas the current regulations relating to the specific market segments of the Frankfurt Stock Exchange are contained in the civil law statutes of the FSE, future regulations will be promulgated by the federal government which is expected to reassure investors and ensure a better and more effective enforcement of such rules by public law.

As in the U.S., in the wake of the recent accounting scandals, the German government plans to significantly revise German securities laws, in particular to fight balance-sheet fraud. More detailed plans are expected to be presented in a joint press conference of the Federal Departments of Finance, Justice, Economics and Labor in the first quarter of 2003. Thus, investors should expect some tightening of the regulatory framework and greater scrutiny of transactions by regulators.

Although Germany may provide some attractive opportunities for private equity investors to make minority investments in German companies, those investors accustomed to investing in the U.S. should carefully structure investments that will provide them with the legal protections and economic rights that they expect. In general, through contractual agreements, many of the features of the U.S.-style securities and investments can be replicated, but there may well be additional delays and risks that need to be accommodated. ▫

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committed in the exercise of their duty to supervise the management board (but not for acts or omissions in the management of the company itself). In certain limited circumstances, supervisory board members may face criminal liability. Criminal liability may be found in the case of acting in complicity with the management board (for example, not disclosing irregularities in the financial statements of which the supervisory board had become aware).

How can a Director be Protected from Liability?

French companies may take out insurance to protect their directors (or supervisory or management board members) against civil liability only. The insurance may not cover liabilities relating to personal benefits received by a director to which he was not entitled, his intentional or willful wrongful acts or omissions, or claims of which he was aware prior to the issuance of the insurance policy. Liability insurance for directors and members of supervisory boards is increasingly common in France, and we would recommend its purchase for private equity firm principals (and others) serving on any boards in France.

Germany

How are German Companies Governed?

German stock corporations (AGs) have a two-tier board structure that consists of a supervisory board and a management board. The supervisory board oversees the activities of the management board. The management board is responsible for the ordinary course business of the corporation and represents the corporation in its dealings with third parties.

Most German private companies, including German portfolio companies of private equity funds, are organized as limited liability companies (GmbHs). Unlike German stock corporations, German limited liability companies are not required to have a two-tier board structure unless they have more than 500 employees. The shareholders of limited liability companies, however, may choose to have a "voluntary" supervisory board and may elect to limit the liability of the "voluntary" supervisory board to damages resulting from intentional acts or gross negligence. Unless the shareholders have limited the duties and liabilities of a limited liability company's "voluntary" supervisory board, the provisions of German law applicable to stock corporations apply to them as well.

German limited liability companies may also have an advisory board (*Beirat*). (Advisory boards are not as common for stock corporations because advisory boards would be in addition to the required supervisory boards.) The role and function of the advisory board is not governed by statute and is determined by the shareholders. In our experience, private equity firms tend to appoint their representatives either as members of the supervisory boards (or advisory boards) of their German portfolio companies. We generally recommend this alternative because the supervisory board's role (and usually the advisory board's role) is limited to overseeing the management board, and thus there is less potential civil and criminal liability for private equity firm principals (and others) serving as members of supervisory (or advisory) boards in Germany.

What are the Sources of Directors' Liabilities?

Members of a supervisory board are only liable for acts or omissions committed in the exercise of their duty to supervise the management board (but not for acts or omissions in the management of the corporation itself). Members of the management board also face civil and criminal liability for their acts or omissions, including violations of certain provisions of corporate law, such as unlawful dividend distributions, financial assistance and the failure to make a timely filing for insolvency.

One of the largest German cases concerning director liability in Germany in the 1990s was the bankruptcy of Balsam Aktiengesellschaft. In the Balsam case, not only were the members of the management board of Balsam sentenced to jail for two to ten years, but a member of the supervisory board was held civilly liable for failing adequately to supervise the actions of the management board. Although the supervisory board member in question had heard rumors about a fraudulent transaction involving the company and the worsening financial situation of Balsam, he did not investigate these stories. The German courts held the supervisory board member liable for the damages of approximately DM 5 million (approximately $2.2 million).

As shown in the Balsam case, a member of the supervisory board is liable for negligently or intentionally failing to exercise: (1) the duty of care (in supervising the management board and acting in the best interests of the corporation) and (2) the duty of loyalty (putting the corporation's interests first). The members of a supervisory board are also criminally liable in a limited number of circumstances (for example, aiding and abetting fraud), but generally not for the acts or omissions of the members of the management board.

The extent of potential liability of the members of the advisory board may differ depending on the structure of

Comparative Points Under Delaware, English, French and German Law

	Delaware corporations	English private limited companies	French corporations (SAs)	German corporations (AGs)
What is the corporate governing body?	Board of directors	Board of directors	Either board of directors or supervisory board and management board	Supervisory board and management board
What are the sources of liability?	Breaches of the duty of care or the duty of loyalty and failing to follow applicable legal requirements	Breaches of statutory duties, the duty of skill and care and fiduciary duties	Failure to supervise the management board (for supervisory board members)	Breaches of the duty of care and the duty of loyalty (for supervisory board members)
May criminal liability be incurred?	Yes	Yes	Yes, but in limited circumstances for supervisory board members	Yes, but in limited circumstances for supervisory board members
Do companies take out directors' insurance?	Yes	Yes	Yes	Yes

the advisory board and its duties, both of which are determined essentially by the shareholders. If the advisory board of a German company assumes the functions of a supervisory board, the potential liability of a member of the advisory board will be similar to that of a member of the supervisory board.

How can a Director be Protected from Liability?

In Germany, lawsuits against supervisory board members for breach of their duties are extremely rare outside of insolvency because of the difficulty in proving breaches of such duties. Procedural and practical limitations include the following: (1) shareholders may assert claims against the supervisory board only if their losses differ from those suffered by the corporation and (2) the difficulty in proving the supervisory board's malfeasance leads to a reluctance in bringing a case against it because the losing parties bear the entire cost of the litigation.

Subject to certain limitations, a German corporation may agree (1) to indemnify the members of the supervisory board or (2) to waive or compromise a claim of damages against the members of the supervisory board (though in respect of a statutorily required supervisory board this may be done only after the passage of three years). German companies may take out insurance to protect their management board and supervisory board members against civil liability and, in certain circumstances, even against criminal liability. Liability insurance for directors and members of supervisory boards is increasingly common in Germany and we would recommend its purchase for private equity firm principals (and others) serving on any boards in Germany. (There is some question as to whether payment of the premiums by the company constitutes taxable income in Germany to the director or other board member.)

A Final Word of Warning

The law and practices in Europe as to directors' duties and liabilities are substantially different from Delaware law and there is no pan-European approach. Company law in Europe is in varying stages of reform or modification.

Despite the fact that the Sarbanes-Oxley wave of corporate governance reforms may not apply to those serving on the boards of European portfolio companies (although they may if high-yield bonds or other securities are publicly offered in the U.S.), private equity firm principals serving as directors or members of supervisory boards need to make certain that they are aware of the applicable rules of, and are following best practices in, the country in question. Moreover, as the rules and practices are evolving, private equity firm principals should make certain that a system is in place so that they are notified by the portfolio company and its counsel of important changes in the rules and practices.

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alert

Goodbye to Lock-Ups?

A recent Delaware Supreme Court order may have a big impact on private equity firms that own large stakes in public companies.

Private equity funds increasingly find themselves with public company stakes – as a result of making significant minority investments in PIPE transactions, receiving public stock as acquisition currency when selling portfolio companies, or using IPOs as a partial exit strategy. Private equity firms that don't usually like to be passive investors are sometimes willing to accept these kinds of stakes if they can have a significant degree of control over their exit strategy.

The Delaware case, which casts doubt on whether there are any circumstances in which directors of a public company can agree to a fully locked up deal, appears likely to erode that control. It's an important decision for private equity sponsors, because inability to control the sale process may have a real impact on how a private equity firm would value having a large interest in a public company.

When it's time for the public company to be sold, the private equity fund will see very quickly one of the main differences between private and public company M&A: in a public company deal, it really ain't over 'til it's over. That's because, unlike a private company, a public company can't get all of its shareholders into a room to vote for the deal at the same time a sale agreement is signed. So the buyer of a public company won't know for sure that the deal will close until the target's shareholders have voted on a merger or have tendered their shares into a tender offer. Some buyers are reluctant to take on the completion risk caused by the delay.

To facilitate deals, M&A practitioners have sought to reduce the risk through a variety of deal protection devices, including termination fees, no-shop clauses and lock-up agreements with major shareholders. The ability to grant a lock-up has given private equity funds – particularly those owning a majority or near-majority of the target's stock – a significant amount of control, and leverage, over the sale process. That may now change.

In November 2002, the Delaware Chancery Court rejected a challenge to a fully locked-up merger transaction. (*In re NCS Healthcare, Inc. Shareholders Litigation*) On appeal, the Delaware Supreme Court reversed. While the Supreme Court has not yet released its full opinion, the ruling seems likely to make it much tougher – and perhaps impossible – for the board of directors of a public company to approve a deal that is fully locked up, even when there have been substantial prior efforts to shop the company.

The merger agreement challenged in NCS included a requirement, permitted under Delaware General Corporation Law Section 251(c), that the proposed stock-for-stock merger between NCS and Genesis Health Ventures be put to a stockholder vote, even if the NCS board no longer recommended approval of the transaction. In addition, stockholders with a majority of the voting power committed to vote in favor of the deal. When rival bidder Omnicare offered a higher price, the NCS board withdrew its recommendation of the Genesis deal – but the Section 251(c) provision, coupled with the support agreements, ensured that the first deal would be approved.

The Chancery Court had held that, under the circumstances, the NCS board did not breach its fiduciary duties by agreeing to the locked up deal. The court's conclusion appears to have been strongly influenced by the fact that NCS had been shopped extensively to over 50 potential acquirers. Moreover, Omnicare, the competing bidder, had offered less than Genesis, and had insisted on a due diligence condition in its previous proposal.

On appeal, a divided Delaware Supreme Court said in its preliminary order that, even if NCS's board had sought a transaction that would yield the highest value reasonably available, "the deal protection measures must be reasonable in relation to the threat and neither preclusive nor coercive." The Supreme Court held that the NCS/Genesis arrangements violated this standard by irrevocably locking up the merger. According to the court, without a fiduciary out, "this mechanism precluded the directors from exercising their continuing fiduciary obligation to negotiate a sale of the company in the interest of the shareholders."

The Supreme Court's full reasoning – and the scope lock-ups can play in future transactions – will not be clear until a formal written opinion is issued, which had not been done by press time. We will report on that opinion in a future issue. ▫

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