Debevoise & Plimpton

Private Equity Report

Volume 3 | Number 4 | Summer 2003

Are the Terms of U.S. and European Private Equity Funds Converging?

In the Spring 2002 issue of this publication, we examined the differences between U.S. and European private equity funds, and found that a number of the previously existing differences had narrowed in the period from 1997 through 2001. In this issue, we look again at trends in structuring European private equity funds and ask the question: "Are the terms of U.S. and European private equity funds converging?" In trying to answer this question, we reviewed the information added to our proprietary funds database since 2001. To refine our analysis further, we took a more detailed look at 40 major European private equity funds raised in the last two years. Finally, we canvassed the lawyers in our London, Paris and Frankfurt offices who work regularly in this area. We found that the trends identified in our Spring 2002 issue have continued and that, in several respects, the terms of private equity funds sponsored by European firms continue to move even closer to those of U.S. funds. We predict that this trend will continue.

The areas of "convergence" that we identified and predict will become more apparent include: a possible movement in Europe toward the "all-deals-realized-to-date" model for carried interest distributions described below; an increased focus in Europe on general partner (GP) clawbacks and increased use of carried interest escrows and, to a lesser extent, personal guarantees of the GP clawback obligation by principals of private equity firms; a movement in the UK away from the multiple partnership structures previously required by the now defunct limit on the number of partners in a UK investment partnership; and an increased use in Europe of so-called "limited partner (LP) clawbacks" and "no fault divorce" provisions. We also continue to see areas where U.S. and European funds differ, and are expected to continue to differ, although this "non-convergence" is often a matter of form over substance.

Timing of Carried Interest Distributions

Historically, most European private equity funds provided for the return to the LPs of all capital contributed by them to the fund before carried interest was distributed to the GP or other carried interest recipient.[1] In this article, we refer to this as the "return-all-contributions-first" model.

In the U.S., by comparison, since the 1980s most private equity funds have used a different model. The U.S. model, like the return-all-contributions-first model, nets gains and losses across the portfolio but, unlike the return-all-contributions-first model, allows the GP to receive carried interest on what we shall call an all-deals-realized- to-date basis. In this distribution model, each time a portfolio company is disposed

continued on page 12

1 *Two comments are worth noting: first, in the case of funds sponsored by UK private equity firms, carried interest is typically paid not to the GP, but to a special purpose LP owned by the private equity firm and/or its principals. However, for the sake of simplicity, in this article we will use the term "GP" to refer to the entity receiving the carried interest from the fund, whether or not it is in fact the general partner of the fund. Second, we note that as recently as the late 1990s boom era, a number of European funds, like many U.S. funds organized before 1985, did not net gains and losses across the portfolio. However, this alternative model is not discussed in the article because the number of these funds in Europe today is very small.*

© 2003 Marc Tyler Nobleman / www.mtncartoons.com

"This is my carried interest."

What's Inside

3 Special Tax Issues for Tax-Exempt and Foreign Investors in Private Equity Funds
4 The New 15% Tax Rate and the Opportunities It Creates
5 Grace Under Pressure: Revisiting Fraudulent Conveyance Risk
6 Guest Column: Be Wary of Consolidation in Private Equity Transactions
7 Update on Big-Boy Letters
8 A Structural Victory for the European High-Yield Market
9 Hedging Bets on Hedge Fund Regulation
10 Recaps Redux
24 Alert: FCC Insulation Provisions Still Needed for Investment in Media
24 Funds With Individual Limited Partners Need to Send Annual Privacy Notices – And Mean It!

letter from the editor

The increase in private equity activity in Europe has prompted many observers to ask: are the U.S. and European private equity marketplaces converging? In this issue, we look at the question from two significant perspectives: fund terms and financing structures. In our cover story, Michael Harrell and Marwan Al-Turki compare fund terms in U.S. and European private equity funds, highlighting the areas in which European funds are becoming more like their U.S. cousins. Their analysis is based on information from our proprietary database as well as the unique perspective on the European private equity industry and U.S. practice gathered from the continuous exchange of information and experience by our team of fund lawyers based in London, Frankfurt, Paris and New York. On the financing front, David Brittenham and Alan Davies discuss how recent developments in structuring European high-yield debt have narrowed (but hardly extinguished) the historical differences between the U.S. and European markets for intermediate capital.

In this issue, we also explore the current phenomenon of "partial-exit" recapitalization, which has provided a method of returning capital to limited partners in a difficult exit marketplace.

Elsewhere in this issue, we discuss several developments in the U.S. tax laws and their impact on private equity. Gary Friedman and David Schnabel briefly outline the new 15% tax rate and how the alignment of tax treatment of dividends and capital gains is likely to impact deal strategies. Adele Karig and David Schnabel focus on the particular tax problems faced by tax-exempt and foreign investors investing in private equity funds who make portfolio investments structured as limited liability companies.

Our Guest Columnists, Edward Kingsley, a Partner, and Randall Sogoloff, a Senior Manager, in the Deloitte & Touche Merger and Acquisition Services Group, discuss the potentially broad impact of the new FASB rule on consolidation of variable interest entities on private equity investing. We also have a number of updates for you on potential hedge fund regulation, developments in media ownership guidelines and privacy notices for individual partners of private equity funds.

Remember that you can elect to receive *The Debevoise & Plimpton Private Equity Report* by e-mail and/or regular mail. If you would like to change your method of distribution or add yourself or others in your organization to our mailing list, please contact Dan Madden at (212) 909-1978, or dmadden@debevoise.com.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of
Debevoise & Plimpton
919 Third Avenue
New York, New York 10022
(212) 909-6000

www.debevoise.com

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

Franci J. Blassberg
Editor-in-Chief

Ann Heilman Murphy
Managing Editor

William D. Regner
Cartoon Editor

Please address inquiries regarding topics covered in this publication to the authors or the members of the Practice Group.

All contents © 2003 Debevoise & Plimpton. All rights reserved.

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

The Private Equity Practice Group
All lawyers based in New York, except where noted.

Private Equity Funds
Marwan Al-Turki – *London*
Ann G. Baker – *Paris*
Kenneth J. Berman – *Washington, D.C.*
Jennifer J. Burleigh
Woodrow W. Campbell, Jr.
Sherri G. Caplan
Michael P. Harrell
Geoffrey Kittredge – *London*
Marcia L. MacHarg – *Frankfurt*
Andrew M. Ostrognai – *Hong Kong*
David J. Schwartz
Rebecca F. Silberstein

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

Special Tax Issues for Tax-Exempt and Foreign Investors in Private Equity Funds

More and more, private equity funds are finding attractive investments in portfolio companies structured as limited liability companies or partnerships that are taxed as flow-through entities for U.S. tax purposes (LLCs). Tax-exempt and foreign investors face special and complex tax issues when considering becoming limited partners in funds that invest in LLCs, and funds face challenges in addressing these concerns. The issues revolve around some of our favorite acronyms: UBTI and ECI, and the solutions generally involve what we affectionately refer to as "blocker structures."

The Issue for Tax-Exempt Investors: UBTI

Most types of tax-exempt organizations, such as corporate pension plans, private foundations and colleges and universities, are (despite being termed "tax-exempt") subject to U.S. tax on income that constitutes "unrelated business taxable income" (UBTI).[1]

If an LLC is regularly carrying on a trade or business, the tax-exempt partner's share of the income from the trade or business will generally be treated as UBTI. Accordingly, when a private equity fund invests in an LLC that is engaged in a trade or business, a tax-exempt partner's share of the entity's current income is generally UBTI. In the case of gain from the sale of an interest in an LLC, the gain is generally capital gain excluded from UBTI except to the extent of any debt financing at the LLC level (which could be significant). In contrast, in the case of a portfolio company that is a corporation, a tax-exempt organization is generally not taxable either on the receipt of current income (dividends) from the company, or on gain from the sale of stock of the company. Note, however, that a purchaser desiring a step-up in basis of assets would likely pay more for a company that is an LLC than it would pay for the same company if it were a corporation.

Tax-exempt corporations are subject to tax on UBTI at regular corporate income tax rates (up to 35%). Pension plans are subject to tax on UBTI at rates applicable to trusts, which are the same as individual tax rates (until 2009, up to 35%, with capital gains subject to tax at 15%). Tax-exempt entities with $1,000 or more of gross UBTI are required to file annual U.S. income tax returns. In the past, some tax-exempt investors that were not already filing such returns, particularly pension plans, viewed merely having to file the return as an unacceptable administrative burden, even if the actual tax liability were immaterial. Today, however, most tax-exempt investors in the private equity fund market are already filing returns (or have become reconciled to the risk of filing), and focus instead on the effect of the UBTI on their investment return.

Certain types of U.S. tax-exempt investors are subject to special rules:

- The prevailing view is that governmental pension plans are not subject to tax on UBTI.
- UBTI is viewed as truly toxic to charitable remainder trusts because their exempt status will be lost if they have any UBTI in the taxable year, in which case they become subject to tax on all of their income for the year, not just UBTI.

The Issue for Foreign Investors: ECI

If a foreign person is considered engaged in a trade or business within the U.S., it is subject to U.S. federal income tax on its income "effectively connected" with the U.S. trade or business (ECI). In addition, the foreign person is required to file a U.S. federal income tax return, and becomes subject to the audit jurisdiction of the IRS (which, rightly or wrongly, many foreign investors dread).

A foreign person that is a partner in a partnership is considered engaged in a trade or business within the U.S. if the partnership is so engaged. Accordingly, if a private equity fund invests in an LLC that is engaged in a U.S. trade or business, a foreign partner's share of the LLC's income is ECI, regardless of whether the foreign partner receives any distributions. In addition, gain from the sale of the fund's interest in the LLC would be ECI. In contrast, if the portfolio company were structured as a U.S.

continued on page 16

---

[1] *UBTI is generally defined as the gross income derived by the organization from any trade or business that is unrelated to its exempt function – which essentially covers almost any business a private equity fund portfolio company would engage in – subject to exceptions for certain types of income such as interest, dividends and capital gain. In addition, a few categories of income that are not business income are, by statute, treated as UBTI – the most important being income from debt-financed property.*

John M. Vasily
Philipp von Holst
– *Frankfurt*

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

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

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

Estate & Trust Planning
Jonathan J. Rikoon

The New 15% Tax Rate and the Opportunities It Creates

The tax bill enacted last month reduces the tax rate for U.S. individuals on long-term capital gain and most dividend income to 15%. As described below, this alignment of the tax treatment of dividends and capital gain is likely to alter significantly the strategies employed in a variety of transactions.

Leveraged Recaps Prior to Exit

Many private funds are currently holding portfolio companies that have appreciated in value but are not in a position to be sold in light of the general state of the public markets and the absence of strategic buyers. Under the new tax legislation, there is an opportunity to extract value from a portfolio company at favorable tax rates prior to sale by having the company borrow and declare a substantial dividend to the fund. In such a case, the effect of the tax bill is to reduce the U.S. individual tax rate from 35% to 15%. In the context of a family-owned corporation, shareholders desiring liquidity, but not wanting to sell the family business or create a public stub, can similarly effect a leveraged recapitalization and be taxed at the favorable rate.

The new legislation maintains the current 30% withholding tax on dividends paid by U.S. corporations to foreign investors. As a result, the new legislation will sometimes cause the tax strategies of foreign investors to diverge from those of U.S. individual investors.

Foreign Investors

The new legislation maintains the current 30% withholding tax on dividends paid by U.S. corporations to foreign investors. As a result, the new legislation will sometimes cause the tax strategies of foreign investors to diverge from those of U.S. individual investors.

Dividends vs. Sales

For funds willing to reduce their interest in a corporation, there are still tax benefits to selling stock in a transaction that results in capital gain treatment rather than dividend treatment. For example, in the case of a sale of shares, the taxpayer reports the *gain* arising from the sale (*i.e.*, the proceeds received less the taxpayer's basis in the shares). By contrast, a shareholder who receives a dividend is generally taxed on *all* of the proceeds with no reduction for any basis in the shares, unless the proceeds exceed the corporation's earnings and profits. Also, as discussed above, the tax bill has no effect on the 30% withholding tax imposed on non-U.S. investors receiving dividends from domestic corporations. Since these investors are generally not subject to any U.S. tax on gains, they will generally prefer transactions structured to generate capital gain treatment rather than dividend treatment.

Taxable Spin-offs

Notwithstanding the dividend relief under the tax bill, tax-free spin-offs will remain the most advantageous way of distributing the stock of a subsidiary to shareholders. In those cases where the stringent requirements to effect a tax-free spin-off (*e.g.*, a valid corporate-level business purpose, two five-year active businesses) cannot be met, however, the reduction of the dividend tax rate makes a taxable spin-off more attractive than under prior law. This will be particularly true for those corporations that have losses that can be used to shield corporate-level gain triggered by a taxable spinoff.

Sales of Divisions

In the current economic climate, many corporations are selling substantial assets so that they can reduce their debt loads. The favorable dividend rates prescribed by the new tax law may encourage companies that are in a relatively strong financial position to make substantial dividend payments or share repurchases when they exit a line of business. Public companies may, however, prefer using the proceeds in a manner that will not reduce earnings per share.

Dividends from Foreign Corporations

Dividends received by U.S. individuals from a foreign corporation are eligible for the 15% rate only if they fall into one of three categories.

Corporation Organized in a Treaty Country

Dividends can qualify for the reduced rate if they are received from a corporation that is eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program, but only if the Secretary of the Treasury determines that the treaty is satisfactory for purposes of applying the reduced tax rate. While there is no guidance on what treaties will ultimately be deemed "satisfactory," it is reasonable to expect that corporations organized in the jurisdictions of our major trading partners will qualify (*e.g.*, UK corporations, French SAs, German AGs, Canadian corporations, etc.).

continued on page 21

Grace Under Pressure: Revisiting Fraudulent Conveyance Risk

Most private equity players haven't been overly troubled by fraudulent conveyance risks since their transactions were called leveraged buyouts. A recent case, however, has some commentators and practitioners concerned that fraudulent conveyance could be resurfacing as a real transactional risk, at least under certain circumstances. Although a closer look at the case reveals that its relevance and applicability may be limited, still, private equity firms would be prudent to take it into account when due diligencing, structuring and pricing a deal.

The Old Days

Back in the 1980s and early 1990s, a number of courts around the nation were finding leveraged buyout transactions to constitute fraudulent conveyances. A typical transaction might have an acquisition vehicle, capitalized with minimal equity and substantial debt, acquire the target's stock through a merger in which the target would assume, by operation of law, all the debt of the acquisition vehicle. Courts sometimes collapsed these transactions and viewed the target as leveraging itself to pay out cash to its stockholders. If things went bad quickly, the cash paid to the stockholders (especially in a private company) could constitute a fraudulent conveyance, voidable by a trustee in bankruptcy.

The trustee would have to demonstrate two things. First, the debtor would have had to receive *less than reasonably equivalent value* for the assets it transferred. Courts had little trouble concluding that the target did not receive reasonably equivalent value when it effectively paid out cash to its stockholders in the transaction. Second, there must have been actual or constructive fraud. Actual fraud requires that the debtor actually intended to hinder or defraud a creditor, or intended to incur, or believed or reasonably should have believed that it would incur, debts beyond its ability to pay as they became due. Constructive fraud only requires that at the time of the transfer, the debtor was insolvent or became insolvent as a result of the transfer (or had unreasonably small capital to conduct its business). Dealmakers got a stark reminder recently from the decision in *In re: W.R. Grace & Co. v. Sealed Air Corporation* that solvency for fraudulent conveyance purposes may be determined in hindsight, and that the risk of calculating wrong at the time of a transaction may fall on the debtor and transferee, not the creditors.

The Sealed Air Decision

Sealed Air arose out of Grace's sale in 1998 to Sealed Air of its packaging division. This particularly complex deal was structured as a "reverse Morris Trust" transaction in order to obtain tax-free treatment for both Grace's and Sealed Air's stockholders. At the time of the transaction, Grace was comprised of two businesses: its specialty chemicals business and its packaging business. The specialty chemicals business had sold products containing asbestos for many years, and was at the time of the deal subject to thousands of pending tort claims, with the promise of thousands more.

Despite its labyrinthine form, the transaction was effectively an acquisition by Sealed Air of Grace's packaging division (Packco). The value of the transaction was put at about $4.9 billion – $1.2 billion in cash, which was effectively paid to Grace, and about $3.7 billion in new equity issued directly to Grace's stockholders. Because about three-quarters of the consideration went directly to Grace's stockholders and not to Grace itself, it seems clear that while Sealed Air may have *paid* reasonably equivalent value for Packco, Grace did not *receive* reasonably equivalent value, and the first prong of a constructive fraudulent conveyance analysis was met.

The case itself, however, addressed only Grace's solvency at the time of the transfer. When Grace went bankrupt, certain creditors argued that Grace was insolvent at the time of the transaction with Sealed Air, because the tens of thousands of asbestos claims that were filed *after* the transaction should be considered liabilities of Grace *as of* the date of the transaction. What about the fact that neither Grace nor Sealed Air could predict the number of claims that would be filed or the dollar amount of those claims? Doesn't matter – it was irrelevant whether the future-filed claims were reasonably foreseeable. The only issue in the *Sealed Air* court's mind was whether, given hindsight, there existed liabilities at the time of the transaction that rendered Grace insolvent.

The application of hindsight and the rejection of "reasonable foreseeability" are not terribly new concepts to fraudulent conveyance lore. However, in the mass tort context, given the unpredictability and potentially massive number of claims, burdening the debtor and the transferor with the entire risk of not guessing right or simply not knowing at the time of the transfer seems unfair – and indeed some other courts have flatly rejected the application of hindsight in the mass tort context. The *Sealed Air* court, though, felt that the victims of asbestos exposure "have their debtor forced upon them," and that "the commercial expectations

continued on page 21

guest column

Be Wary of Consolidation in Private Equity Transactions

In January 2003, the Financial Accounting Standards Board (FASB) released Interpretation No. 46 "Consolidation of Variable Interest Entities," an Interpretation of Accounting Research Bulletin (ARB) No. 51 (the Interpretation). The FASB had originally planned to limit its scope to special-purpose entities where perceived abuses had occurred. However, the FASB found it impossible to define such an entity, and, therefore, created the Variable Interest Entity (VIE) concept, which makes the scope of the Interpretation much broader than originally anticipated. As a result, the Interpretation will likely impact the accounting for many types of entities, including those used in many private equity deals. Private equity investors should understand the new rules and pay careful attention to how the new rules may impact the accounting for their past and future transactions.

Why is it important?

The Interpretation will likely impact private equity investors in a number of different ways. Many structures used to either acquire or sell an investment by investment partnerships and corporations will likely be subject to the new rules. The use of many traditional features such as put and call options, guarantees, seller related financing and management agreements may have a significant impact on the determination as to which party consolidates the target or venture. Additionally, the type of equity instrument held by investors (*e.g.*, common stock, preferred stock) and the type of debt used by the entity (*e.g.*, investment grade, high-yield) may also have a significant impact on the determination as to which party consolidates. Therefore, a transaction structured without considering the new rules may result in consolidation of the investment or joint venture by an unsuspecting investor, or, in some instances, may require the seller to continue to consolidate an entity it planned to be able to deconsolidate.

[I]t is important to note that many implementation issues with respect to the Interpretation's consolidation model remain unanswered. These unknowns will likely create additional difficulties in structuring transactions that involve entities that may meet the definition of a VIE.

The following is intended to provide some insight as to the potential impact of the Interpretation on private equity investors. However, it is important to note that many implementation issues with respect to the Interpretation's consolidation model remain unanswered. These unknowns will likely create additional difficulties in structuring transactions that involve entities that may meet the definition of a VIE.

- Private equity funds, including those currently reporting investments at fair value, must apply the provisions of the Interpretation since private equity investment partnerships are not uniformly scoped out of the Interpretation. However, there is great uncertainty as to how to apply the Interpretation's rules with respect to a fund's investments and the potential impact on the fund's reporting if consolidation of an investment is required. Situations where certain investments in portfolio companies are required to be consolidated by the fund, while others are carried as a one-line investment at fair value, will likely minimize the utility of the fund financial statements to investors.
- A structure in which the holders' voting rights are not proportionate to their investments may cause an entity to be considered a VIE. For example, a limited partnership structure whose activities are controlled by a general partner may be problematic since the general partner typically has a controlling voting right but only a minority investment.
- The determination as to whether an entity is a VIE is based in part on the amount of equity at risk and whether that equity is "sufficient." Investments that do not participate significantly in profits and losses of equity investments provided by certain related parties would not be considered equity under the Interpretation. For example, investments in no-dividend perpetual preferred stock or investments in certain redeemable securities may not meet the definition of equity. Investments that do not meet the definition of equity cannot be used in evaluating whether "sufficient" equity exists. The exclusion of these investments from total equity may make it more difficult for an investor to conclude that the entity has "sufficient" equity.

continued on page 20

Update on Big-Boy Letters

The last issue of *The Debevoise & Plimpton Private Equity Report* featured an article on so-called Big-Boy letters. In our article, we noted that Big-Boy letters arguably violate Section 29(a) of the Securities and Exchange Act, which provides that waivers of compliance with any provision of the securities laws are void. We also noted that there is no case law specifically addressing the enforceability of these letters. Still, we concluded that Big-Boy letters were likely to be enforced in most cases due in large measure to a very strong judicial bias in favor of enforcing express contractual arrangements as written, particularly when they are the product of arm's-length negotiations between sophisticated, well-represented parties. We cited a series of cases decided in the Second, Seventh and Ninth circuits in support of this conclusion.

But a case decided by the Court of Appeals for the Third Circuit since the publication of our article suggests that it is unlikely that the Third Circuit would enforce the waiver and disclaimer provisions in a Big-Boy letter to necessarily preclude any subsequent 10b-5 claim by the non-insider as a matter of law. On the other hand, the case very much supports the proposition that the inclusion of these provisions in a Big-Boy letter will nonetheless make it very difficult for a plaintiff to demonstrate as a factual matter the "reasonable reliance" that is an essential element of any successful 10b-5 or fraud claim.

In *AES Corp v. Dow Chemical Co.*, 3d Cir., No 01-3373, 4/14/03, AES asserted 10b-5 and fraud claims against Dow based on a variety of affirmative misrepresentations and omissions allegedly made by Dow outside of a definitive purchase agreement for AES' purchase of a Dow subsidiary. The definitive agreement contained no representations regarding the business of the subsidiary. Moreover, under the confidentiality agreement between the parties as well as the definitive agreement, AES expressly disclaimed reliance on any representation and warranty not expressly set forth in the definitive agreement.

Dow did not dispute that there were a number of statements made outside of the definitive agreement, but it promptly moved for summary judgment on the basis that the disclaimer provisions would make it impossible for [AES] to show reasonable reliance on any such statements as a matter of law.

The U.S. District Court for the District of Delaware granted Dow's motion. But the Third Circuit reversed, concluding that to enforce the non-reliance clause to bar AES' 10b-5 claims as a matter of law would be inconsistent with Section 29(a)'s prohibition on anticipatory waivers of the duties imposed by Rule 10b-5. The court said, "As we have noted, reliance is an essential element of a Rule 10b-5 claim. It necessarily follows that, if a party commits itself never to claim that it relied on representations of the other party to the contract, it purports anticipatorily [sic] to waive any future claim based on the fraudulent misrepresentations of that party."

While this holding would seem to augur poorly for the utility of Big-Boy letters in the Third Circuit, the court went on to emphasize that even though non-reliance clauses cannot bar 10b-5 claims as a matter of law, the clauses are highly relevant in determining the reasonableness of any reliance on the alleged fraud as a factual matter. The court noted:

> Clearly, a buyer in a non-reliance clause case will have to show more to justify its reliance than would a buyer in the absence of such a contractual provision. For this reason, cases involving a non-reliance clause in a negotiated contract between sophisticated parties will often be appropriate candidates for resolution at the summary judgment stage. We are unwilling, however, to hold that the extraction of a non-reliance clause, even from a sophisticated buyer, will always provided immunity from Rule 10b-5 fraud liability.

The lesson of *AES* seems to be that, at least in the Third Circuit, waiver and non-reliance clauses of the type commonly found in Big-Boy letters may not always enable the defendant to dispose of a subsequent claim quickly, as a matter of law. Even so, they are useful tools in managing down, if not eliminating, the risk of subsequent 10b-5 and fraud claims by undermining a plaintiff's ability to make out one of the elements of a successful 10b-5 case.

Of course that may feel like a Pyrrhic victory to a defendant in the Third Circuit who has to deal with the cost and hassle of a full trial to prevail on a 10b-5 claim, as opposed to a defendant in a different Circuit who may well be able to get the claim dismissed quickly on summary judgment. ■

— Stephen R. Hertz
srhertz@debevoise.com

A Structural Victory for the European High-Yield Market

Recent developments in structuring European high-yield debt have narrowed the historical differences between the U.S. and European markets for intermediate capital in leveraged financings. Increasing pressure from institutional investors for change culminated late last year in a letter from a group of investors to several prominent European underwriting houses demanding a number of structural improvements. These tensions eased earlier this year with the successful April closing of a euro and sterling senior note offering by Brake Bros, a UK foodservice distributor, in which a set of novel structural changes was hammered out by the underwriters, the senior bank lenders and the issuer. In this article, we examine the debate on structural and subordination issues between European senior banks and high-yield investors, and the recent innovative compromise reached in the Brake Bros financing.

The origins of that debate lie in the distinct evolution of the European leveraged-finance market. Intermediate capital – the portion of the capital structure between the senior bank debt and the equity – has traditionally come from the private mezzanine market, which is well-known in Europe, and remains a significant financing source today. European private mezzanine debt is provided by a relatively small group of institutions, principally large investment banks, commercial banks and specialized mezzanine debt providers. It generally has standardized rights and remedies, typically benefiting on a subordinated basis from the same security and guarantee package as the senior bank debt, with standard subordination blockage periods on payment as well as on the exercise of enforcement remedies. Senior banks are usually willing to rely on contractual subordination protections with respect to mezzanine lenders, and do not insist on structurally subordinating the mezzanine debt at a separate corporate level. Mezzanine debt in European markets is well-established, with a generally agreed set of rights and remedies, and its commercial and legal implications are understood and accepted by the banks providing senior debt.

> *Largely as a result of senior lender resistance, structural subordination has been the norm in European high-yield offerings rather than contractual subordination alone.*

In the U.S. financing markets, high-yield bond financing has largely supplanted private mezzanine debt in larger financing transactions, driven in significant part by lower cost and greater covenant flexibility for issuers, as well as greater liquidity for investors. U.S. high-yield bonds may be either senior or senior subordinated debt. Senior notes are generally of equal priority with senior bank debt, with the same or a similar guarantee package, and are sometimes secured. Senior subordinated notes are contractually subordinated to senior bank and other debt, but are not subordinated to trade creditors and typically have a claim on some or all of the same operating entities as the senior banks, either directly or by way of guarantee. In addition, U.S. high-yield debt does not generally limit the exercise of enforcement remedies. These characteristics, together with the automatic stay and other features of the U.S. bankruptcy laws, help give high-yield investors leverage in dealing with troubled U.S. companies and other creditors.

High-yield bond financing began to develop in Europe in the mid-1990s, and became a popular means of raising capital in the telecom sector, among others. The relative rights and structural position of high-yield bondholders, however, have been substantially less favorable in European financings than in U.S. transactions. Generally, European senior bank lenders have insisted that high-yield debt be structurally subordinated to the senior bank debt, placing high-yield bondholders in a worse position than their mezzanine lender counterparts. That insistence has been driven in significant part by the belief that bondholders, particularly buyers of distressed debt, are less interested than traditional mezzanine lenders in working with senior banks to achieve a consensual restructuring in the event of borrower default, preferring instead to exit swiftly even if it means a lower realization on their investment. Largely as a result of senior lender resistance, structural subordination has been the norm in European high-yield offerings rather than contractual subordination alone. Thus, in many European transactions, "senior notes" have been issued by a holding company, without any restriction on the exercise of enforcement remedies against the issuer, but with no contractual rights at all at the operating company level – making these notes effectively equity. In other European transactions, holding company notes have had the benefit of a pledge of a subordinated downstream loan of the high-yield pro-

ceeds to the borrower on the senior bank debt, but not of guarantees from the operating subsidiaries of that borrower that guarantee the senior bank debt.

Throughout the late 1990s, it was commonly predicted that high-yield debt would supplant mezzanine debt as the preferred method of raising intermediate capital in Europe, as it had in the U.S. But, as default rates soared and companies failed in increasing numbers in the last several years, the structural position of European high-yield debt, combined with significantly different and less favorable European insolvency regimes, led to painful losses and poor recovery rates for high-yield investors. Not surprisingly, high-yield investors became less and less enthusiastic about investing in European leveraged transactions.

The structural versus contractual subordination debate came to a head in the Brake Bros high-yield financing. In mid 2002, Brake Bros was acquired by an investor group led by Clayton, Dubilier & Rice, Inc. The transaction was initially financed with senior bank facilities, together with a structurally subordinated interim loan facility provided to a holding company parent of the bank borrower, with the expectation that the interim facility would later be refinanced with similarly structurally subordinated high-yield notes. However, high-yield investors balked at investing in Brake Bros high-yield notes on

continued on page 22

Hedging Bets on Hedge Fund Regulation

Over the past year, the SEC has been trying to cast some light on the traditionally secretive world of hedge funds. With the tremendous growth in the number of hedge funds and the amount of assets they manage (from $50 billion in assets in 1990 to almost $600 billion today), many commentators believe that hedge funds may now be ripe for some form of regulatory oversight. In May 2002, the SEC launched a formal investigation of hedge funds. In spring 2003, the SEC hosted a public roundtable discussion on hedge funds, and Chairman Donaldson testified about his concerns before both Senate and House subcommittees in hearings devoted to hedge funds. The issues under discussion included the following.

Marketing Issues

One of the SEC's primary concerns is the "retailization" of hedge funds through the emergence of registered fund of hedge fund products with minimum investments as low as $25,000. The SEC and NASD are both concerned about marketing efforts targeted at financially unsophisticated investors, including through the Internet. Proposals to limit sales of hedge funds to "accredited investors" may do little to assuage the SEC's marketing concerns, because the income and net worth standards ($200,000/$1,000,000) of Regulation D adopted in 1982 may now be outdated. The SEC may consider raising these standards in an effort to curb "retailization." Of course, any such revisions to the accredited investor standards could affect all private funds, not just hedge funds.

Hedge Fund Disclosure

The SEC is also questioning whether hedge fund disclosure is adequate in terms of both content and frequency. While the SEC grapples with exactly what type of information hedge funds should disclose, Chairman Donaldson seems poised to consider disclosure proposals that enhance position transparency as well as measures to increase investor protection.

Addressing Fraud through Regulation

The SEC's focus on hedge funds is attributable at least in part to what it perceives to be a "mini boom" in hedge fund enforcement cases over the last year or so. With little to no regulatory contact with most hedge funds (which, along with their managers, are usually unregistered), the SEC has limited means to police or prevent fraud. The SEC may consider requiring hedge fund managers to register under the Investment Advisers Act, an initiative which could affect private equity fund managers as well.

After the SEC has digested the information gleaned from the roundtable and any public comments submitted, we expect that the SEC staff will issue, by year-end, a report summarizing the results of its investigation, including proposals for more hedge fund regulation. Whether such proposals will impact the private fund world more generally remains to be seen, but we will report any further developments as they happen. ▫

— Jennifer A. Spiegel
jaspiegel@debevoise.com

Recaps Redux

"Partial exit" recaps have gotten a lot of buzz from the business press and have been roundly welcomed by limited partners, fund sponsors and investment bankers alike. They provide an interim solution in a difficult marketplace where limited partners are grateful for returns of capital to offset market losses and "rightsize" their private equity allocations, fund sponsors are concerned about fund performance and IRRs but are unwilling to sell at today's multiples, and investment bankers are excited about an intermittently vibrant high-yield market in an environment where IPOs are rare. Transactions structured as recapitalizations are nothing new to the private equity landscape and have been utilized in a variety of contexts for many years. For example, transactions accounted for as recaps traditionally provided (and still can provide, especially where there are significant appreciated identifiable intangibles and fixed assets) accounting advantages to private equity acquirors that strategic buyers could not benefit from in cash transactions. (See, "Without Pooling, Are Recaps Doomed?" in the Spring 2001 issue of The Debevoise & Plimpton Private Equity Report.*) In addition, recapitalizations to "adjust" the capital structure of troubled companies in connection with workout situations have involved private equity firms, whether as the providers of new capital or the "squeezed-out" equity, through many business cycles. The emergence of the partial exit recap, however – in which basically healthy portfolio companies, which have substantially paid down existing debt and generate enough strong cash flow to handle additional leverage, refinance their existing debt to provide a return of capital to equity holders – is a function of an alignment of the stars – including historically low interest rates, a dormant IPO market and low purchase multiples.*

These transactions permit a well-performing portfolio company to use its proven and projected earnings capacity to unlock appreciated value and to refinance (and increase) its debt load as a way of generating cash returns for investors. Recaps may sound too good to be true. Following the refinancing, the portfolio company makes a distribution to shareholders via a dividend or by repurchasing a portion of its outstanding equity. Unless a new equity participant has invested, existing equityholders still own the business, but have gotten their capital returned and sometimes two or three times that. Private equity firms and their portfolio companies need to be careful before proceeding with a partial exit recap in order to make sure that the transaction does not raise issues of illegal dividends, fraudulent conveyances and disparate treatment of equityholders and create unanticipated future impediments to sale. In addition, notwithstanding the recent change in the tax law, careful structuring can make a recapitalization more tax efficient if capital gains treatment can be achieved. Here's a primer on how to avoid foot faulting in structuring a partial exit recap:

Finding the Right Source of Financing

Most partial exit recaps of any magnitude are dependent on the high-yield market. While financing for leveraged recapitalizations can come from a variety of sources, the high-yield market has been especially robust in recent months, although the market is episodic and the windows seem to open and close without many clues as to the rationale other than the amount of money flowing into the market. In most recapitalization transactions, senior debt will need to be refinanced because the distribution of excess cash to equityholders is generally prohibited by senior debt covenants. Additional senior debt can often reduce the overall borrowing costs of a recapitalized portfolio company, but secured lenders will generally not permit proceeds from their loans to be used to fund shareholder distributions. That's because security interests held by senior lenders would be invalidated in the (hopefully, remote) event that the distribution were found to be an illegal dividend, and senior lenders are unwilling to take that risk. The senior loan proceeds can be used to refinance the existing senior loan, pay transaction expenses and for other general corporate purposes.

Meeting the Dividend Test and Avoiding a Fraudulent Conveyance

The risk of personal liability is understandably of huge concern to corporate directors who can be found personally liable for the declaration of a willful or negligent dividend or another impermissible distribution to shareholders. That's why great care needs to be taken to structure recapitalized transactions in ways that effectively manage the risk of that liability.

Generally, corporations can pay dividends only out of surplus (total assets minus total liabilities). In most jurisdictions, surplus may be determined by any method reasonable under the circumstances and is generally not based on a balance sheet test. In some states, an additional requirement provides that distributions out of surplus are permitted only if a corporation would be able to pay its debts as they come due after the distribution.

In addition, state fraudulent conveyance statutes prohibit corporate distributions to shareholders that (with some variations): leave the corporation with unreasonably small capital (*e.g.*, the corporation becomes insolvent within a reasonable period of time after the dividend or the corporation cannot generate sufficient revenue to sustain its operations); or were made with an intent to hinder, delay or defraud any creditor; or were made when the corporation believed it would incur debts beyond its ability to pay.

Unlike state illegal dividend statutes, fraudulent conveyance statutes impose liability for wrongful distributions on the recipients of such dividends – a company's equity holders and, potentially, the limited partners who receive the distribution from the private equity fund. The statute of limitations in many states for recovery of a corporation's fraudulently conveyed assets can extend up to six years. In light of LP clawback provisions in many fund documents, limited partners are naturally concerned that they not receive proceeds from leveraged recaps that are distributed in violation of fraudulent conveyance statutes.

Fortunately, state law generally protects director decision-making by applying the business judgment rule. In the U.S., courts are loathe to substitute their judgment for that of a company's directors, as long as the directors' judgment at the time was reasonably defensible as a business matter, even if wrong in hindsight. As noted above, in the case of a dividend, state law generally permits a corporation's board to use any method reasonable under to circumstances to value its assets and liabilities for purposes of calculating available surplus. Most states also protect directors who rely on professional evaluations or other expert opinions which demonstrate that a corporate action such as declaration of a dividend was within the appropriate legal parameters.

Directors seeking to approve a distribution to equity holders should be especially vigilant about the process they undertake to evaluate the merits of a leveraged recapitalization. A record reflecting careful deliberation and thoughtful analysis will go a long way towards protecting the directors from liability in the event that 20/20 hindsight shows that the portfolio company could not support additional debt added in the recap.

Directors should also understand the provisions of the Directors and Officers Liability Policies (D&O Policies) applicable to their actions. Typically, such policies cover directors for wrongful acts such as negligence, breach of duty and error, but not for willful violations or deliberate acts of fraud. While there is no case law that addresses whether improper dividends constituted insured, wrongful acts under D&O Policies, negligent acts should be covered, but willful or intentional acts giving rise to an improper dividend will probably not be covered. Therefore, directors will want to make sure that the decision to pay a dividend was considered in a manner that would make it hard for their actions to be found to be a willful violation of the dividend statute. Directors should have a sound basis to conclude that they are following the applicable law.

Recapitalizations of portfolio companies organized in foreign jurisdictions may be particularly quirky. Directors of companies organized in those jurisdictions may not have the advantage of protective doctrines like the business judgment rule. Many jurisdictions that are popular for holding companies (*e.g.*, the Netherlands, Luxembourg, etc.), however, have statutory tests for distributions to shareholders that are not dissimilar from the tests for a Delaware or other U.S. corporation. Although it is generally the case that the director of a foreign company should be as vigilant as a U.S. director in approving a dividend, no leveraged recapitalization should be undertaken in any jurisdiction (be it Luxembourg or Colorado) without advice from competent local counsel.

One of the ways that a Board can enhance a record of due deliberation is to engage a valuation expert to vet the proposed transaction in order to get comfort that it has satisfied applicable legal standards in approving the transaction. Typically, an expert will value the portfolio company on a going-concern basis by applying standard valuation techniques, including discounted cash flow analysis and market valuation

continued on page 18

Directors seeking to approve a distribution to equity holders should be especially vigilant about the process they undertake to evaluate the merits of a leveraged recapitalization. A record reflecting careful deliberation and thoughtful analysis will go a long way towards protecting the directors from liability in the event that 20/20 hindsight shows that the portfolio company could not support additional debt added in the recap.

of at a gain, the GP is allowed to take its carried interest on that deal, so long as investors have received a return of all capital invested in that portfolio company and in all portfolio companies previously disposed of, related fees and expenses, and amounts by which companies that remain in the portfolio have been written down or written off.[2] The all-deals-realized-to-date model has the advantage of potentially allowing the GP to receive carried interest much earlier than would be the case with the return-all-contributions-first model, but significantly increases the risk of the GP receiving an "overdistribution" of its carried interest entitlement, requiring a "clawback" from the GP of the over-distribution. (For more detail on these two models and GP clawbacks, see "Clawbacks: Protecting the Fundamental Business Deal in Private Equity Funds" in the Fall 2000 issue of this publication.)

Whatever one's preferred model, it is the case that, until recently, most private equity funds organized by European sponsors have followed the return-all-contributions-first model. This may be due in part to the historically greater proportion of institutionally sponsored funds in Europe (which is rapidly changing as such institutions spin off their private equity businesses), as compared to the U.S. with its large number of boutique private equity firms. It seems likely that institutional fund sponsors with multiple lines of business are less focused on early receipt of carried interest (they may be less dependent on the cash flow and thus happy to defer receipt of income and tax thereon) than is the case with private equity boutiques owned by individual principals. In addition, an institutional fund sponsor may also be more averse to exposing the institution to clawback risk. For both reputational reasons and because it is a "deep pocket," an institutional fund sponsor may realize that it will be required to make the fund whole if a clawback is triggered, even if some of the carried interest was paid to individuals who worked for the institution but then left and defaulted on their fair share of the clawback obligation.

The information in our database shows an increase in the number of European funds following the U.S. all-deals-realized-to-date model in the last 12 months. However, the U.S. model is by no means "market" in Europe, and the best-known and most successful UK funds continue to follow the European model of returning all contributions first. A number of European LPs have told us that they are resisting any trend in Europe toward adoption of the U.S. distribution model. We are aware, for instance, of a recent high profile European fund that went to market with a U.S.-style all-deals-realized-to-date distribution scheme, but was forced during the course of negotiations with LPs to change to the return-all-contributions-first model.

Interestingly, in recent months, some U.S. LPs have been discussing the desirability of returning to the return-all-contributions-first model for U.S. funds (or for annual "true-ups" of the clawback, which has a similar economic effect). This is perhaps not surprising, given the number of U.S. GPs that are currently facing large clawback obligations in funds using the all-deals-realized-to-date model. However, thus far we have not seen this approach seriously negotiated in the U.S.

We think that it is likely that, for better or worse, the movement in Europe toward the U.S. all-deals-realized-to-date model for distributions will continue. European LPs may succeed in slowing this down in the short term, but in the long term we think the trend will accelerate for a number of reasons. First, European GPs, in particular the middle market buyout funds that are currently in vogue, are asking for it more frequently. Second, despite clawback concerns, this model has achieved broad acceptance in the U.S. and has obvious appeal to European private equity firms not affiliated with large institutions (the number of which, as noted above, is rapidly increasing in Europe in proportion to the number of institutional houses). Third, U.S. LPs, who are increasingly active investors in European funds, are familiar and generally comfortable with this approach.

As for the U.S., we do not expect to see the return-all-contributions-first model take hold there in any meaningful way, despite concerns expressed by some U.S. LPs about the greater clawback risk posed by the all-deals-realized-to-date model.

Security for GP Clawbacks

Clawbacks from the GP of overdistributions of carried interest are almost universal in the U.S. and in Europe. However, one area where we do see a difference is in the security for these clawbacks. Since most GPs are special purpose vehicles that immediately distribute carried interest out to the private equity firm and/or its principals, the GP's clawback obligation to the fund has little substance: the GP

2 We note that many U.S. venture capital funds use a somewhat different formulation, which appears to be the "return-all-contributions-first" model, but is not. The partnership agreements of these venture funds state that all contributions must be returned first, but then permit early payouts of carried interest if certain fair-value tests are met. In effect, these funds operate much like buyout funds, on an all-deals-realized-to-date basis.

generally has no assets. Thus, in the U.S. LPs have required that most clawback obligations be guaranteed by the individuals or institutions that own the GP. Indeed, these guarantees are almost universal and clearly "market" in the U.S., although there are often intense discussions between GPs and LPs as to whether the guarantees should be joint and several, or merely several, obligations of the guarantors. Holdbacks or escrows of carried interest to secure the clawback obligation are relatively unusual in the U.S., by comparison. Only 18% of the buyout funds and 5% of the venture capital funds in our database that were organized after 1990 have such provisions (not surprisingly, escrows and holdbacks are more frequent in first-time funds, and less so for funds sponsored by more established firms).

In Europe, the situation seems to be reversed. We see holdbacks/escrows securing the clawback obligation with increasing frequency in Europe; indeed, they are much more common in Europe than in the U.S. Until recently, however, we rarely saw personal guarantees by principals. This may be changing. In the past six months or so we have seen a small increase in the numbers of personal guarantees in European funds. It is possible that personal guarantees will become more prevalent in Europe, particularly as U.S. institutions increase their participation in the market; however, there remains a deeply ingrained resistance to personal guarantees by European principals, who may well prefer continuing to offer large carried interest holdbacks rather than guarantees.

LP Clawbacks

As discussed in our Spring 2002 issue, from 1990 through 1996, none of the European funds in our database had LP clawback provisions. (Such provisions require partners to return distributions to cover "end-of-the-fund" liabilities, including fund indemnification obligations.) This compared to 19% of U.S. buyout funds in our database that had LP clawbacks during this period. Since 1997, the percentages increased to 15% for European funds and 37% for U.S. funds. In the past year, we have seen this trend accelerate in Europe. Of the 40 European funds reviewed for this article, 18% had LP clawbacks. LP clawbacks now appear frequently in at least the first drafts of partnership agreements of European funds that we review, whereas even two years ago we rarely saw such provisions in European funds.

We expect that LP clawbacks will become more common in both U.S. and European funds, and that they will rapidly become as prevalent in European as in U.S. funds.

No Fault Divorce Provisions

As with LP clawbacks, we are seeing more European funds include so-called "no-fault divorce" provisions, *i.e.*, provisions that allow a supermajority of LPs to vote either to suspend the investment period or to remove the GP, in either case without cause. In our Spring 2002 look at this issue, we saw that in the period from 1990 to 1996 (when the Mercer Report, which strongly advocated such provisions, was issued), no-fault divorce provisions were included in 32% of U.S. buyout funds and 25% of European funds. In the period from 1997 to 2001, the percentages had increased to 51% for U.S. funds and 26% for European funds.

Since 2001, we have seen a significant increase in the frequency of these provisions in European funds, due perhaps to increased penetration of the European private equity market by U.S. institutional investors. Whatever the reasons, we believe that these provisions have now become "market" in Europe. Of the 40 recent European funds reviewed for this article, 68% (27) had a no-fault divorce provision in one form or another. We expect this trend to continue, with these provisions possibly becoming as common in European funds as in U.S. funds.

In general, as the European market matures, and with regulatory changes and increasing transparency, we believe that European funds will move more toward the U.S. models and adopt the U.S.-style terms.

It should be noted, however, that there is one twist that differentiates European no-fault divorce provisions from their U.S. counterparts. European no fault removal (but not no fault suspension) provisions usually have "tails;" that is, they generally provide that the fund manager will be entitled to receive management fees for anywhere from six months to two years after the no-fault removal provision is exercised. U.S. provisions do not contain this tail; in the U.S. such a tail is seen as overly aggressive by most LPs and, in any event, most likely would be deemed a penalty that is not permissible under the Investment Advisers Act of 1940.

Single Partnership

In the Winter 2002 and Winter 2003 issues of this publication, we reported on the elimination in the UK of the requirement that UK investment partnerships have no more than 20 partners. The old requirement had resulted in many UK funds being organized as a series of parallel partnerships, each with no more than 20

continued on page 14

partners. The resulting proliferation of vehicles, especially as UK funds grew much larger in the late 1990s, has had a number of negative consequences: it increased organizational costs; it complicated closings (because, for example, if the fund made an investment in a portfolio company before its final closing, and then the relative sizes of the parallel partnerships shifted as additional investors were admitted, it became necessary to transfer cash and securities among partnerships to keep their respective holdings proportionate to their relative sizes); it increased administrative burdens, and costs, on fund managers over the entire 10 year (or longer) term of the fund; it required that separate audits be done for each partnership; and it complicated voting on, for instance, amendments. Some LPs have expressed concern that these multiple partnerships also decrease transparency: one LP may never see the partnership in which another similarly situated LP invests.

The use of parallel partnerships encouraged UK sponsors to place different categories of investors into different partnerships. The most typical example of this is U.S. investors, whom UK fund sponsors have often placed into a parallel partnership, which was sometimes a Delaware (as opposed to an English) partnership. U.S. pension plans and other investors subject to ERISA sometimes also have had their own partnership.

In the U.S., by comparison, there has been no such restriction on the number of partners in an investment partnership, and for over two decades our firm has helped organize funds for U.S. fund sponsors using a single partnership, with special provisions "built in" to address concerns of particular classes of investors, such as ERISA investors and banks. That being said, we do often help U.S. fund clients organize parallel and feeder vehicles to deal with tax and regulatory concerns of particular classes of investors (including certain European investors), but investors often decide, upon closer examination, that these additional vehicles are not needed. As a result, most U.S. private equity funds consist of one partnership or, at most, two or three parallel and feeder vehicles that address the needs of all classes of investors, eliminating unnecessary cost and administrative burdens.

Some fund groups and lawyers in the UK have continued to organize funds with multiple partnerships for reasons other than tax concerns. They may wish, for instance, to keep all U.S. investors, or all ERISA investors, in a separate partnership to insulate non-U.S. investors from perceived adverse U.S. taxation, ERISA or litigation risk. While we understand these concerns, we believe that some of them are overstated and can be addressed with, for instance, excuse and mandatory transfer provisions (as is common in the U.S.).

It should be noted that, because the tax regimes across Europe are not harmonized, we do expect to continue to see and work on more parallel and feeder vehicles in Europe than is the case in the U.S., in order to optimize returns for different classes of European investors. An example is the Netherlands parallel C.V./B.V. structure, often used because corporate fund structures, which are rarely used in the U.S., are tax efficient for certain European corporate investors, resulting in the creation of a B.V. for them and a C.V. or a partnership vehicle for other categories of investors. Nevertheless, with the elimination of the artificial UK 20-partner limit, and as funds and their counsel adjust to the new regime, we believe that the simpler and less burdensome U.S. model, of only one partnership or perhaps two or three parallel and feeder vehicles, will become the norm in the UK.

Other Areas of Convergence

We see additional areas where the terms of U.S. and European private equity funds are becoming more alike. First, while levels of investor due diligence and insistence on transparency, as well as the sophistication of investors in negotiating fund terms, is uneven on both sides of the Atlantic, European investors are perhaps still behind their American counterparts in these areas. We expect, though, that the amount of due diligence by European investors, and their aggressiveness and sophistication in negotiating terms and insisting on greater disclosure by GPs, will increase as their exposure to private equity as an asset class increases.

In addition, we expect investors in funds organized in both the U.S. and Europe to negotiate more intensely over the sharing of transaction fees charged by fund sponsors. This has been an issue of concern to LPs for many years now, and has not gone away. Our sense is that, in the past, this issue was less heavily negotiated in Europe than in the U.S. We believe, though, that recently European investors have become as heavily focused on this issue as their U.S. counterparts. We predict that this issue

will continue to be a major focus for investors on both sides of the Atlantic.

In general, as the European market matures, and with regulatory changes and increasing transparency, we believe that European funds will move more toward the U.S. models and adopt the U.S.-style terms discussed above. Our view comes from the perspective that we have of the European industry through our team of fund lawyers in London, Paris and Frankfurt, who work closely with our U.S. fund lawyers and continuously exchange market intelligence across the Atlantic divide.

Areas Where Differences Remain

Despite the areas of convergence discussed above, in a number of respects, U.S. and European private equity funds will continue to differ, although these differences are often more a matter of form than substance. First, European funds will continue to be structured somewhat differently from U.S. funds, largely for tax reasons. At the investor level, this is driven by the fact that European tax and regulatory regimes vary greatly, so that one fund structure will not necessarily work for all of the main European investors in this asset class. At the GP level, carried interest optimization poses challenges where principals are tax residents of more than one country, for much the same reasons. This leads to a variety of solutions to this problem, which are generally different from those used in the U.S. At the manager level, VAT concerns (where VAT is charged on management fees, resulting in an irrecoverable cost to the fund) are also relevant; for instance, in order to get over this problem, UK funds structure the management fee as a guaranteed profit share of the GP (which in turn pays some or all of that amount on to the fund manager). As for carried interest, UK funds generally follow the BVCA/UK Inland Revenue model and pay carried interest to a special purpose LP rather than to the GP. These last two issues are outlined in the article comparing the structures of U.S. and European funds appearing in the Winter 2003 issue of this publication.

Second, some techniques that are commonly used in the U.S. to achieve tax savings for GPs – as payment of organizational expenses and placement fees by the fund, coupled with offsets to the management fee for organizational expenses in excess of the cap and offsets for all placement fees – have not been used in Europe, generally because the same tax concerns do not exist in Europe.

Third, other innovative techniques that we have developed for private equity sponsors – such as funding of the GP's capital commitment through a management fee deferral mechanism, and integrated estate planning for the principals of private equity firms – are only now beginning to be seen in Europe. We are discussing these techniques and approaches, which we have used in the U.S. for well over a decade now with our European clients, but thus far they have not been widely adopted in Europe.

Finally, we note that an understanding of the laws of the jurisdictions where private funds are organized or operate is important. Some terms of U.S. private equity funds and European private equity funds appear to be the same or are expressed in the same way (such as the standard of care and the mechanics of default provisions). However, such provisions in fact may operate differently because of differences in the interpretation or enforceability of such provisions in different jurisdictions. For example, although many fund agreements purport to indemnify the GP against acts other than "gross" negligence, the laws of Delaware, France, Germany, Jersey, England and The Netherlands may give this term different meanings – or no meaning at all. Similarly, although many fund agreements provide for forfeiture by an LP of some or all of its interest in the fund if the LP defaults on a capital call, such provisions may not be enforceable in some of these jurisdictions, such as England, in contrast to Delaware, where forfeiture provisions are explicitly authorized by the Delaware limited partnership law. Thus, differences will continue to exist among jurisdictions, absent changes in the law, even where the fund terms do not appear to be different.

Conclusion

The European and the U.S. markets for private equity funds continue to evolve. While we cannot predict the future, we are seeing the adoption in Europe of a number of U.S.-style terms and provisions with which we are intimately familiar, and we expect these trends to continue. ■

— Michael P. Harrell
mpharrell@debevoise.com

— Marwan Al-Turki
malturki@debevoise.com

corporation, current income (such as dividends) would be subject to U.S. withholding tax at 30% (subject to treaty reduction), but gain on the sale of stock of the portfolio company would not be taxed (unless the portfolio company were a so-called "FIRPTA" company – but that's a subject for another article). Note again, however, a purchaser might pay more for an LLC than it would for a corporation.

A foreign person is subject to U.S. federal income tax on its income effectively connected with a U.S. trade or business at the regular graduated rates applicable to U.S. individuals or corporations, as applicable (currently, the maximum is 35% for corporations and 38.6% for individuals). In addition, however, a foreign corporation is subject to the "branch profits" tax at the rate of 30%. This is a tax on the "dividend equivalent amount" of a foreign corporation, which approximates the 30% withholding tax that would be applicable if the foreign corporation conducted the business through a U.S. corporate subsidiary and then the subsidiary dividended out the profits to the foreign corporation. As a result of the branch profits tax, a foreign corporation could have an effective U.S. federal income tax rate as high as 54.5%. (The branch profits tax may be reduced by treaty.)

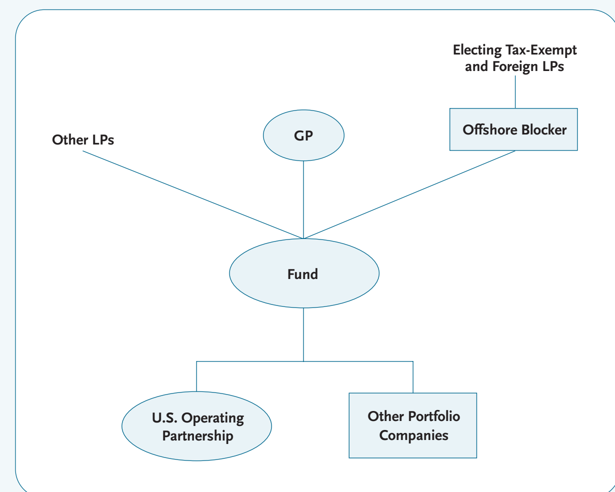
Certain types of foreign investors are subject to special rules:

- Foreign governments (including governmental pension trusts) are subject to special rules – they are generally exempt from tax on all their income from stocks and bonds and domestic securities.
- Some foreign charitable entities receive exempt status under the Code, in which case they are only subject to tax on their ECI or U.S. income which is UBTI.

What Can Be Done?

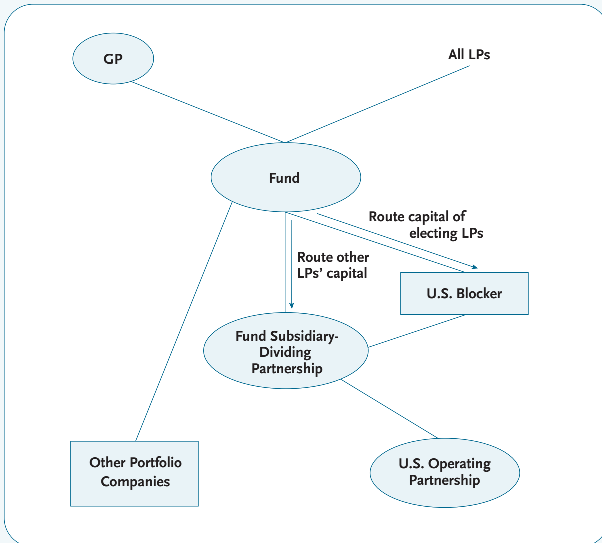
Prior to the mid-1990s when LLC investments became more common, the typical private equity fund desiring to attract U.S. tax-exempt and foreign investors simply agreed to use "best efforts" or "reasonable best efforts" (or some lesser standard) to minimize or avoid UBTI and/or ECI. Once all of the 50 states adopted LLC statutes, and funds began to see more and more prospective targets structured as LLCs, they (naturally) became more and more reluctant to constrain their ability to make these investments. However, funds clearly wanted to offer some protection to their tax-exempt and foreign investors, which are a large constituency. Funds took a number of different approaches: some utilized an excuse (or opt-out) mechanism, whereby a tax-exempt or foreign investor could opt out of an investment that was expected to produce UBTI or ECI (but this had limited appeal to sponsors of funds with significant tax-exempt and foreign investors); a "group trust" was occasionally used by some pension plans that didn't want to file returns, but it could not be utilized by any other investors, and only served to shift the filing burden without mitigating the tax (and imposed administrative costs and burdens). Ultimately, the most popular approach became the blocker structure.

There are as many variations of blocker structures as there are law firms creating blocker structures (perhaps more!), but the essence is that the investment in an LLC is held through an entity taxed as a corporation for U.S. tax purposes (a blocker corporation) for those tax-exempt and foreign investors who elect to invest through the blocker structure. For all other investors (including the general partner of the fund), the LLC interest is not held through the blocker corporation. In the simplest blocker structures, the electing tax-exempt or foreign investors simply invest in the fund through an offshore "feeder" – an entity that becomes a limited partner in the fund. (This is the structure commonly used for hedge funds.)



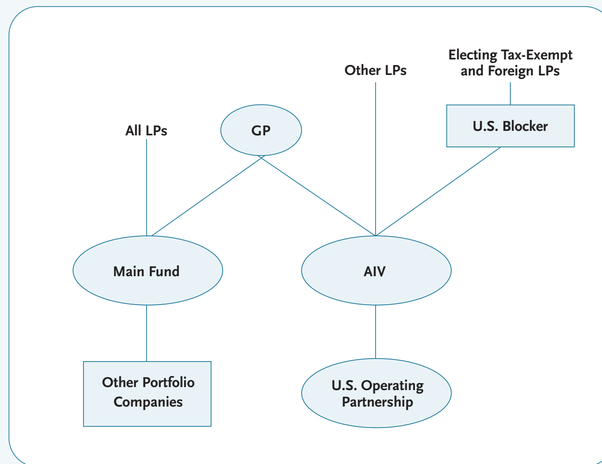
This structure serves the purpose of eliminating the U.S. tax return filing requirement for the electing investors, but does not eliminate the tax – and in some cases may increase the tax (because, for example, foreign investors will lose the benefits of any tax treaties with the U.S. they may be entitled to, and tax-exempt investors subject their income to the branch profits tax).

A second blocker structure is the subsidiary structure, where the tax-exempt and foreign investors become direct limited partners in the fund and the fund establishes the blocker corporation as a subsidiary of the fund. In this structure, when the fund invests in an LLC, it routes only the capital of the electing tax-exempt and foreign investors through the blocker corporation, and specially allocates income from the LLC to non-electing partners and income from the blocker corporation to electing partners.



This structure has some weaknesses – foreign investors may be required to file U.S. tax returns, for instance – but it provides for possibilities to eliminate tax on exit of the investment. For example, if the LLC goes public, the fund can utilize the blocker corporation as the IPO entity (or merge the blocker corporation into the portfolio company once it has converted to a corporation) and then sell the stock without triggering any tax to the electing tax-exempt or foreign investors. If the LLC fails to convert to a corporation, the fund may be able to sell stock of the blocker when it exits the investment, again eliminating any tax for the electing investors (but probably with some reduction in the purchase price, because a buyer of the stock will not receive a tax basis step-up on the share of the assets held through the blocker).

As a third alternative, a private fund could establish a parallel partnership (sometimes referred to as an "alternative investment vehicle") that will make all operating partnership investments to be made by the fund. In one variation, all of the fund's investors would become partners in the alternative investment vehicle, and electing tax-exempt and foreign investors would invest in the alternative investment vehicle through a blocker corporation.



This structure has the advantage of not requiring electing foreign investors to file U.S. tax returns, as with the first structure, and offers flexibility on exit as with second structure, but at the price of some complexity.

Some things to note about blocker structures:

- Generally, the more complicated you are willing to go, the more you are able to optimize the tax results to different categories of investors.
- Some blocker structures must be established upon formation of the fund, which is a benefit if the fund is reasonably certain it will invest in LLCs, because the structure is set and ready to go when an LLC investment is found. Others can be postponed (and the costs, expenses and complications postponed) until an LLC investment is found, which is a benefit for funds that are unsure they will ever make an LLC investment.
- A blocker corporation could have the added benefit of "blocking" trade or business income for state tax purposes, shielding the tax-exempt or foreign investor from the requirement of having to file state tax returns in states where the private fund's LLCs are doing business. Some funds have used blocker corporations primarily for this purpose. ■

— Adele Karig
akarig@debevoise.com

— David H. Schnabel
dhschnabel@debevoise.com

analysis based on a portfolio company's industry peer group comparables. Other techniques that value a company's assets on a stand-alone basis are generally less useful where the company is expected to continue as a going-concern. Even though the surplus test might seem to imply a preference for an asset-based valuation method to determine the amount by which a company's assets exceeds its liabilities, case law (in Delaware) and dividend statutes (in other states) generally make it clear that the directors may use any reasonable method to calculate the value of a company's assets and liabilities to determine available surplus for a dividend.

In addition, the valuation expert can analyze the portfolio company's projections and provide an independent basis for concluding that the company should be able to pay its debts as they come due, after giving effect to the recapitalization. Such analysis is similar to the work a consultant would do if rendering a solvency opinion to the portfolio company's board, a service not all valuation firms provide. A Board should also consider receiving a solvency or similar opinion, especially if the requirements for approving shareholder distributions in the jurisdiction in which the portfolio company is organized conditions a permissible dividend, in part, on a finding that the corporation is expected to be able to pay its debts as they come due and permits directors to reasonably rely on expert advice. Although Delaware corporations sometimes get solvency opinions prior to effecting leveraged recaps, Delaware does not condition payment of a legal dividend on such a finding. As a matter of corporate governance, however (not to mention fraudulent conveyance analysis), at a minimum directors should review their company's projections and discuss with management the company's ability to satisfy comfortably its obligations following the recapitalization.

The report prepared by the valuation consultant should be addressed to the Board and delivered prior to the meeting evaluating and approving the recapitalization transaction. As with many major transactions, two meetings are often better than one – an initial meeting to discuss the recap proposal and a second one to approve it. While hiring an outside valuation consultant may seem like an unnecessary transaction expense to a private equity firm that values, buys and sells businesses professionally, the consultant's fees are "short money" for the procedural protection they buy for the directors and shareholders. In addition, an independent valuation review can serve as an important "reality check" for the business and its projections.

Transaction Tip: The valuation report should address the appropriate applicable law. Careful review of a draft of the report well in advance of a Board meeting is advisable so that it can be revised to address all of the important issues unique to your transaction. While these points may seem obvious, the valuation report is of little value if it consists mostly of boilerplate, rather than a clear analysis that addresses the legal standards and other matters necessary to demonstrate the appropriateness of the specific transaction.

Structuring a Recap to Minimize Taxes

Your tax advisor is sure to point out to you that the size of the dividend is less important than the amount of it you are able to keep, after paying taxes. Before May 2003, when the tax rate for U.S. individuals on most dividend income was reduced to 15% from 38.6%, it was often critical to structure a recapitalization so that distributions to equity holders received capital gain treatment. However, now that the U.S. individual tax rate for capital gain and dividend income is generally the same (15%), obtaining capital gain treatment is less important. (See, "The New 15% Tax Rate and the Opportunities It Creates," elsewhere in this issue.) Nevertheless, there are still benefits to structuring a recapitalization in a manner that results in capital gain treatment. For example, when capital gain treatment applies, an equity holder is taxed on the gain received in the recapitalization (*i.e.*, the proceeds, less the basis in the equity repurchased). In contrast, an equity holder who receives a dividend is generally taxed on all of the proceeds received with no reduction for any basis in the equity (unless the distribution exceeds the corporation's earnings and profits).

In addition, the recent changes in U.S. law do not affect the 30% withholding tax imposed on non-U.S. investors receiving dividends from U.S. companies. Such investors are generally not subject to U.S. tax on gains and will generally prefer a transaction structured to result in capital gain treatment.

Thus, structuring a leveraged recapitalization will in many cases continue to be an exercise of turning dividend income into capital gain income. In some cases this is easy. For example, if the portfolio company was funded in part with convertible debt, a repurchase of the debt generates capital gain, including any gain

attributable to the conversion feature. Even better, if the portfolio company is an LLC (treated as a partnership for tax purposes) it may be possible to structure the debt-financed distribution on a tax deferred basis.

In the more typical case, however, achieving capital gain treatment is more complicated. Specifically, capital gain treatment requires that the distribution be effected as a redemption in which the portfolio company buys back stock from its equity holders, such as the fund (rather than declaring a dividend) and the fund reduce its percentage interest (based on vote and value) in the portfolio company by a significant amount. Although there is no minimum reduction required, the fund can qualify for a capital gain safe harbor if its percentage interest in the vote and value of the company after the redemption (and any related transactions) is 80% of its percentage interest in the company prior to the redemption (and the related transactions) and the fund ends up with less than 50% of the total voting power of the company.

If a company redeems stock from all of its shareholders *pro rata*, each shareholder's percentage interest in the company will remain unchanged and the redemption will be treated as a dividend for tax purposes. However, if the redemption is coupled with a new equity infusion, the redeeming shareholders' percentage interest in the company will go down and the transaction can result in capital gain treatment. Sometimes other private equity participants provide the new equity infusion and become minority shareholders in the newly recapitalized company.

Disparate Treatment of Equity Holders

Directors approving recapitalization transactions should make sure that all equity holders are treated fairly, although they need not be treated the same. For example, a large portion of management's equity is generally held in the form of options. Option holders generally would not participate in a distribution to shareholders. In addition, the shareholder distribution will reduce the company's equity value and thereby reduce the value of outstanding options. Therefore, the Board needs to consider how the recap impacts management options and may decide to pay a special bonus and/or provide for an adjustment to the strike price of outstanding options, regardless of whether the option plan automatically provides for such an adjustment.

The possibility of disparate treatment of equityholders has important implications and requires focusing on the company's aggregate equity value early in the transaction process. The board members must be careful that they are fulfilling their duties to all shareholders. If some portfolio company directors are also shareholders who will increase their holdings or will otherwise benefit from the recap in a manner different from other stockholders, such directors may be deemed interested directors not entitled to the protection of the business judgment rule. In those instances, it may be appropriate to form a special committee of disinterested directors to review a proposed leveraged recapitalization transaction in order to preserve the protection of the business judgment rule.

Impact on Final Exit

Although a partial exit may be very attractive to private equity sponsors and their limited partners, the new debt incurred to effect a leveraged recap may adversely impact the cost or timing of the final exit.

High yield debt and other mezzanine debt generally has "no-call" protection, which prohibits a debt from being redeemed for a fixed period, often four or five years. Most strategic buyers would to be forced to tender for the high yield debt, which would increase their acquisition cost by a significant amount. After the "no-call" period, the debt is often redeemable, but only at a premium that could also be expensive to an acquiror. Change of control puts are often included in high yield debt to protect bondholders, although, depending on the interest rate environment, bondholders may prefer not to exercise the put (often at 101% of par or sometimes higher) if they could benefit from a strategic acquiror owning and deleveraging the business.

Directors approving recapitalization transactions should make sure that all equity holders are treated fairly, although they need not be treated the same.

Given the relative state of the high-yield and IPO markets and the understandable appetite of limited partners for returns of capital, carefully structured recapitalizations are an attractive partial exit alternative for strong cash flow generating businesses held by private equity sponsors.

— Franci J. Blassberg
fjblassberg@debevoise.com

— Marc A. Kushner
makushner@debevoise.com

— Newton Davis
ndavis@debevoise.com

- Even if the investments meet the definition of equity, other aspects may be problematic with respect to whether the equity is "sufficient" under the Interpretation. For example, the use of high-yield debt to fund a transaction or the existence of a debt guarantee may result in the conclusion that the equity is not "sufficient," because the entity cannot operate without additional subordinated financial support from other parties. This may result in the conclusion that the entity is indeed a VIE.
- The characteristics of the equity at risk is also critical in determining whether an entity is a VIE. Many structures include provisions that may not impart the equity with the right characteristics. Examples of typical provisions that may be problematic include a put option that allows the holders to put their investment to a third party, a guarantee provided by a third party that requires additional funding if needed, a minority veto or participating right attached to mandatorily redeemable preferred stock or the existence of a management service agreement between the entity and a third party service provider. The inclusion of such provisions may, in certain circumstances, result in the conclusion that the entity is a VIE.

If the entity is considered a VIE, the determination as to which party should consolidate is based on which party will absorb the majority of the risks (expected losses) and/or the majority of the rewards (expected residual returns) of the VIE.

There are other projects at both the FASB and the Accounting Standards Executive Committee that will provide guidance related to the appropriateness of fair-value accounting by certain investment partnerships and consolidation of a general partner's interest by a parent organization. Once finalized, this guidance will need to be considered along with the Interpretation by investment partnerships and corporate parents.

What is the Effective Date?

The Interpretation is effective immediately for new transactions entered into on or after February 1, 2003. For public company transactions that closed prior to February 1, 2003, the new rules are effective on July 1, 2003. For private-company transactions that closed prior to February 1, 2003, the new rules are not effective until the end of the next annual reporting period (December 31, 2003 for calendar year-end companies). The requirements of the Interpretation apply to all transactions (past and future) involving variable-interest entities. Amendments to past transactions may be necessary to continue to achieve off-balance sheet treatment.

Given the complexities involved in implementing the Interpretation's rules and the potential impact on private equity deals, private equity investors should carefully consider the new rules when structuring transactions. This will help avoid any last-minute structuring surprises or unintended accounting consequences for all parties involved in the transaction.

— Edward Kingsley
Partner, Deloitte & Touche

— Randall Sogoloff
Senior Manager, Deloitte & Touche

If the entity is considered a VIE, the determination as to which party should consolidate is based on which party will absorb the majority of the risks (expected losses) and/or the majority of the rewards (expected residual returns) of the VIE.

The New 15% Tax Rate and the Opportunities It Creates (cont. from page 4)

Readily Tradable on a U.S. Exchange
Dividends from a foreign corporation can also qualify for the reduced rate if "the stock with respect to which such dividend is paid is readily tradable on an established securities market in the U.S." Thus, a publicly traded Bermuda company can pay dividends that qualify for the 15% tax rate.

Shares of a Corporation Incorporated in a U.S. Possession
Finally, dividends are eligible for the 15% rate if they are received from a corporation incorporated in a possession of the United States.

Hybrid Instruments

The new law creates an incentive for foreign issuers to sell securities into the U.S. market that qualify as equity for U.S. tax purposes (thereby entitling U.S. individual holders to the beneficial rate of tax on dividends), but as debt for foreign purposes (thereby entitling the issuer to a local deduction for interest). Hybrids of this variety have long been used in intra-European transactions. ▫

— *Gary M. Friedman*
gmfriedman@debevoise.com

— *David H. Schnabel*
dhschnabel@debevoise.com

Grace Under Pressure: Revisiting Fraudulent Conveyance Risk (cont. from page 5)

involved in corporate tax-avoidance must take second place." Ultimately, the parties settled, and Sealed Air paid Grace's estate more than $800 million in cash and stock, effectively increasing the original purchase price by 17%.

Lessons for Private Equity

So what are the lessons for private equity firms? Perhaps the most important message is that when acquiring a business from a parent company, the buyer may want to look at whether the parent is rendered insolvent by the transaction. Performing some measure of due diligence on the parent may be as critical as performing it on the target business. What are the parent's liabilities? What might they be expected to be? In particular, are the parent's products prone to result in mass tort liability? This might be true, for instance, of chemical or drug manufacturers.

But another important message is that no matter how good the due diligence is, no matter how carefully the solvency of the parent was analyzed (for instance, Sealed Air obtained a solvency opinion as a condition to the closing of the transaction), under the *Sealed Air* case, none of that matters – the only question is whether *in fact*, based on hindsight, the seller's liabilities exceeded its assets at the time of the transaction. There is very little that a buyer can do to protect itself if there are liabilities that are simply unknown at the time of the transaction. Due diligence may, however, uncover risks or the tip of what an alert buyer may predict to be a much larger iceberg. The buyer could then decide against going forward, or focus more carefully on the structure of the transaction.

Even where a private equity buyer is acquiring an entire company (rather than a business or subsidiary of a larger entity), awareness of the fraudulent conveyance risk can prove to be quite important. For instance, if a buyer wanted to acquire Sealed Air (before the lawsuit was filed), an investigation of its former transactions might have uncovered the fraudulent transfer risk inherent in the Grace deal.

Evaluating the structure of transactions is also critical. Even if there is a question of solvency, there can be no fraudulent conveyance if the debtor receives reasonably equivalent value in the transaction. Buyers should try to avoid structures where value paid for an asset goes to stockholders rather than the seller itself. Fraudulent conveyance concerns may also arise where a portfolio company returns value to its stockholders in the form of a dividend – something that may become more common under the recently enacted tax rules. While these types of structures have always raised a red flag, the *Sealed Air* case highlights the fact that through the application of hindsight, the risks may be greater than one might think, particularly where mass torts are involved. ▫

— *Andrew L. Bab*
albab@debevoise.com

that basis and demanded structural enhancements to their rights. The senior banks, on the other hand, had restrictions in place prohibiting the bank borrower and its subsidiaries from issuing or guaranteeing the high-yield refinancing of their parent's interim facility, and were not initially prepared to waive any of those restrictions and rely solely on contractual subordination of the high-yield debt.

In a complex compromise, the senior banks ultimately agreed to allow the high-yield debt issued by the holding company parent the benefit of several structural enhancements which, while falling short of granting complete structural parity with the senior bank debt, together represented a significant improvement over previous European transaction structures. The enhancements included a first priority lien on the downstream loan of the high-yield proceeds to the borrower of the senior bank debt, subordinated upstream guarantees of the notes from the bank borrower and its material subsidiaries and a second priority lien over the shares of the main operating company, the principal asset of the bank borrower.

Taken together, the guarantee and security interest enhancements brought the transaction structure closer to the typical structure for a senior subordinated note offering in the U.S., giving the high-yield investors meaningfully improved rights and remedies, while preserving for the issuer the cost and flexibility advantages of a high-yield financing.

These changes gave the high-yield investors the following benefits: first, the bondholders have a direct claim on the bank borrower and its material subsidiaries on a subordinated basis, through the intercompany loan pledge and the upstream guarantees, subject to payment and remedy blockage provisions. Second, the operating company guarantees give the high-yield investors equal priority with trade creditors of those companies. Third, the second priority lien over the shares of the main operating subsidiary puts the high-yield investors ahead of non-bank creditors of the bank borrower with respect to those shares, its principal asset. The second priority lien is particularly important to providing recovery value for the high-yield investors, because their subordinated operating company guarantees are released upon foreclosure on the stock of the main operating company by the senior banks, and that foreclosure action may not be subject to any stay on insolvency; current English law permits senior lenders with a security interest in substantially all of a borrower's assets effectively to block such a stay, although pending changes in English law will reduce their ability to do so in future transactions. At the same time, the contractual subordination provisions applicable to the high-yield debt, including a remedy standstill period, give the senior banks sole control over enforcement against the bank borrower and its subsidiaries for a period of time following a default.

The issuer also received some benefits from the structural revisions, including some protection against enforcement action against it unless some period of time had passed and the action received majority bondholder approval. The elimination of SEC registration obligations avoided a statutory prohibition on provisions limiting a single bondholder's ability to sue for past due payment, and relieved the company of increased financial reporting obligations that would have arisen from the guarantee standstill provisions.

Taken together, the guarantee and security interest enhancements brought the transaction structure closer to the typical structure for a senior subordinated note offering in the U.S., giving the high-yield investors meaningfully improved rights and remedies, while preserving for the issuer the cost and flexibility advantages of a high-yield financing. As the subordination debate continues, these improvements are likely to become a baseline against which future European high-yield offerings will be measured. ▫

— David A. Brittenham
dabrittenham@debevoise.com

— Alan J. Davies
ajdavies@debevoise.com

Recent and Upcoming Speaking Engagements

June 12	Michael P. Harrell, Marwan Al-Turki **Are the Terms of U.S. and European Private Equity Fund Terms Converging?** Practitioners' Roundtable London, England
June 20	Kevin M. Schmidt **Update on Private Equity Trends** Advanced Doing Deals New York, NY
June 24	Sherri G. Caplan **Negotiating Lower Management Fees, Carries and Other More Favorable Terms for Private Equity Funds** 2003 Limited Partners Summit New York, NY
July 9	Marwan Al-Turki **Dealing with Departures of Private Equity Executives** The 2003 Private Equity COOs and CFOs Forum London, England
August 12	Kenneth J. Berman **The Future of Advisers Act Regulation** New York, NY
September 11-12	Franci J. Blassberg **Special Problems When Acquiring Divisions and Subsidiaries** ALI-ABA Conference on Corporate Mergers and Acquisitions New York, NY
September 23	Michael P. Harrell **Best Practices in PPMs and Roadshows** Franci J. Blassberg, Moderator **Innovations in LBO Deal Structuring** The Private Equity Analyst Conference New York, NY

alert

FCC Insulation Provisions Still Needed for Investment in Media

The loosening of rules that restricted one company's ownership of multiple media outlets by the FCC in early June is some of the biggest news in years for private funds interested in media transactions. On the upside, the regulations will make it easier for funds targeted at the media sector to invest in multiple television stations – or television and radio stations and newspapers – in the same market. Of course, one shouldn't start organizing multiple closings quite yet, because the FCC's decision will be appealed and could still get reversed by the courts or be repealed by Congress. Furthermore, private funds investing in the media space will still have to pay attention to the FCC's cross-ownership restrictions, because the decision left many of those rules completely untouched.

The decision also leaves unchanged the complicated rules that govern how the FCC counts whether a fund (or any other investor) "owns" – or is deemed to have an "attributable interest" in – a media company for purposes of determining compliance with the various ownership rules. Currently, the FCC rules provide that limited partners will, generally speaking, have an attributable interest in any media company in which the fund itself is deemed to have an attributable interest. Fortunately, the FCC allows a fund and its limited partners to avoid this result if the partnership agreement contains certain prescribed provisions that effectively "insulate" the limited partners from having any control over or connection with the fund's media portfolio companies (including with respect to the addition or removal of a general partner). These provisions are included in documentation for funds that may make investments in communications companies in order to allow both the limited partners (and the funds themselves) greater freedom to make investments in the communications sector within the restrictions of the FCC's rules without having to worry about the limiting effect of any present or future separate investments by any of the limited partners.

In short, in the wake of the decision, these insulation provisions are still with us: they remain necessary to ensure that limited partners do not, by reason of fund investments, have interests in media companies that are in excess of what the now-somewhat liberalized multiple and cross-ownership rules permit. ■

— Jeffrey P. Cunard
jpcunard@debevoise.com

Funds With Individual Limited Partners Need to Send Annual Privacy Notices – And Mean It!

In recent years, having individual limited partners has imposed an additional regulatory burden on private equity funds. U.S. federal regulations impose restrictions on disclosure by private funds of the personal information of their limited partners who are individuals (as opposed to trusts, pension plans, corporations, foundations and other institutional investors). The regulations do not require that a fund "look through" non-individual investors. These regulations apply to domestic U.S. funds (*e.g.*, funds organized in Delaware).

Basically, if your private equity fund has individual limited partners, you may be required to send each of those partners so-called privacy notices when they join the fund and annually thereafter. Federal privacy regulations require that a domestic fund send a privacy notice to all its limited partners who are individuals at the start of the partner's relationship with the fund and annually thereafter. Fund sponsors should determine when their annual update notice should be sent; in many cases, the date would have been July 1 (the anniversary of the date when notices were first required to be mailed).

Federal regulations also require that a domestic private fund develop, implement and maintain a comprehensive written information security program providing administrative, technical and physical safeguards designed to protect partners' personal information. Such a program must address safeguards implemented by any service providers with whom the fund shares information about individual limited partners. Contracts with service providers must contain provisions to ensure that the service providers institute appropriate safeguards. (Certain existing contracts must be amended to include these provisions by May 24, 2004.) In light of these requirements, we have prepared model Policies and Procedures for the Safeguarding of Limited Partner Information. Please contact us if you would like to receive a copy of our model. ■

— Kenneth Berman
kjberman@debevoise.com

— Shannon Conaty
sconaty@debevoise.com