Debevoise & Plimpton

Private Equity Report

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Presented for Your Approval: Parachute Payments Enter the Twilight Zone

Private equity firms controlling private portfolio companies rarely worried about golden parachute excise taxes in the event that executives they hired received significant change of control payments when the business was sold. Executives were, after all, entitled to "get rich" if the business was successful and appreciated the certainty of knowing that their employment agreements and change of control payments would not be subject to excise taxes because the package had been approved by shareholders. Those days are over.

The Internal Revenue Service has finalized regulations in respect of the so-called "golden parachute excise tax" provisions that have placed substantial constraints on the ability of private companies to rely on the shareholder approval exemption from the application of this tax. These restrictions make it virtually impossible for a privately held company to commit, prior to the occurrence of an actual change of control, to provide its employees with additional compensation related to a change of control without risking the loss of the tax deduction associated with these payments and the imposition of an additional 20% excise tax on the individuals receiving such payments. Worse, in fact, is that shareholder approval of arrangements that were entered into before the revision to these regulations must satisfy these more stringent standards to qualify for the exemption from the application of these excise tax provisions.

The bottom line is that an issue that a private equity firm and its portfolio company executives thought they could eliminate by following a careful approval process has become as real and perhaps as troubling for them as it is for public companies, where the majority practice has become for the company to bear the full burden of the tax through gross-up arrangements. But private equity funds have not calculated this added cost into their existing compensation arrangements (and indeed may have agreed to gross-up provisions believing that their approval of the relevant change-of-control arrangements would assure that no tax would be imposed and no gross-up required).

What the Statute Does

Since the mid-1980s, because of perceived abuses in the context of payments made in connection with a change of control, special additional excise taxes have been imposed on certain employees, and a tax deduction is denied to the employer of such employees, with respect to amounts treated as "excess parachute payments." A parachute payment is generally any payment, the amount of which is increased, or timing of payment of which is accelerated, on account of a change of control. A payment will not be treated as an excess parachute payment, however, to the extent that the total amount of payments that are made or accelerated on account of a change of control do not equal or exceed an amount equal to the product of three times the

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What's Inside

"I guess they just don't give out parachutes the way they used to."

letter from the editor

Private equity firms think of themselves as champions of management teams and generally advocate significant stock ownership by management as a way to enhance the returns on portfolio investments. While this strategy is still basically sound, we highlight some new regulations that change the rules for private company executives and their private equity investors.

On our cover, Larry Cagney discusses the unexpected results that new regulations taxing payments that were previously exempt from the golden parachute excise tax may have on executive compensation packages in private equity transactions. Also on a benefits topic, Dave Mason reports on two surprising decisions impacting cash balance plans and warns both buyers and companies considering converting their plans to cash balance plans to do so with care.

Also in this issue, we review several recent legal developments that impact the private equity industry. We describe a recent Delaware case that has narrowed the potential pool of independent directors that may serve on committees where potential conflicts of interest may occur. From the UK, we report on action by the UK Inland Revenue creating a safe harbor for carried interest holders from application of the adverse tax treatment generally applicable to restricted securities.

In our Trendwatch piece, we focus on the role of Advisory Boards in U.S. and European private equity funds and explain that U.S. Advisory Boards generally have more significant approval rights than their European counterparts. In our Guest Column, David Lobel of Sentinel Capital Partners notes that while the volume of public-to-private deals by private equity firms will likely not be as significant as anticipated, such transactions, especially involving small-cap companies with complex capital structures or difficult operational issues, can be opportunistic for private equity firms. John Allen also explores whether, and under what circumstances, the power industry might present opportunities for private equity investment.

We also provide the second installment in our series on directors and officers insurance, exploring how to analyze whether private equity firms should consider D&O policies for themselves as well as for their portfolio companies.

We welcome your thoughts on our publication and on how we can make it more helpful to you. Please feel free to contact any of us if you have questions on any of the articles or the topics they discuss.

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
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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.

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

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How "Independent" is Independent Enough?

When private equity firms invest in publicly held companies, they often negotiate special governance arrangements, including as to composition of the board of directors. Sometimes the private equity firm will get the right to nominate one or more directors, and often there will also be an agreement to nominate a specified number of "independent" directors, mutually acceptable to the company and the private equity firm.

What happens when the private equity firm is asked to suggest an "independent" director? Often, it turns to a trusted businessperson who, while having no economic ties to the firm or its portfolio companies, is well known to the firm's principals through prior business dealings or social ties – sometimes ungraciously called a "house independent," if the relationship is cozy enough.

A recent Delaware case, involving a special litigation committee formed by Oracle Corporation, suggests that some independent directors – even those considered "independent" for purposes of stock exchange rules – may not be independent enough to deal with serious conflict issues.

A special litigation committee (SLC) is a group of independent directors formed to consider whether a shareholder derivative action – a lawsuit brought by shareholders asserting claims on behalf of the corporation – should proceed. If the SLC is independent and concludes after careful review not to proceed with the litigation, the SLC's motion to terminate the action is likely to be granted.

The Oracle SLC was formed to consider shareholder derivative litigation claiming that Oracle CEO Larry Ellison and several other Oracle directors had breached their duties to the company by engaging in insider trading – selling Oracle shares before an earnings shortfall became public. Oracle's SLC consisted of two directors, both of whom had joined the board well after the alleged insider trading.

Counsel for the SLC interviewed 70 witnesses, with SLC members participating in several of the key interviews. The SLC produced an 1,100-page report, concluding that the defendants did not have any material nonpublic information about the earnings shortfall and that Oracle should not pursue the claims against the defendants. The SLC moved to terminate the derivative litigation.

The Delaware Chancery Court denied the motion, finding that the SLC had failed to demonstrate that no material factual question existed regarding its independence. The court noted that: both SLC members were both professors at Stanford; one of the defendants was a professor at Stanford who had taught one of the SLC members; another defendant was a big donor to Stanford (one of his gifts was $50,000, made after an SLC member gave a speech at the defendant's request); and Ellison himself was reported to be considering giving $170 million to Stanford. The court found "a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it." To the court, the connections suggested that "material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments."

The court reached its conclusion even though the two SLC members had tenure at Stanford and so weren't vulnerable to being fired, had no fund-raising responsibilities at Stanford and weren't shown to be controlled by any of the defendants. Although prior Delaware cases had held that personal friendship, absent a showing of control or a material economic relationship, was not enough to show a lack of director independence, the court noted that economic interest is not the only human motivation: "*homo sapien*s is not merely *homo economicus*."

Will private equity firms now propose complete strangers to the boards of portfolio companies? That's unlikely: private equity firms will probably want to have some first-hand basis for believing in the trustworthiness of even an "independent" candidate – which requires some kind of relationship. What private equity firms must

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Fund Terms and Conditions: Beware of "Solving the Valuation Conundrum"

With the economy slow, fund realizations below expectations and private equity funds making news for their lack of transparency, investors have naturally started asking more questions about how fund sponsors value their investments. It's a critical question, since there are currently no standardized methods of valuation for the privately held companies in which most LBO funds invest. Given the lack of standards, and the economic risks posed by over-valuation, some investors have attempted to take matters into their own hands by pressing for terms they think will keep fund general partners in line. As they are discovering, it's more complicated than it may seem.

The Risk of Over-Valuation

Most U.S. buyout funds, and many European ones, permit the general partner to begin to share in profits on realized deals before returning the limited partners' invested capital in unrealized deals (See, "Are the Terms of U.S. and European Private Equity Funds Converging?" in the Summer 2003 issue of this Report) The theory is that, over time, investors will receive a return of their capital in all deals, plus a preferred return (generally 8% annually), and that all profits will be split 80% to the limited partners and 20% to the general partner as its carried interest. However, it's not hard to imagine a scenario where a fund's troubled investments remain unrealized until the end of the fund's life, while the successful ones are sold. When the duds are finally sold, they may not generate enough cash to return capital plus 8% to the limited partners on those deals. In that situation, the general partner has received more than 20% of the overall profits and needs to return (or "claw back") the overdistributed amount, subject to certain caps. Nobody wants this situation – limited partners don't want to have to chase the general partner, and general partners don't want to suffer the reputational damage of having a clawback in their fund.

To avoid clawbacks, most fund agreements treat a write-down or write-off of an investment as a "realization" for purposes of returning capital to investors – meaning that the next time the fund sells an investment, in addition to returning capital on the investment sold, a portion of the proceeds will go toward returning capital to the extent of the write-down or write-off. This reduces the amount of "profit" from the successful deal and accordingly reduces the amount of carry the general partner receives. Assuming investments are valued appropriately, this mechanism should help keep the general partner from being overdistributed over the life of the fund. (Of course, there is always the risk that one or more portfolio companies will decline dramatically in value long after the general partner has received carried interest, at a point when subsequent realizations won't produce enough cash to make up the amount of the write-down – the classic "end of the day" clawback scenario.) However, if the general partner does not write down the value of troubled investments sufficiently (or at all), or otherwise overvalues unrealized investments, the risk of clawback is greatly increased.

The Call for Standards

So why not just force general partners to value their investments correctly? That's easier said than done. One oddity of the current private equity scene is that investors who invested in a single portfolio company through more than one fund – an increasingly common phenomenon in this era of club deals – may find that different funds assign the company very different valuations. This odd result occurs because each fund has its own valuation methodology and procedures – none of them "right" or "wrong," just different.

Unfortunately, there is no uniform measure of "value" that can be applied to all privately held companies, and there is no industry-wide accepted valuation practice. Even where a fund uses GAAP reporting methods, which require that sponsors assign a "fair value" to their investments on a periodic basis, there is no uniform method for assigning that value. A value can be inferred from sources such as cost, P/E multiples, revenue streams, or the value of the company's assets, but one or more of these may not be representative of actual "value" in any real sense for a particular company. What's more, valuations based on these indicators are still inherently subjective: different (well-informed) investors in the same company could interpret the same economic indicator differently and assign the company a different value. Several industry groups, including the National Venture Capital Association and the Association for Investment Management and Research, are actively pursuing valuation guidelines that might be adopted across the industry, but to date these efforts have not borne fruit.

Interim Solutions – Fund Terms

Concern over this state of affairs has caused some investors to press sponsors for fund terms that require general partners to value their portfolios frequently, or that tie the general partner's economics more closely to the value of the portfolio. While this may seem at first blush a reasonable way to address performance-related fears, these terms don't necessarily address the underlying problem, and may actually end up creating an incentive for general partners to overvalue their portfolios, thereby increasing rather than decreasing the risks they are meant to mitigate. Any term that rewards the GP for a high valuation can lead to a risk that investments are aggressively valued and could create a greater risk for a GP clawback at the end of the fund's life.

Management Fees

For example, when investors request that the management fee base following the investment period – often described as "dollars at work" – be adjusted to reflect write-downs and write-offs, they should bear in mind that it may give the manager a perverse incentive. The sponsor may be slow to write down the value of an ailing investment if it knows that doing so will reduce its management fee – and most sponsors will tell you that a troubled company takes more management time and attention than a more robust portfolio company, so the fee reduction can become a sore issue.

Clawbacks

Other proposals address the clawback more directly. The clawback calculation for a fund is typically made after the fund's last investment is sold, since it is only then that one can accurately determine what, if anything, is owed. Since fund returns in general have slowed and clawbacks are no longer a purely theoretical concern in some sectors, some investors have proposed value-based protections that apply before the end of the fund. None of these proposals has gained much traction in the industry, in part because they address the symptom, rather than the problem, of the difficulty inherent in valuing these kinds of investments.

One such proposal is requiring all or a portion of the general partner's carried interest to be deposited into an escrow account until such time as it can be determined (based on a valuation of the portfolio) that the money will not be needed to fund a clawback. Aside from the obvious economic downside of locking up a portion of fund profits for years, depriving the general partner of its use and earning a paltry return, the escrow contains an insidious incentive for sponsors to overvalue their investments in order to release the funds as soon as possible.

Another proposal would require interim clawback calculations, so that at some specified interval, the general partner determines whether, as of that date, a clawback would exist if the fund were to be liquidated. This approach doesn't really add anything to the normal end-of-fund calculation, however, since it depends on the same valuation methodology the general partner would use for write-downs and write-offs. In other words, assuming the general partner is able to return capital on a current basis for write-downs and write-offs (as described above), the "clawback" calculation will be made every time there is a realization.

Yet another, much more drastic, proposal is simply to make the general partner return all invested capital and the preferred return before it begins to share in profits. In most cases this is a surefire way to avoid having a clawback, but it is also a major economic disincentive for the general partner. It can keep the general partner from sharing in profits for the first several years of a fund's life – and given the compensation structure of most fund sponsors, this is usually simply unacceptable.

Third-Party "Checks" on Valuation

Many funds provide that certain transactions (*e.g.*, purchases or sales of investments where an affiliated party is involved and in-kind distributions of portfolio company securities) require an independent third party to value the investment in question. This is a healthy practice where there is a potential for conflict of interest, but investors should beware of trying to apply this approach to ordinary course valuations. Not only will the cost of the valuations decrease *all* partners' fund returns, but third parties suffer just as much as the general partners from the basic problem of lack of a standardized approach to valuations. Add to this the fact that the appraiser will not know the company nearly as well as the fund sponsor, who is actively involved in the company's management, and the likelihood that the appraiser's value will be more accurate than the sponsor's is small indeed.

Some investors try to take comfort on valuation issues by requesting a seat on the fund's advisory committee and requesting that the advisory committee approve valuation determinations. A word of caution: there are risks associated with playing that role. The concern is that there may be liability associated with approving or failing to object to a particular valuation. For this reason, some limited partners will not sit on an advisory committee that plays a role in valuation. Investors that sit on advisory committees that participate in valuation should be sure that they are appropriately indemnified for all actions they may take as a member of the advisory committee.

What is to be Done?

There is no easy answer to the conundrum posed by valuation. Private equity funds invest in every industry, each one of which has specialized characteristics that imply certain valuation assumptions.

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guest column

Public to Private: Few Companies Have Shown Up for the Party

As Wall Street redirects most of its shrinking research coverage on the larger, better-known companies, and Sarbanes-Oxley adds another layer of risk and liability for CEOs of public companies, it would be logical to conclude, as many commentators have suggested, that going-private transactions would mushroom. Right?

Wrong. The much-anticipated going-private party so far has failed to swing into high gear. In fact, the trend seems to be going in reverse, much to the dismay of many private equity sponsors with an abundance of capital to deploy. According to Thomson Financial, only 29 public-to-private deals were announced in the first six months of 2003, mostly involving small-cap companies, compared with 71 for all of 2002.

So what's going on? While the reasons most commonly cited for the slow pace of going-private deals – procedural headaches associated with the process and increased board scrutiny for anything perceived to be a potential conflict of interest – are certainly valid, there are other formidable factors at play, not the least of which is the rebound in stock valuations.

Through August of this year, for example, the Russell 2000 is up over 30%, and the other indices have shown strong year-to-date performance. The run-up is being supported by investor expectations of a recovery six to 12 months down the road. And management teams, especially of small companies, tend to believe what the stock market is saying when their stock prices move northward. This, of course, makes it much more difficult for private equity firms to purchase a public business at an attractive price.

In the world of small caps, where the going-private action has been widely anticipated, however, the most significant impediment is management and board entrenchment. While entrenchment and related governance issues are well documented in larger companies, these same issues are far more pronounced in small companies and are frequently coupled with a sense of entitlement – that the company is theirs, not the shareholders'.

Small businesses that are public don't always act like it. Public ownership, particularly for OTC- and Pink Sheet-listed companies, is often incidental. With management and the board in complete control of strategy, compensation and perks, the public shareholder is at best a distant abstraction. It's a comfortable and predictable life for those who run the business and sit on the board. The truth is that small company leadership will not give away control, unless they are compelled to do so. No wonder no one answers the phone at small publicly traded companies when private equity firms call – that is at small companies performing reasonably well, which brings me to my real point.

What kinds of small public companies are likely to show up for the going-private party? For starters, they may not be from the "A" guest list. Most will have a lot of "hair" on them – ugly balance sheets, overly complicated business models or failed strategies. For these walking wounded, doing nothing is not a viable option.

The most fertile areas for going-private transactions are those situations where private equity capital is capital of last resort. The good news is that small-cap companies with complex profiles are not likely to attract a big crowd of suitors. In that sense, these situations may represent the closest thing to a quasi-exclusive deal that a private equity firm can see today. The bad news is that there is likely a very good reason why others will not go near them. Assuming, however, that the company's capital structure can be cleaned up, its strategy clarified and management refocused on execution, our experience teaches us that there is a good chance that taking a company private can generate superior returns for private equity investors.

A couple of recent examples illustrate the potential that small-cap "hairy" public companies hold for private equity investors. Take Edison Schools. Started by Chris Whittle in 1992 on the promise that it could improve public schools in the U.S. and generate profits in the process, Edison made its debut on Wall Street in 1999 amid a lot of fanfare.

Unfortunately, the company's four years as a publicly held company were marked by political controversies, strategic setbacks and a string of losses, all reflected in the stock price declining from its IPO price of $18 a share to as low as $1.63 a share on July 14, 2003. Last year, in particular, was one of compounding horrors for Edison, its shareholders and Mr. Whittle. The company settled a regulatory complaint over its accounting, was sued by its shareholders, restated earnings and lost a very public battle in Philadelphia by which it lost half the schools it was originally hired to manage.

Wall Street soon lost confidence. By July of this year, Edison's market capitalization was just $81.4 million, even though its cash and other current assets amounted to close to $150 million. News of a management buyout produced little reaction in Edison's stock price. Faced with the very real prospect of extinction, Edison decided to go private in a management-led buyout in the hopes of stabilizing its access to funding, diminishing the added scrutiny that comes with being a public company, and securing a friendlier, more committed long-term shareholder. The complexity of the Edison story has made this deal a quasi-exclusive transaction – no other bidder has come out of the woodwork and Edison's stock price has remained relatively dormant since the announcement to go private was made.

Another example of the potential value embedded in small public companies that fall below Wall Street's radar screen in terms of size is Castle Dental Centers. With sales of approximately $100 million, Castle had a business model to roll up dental practice groups into one large integrated network. While Castle has been around since the early 1980s, its roll-up strategy proved to be more expensive and challenging to manage.

Starting with a small footprint of dental clinics in Houston, Castle went public in 1997 and raised considerable capital to pursue its roll-up strategy. In the succeeding few years, Castle acquired many new dental centers over a large geographic area stretching from California to Florida. Castle depleted its cash and incurred considerable debt to fund the acquisition strategy. The company also used stock to pay for acquisitions.

Ultimately, Castle was unable to manage and execute the integration of the acquired businesses and the wheels came off. Castle entered 2002 saddled with approximately $65 million of debt and little or no cash flow. Auditors questioned its future viability and the company's stock sank to a low of $0.02 a share, down from its IPO price of $13.00 a share. A crisis-management firm was retained to assist the company, and by the end of 2002, Castle's debt had been pared down to $52 million and its operations stabilized.

Despite the progress, Castle had few viable options to go forward as a going concern. Castle's board therefore determined that a comprehensive financial restructuring led by a private equity firm was its best option for survival. The new capital would address Castle's over-leveraged balance sheet, provide greater certainty to its executives and network of dentists and allow management to refocus on running the business.

In May of this year, our firm led an investor group that invested $13 million in Castle, $7 million in subordinated debt and $6 million in Series B preferred stock for a controlling 62% ownership stake in the still publicly traded company. Following the $66.2 million recapitalization and Sentinel's investment, Castle's total debt fell from $52 million to $21 million of which $7 million was held by Sentinel. The balance sheet, which at one time was strangling the company, is now in good shape and Castle is well-positioned for growth.

Both Edison and Castle fit the profile of suitable going-private candidates. Both businesses serve a basic and fundamental economic need, yet their respective strategies proved more expensive to execute than management expected. Operational issues all too quickly swelled into financial structure issues, leaving the companies little room to maneuver.

The decisions to relinquish control to private equity investors made by Edison and Castle were not easy ones to make. However, partnering with a private equity firm holds the promise of immediate balance sheet repair and the freedom to adjust their business plans without the distractions of being in the public limelight.

Both companies' situations also affirm the notion that, despite all of their challenges, public-to-private deals can be beneficial to all parties involved. Public shareholders get immediate liquidity and management teams, in many cases, can retain significant equity stakes in the ongoing success of their companies.

While the volume of public-to-private deals will probably never live up to the hype, they merit careful consideration, particularly by small companies confronting capital structure and operating issues and private equity firms willing to tackle complex challenges. Boards and outside shareholders of such companies should urge management to consider going-private transactions as a transitional strategy to address their challenges away from public scrutiny and the increasing demands that accompany public ownership. Beleaguered management teams might be receptive, even though they will often have difficulty relinquishing their "control entitlement." ▢

— David S. Lobel
Founder and Managing Partner,
Sentinel Capital Partners

Making Sense of the Cash Balance Plan Brouhaha

Gone are the days when potential buyers of businesses were thrilled to see cash balance plans rather than their older cousins – final average pay defined benefit plans – as the key benefit plans at acquisition candidates. Cash balance plans were front-page news this summer. In one widely reported court decision, lump-sum payments made under Xerox's cash balance plan were found to have been miscalculated (in Xerox's favor) to the tune of about $300 million. On top of that, a different court decided that IBM's cash balance plan (and by extension practically all other cash balance plans) fundamentally violated one of ERISA's rules – and a politically sensitive rule about age discrimination at that. The decision in the Xerox case came as no real surprise. The IBM case, on the other hand, shocked many benefits gurus, and gave pause to companies considering converting their pension plans to a cash balance plan formula. Both buyers and sellers of businesses should understand the uncertainty surrounding cash balance plans in negotiating acquisition transactions.

What is a "Cash Balance Plan" Anyway?

A cash balance plan is a particular type of ERISA-governed tax-qualified pension plan. Under ERISA, a qualified pension plan is either a "defined benefit plan" (a traditional pension plan) or a "defined contribution plan" (such as a 401(k) plan).

A traditional defined benefit plan might have a formula for determining an annual pension benefit that is something along the lines of "for each year of service, 1.5% of average final five years' compensation." For an employee with 30 years of service and an average pay over the first five years of $60,000, this would translate into $27,000 a year. A participant's benefit is determined under the plan formula, without reference to the plan's assets. If we total up all the plan participant's accrued benefits, that total might be higher or lower than the value of the plans assets. Thus, a defined benefit plan may be underfunded or overfunded depending on how its assets compare with its liabilities (accrued benefits).

A cash balance plan is a defined benefit plan that is designed to walk and talk (as it were) like a defined contribution plan. And therein lie many of the problems.

A defined contribution plan – again, think 401(k) plan – is very different. Each participant has a separate "account" that is invested in investments usually chosen by the participant from a menu of available alternatives (*e.g.*, mutual funds). The account is credited with contributions, and credited with earnings and charged with losses on the investments. A particular participant's benefit under the plan is determined directly by reference to his or her account balance (and is usually delivered as a lump-sum payment of that amount). The assets of the plan always total up to the sum of the participants' account balances, which in turn equal the total accrued benefits under the plan, and hence there is no under- or over-funding in the case of defined contribution plans.

A cash balance plan is a defined *benefit* plan that is designed to walk and talk (as it were) like a defined *contribution* plan. And therein lie many of the problems.

A cash balance plan has *accounts* for each participant – but they are only notional accounts, merely bookkeeping entries. That notional account typically earns a "yield" or "interest" of one sort or another, and is credited with additional contributions each year. A cash balance plan might, for example, credit each participant's account with 5% of his or her compensation paid for that year, and then provide for additional accruals in the form of interest credits on that account at a rate established as part of the plan design. Often, this rate is some floating rate determined by reference to Treasury securities or high-rated corporate notes of a particular maturity. (Embedded in this benign and quite age-neutral sentence is the key to the ersatz age-discrimination issue that is the heart of the *IBM* case, but more about that later.) Because the interest credits are actually part of the accrual for the services already performed, when someone ceases employment, unless a distribution of the account is made, his or her account continues to be credited with interest (but of course there would be no more accruals with respect to the individual's compensation). Although most participants do take a lump-sum payment equal to his or her account balance when they leave the company, some do not and calculating the "accruals" that would have related to the additional "interest" credits is the hard question, and one that lead to the $300 million *Xerox* issue, but more about that later, too.)

Because cash balance plans have "accounts" and a participant might even receive a monthly or quarterly statement that shows an "account balance" – cash balance plans were meant to act like defined contribution plans. There is, however, no direct correlation between participants' benefits and the amount of the plan's assets. It is just a notional account notionally invested in a hypothetical investment, not reality. A cash balance plan may be underfunded or overfunded, and a review of the company's financial statements should reveal the plan status. It is a defined benefit plan.

Before turning to the real (or imagined) problems with cash balance plans, it is worth noting one more rather important difference between cash balance plans and traditional pension plan formulas that may create perceived age-discrimination issues. The way a traditional pension plan formula works – in our earlier example, "1.5% of final five years' average pay per year of service," employees with more experience (*older employees*) actually accrue more of their total benefit toward the end of their career. This is because an employee's pay usually increases over his or her career so that the final average pay is higher than, say, a career-average pay, and that increasing average pay gets the added bang of an increased multiplier because years of service is also going up. Thus, this class of employees is always disadvantaged when a traditional plan is converted into a cash balance plan, and the class can often become a unified force for an employer to contend with.

The Trouble With Cash Balance Plans: Round 1

When companies first started converting their traditional pension plans to cash balance plans in the mid- to late-1980s, there was a flurry of controversy. This early wave of controversy, however, largely related to the way traditional defined benefit plans were converted to a cash balance plan formula rather than to the very nature of the formula itself.

One of ERISA's fundamental protections is that an employee's accrued pension benefit cannot be taken away or reduced. Therefore, when a company converts from one formula to another, it cannot do so in a way that reduces the accrued benefit of a participant. When companies converted their pension plans to cash balance plans, they would calculate an amount equal to the employee's accrued benefit under the pre-conversion formula. Some companies may have gotten this wrong, which led to some disputes, but companies seem to be getting it right these days (although it is worth having actuaries double check this in due diligence for an acquisition if there is a large cash balance plan involved.)

The requirement that the prior benefit be preserved, however, led to the so-called wearaway problem. Wearaway is ultimately a human relations/public relations/political problem, but because the issue has so tainted cash balance plans, it may be informing what might otherwise be dispassioned legal analysis as well.

As we mentioned above, when plans converted from a traditional pension plan formula to a cash balance plan, they would calculate each individual's *protected* accrued benefit, calculated in accordance with legal requirements. They would also calculate a starting balance for each employee's account, and this starting balance often differed from the protected accrued benefit because it could be calculated using different factors from those used to calculate the protected benefit. (The discount rate might, for example, be different.) Where the protected benefit was higher than the starting account balance – as might often be the case for older workers – the employee would often not enjoy any true additional benefits under the cash balance plan formula until he or she caught up with the protected benefit. For example, if the protected benefit at normal retirement age had a present value of $80x and the starting balance were only $70x, the employee would actually not be accruing any additional benefits even though the plan was growing the account balance until that balance exceeded $80x (the value of the protected benefit). The wearaway problem was very controversial. Some thought that the very fact of wearaway was evidence of age discrimination, but the First Circuit Court of Appeals has held otherwise. Even more problematic, however, was the perceived unfairness to older workers. Many companies resolved this issue by grandfathering older individuals into the traditional plan formula, or by providing that the additional credits to the account for additional service would be added to the protected benefit.

The Trouble With Cash Balance Plans: Round 2

In the next wave of cash balance plan disputes was the *Xerox* case, the third decision of a U.S. Appeals Court to address how cash balance plans must calculate lump-sum payments made to individuals who take a lump-sum payment before normal retirement age. These blue-chip decisions – in addition to Xerox, one case involved Georgia-Pacific and another a company acquired by Bank of Boston – show some of the problems raised by trying to design a so-called "hybrid" pension plan to comply with ERISA legislation designed before these plans existed.

A traditional defined benefit plan may provide that people who leave before normal retirement can elect to take a lump-sum payment from their pension. In calculating that lump-sum payment, the rules essentially say to look at what the benefit would be at normal retire-

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Sign on the Dotted Line?

Background

You are a buyer in an M&A transaction on the eve of signing a definitive purchase agreement. You and your advisors have worked hard to draft and negotiate the agreement and, at long last, you believe it is in final form. Signature pages have been exchanged and you are starting to plan ahead for the closing. Then, much to your unpleasant surprise, the seller's controlling shareholder simply refuses to sign the agreement. The deal is off, right?

Hard to believe, but maybe not. In a July 2003 case (*AIH Acquisition Corp. LLC v. Alaska Industrial Hardware, Inc.*), a court in the Southern District of New York was presented with a similar fact pattern. In its opinion, the court denied a motion to dismiss by the seller, indicating that, unless the parties presented factual support for a different outcome,[1] it would grant the buyer's summary judgment motion to enforce the agreement – even though it was never signed by the controlling shareholder of the seller. In addition, the court enjoined the seller from selling the business to a third party prior to the final determination of the summary judgment claim.[2] In reaching these conclusions, the court cited a 1979 decision of the New York Court of Appeals (*Municipal Consultants & Publishers, Inc. v. Town of Ramapo*), which held that "when the parties have agreed on all contractual terms and have only to commit them to writing... the contract is effective at the time the oral agreement is made, although the contract is never reduced to writing and signed... *in the absence of a positive agreement that it should not be binding until so reduced to writing and formally executed*." (Emphasis added.)

Consequences

Even if the court ultimately enforces the purchase agreement against the seller, prior case law suggests that this decision should not affect most M&A transactions between sophisticated parties, in which the letter of intent or term sheet (if any) and the purchase agreement would generally be interpreted to give effect to customary language requiring that the definitive agreement between the parties must be reduced to writing. (Examples of such provisions are included below under "Recommendations.") However, the *AIH Acquisition* case introduces an unexpected degree of uncertainty into the acquisition process. Rather than operating on the traditional assumption that "it ain't over 'til it's over" – that there is no deal until the papers are signed by all of the parties – if the case is not overruled on appeal, parties to M&A transactions would be required to determine whether, at any time prior to signing, there exists an oral agreement "on all contractual terms."

The Court's Analysis

The discussion of the court's reasoning in the *AIH Acquisition* case is very brief and the facts provided are scant. The court's preliminary conclusion was that there was a "complete written agreement containing all material terms in final form" solely on the basis of an email from the *buyer's* counsel, which stated, in relevant part: "Attached is the final SPA. Everyone, including the lawyers, has stated that it is final without qualification." However, the opinion does not otherwise demonstrate that the *seller* had concurred that the agreement was final. The decision suggests that the buyer raised issues relating to the controlling shareholder's mental condition and capacity, but the court does not attempt to explain the seller's failure to sign the agreement. Did the seller in fact lack capacity or was it instead a classic case of "seller's remorse?" Or, perhaps, did the "final" draft simply not address all of the seller's concerns in a satisfactory manner? Did the e-mail message correctly reflect a meeting of the minds between the parties, or was it merely a self-serving exercise in wish fulfillment by a frustrated lawyer, anxious to avoid another round of edits? Is this case just a bad dream?

The Precedents

The background of the *Municipal Consultants* case cited by the court was quite different from the M&A context of the *AIH Acquisition* case. In *Municipal Consultants*, the town board of Ramapo, New York approved a contract with a publishing company and passed a resolution authorizing the town supervisor to sign the contract on the town's behalf. Although the resolution did not specifically direct the town supervisor to execute the contract, local law provided the town board with the sole authority to award contracts and granted no discretion to the town supervisor with respect to contracts previously authorized by the board. The *AIH*

1 *As of the date this article went to print, the parties had submitted additional information to the court in connection with the motion to dismiss the plaintiff's claim for specific performance, but no further decision on this motion had been issued by the court.*

2 *As of the date this article went to print, an appeal with respect to this injunction had been filed in the Second Circuit Court of Appeals, but had not yet been briefed for argument.*

Acquisition opinion cites this case in support of the proposition that the "mere lack of signatures is but a ministerial formality." However, in *Municipal Consultants*, it was the lack of discretion on the part of the signatory that rendered the execution of the contract a mere formality, not, as *AIH Acquisition* suggests, the fact that the agreement was in allegedly final form. By contrast, it is difficult to argue that the controlling shareholder in *AIH Acquisition* does not have full discretion over his decision to sign or not sign an agreement relating to the disposition of his shares.

The *AIH Acquisition* opinion also cites the 1984 decision of the Second Circuit Court of Appeals in *R.G. Group, Inc. v. Horn & Hardart Company*, but fails to indicate that the *R.G. Group* decision in fact reached a *contrary* conclusion. In *R.G. Group*, the plaintiffs sought injunctive relief to enforce an unexecuted franchise agreement and prevent a restaurant chain from granting franchises to third parties within the territorial scope covered by the agreement. Despite uncontroverted evidence that the parties agreed on at least one occasion that they had a "handshake deal," the Second Circuit held that, "if parties do not intend to be bound by an agreement until it is in writing and signed, then there is no contract until that event occurs." In determining the intent of the parties, the court relied primarily on the presence in the standard form franchise agreement of a boilerplate "merger clause" (*i.e.*, that the contract "contain[s] the entire agreement and understanding between the parties hereto with respect to the subject matter hereof") – to be sure, not a provision that likely attracted much attention during the negotiations. Nevertheless, the Second Circuit in *R.G. Group* was satisfied that this provision sufficiently demonstrated the parties' intent to be bound only by a written agreement, which intent the court would not frustrate, "handshake deal" or not.

Recommendations

To avoid any traps for the unwary that might arise in the wake of the *AIH Acquisition* case, private equity firms and others involved in bids or M&A procedures, and M&A practitioners should remember:

- If you will be using a bid letter, letter of intent or term sheet in your transaction, include explicit disclaimer language to the effect that the bid letter, letter of intent or term sheet is merely an expression of interest to proceed with the proposed transaction outlined therein, and that no binding agreement will exist between the parties until definitive written agreements have been executed and delivered.
- Make sure that your purchase agreement adequately manifests your intent only to be bound by a written agreement. In addition to the customary "merger clause" mentioned above, the court in *R.G. Group* suggested that such intent would be demonstrated by provisions such as standard amendments language (*i.e.*, that the agreement could not be "modified, waived, discharged or terminated… *except by a writing* signed by the parties") and enforceability representations (*i.e.*, that the agreement, "*when executed and delivered*,… will be a valid and binding agreement"). (Emphasis added.)

Even if the court ultimately enforces the purchase agreement against the seller, prior case law suggests that this decision should not affect most M&A transactions between sophisticated parties, in which the letter of intent or term sheet (if any) and the purchase agreement would generally be interpreted to give effect to customary language requiring that the definitive agreement between the parties must be reduced to writing.

- Create the appropriate paper trail. If you receive a distribution of transaction documents that purports to be "final," but you have not yet signed off on their terms, be sure to reserve your right to right to further comment.

Stay tuned to find out the final judgment in the *AIH Acquisition* case. ☐

— Joshua J. G. Berick
jberick@debevoise.com

— Franci J. Blassberg
fjblassberg@debevoise.com

An Introduction to Private Equity Firm D&O Insurance Coverage

In our Fall 2002 issue, we discussed indemnification and directors and officers (D&O) liability insurance generally, and how to apply those mechanisms to directors and officers of portfolio companies. We promised a future article that would focus on D&O insurance for private equity funds, their general partners or managing members, and the management company (referred to hereinafter as "firm D&O insurance").

In this article, we summarize some of the issues that a private equity firm thinking about purchasing firm D&O insurance might face in answering the questions: Why get coverage? How do you know you are getting appropriate coverage? What issues should you look for? In other words: Is the policy worth the premium?

Why Get Coverage

The principals of many firms, not surprisingly, are concerned about their liability as a fund manager. The concern is, in particular, whether the D&O insurance and indemnities received at the portfolio company level will be sufficient to protect the private equity fund, the general partners or managing members, and the management company. Principals could be exposed to lawsuits for breach of fiduciary duty, claims for wrongful acts or omissions, or could be the subject of regulatory or securities investigations. A portfolio company's D&O insurance will cover a principal only to the extent that the principal is a director of the portfolio company and a claim is made against that principal for a wrongful act committed in his or her capacity as a director for that portfolio company. Stated another way, the portfolio company's D&O insurance does not (and most likely cannot be modified to) extend to the private equity fund, the general partners or managing members, and/or the management company. Thus, the fund manager and its principals are not covered by the portfolio company's D&O insurance when they are acting in any capacity other than their capacity as directors or officers of that portfolio company. Furthermore, a principal with a minority interest in a portfolio company will probably not be in a position to dictate and negotiate the terms of that portfolio company's D&O insurance. Inadequacy of coverage and restrictive terms and conditions, which are common problems with D&O insurance today, could lead to uncovered claims.

Still, not every private equity firm purchases firm D&O insurance. Many firms rely on contractual indemnities from the funds they manage and from the portfolio companies in which the funds invest. The typical fund indemnity covers the fund manager and general partner and their respective officers, directors, employees, partners and agents. This indemnity would be funded by the liquid assets of the fund, or by calling capital contributions (or a return of distributions, if the fund terms incorporate a limited partner clawback provision). Of course, indemnification typically does not apply to the extent the loss arose primarily from the gross negligence or willful malfeasance of the indemnitee, and limited partner clawback obligations are often subject to limitations on the amount that can be clawed back and/or the time during which the clawback can be required. Moreover, it can be difficult (and unpopular) to enforce a limited partner clawback obligation.

Although limited partners of a limited partnership have limited liability in most circumstances, limited partners wanting to protect their investments (and the distributions they have already received) may approve the fund manager's obtaining firm D&O insurance. The limited partnership agreements of many funds often allow the general partner to treat firm D&O insurance as a fund expense. In fact, many fund investors have expressed concern about their contractual indemnification obligations to the fund and its managers, and have suggested – strongly, in many cases – that the fund manager insure those obligations as a fund expense.

Who is Covered?

Private equity firms should remember that the terms and conditions in D&O insurance designed for an operating company won't work for them. For example, a portfolio company's D&O insurance is typically written to cover the parent company and its majority-owned subsidiaries. This coverage structure, however, will not work for a private equity fund and fund managers. While the manager acts for the fund pursuant to a management agreement, it generally has no direct ownership interest in the fund or its general partner. A private equity firm with several funds may have a separate general partner for each fund, each with different ownership, that also do not fall within the parent/subsidiary relationship with either the manager or with the other general partners and funds.

When securing firm D&O insurance, it is extremely important to identify to the insurance broker and underwriters each entity to be covered, to explain the relationships of those entities among one another and to the portfolio companies, and to discuss who the individual insureds must be. The various defined terms in any D&O policy should respond to the correct terms applicable to the entity. The definition of "insured" can be modified to cover the private equity fund and its general partner, and partners of those entities as well as the manager of the private equity fund. If there are co-investment entities, which are used to facilitate, among other things, the principals' estate planning, those entities will not be covered unless they are specifically included in the policy (some of which may not even require an additional premium if the commitment amounts are small). Coverage may also be extended to non-principal professional employees, to the extent specifically identified.

How Do You Know You are Getting Appropriate Coverage?

Of course, potential purchasers of firm D&O insurance will look at price and coverage limits. The D&O insurance market is currently very difficult to navigate. Premiums are high and terms are more restrictive than ever. Careful review of the proposed firm D&O insurance and all of the endorsements is warranted, including the definitions, requirements for coverage and exclusions as they apply to the contractual arrangements for the manager, general partner and fund. Insurers generally offer several standard D&O insurance forms and, upon the insured's request, will modify language to address particular risks. The manager should negotiate any provisions that don't fit the firm's particular needs, should make clarifying amendments to the language of ambiguous provisions and should obtain specific comfort from the insurer regarding the interpretations that will be applied in this context to ensure that coverage will be provided when it is needed.

In addition, new policy forms are now available to cover directors and officers for claims if the private equity firm (or, for that matter, the portfolio company) rightly or wrongfully refuses or is financially unable to indemnify the directors and officers. These policies are referred to in the insurance market as "Side A excess policies." All Side A excess policies, however, are not created equal. Some Side A excess policies contain a "drop-down difference-in-conditions" (DIC) term. Side A policies with DIC terms frequently have limited or narrowed exclusions relating to personal profit or advantage and dishonesty. Some Side A policies with DIC terms cannot be rescinded based on the restatement of any financial statements included within the application. These broad coverage features (which are not typically offered in a primary D&O policy) become crucial when a claim is made, inasmuch as a Side A policy with DIC terms will act as a primary policy (subject to its own terms and conditions) in the event the primary D&O insurance will not cover a particular claim. A Side A policy will also act as an excess policy, protecting the directors and officers (not the corporation) in the event the primary policy limits are exhausted.

Does the Coverage Protect Against Suits by the Fund's Limited Partners?

D&O policies generally exclude claims brought by or on behalf of one insured person against another insured person, subject to certain exceptions (such as shareholder derivative actions.) This is commonly referred to as the "insured vs. insured" exclusion. Since the limited partners are, of course, partners of the fund and could, therefore, be deemed an "insured" under firm D&O insurance, this may exclude from coverage claims by the limited partners against the general partner or manager, particularly if the suit is brought as a derivative action in the name of the fund. In some instances, the insured vs. insured exclusion can be modified to cover these risks in whole or in part.

Are the Innocent Protected?

Many D&O policies now being offered by insurers void coverage for all directors and officers if one insured committed fraudulent acts or withheld material information on the D&O insurance application. Thus, those "innocent" directors sitting alongside a wayward director could find themselves unprotected and exposed, even though they acted in good faith and are without fault. In addition, knowledge of past events known by one board member that may give rise to a claim may be attributed to other board members, making it difficult or impossible for the private equity firm to add a new principal. Further, some insurers have added broadly worded exclusions whereby any "statement made in or out of a court" could be used as evidence of fraud and, therefore, to void coverage. Informed insureds and their lawyers, finding such provisions unacceptable, have been aggressively negotiating these terms and exclusions with potential insurers, with various degrees of success. Despite the tight D&O insurance market, insurers are willing, in certain cases, to modify these provisions, keeping the innocent directors protected in the event of a claim.

Other Issues to Look For

Coverage under firm D&O insurance often does not extend to a principal's membership on a portfolio company's board (public or private) on the basis

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alert

SEC Staff Recommends Registration of Hedge Fund Advisers – Private Equity Advisers Likely to Be Unaffected

As we went to press, the SEC Staff issued its report and recommendations on hedge funds, culminating after a year-long study and investigation. The key recommendation made by the Staff was that hedge fund advisers of a certain size be required to register with the SEC by amending a rule to the Advisers Act. The Staff noted that registration would have at least one significant effect beyond increased SEC oversight: it would effectively increase the minimum investment requirement for investors in some hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have at least $750,000 invested with the adviser or have a net worth over $1.5 million.

The Staff recommended that sponsors of private equity and venture capital funds not be subject to the new registration requirement. Rather, they would continue to be subject to the current regime, which exempts advisers with fewer than 15 clients. Finally, the Staff requested the Commission to consider eliminating the general solicitation restriction for hedge fund offerings limited to highly sophisticated investors (*i.e.*, individuals owning $5 million or more of investments and institutions owning or managing $24 million or more of investments).

We will update you with a fuller description of the report in our Winter 2004 issue. ▫

— Jennifer A. Spiegel
jaspiegel@debevoise.com

Recent and Upcoming Speaking Engagements

October 9

Andrew N. Berg
Corporate Debt Restructurings
New York, NY

October 20

David H. Schnabel
The Use of Partnerships & Disregarded Entities in Corporate Planning
Institute on Federal Taxation
New York, NY

October 30-31

Woodrow W. Campbell, Jr., Chair
Private Equity Funds: Current Issues in Structuring and Fund Terms

Paul S. Bird
Fundamentals of Private Equity Investing: Parts I and II
Ethical Issues: "Noisy Withdrawal" Under Sarbanes-Oxley

Private Equity Forum: Legal & Financial Strategies for Dealmaking in a New Regulatory Regime
New York, NY

November 13-14

Franci J. Blassberg
Negotiating Corporate Acquisitions
New York, NY

January 13-14

Franci J. Blassberg
Corporate Governance: Managing Risk for the GP

Michael P. Harrell
Partnership Strategies and Structures for GPs and LPs

The 2004 North American Private Equity COOs and CFOs Forum
New York, NY

UK Provides Relief for Carried Interest Holders from Application of New Tax Rules

The UK's Finance Act 2003 changes significantly the UK tax treatment of equity-based compensation plans. The new rules, in Schedule 22 of the Finance Act, apply to grants of "restricted securities" after April 16, 2003 to employees who are both "resident and ordinarily resident" in the UK.[1] Grants of carried interest in a private equity fund to UK-based executives are within the scope of Schedule 22 and therefore are potentially subject to adverse UK tax treatment. In a significant concession to the private equity industry, however, the UK Inland Revenue recently published a safe harbor that limits substantially the application of Schedule 22 to carried interest holders.

New Tax Treatment of Restricted Securities

If Schedule 22 applies to a grant of restricted securities to an employee, he or she will be subject to a tax regime that is similar to the rules applicable to U.S. "section 83(b) elections:"

- If the employee and his or her employer make a joint election within 14 days of the grant, the employee will be subject to UK income tax up front on the excess of the fair market value of the securities at the time of grant, ignoring the negative impact of any vesting, transfer or other restrictions on the securities, over the amount that the employee pays for the securities. The employee, however, will not be subject to additional tax charges under Schedule 22.
- If the employee and his or her employer do not make the election, the employee will still be subject to UK tax on the excess of the fair market value of the securities at the time of grant over the amount that the employee pays for the securities, but in this case fair market value will be determined taking into account the negative impact of any vesting, transfer and other restrictions. The employee, however, will be subject to additional UK income tax on the earlier of the date that the vesting or other restrictions lapse and the date that the executive sells the securities, based on the gross value of the shares at the later date multiplied by the percentage discount, determined at the time of grant, attributable the vesting, transfer and other restrictions.

Whenever the employee is subject to income tax under Schedule 22, the employer and the employee will also be subject to a corresponding UK employment tax charge.

The significance of Schedule 22 to a private equity fund executive who is resident and ordinarily resident in the UK is that, if Schedule 22 applies to a grant of carried interest, the executive may be subject to a significant income and employment tax charge at the time of the grant of carried interest and each time the executive's share of the carried interest increases (if the executive and his or her employer make the election), or at the time that the vesting restrictions lapse or the fund makes carried interest distributions (if the executive and the employer do not make the election). In either case, the impact of Schedule 22 would be of particular significance to an executive who is not domiciled in the UK and who, in the absence of Schedule 22, would not be subject to UK tax on all or part of his or her carried interest distributions under the UK's remittance-based tax system.

Safe Harbor for Carried Interest

The Inland Revenue recently provided a safe harbor from the application of Schedule 22 in relation to carried interest holders. Under the safe harbor, the issuance to an executive of securities representing a share of the carried interest in a private equity fund, and subsequent increases in the executive's share of the carried interest, will not be subject to tax under Schedule 22 if the issuance occurs at the time the fund is formed, or if the issuance or increase occurs at a time when the aggregate value of the fund's portfolio investments does not exceed the aggregate acquisition price of the portfolio investments. The safe harbor does not address specifically the grant of carried interest that relates to some but not all of the portfolio investments of a fund (for example, the issuance to an executive of securities representing carried interest that relates only to profits from future portfolio investments), however, under the principles articulated in the safe harbor, this type of grant would not be subject to tax under Schedule 22.

To qualify for the safe harbor, the fund and the executive must satisfy a

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[1] *Generally, an individual will be treated as resident and ordinarily resident in the UK upon arrival if he or she arrives in the UK with an intention to remain in the UK for at least three years. An individual who does not arrive in the UK with this intention will become resident and ordinarily resident if he or she subsequently develops an intention to remain in the UK for more than 3 years from arrival. Also, if an individual remains in the UK for an average of 91 days or more each tax year, the individual will become resident and ordinarily resident in the UK at the beginning of the fifth UK tax year during which he or she is present in the UK.*

Is It Time for a Power Play?

As the blackout of this past August brought close to home, the last few years have not been good ones for the power-generation sector. Challenging times for the power-generation sector may create powerful opportunities for private equity players. The combination of headline-grabbing reports of manipulative energy trading (and whopping penalties), overbuilding, the recession and regulatory uncertainties have caused values reached in 2000 to plummet, offering potentially attractive investment opportunities to those who continue to have access to capital and the requisite knowledge base to evaluate this complex market sector. Not surprisingly, private equity players are showing increased interest in this field.

How Did Things Get This Bad?

The recent downward spiral in the power sector is the result of a combination of factors. Not so long ago, independent wholesale power producers (IPPs) were viewed as the lean-and-mean players in the industry, unencumbered by rate regulation and the overhead and bureaucracies seen as the hallmarks of integrated investor-owned utilities. In the post-Enron era, the volatility of energy prices, the collapse of energy traders and the threat of overcapacity posed by recent construction, have left most IPPs and companies operating in the merchant energy market, trading at a small fraction of their values of only two years ago.

The decline in the equity market has been accompanied by significant negative impact on the credit profile of power-sector companies. Rating-agency downgrades were commonplace throughout 2001 and 2002. Virtually all pure-merchant IPPs had ratings below investment grade by the end of 2002 – a function of declining coverage and increased leverage ratios. Deteriorating credit ratings have, in turn, triggered significant collateral calls under power-trading contracts, while at the same time making access to capital a much more expensive proposition. The crunch has been particularly acute for those companies that relied upon short- or medium-term debt, as the prospect of refinancing has become more tenuous. Facing spiking credit spreads, buyers have turned into sellers. Some owners have simply handed over the keys to their banks.

Prevailing energy prices have contributed to the slump. The combination of a weakened economy and perceived overcapacity has translated into declining prices (or so-called forward spark spreads) for the near to medium term. Bankruptcy seems not too far off for those deepest into the downward spiral.

Where Does It Go From Here?

It should come as no surprise that one outgrowth of these developments has been an increasing number of generation assets being put up for sale by strapped industry players. While the volume of sales in 2001 and 2002 may not have outstripped that of the late '90s, many of the industry's traditionally active buyers have been sidelined by the prevailing credit crunch, or transformed into sellers. The result is a buyer's market, with many former buyers out of the game.

Faced with these developments, certain players with access to capital, including some private equity firms, have seen an opportunity. MidAmerican Energy emerged as Berkshire Hathaway's platform for investment in the energy sector. KKR teamed with Trimaran Capital Partners to buy DTE Energy's electric transmission assets. Another private equity firm has purchased gas pipeline facilities from the Williams Companies. As a general matter, however, the sales to date have involved transportation assets (*e.g.*, transmission systems or gas pipelines) or generation assets with future output that has been sold under long-term supply or output contracts. To date, very few, if any, pure merchant plants (*i.e.*, generation plants that must rely entirely on sales in the wholesale energy market) have changed hands, although the field of potential sellers appears to be growing.

Why Private Equity?

Private equity firms have a couple of things going for them in the current market. First, and most importantly, they have the ability to access substantial equity capital on an assured and timely basis. Private equity players may have other advantages, as well:

- As private entities, they may have a greater willingness and ability to expand into the energy sector, which has had more than its share of headline-grabbing scandals that may prompt those closer to the glare of public opinion to hesitate.
- In at least some instances, private equity firms may enjoy a regulatory advantage over other market players. A neighboring integrated electric utility may face tough scrutiny by both the Justice Department/FTC and the Federal Energy Regulatory Commission as to the competitive implications of any acquisition that would expand or

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Germany to Modernize Fund Laws

In an effort to attract foreign investment funds and managers, the German Ministry of Finance recently published its long-awaited draft of legislation for reform of Germany's heavily criticized and outdated public investment fund and tax laws. The laws will now be considered by the German Parliament and are expected to become effective on January 1, 2004.

Although the focus of the legislation is on the offer and sale of public funds in Germany, there are some new provisions that are meaningful to our private equity clients. The legislation provides that investment management companies regulated in another EU member state and complying with the UCITS regime can provide fund-management services, including investment advice, distribution and depositary services, to German clients. This should make it easier for our private equity sponsors with subsidiaries licensed in London, for example, to provide cross-border services in Germany.

With respect to *non-European* investment management companies, the Ministry of Finance has the power to promulgate a kind of passporting regime, depending upon reciprocity in the relevant non-European home country. We are hopeful that the reciprocity will be used to permit U.S. managers registered with the SEC to offer services in Germany.

Moreover, codifying recent practice, outsourcing of discretionary investment management will be expressly permitted. U.S. and other non-European investment managers can import their investment management services into Germany by entering into an outsourcing agreement with either a German-licensed management company or another licensed European management company that is passported in Germany. While outsourcing of portfolio management has in practice been used over the past few months, the new law explicitly blesses these arrangements and makes clear the specific basis on which they can be implemented.

For the first time, Germany will also permit the organization and offer of hedge funds for sale in Germany. The much-hyped hedge fund provisions offer little additional opportunity for private equity sponsors, though. A German hedge fund cannot invest more than 30% of its net assets in unlisted securities, such as direct investments in private equity or private equity funds. In fact, the Ministry of Finance clearly stated that the hedge fund provisions were meant to prevent hedge funds from being used as pseudo-private equity funds.

The new Act will also make significant changes to the taxation of funds, especially foreign funds, sold in Germany. The existing distinction between white, gray and black funds, and the penalizing taxation of black funds will be abolished after a transition period of two years. We will provide you with a more detailed analysis of these tax changes in an upcoming issue of *The Private Equity Report*. □

— Marcia L. MacHarg
mlmacharg@debevoise.com

— Patricia Volhard
pvolhard@debevoise.com

— Christian R. Doerre
crdoerre@debevoise.com

How "Independent" is Independent Enough? (cont. from page 3)

remember, however, is that a "house independent," depending on the nature and extent of any ties with the private equity firm, may not be able to act as an independent director in a situation in which the company has a serious conflict of interests with the private equity firm – *e.g.*, serving on an SLC if there's derivative litigation against the private equity firm, or serving on a special committee to consider a going private transaction involving the firm. Private equity firms should also remember that relationships with directors may in some contexts be disqualifying, even if they're not economic relationships. □

— Meredith M. Brown
mmbrown@debevoise.com

— William D. Regner
wdregner@debevoise.com

recipient's "base amount," which, in the case of an employee, is generally the individual's average W-2 compensation for the five calendar years preceding the calendar year in which the change of control occurs.[1] This amount is usually referred to as the "Safe Harbor Amount."

This tax (and the loss of the deduction) does not apply with respect to change of control of a corporation that had no class of stock that was readily on an established securities market[2] immediately prior to a change of control so long as, after adequate disclosure to shareholders of all material facts concerning all payments that would be subject to such tax, the persons who, immediately prior to the change of control, owned at least 75% of the voting power of all outstanding stock of the corporation entitled to vote approved the making of such payments. This approval must determine the right of the affected individuals to receive the applicable payment.

Prior Practice

What this has meant in the past is that, whenever any compensatory plan, program or arrangement has been adopted by a closely held company, shareholders would approve the provisions of that arrangement which would permit the payment of additional compensation (or that would accelerate the timing of the payment of such compensation) upon a change of control. Thus, when a new stock-option plan was implemented that had a provision to accelerate vesting upon a change of control, or an employment agreement was being negotiated that would provide for severance benefits (whether or not specifically related to the occurrence of a change of control), the approval of the requisite shareholders would be obtained at that time. This allowed the participants in the plan or the employee covered by the agreement to know with certainty what benefits would be payable upon a change of control, and still provide the opportunity to preserve the deduction for the corporation and for the employee to avoid the added tax. The only perceived risk was that the shareholder population might change sufficiently prior to the actual change of control so that those who approved the payment would not qualify to grant the required approved; that is, the approving shareholders would not constitute 75% of the shareholders of the outstanding stock entitled to vote at the time of the change of control.

The New Standard

The Revised Regulations now specify that to meet the applicable disclosure requirements there must be "full and truthful disclosure of the material facts" surrounding the parachute payments that are the subject of the shareholder action. However, in defining what is material, the IRS has made it virtually impossible to meet this standard of approval prior to knowing the details of the actual change of control upon which the payments are eventually to be made:

> For each disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements... are not met and a brief description of each payment (*e.g.*, accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a subsubstantial likelihood that a reasonable shareholder would consider it important.[3]

Thus, while not all payments that would or could be parachute payments need be presented to shareholders for approval, the IRS requires disclosure of all parachute payments for the approval of any such payment to be effective. This presents two huge practical problems:

1. How does the corporation identify the "total amount of the payments" that would be parachute payments in advance of the actual transaction?

2. If an employee is to receive more than one parachute payment, how does the approval of each such payment both determine the right to receive the payment and discuss all of the payments that may be made?

Presumably, the IRS would have to recognize that the "total amount" may be determined by a formula, since it is often the case that the actual amount payable to shareholders in a change of control will not be known at least until closing (such as in a stock for stock deal where the value of the consideration to be received can fluctuate with market prices) or after closing (such as where there is a closing balance-sheet adjustment or an escrow arrangement or earn-out that is not settled until well after closing). It might be possible to

1 If the employee has been employed less than five years, the average is generally determined based on his or her period of employment.

2 Because this provision treats all entities that are considered part of the same control group of corporations for federal tax purposes as a single entity, to use this exception, no other company under common control with such company can have any class of stock that is traded on an established securities market.

3 The IRS has also stated that the disclosure must be made to every shareholder of the corporation entitled to vote. Since these shareholders are determined "immediately prior to the change in control," any change in the composition of the shareholders (other than during the limited grace period permitted under the regulations) would cause this condition not to be satisfied.

assert that this disclosure requirement can be met by illustrating the effect of the change of control provisions at various stock prices or with the application of other sets of assumptions (such as the date at which an employee's employment would terminate due to a change of control), so that shareholders would generally understand the amounts that could possibly be payable upon an actual change of control. However, the IRS position on the first issue clearly precludes the ability to give a blanket approval of a generic provision, such as with respect to a change-of-control provision in a stock-option plan, as the shareholders will not know the amount payable to each employee, nor will they be able to determine such amount pursuant to a formula, as they will not know the amount of options that each such employee will eventually hold.

Moreover, even if the shareholders were to approve each and every compensatory arrangement that contained any change of control provisions, the requirement that the shareholders receive disclosure of all parachute payments cannot be met if an employee receives a stock-option grant with change-of-control provisions, a severance commitment or a retention payment after the date on which a prior change of control benefit has been approved. For example, if an executive is granted stock options, the vesting of which is contingent on a change in control, in year one; awarded in year-two participation in a bonus plan that pays prorated payments in the event of a change of control; and granted a severance commitment in year three (whether or not specifically contingent on a change of control), none of these payments could be approved by shareholders at the time that they were adopted and satisfy the requirements imposed by the IRS in the Revised Regulations. If each were approved as adopted, the corporation could not give the shareholders adequate disclosure at the time of adoption of the first two benefits in the example, because all parachute payments would not be known at that time due to the addition of the third benefit. Moreover, as the shareholder approval "must determine the right of the disqualified individual to receive the payments," approval after adoption will generally not satisfy this condition. Thus, approval of the first two benefits could not be obtained when the last benefit is approved, because these earlier benefits will already have been approved or committed when the last benefit is adopted.

What the Executives Will Want

It is unlikely that the employees at privately held companies will be willing to leave to some future shareholder vote the question of what severance that they will receive or what happens to their options in the event of a change of control. They will argue (as do the executives at public companies) for certainty and for the corporation to bear the possible impact of the parachute provisions by providing a full tax gross-up so that the corporation pays all the costs associated with the additional tax on the employees, including the income and employment taxes payable with respect to the gross-up. And the cost of the gross-up (which itself will be entirely non-deductible) will be in addition to the lost tax benefits that the corporation will incur due to the denial of the tax deduction.

Recommendation

The best solution is half a loaf now, with the rest to come on a contingent basis. That is, change-of-control provisions would be incorporated into the various compensatory agreements, as they have been in the past. Now, however, all compensatory arrangements would provide that, in no event, will the amounts payable in connection with a change of control exceed the Safe Harbor Amount referred to above, unless the shareholders vote, in connection with the transaction, to remove the cap. Existing programs could be revised to add such a limit. This may require employee consent, but if there is no commitment regarding a gross-up, the employee will very likely benefit from the proposed revision, because he or she will bear the burden of the added excise tax. Employees who have gross-ups will be reluctant to give them up, but that could be made a condition of any future compensation award that is made (including an additional award that is an inducement to waive the gross-up).

By imposing the cap, the employees would have a commitment up to the maximum amount that could be paid to them without the additional tax being applicable, which can provide them significant benefits given the favorable way in which the parachute impact of certain awards – such as time-vested stock options – is measured for purposes of applying such a cap. And, if the shareholders agree to lift the cap, the full benefits would be paid, without a tax and without the loss of any tax deduction. Moreover, the corporation could even commit to employees to exercise its commercially reasonable best efforts to obtain the necessary shareholder approval at the time of the transaction. No shareholder should make any legally binding commitment prior to the time the actual vote is sought in connection with the actual change of control transaction. However, a shareholder might, in appropriate circumstances, earlier express its then-current intention to support the waiver of the cap if and when requested. ▢

— Lawrence K. Cagney
lkcagney@debevoise.com

Fund Terms and Conditions: Beware of "Solving the Valuation Conundrum" (cont. from page 5)

Those assumptions may change over time (look, for example, at valuations in the telecommunications and energy industries today versus 1999). Investing in privately held concerns means that there is no reliable market available for comparison.

However, there are some things investors and sponsors can do to help lessen some of the tension surrounding valuation issues. Investors can take steps to educate themselves, such as understanding their sponsors' valuation methodologies and discussing with the general partner the fund's approach to distributions when there are problems in the portfolio. Sponsors, in turn, while continuing to pursue uniform standards, will be well served by maintaining open lines of communication with their investors about the fund's investments. Sponsors need to be frank with their investors when a portfolio company is troubled, take write-downs when warranted and take steps to assure their limited partners that they are doing everything in their power to avoid a clawback situation. Trust on each side that the other party is working towards understanding the particular portfolio and doing what is necessary to avoid a clawback can go a long way toward avoiding this particular risk of private equity investing.

— Jennifer J. Burleigh
jjburleigh@debevoise.com

ment and then discount back using a government-prescribed interest rate to the date the lump-sum payment is to be made. This is a hard-and-fast rule, and by requiring that the government-prescribed discount rate be used is intended to prevent individuals (who might not know about present value concepts, etc.) from "selling" their pension benefit for too little.

Early designers of cash balance pension plans wanted the lump-sum payment always to equal the individual's account balance at any time. That was one of the hoped-for design "features" or selling points of cash balance plans. Young and mobile workers would know that their benefit at any time was their account balance, which was portable in that they could take the money if they left the company (and roll it over into an IRA or other plan if they desired).

Thus the goal of the designers of cash balance plans was to "force" the early lump-sum payment to equal the account balance. The only way to be sure of this is to project forward from termination of employment to normal retirement age, and then discount back again at the same interest rate. Thus, one approach would be to take the account balance and project forward at the interest rate that would be credited to the account balance under the plan, and then discount back using that rate. That, however, was found to run afoul of the requirement that the early lump sum be discounted back from the normal retirement age benefit *at the government-prescribed interest rate*.

The other approach to "force" an early lump sum to equal the account balance would be to project forward at the government-prescribed interest rate and then, safely, discount back at that same prescribed rate. However, when a different (and more favorable) method is used to credit interest on the accounts of those employees who have not left service, this approach denies the participant a portion of his or her accrued benefit. For example, if the plan provides that an individual's account balance will generally be credited at a floating one-year T-Bill rate, then that is what has to be used to project forward to normal retirement age, rather than the rate that the government prescribes for use in discounting the normal retirement benefit back to its present value.

So the bottom line is: A cash balance plan is subject to the rules for defined benefit plans. When calculating early lump-sum payouts, the *plan* rate must generally be used to project forward to normal retirement age. The government-prescribed rate must be used to discount back. These rates will usually differ, so the hypothetical early lump-sum payment calculated for each individual will, as a result, differ from the individual's account balance. This was the issue for Xerox, and a costly one because the normal crediting rate was much more generous than the applicable discount rate.

These mismatch quirks could cut either way, depending on the difference between the rate being used to project the account balance forward to normal retirement age versus the rate that must be used to discount back to determine the lump sum. (Although the plan should be able to use the account balance as a floor, that is, as the minimum amount payable.) In Xerox's case, it helped the individuals. Which is why the plan participants sued. The law does, however, seem settled that there is no "hybrid" exception to the defined benefit pension plan rules on how to calculate lump-sum payments made ahead of normal retirement age. Buyers of companies should make sure that any cash balance plans in the target company have tackled this issue and that early lump-sum payments as well as employee disclosure of "lump-sum" account balances has been accurate.

The Trouble With Cash Balance Plans: Round 3

The *IBM* case broke some new ground in the dispute over cash balance plans because the district court judge found that in addition to all of these other problems with cash balance plans, the plans actually violated a provision of ERISA that acted as a prohibition against age discrimination.

The IBM case broke some new ground in the dispute over cash balance plans because the district court judge found that in addition to all of these other problems with cash balance plans, the plans actually violated a provision of ERISA that acted as a prohibition against age discrimination.

The district court's reasoning was seductively simple (and distressingly conclusory), and can be summarized as follows: Section 204(b)(1)(H) of ERISA prohibits a plan from reducing "the rate of an employee's benefit accrual…because of the attainment of any age." Although the law does not define what "the rate of an employee's benefit accrual" means (that would be too helpful), it must be measured by the value of an annuity commencing at normal retirement age (65). If there are two employees identical except for age, a cash balance plan formula that credits them with the same formula amount discriminates against the older worker. How can this be? Because that same dollar credited to the younger employee will grow over time and produce a larger annuity at his normal retirement date, whereas the dollar credited to the older employee will not grow as much because there is less time for the employee to receive the interest credits before retirement.

This article is not the place for a detailed discussion of the merits of the district court's decision in the *IBM* case, but suffice it to say there are some flaws in the court's reasoning. Another district court in *Onan Corporation*, a particularly detailed opinion, also examined this same question and held exactly to the contrary, reasoning that a review of the legislative history showed that the provision at issue was intended to apply *only* to situations where the employee continues to work beyond normal retirement age, a fact that is apparent from the very heading of the corresponding provision of the Internal Revenue Code. (ERISA and the Internal Revenue Code have many provisions that are intended to operate in tandem. Only the ERISA section was properly before these courts, because the meaning and interpretation of the Code provisions are between the IRS and the plan and sponsoring employer.)

In addition, even if the ERISA provision were intended to apply in these circumstances, there is no such requirement that "the rate of an employee's benefit accrual" be measured solely by reference to the value of an annuity commencing at normal retirement age, a concept that got the *IBM* court befuddled. As noted below, the IRS has issued proposed regulations that address this very requirement and take a contrary view of this requirement in the context of cash balance plans.

So Where Are We Now?

It's important to note that defenders of cash balance plans are *not* proponents of age discrimination. A finding that the particular ERISA provision at issue in the *IBM* case is not a violation of the non-discrimination rule would still leave a whole armada of protections for employees. It may be that it is too late to change the political tenor of the plan debate, but it is a point worth keeping in mind.

If we were keeping score, one district court has held that cash balance plans violate the prohibition on age discrimination, but without much analysis. Another court in a fully reasoned opinion came to the contrary conclusion. Still another district court volunteered that cash balance plans do not violate the age-discrimination rule, but this was in non-binding dicta. Three Courts of Appeals have looked at cash balance plans in depth and failed to note this alleged fundamental flaw, but that issue may not have been properly raised before those courts, so we should not take too much comfort from this.

The IRS has issued proposed regulations that would provide an express safe harbor under the tax Code's analogous no-age-discrimination provision for cash balance plans that met certain requirements, so it appears that the IRS and the Treasury do not share the views of the *IBM* court. Recently, however, the House of Representatives tacked on a provision to an appropriations bill that would prohibit the IRS from issuing those regulations in final form. So who knows if the regulations will be issued.

At this point, IBM's much-publicized appeal and a reversal of the district court's decision would help remove some (but not all) of the uncertainty that hangs over cash balance plans, an uncertainty that buyers and sellers of companies may assess differently (and therefore "price" differently). Some quantum of risk remains. Even ill-reasoned decisions like the one in the *IBM* case sometimes do prevail.

A legislative solution would avoid all doubt, but gridlock seems the order of the day, and resolving the confusion over cash balance plans may not be high on Congress' list – particularly because of some of taint that goes back to the way plans were converted in the past. Until the law is clearer, it may be hard to assess the impact of cash balance plans on acquisition transactions. ▢

— David P. Mason
dpmason@debevoise.com

An Introduction to Private Equity Firm D&O Insurance Coverage (cont. from page 15)

that a portfolio company should have its own D&O policy. If coverage needs to be extended (because the portfolio company has no coverage or inadequate coverage), information about the particular portfolio company board membership should be obtained and submitted to the insurer. The insurer will review the information and may extend coverage on a case-by-case basis, perhaps with an additional premium.

Under certain policy forms, coverage for the directors becomes unclear in the event of bankruptcy of the insured company. In the case of bankruptcy, in order to maintain the policy for the benefit of the directors and officers, express language must be included in the policy to make sure the directors and officers will continue to be covered in the event the corporation is financially unable to indemnify them. In addition, suits brought by a bankruptcy trustee or creditors' committee against the directors and officers should expressly be included as covered.

Another issue to look for is that most D&O insurance policies expressly exclude coverage for liability arising out of an individual rendering "professional services." Thus, when a director or officer, who, for example, is a CPA, renders advice in his or her capacity as an accountant, liability arising from accounting errors is most likely not going to be covered by most D&O policies. The professional services exclusion in firm D&O insurance could be very broad and, in some cases, should be modified or a separate professional liability insurance policy may be appropriate to provide full protection.

Conclusion

Private equity firms thinking about purchasing firm D&O insurance should closely evaluate their exposures and make sure that the policy is crafted to address their particular needs, including their organizational structure. Properly tailored firm D&O insurance can be an asset in attracting talented individuals to private equity firms. It is important to review the proposed firm D&O insurance form and endorsements thoroughly to ensure that the private equity firm is properly covered. ▫

— Robert J. Cubitto
fjcubitto@debevoise.com

— Heidi A. Lawson
halawson@debevoise.com

UK Provides Relief for Carried Interest Holders from Application of New Tax Rules (cont. from page 17)

number of technical requirements. Although these requirements will need to be reviewed on a case-by-case basis, they are unlikely to create difficulty in the context of typical private equity carried interest arrangements. The safe harbor envisages that the carried interest will be held through an English limited partnership, but it recognizes that non-UK investors may invest through alternative structures (for example, a limited partnership formed under the laws of Delaware or the Cayman Islands).

The safe harbor does not apply to issuances to executives of (or increases in an executive's interest in) carried interest in relation to portfolio investments that have appreciated in value on an aggregate basis. For example, if an executive forfeits all or a portion of his or her carried interest in respect of appreciated portfolio investments in connection with the termination of the executive's employment, and the forfeited carried interest is reallocated to the other fund executives based on a formula or otherwise, the other executives who are resident and ordinarily resident in the UK will be subject to tax under Schedule 22. In this situation, the UK-based executives should consider whether to make the election to be taxed currently under Schedule 22 in order to reduce the eventual tax charge at the time the fund makes distribution of carried interest.

The new safe harbor for carried interest holders affords significant relief for UK-based carried interest holders. Nevertheless, it is important to get a UK tax advisor on board to ensure that issuances and reallocations of carried interest are structured in the most tax efficient manner for the UK-based executives and the private equity firm, particularly in light of the short time frame for making the election under Schedule 22 if the safe harbor is not available. Since the new rules are broadly drafted and the safe harbor will require some interpretation, the UK tax advisor will also be able to advise upon the way in which market practice in relation to Schedule 22 is evolving. ▫

— Peter F. G. Schuur
pfgschuur@debevoise.com

— Kerry Westwell
kwestwell@debevoise.com

entrench an existing distribution or transmission network.

- Private equity firms may also have an edge over regulated utilities where the target is, or includes, so-called "qualifying facilities" (QFs). The Public Utility Regulatory Policies Act of 1978 (PURPA) was enacted by Congress to encourage the introduction of non-utility generators into the U.S. electric industry. QFs include certain cogeneration units or small power-production facilities of up to 80 megawatts. PURPA accords QFs two principal benefits: (1) requiring electric utilities to purchase QFs electric output at the utilities' avoided costs of producing power and also requiring that they interconnect with any QF in their service territory; and (2) exempting QFs from the provisions of the Public Utilities Holding Company Act and the Federal Power Act, including provisions relating to rate regulation. Because PURPA restricts the ownership of a QF to "a person not primarily engaged in the generation or sale of electric power," where a target includes QFs that have above-market, long term power sales contracts (as is frequently the case), a private equity firm (unlike a regulated electric utility) may be able to preserve the attractive economics of QF status post-acquisition.

Bridging the Experience Gap

While private equity players may have some advantages as potential buyers, they are likely to be starting from a significant knowledge deficit in a highly complex industry. This deficit poses challenges for informed pricing. There is the need to evaluate the condition of assets, related fuel and transmission arrangements, environmental risks, applicable regulatory framework, existing output/power purchase agreements, dispatch constraints, operational agreements and the ins and outs of the energy-trading business. Moreover, given the substantial uncertainty as to when the market for generation assets may rebound, any prospective buyer needs a clear strategy for operating and deploying resources during the interim period. To address this steep learning curve, a number of approaches are open to private equity sponsors and investors, including:

- *Hiring experienced industry players.* With the slump in energy-trading operations and IPPs, it should come as no surprise that there are persons with substantial industry experience available in the marketplace. Such individuals can be invaluable to equity fund sponsors in the due diligence process and in monitoring risk management and operations post-acquisition.
- *Equity fund/industry-player partnerships.* Creating a successful new private equity fund requires substantial time and effort. Some power/energy players have sought to shortcut that process and speed their access to capital by joint venturing with an existing major private equity fund interested in gaining exposure to the market.
- *Partnering with sellers.* Given the complexity of efficiently operating a generation facility and trading its output, it may make sense to structure acquisitions where sellers provide these services going forward, either on a pure contractual basis or in conjunction with a retained ownership interest or output arrangement. The questionable credit of many sellers adds risk to over-reliance upon this approach, however.
- *Partnering with fuel suppliers.* Most of the newer power generation on the market is gas fired, and fuel supply is the greatest expense of gas-fired generation. It may be possible to address fuel supply and associated cost fluctuation risks by partnering with a gas supplier willing to enter into a tolling agreement, providing for an assured long-term gas supply in return for a portion of the output of the facility.
- *Sector-specific funds.* On the investor side, a number of private equity funds focusing on the power and energy sector have been set up in the last few years. Given the volume of assets on the market, and the prevailing sense that the current depressed market may not last for long, the number of follow-on funds, as well and new funds of this type, are likely to be multiply in the near term.

Notwithstanding the numerous challenges facing the energy sector and the not-inconsiderable barriers to entry for a non-strategic buyer, private equity firms may find with careful planning and structuring that the power play is a golden opportunity. ▢

— John M. Allen, Jr.
jmallen@debevoise.com

Creating a successful new private equity fund requires substantial time and effort. Some power/energy players have sought to shortcut that process and speed their access to capital by joint venturing with an existing major private equity fund interested in gaining exposure to the market.

alert

France: Private Placement of Foreign Closed-End Funds Now Easier

Two recent amendments to French law now make it easier for foreign closed-end funds to privately place their interests in France, especially those funds established in non-Organization for Economic Cooperation and Development (OECD) countries and those offered to "qualified investors."

The Prior Regime

Under French law, an offer of financial instruments (including interests in a non-French closed-end fund) is considered a private placement, and therefore exempt from the prospectus delivery requirement, if it is made to "qualified investors" and/or a "close circle" of investors acting in each case for their own account. "Qualified investors" are institutional investors and other corporate investors specifically listed in the law. A "close circle" of investors consists of investors other than "qualified investors" who know one of the members of the issuer's management personally and who have either a family or professional relationship with such member.

Until recently, the implementation of these private-placement exemptions was subject to two major obstacles.

First, it was not possible for funds established in jurisdictions that were not members of the OECD, such as the Cayman Islands, to offer their interests in France, even under a private-placement exemption, without the prior authorization of the Ministry of Finance. This authorization was never granted. Thus, an offering in France of interests in Cayman Islands funds, even to a few institutional investors, was impossible. Fund sponsors and their advisors had developed the practice of making the placement outside France, (*i.e.*, sending the offering materials to an address outside France, executing the subscription agreement outside France and having the stock certificates, if any, deposited with a custodian outside France).

Second, the *démarchage* (solicitation) rules were very restrictive. In particular, *démarchage* was prohibited with respect to financial instruments (including interests in a closed-end fund) not listed on a stock exchange. Whereas the *démarchage* rules were clearly intended to be consumer-protection rules, this prohibition applied to offerings made under the private-placement exemptions, including to "qualified investors." As interests in closed-end funds are almost never listed on an exchange, this meant that offerings to "qualified investors," although exempted from the prospectus delivery requirement, could not technically be offered to such investors by way of *démarchage*. In order to avoid this restriction, and, as suggested by the French Securities Commission, it was usually recommended that the offering materials be sent to potential investors upon their written request. The subscription agreement was sent subsequently, and only upon the potential investor's written request.

The Liberalized Rules

The first amendment makes the offering of closed-end funds established in non-OECD countries, such as the Cayman Islands, possible. Decree No. 2003-196, dated March 7, 2003, no longer requires the prior authorization of the Ministry of Finance with respect to the offering of interests in closed-end funds. Authorization is, however, still required for the offering of non-OECD open-end funds.

The second improvement results from amendments to the *démarchage* rules, which were introduced by Law No. 2003-706 dated August 1, 2003. Similarly to the old provisions, the new law prohibits the *démarchage* of persons for the purchase of financial instruments (including interests in non-French closed-end funds) which are not listed on a French or E.E.A-regulated market or a "recognized" market. The new law, however, expressly provides that the *démarchage* rules do not apply to contacts with "qualified investors." On the other hand, an offering made in reliance on the "close circle" private-placement exemption remains subject to the *démarchage* rules. For example, an offering of interests in a non-French employee fund to employees in France will be subject to the *démarchage* rules, even if it can be made in reliance on the "close circle" private-placement exemption.

If you have any questions concerning the application of the new rules, please contact our Paris office. ■

— Sylvie Deparis-Maze
sdeparis@debevoise.com