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Private Equity Report

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Catching the Secondary Wave: Opportunities and Risks

The size of the secondary market for private equity funds has exploded in recent years. Banks and other financial institutions are actively selling their private equity portfolios in an attempt to reduce the volatility of their earnings and rebalance their portfolios. Individuals and corporations experiencing financial difficulties are also active sellers of limited partnership interests often, in the case of defaulting limited partners, with the help or at the insistence of the general partner.

Secondaries generally fall within two categories of deals. In the first category, the seller transfers a limited partnership interest in an existing partnership that continues its existence undisturbed by the transfer. In the second category, the seller transfers a portfolio of private equity investments in operating companies. The buyer of such operating companies is often an entity managed by the former managers of the seller's private equity portfolio. This article will focus principally on the practical and legal issues associated with the first category, although we will briefly discuss some issues raised by the second category.

Buyers of secondary interests include increasingly large pooled investment funds as well as institutional investors. Secondary buyers of partnership interests are often able to purchase partnerships with substantially invested portfolios which allow the buyer to evaluate the actual underlying portfolio (as opposed to primary investments where the buyer is purchasing a "blind pool"). In addition, expenses and early losses may cause a seller's aggregate capital account to be lower than its aggregate capital contributions, allowing a buyer purchasing at a price equal to seller's capital account to purchase effectively at a discount. Not surprisingly, opportunities like these usually come with some risk.

The Players

In addition to the seller and buyer, the general partner is a crucial participant in secondary transactions. In nearly all cases, the consent of the general partner is required in order to transfer a partnership interest.

The seller may seek to clear prospective buyers or classes of prospective buyers with the general partner to save valuable time. Sometimes a general partner will actually supply a seller with names of potential buyers that are acceptable to it. Particularly in the case of a defaulting limited partner, the general partner will actively participate in the sale process. Involving the general partner at the very beginning of the process will greatly facilitate legal and business due diligence, as well as the actual transfer of the partnership interest.

Understanding the Existing Documents

One of the first steps in analyzing a secondary purchase of an existing partnership is to identify the relevant documents governing the GP/LP relationship, including the original private placement memorandum (and any supplements),

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What's Inside

"I bought my L.P. interests on eBay – why, did you guys pay retail?"

letter from the editor

The past year turned into an exciting time for the private equity community, and 2004 is off to a busy start. Financing for new deals is readily available, exits are increasingly viable in a variety of forms and new markets for fund interests have emerged for those who have overcommitted to the asset class. For private equity firms, this new environment can be challenging, but it certainly looks and feels better than it has in awhile. In this issue, we provide some guidance on the opportunities and risks of the current landscape.

First, on our cover, we discuss the exploding market for secondary interests in private equity funds and outline the unexpected pitfalls for buyers used to open negotiations and full due diligence. In an effort to focus on new exit opportunities, Jeff Rosen, Andrew Bab and Peter Furci introduce you to the income deposit security, a new capital market product that we have helped develop over the past year and which is poised to provide an attractive new exit strategy for private equity sponsors. In our Guest Column, Alan Jones, Managing Director and Co-Head of Global Financial Sponsors of Morgan Stanley, argues that while the improving equity markets may increase the competition for deals from strategic buyers, private equity firms need not be too worried: the combination of plentiful debt financing, robust equity capital reserves and the unique and adaptive strategies that private equity firms bring to deal structure and post-acquisition operations will ensure that private equity firms are active buyers.

From the European perspective, Antoine Kirry warns investors in France to be wary of blithely adopting U.S.-style, English-language acquisition agreements for use in French deals without first clarifying which U.S. terms of art may be construed differently by French negotiators and by French courts. We also report on recent legislation in Germany and Italy that should make doing deals in those two countries easier for private equity firms.

Elsewhere in this issue, Sarah Fitts outlines some of the unusual and procedural differences that buyers contemplating acquiring a troubled company in a bankruptcy sale may face. And Rebecca Silberstein and Tim Bass describe how general partners can minimize the potential litigation risk from disgruntled limited partners.

We look forward to any comments you might have on our publication or questions you might have about our global private equity practice.

Franci J. Blassberg
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Managing General Partner Litigation Risk

One effect of the recent economic downturn: many private equity funds have suffered significant losses, including funds that were top performers just a few years ago. Some investors have looked to litigation to recoup some of their capital losses, particularly where they believe the losses are attributable to a breach of duty by the general partner. For example, in February 2002, a lawsuit was filed by the attorney general of the State of Connecticut against Forstmann Little & Company following a write-down of investments in XO Communications Inc., although that case has not yet resulted in a decision on the merits of Connecticut's claims. Although lawsuits by limited partners against general partners of private equity funds are still not commonplace, even funds that are well-managed and have honest general partners can lose money; thus, general partners have become increasingly focused on ways to avoid the reputational and financial damage of litigation by investors.

Litigation exposure will depend to some extent on the type of entities involved and the terms of the organizational documents. General partners of private equity funds and their principals may act both on behalf of the fund itself, ordinarily a Delaware limited partnership, and also as directors of public or private portfolio companies. The first part of this article examines some of the risks and relevant standards of conduct that apply to general partners and their designees. In the second part of the article, we suggest some guidelines to help reduce these risks.

The Relevant Duties: A Reminder

Private equity funds customarily organize as limited partnerships (although this discussion generally applies to limited liability companies as well). The Delaware Revised Uniform Limited Partnership Act provides that a partnership agreement may expand or restrict the general partner's fiduciary duties. If the partnership agreement does not establish an explicit standard, the fiduciary duties relevant to directors of corporations apply to general partners by default – namely, the duty of loyalty (the director's actions are solely motivated by the best interests of the corporation and its stockholders) and the duty of care (the director exercises the degree of care and prudence that would be expected if the director managed his or her own affairs). Generally, if directors of a Delaware corporation observe their duties of loyalty and care to the entity and its stockholders, they will be entitled to rely on the business judgment presumption, which is intended to prevent liability for losses caused by business decisions that turn out to be wrong, so long as they were made on an informed basis and in the honest belief that they were in the best interests of the corporation and its stockholders. However, if a director (or its affiliate) is on both sides of a transaction, the entire fairness standard may apply, requiring both a fair price and a fair process, which may include a determination made by "independent" directors.

Under the default duties applicable to general partners (absent modification in the partnership agreement), the general partner's decisions should be shielded by the business judgment presumption if it complies with the duties of loyalty and care. However, in a transaction where the general partner has a personal financial interest in the result, the enhanced duty of entire fairness may apply. The distinction between directors and general partners is that general partners cannot be truly "independent." Although the economic interests of a general partner that invests its own capital in its private equity fund are in part aligned with the interests of the fund's limited partners, there are inherent conflicts of interest between a general partner and its limited partners that cannot be entirely eliminated given the economic and business deal common to private equity funds – among other things, the general partner's carried interest and the other activities of the general partner or its affiliates. Fortunately, unlike a corporation, as stated above, a partnership can modify the default fiduciary duties by clearly providing for it in the partnership agreement – this freedom of contract principle is critical to allow a fund to provide a reasonable approach to dealing with conflicts that may arise. For example, partnership agreements for private equity funds often have provisions allowing for allocation of investment opportunities that might be appropriate for the fund or other entities or affiliates, or setting out specific guidelines to be

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The Pitfalls of Using an English-Language, U.S.-Style Acquisition Agreement in Transactions Governed by French Law

The growing use of English-language, U.S.-style acquisition agreements in transactions governed by French law poses new challenges to French M&A practitioners, and requires that they be extremely careful in using words and clauses that were initially intended to operate under a different legal system.

If one looks back at the evolution of the M&A practice in France (and indeed in most of Europe) over the past 15 years, one of the salient features is the much broader acceptance of English-language legal documentation, certainly for cross-border transactions on the Continent and even for purely domestic transactions. There are several reasons for this. First, a number of major French industrial and financial groups, especially those with a sizeable presence outside France, have adopted English as their working language. Second, interest by international investors in transactions involving French companies has continued to grow steadily, making France one of the principal countries in the world for international investment. Third, most CEOs, general counsel and CFOs of large French companies, as well as their legal and financial advisors, have become familiar with U.S.-style deal management methods and drafting techniques, and tend to use them even for purely domestic transactions.

As a result, more and more agreements are being negotiated and executed in English, and include in many instances legal, financial and accounting words and clauses that are derived from the U.S. practice. This carries with it the risk that there might be a disconnect between the words and clauses used and the rules of French law, if not the actual intention of the parties to the agreements. The potential for difficulty is made even greater by some of the French Civil Code rules on the construction of contracts, particularly the rule under which the parties to an agreement are not supposed to include in their agreement words and clauses which are not intended to produce some legal effect. There would be no room, therefore, for disregarding certain words and clauses as irrelevant in a French law agreement just because they would be the "usual U.S. legal verbiage." Several examples illustrate what the resulting difficulties might be.

Terminology Issues

It is not uncommon in U.S.-style legal documents to see series of words of close if not identical meaning. Many of these "word chains" owe their origins to the course of U.S. corporate litigation and case law, the explanation of which is beyond the scope of this article. Take, for example, the classic transfer wording contained in a U.S.-style acquisition agreement, in which the seller will usually "sell, transfer, convey, assign and deliver" the shares or assets to the buyer. Finding a distinct meaning for each of these words under French law is a tricky exercise, yet one that must be faced if one has adopted without caution the standard U.S.-style wording. Under French law, one would be tempted to think that things are somewhat simpler: the seller sells. Selling, by law, implies several obligations, one of which is to deliver the item sold; another is to provide certain warranties with respect to this item. There is no point, therefore, restating in a contract what the seller undertakes to do when this is all provided for by law, except where the parties want to expand or narrow the scope of the seller's obligations. Using the "sell, transfer, convey, assign and deliver" wording in a French law agreement may lead to uncertainties because each of these words may not have a definite meaning under French law.

Similar comments can be made about series of words such as "agreements, commitments, arrangements or understandings" or "mortgage, pledge, deed of trust, hypothecation, security interest, encumbrance, liens." In each case, there is certainly a valid reason why these words are used in a U.S. agreement: each of them must have a distinct meaning, and the practice of expressing them in series is intended to cover all meanings. Under French law, this is usually unnecessary because there is a generic word with a meaning that, by statute or pursuant to case law, covers all the various aspects that the U.S.-style series is intended to capture.

Other terminology issues can be found in the use of words and expressions that cover U.S. legal, financial or accounting concepts that may or may not have counterparts on the French side (and, if they do, these counterparts may or may not convey exactly the same meaning as in the U.S.)

An obvious example is the notion of "authorized capital stock," which seems so basic to most U.S. lawyers that they find it difficult to believe that a similar concept does not exist under French law. Indeed, it does not, so that a representation made about the "authorized capital stock" of a French corporation (or many corporations of other European countries) would not make much sense. However, just like in the U.S., it

is important in a French law transaction to obtain assurances as to the actual and potential capital of a target company. These assurances are usually obtained on the basis of French law concepts of corporation law, so that beyond the terminology issue, this issue is substantively covered to the same extent as it would be in a U.S. transaction. There are scores of other examples of this nature, posing as many traps to the inadvertent user of U.S.-style agreements: references to "share certificates" for instance, since, for a French corporation, shares only exist in book entries, or references to the "delivery" of an agreement, which is a concept that is wholly alien to French law.

Elements of Deal Structure

Beyond terminological issues, there are a number of clauses or techniques that are commonly used in U.S.-style acquisition agreements that do not work well in the context of a French law transaction.

A striking example is the reference to "GAAP." The issue in France has been largely due to a common belief among French practitioners that French GAAP was a comprehensive body of accounting rules that could be referenced to resolve accounting disputes, particularly in the context of price adjustment mechanisms using parameters based on financial statements. While there is some danger in proceeding on the basis of a similar belief in the context of a U.S.-style agreement, doing so in the context of a French law agreement is even more risky because, in most cases "French GAAP" offers little guidance to resolve "real-life" issues that may arise in the context of these disputes. Therefore, in a French law transaction, providing in a clause that any accounting issue that may arise in connection with such clause should be resolved "in accordance with GAAP" does not help. "GAAP consistently applied" or another formula that would mean "consistent with past practice except when such practice is inconsistent with GAAP" is much better, but this wording leaves open the question of what the accountants should do if one or more of the past practices are found inconsistent with GAAP, without affecting the entire transaction or giving rise to a claim for indemnification under the representations and warranties covering financial statements. In practice, one comes to the conclusion that the reference to GAAP is not really helpful in this context, and that parties would be well advised to agree on a set of detailed accounting rules addressing the key accounting issues that may arise in light of the particular business involved (*e.g.*, in a distribution business: how to characterize and reserve for slow-moving items? When and to what extent to reserve for customer receivables?). Most accounting firms seem to favor this approach, which facilitates their work and avoids endless discussions about what options should be taken when existing accounting practices have to be modified.

Another example in a similar vein is the potential impact of the management restrictions that buyers typically impose on sellers for the period between the signing of an acquisition agreement and the completion of the transaction. These restrictions often go into the detail of day-to-day management and include approval rights for hiring employees, making investments or expenditures in excess of specified amounts, etc. One easily understands the rationale for those restrictions: the buyer legitimately wants to avoid that actions taken in this interim period adversely affect the value or prospects of the proposed investment. Yet, because of specific rules of French bankruptcy law, overly tight restrictions may have a potential for backfiring in the event that the transaction is not completed and the target company files for bankruptcy at a later stage. In the context of bankruptcy proceedings, if there is any shortfall of assets vis-à-vis liabilities, the persons who have acted as managers of the bankrupt company may be ordered to pay for all or part of this shortfall. This applies also to *de facto* managers, *i.e.*, the persons or entities who have been involved in the management of the target company without having legal authority to do so. Negotiators for buyers should be very careful, therefore, not to satisfy themselves with having obtained from sellers very tight management restrictions of the type one sometimes sees in U.S.-style acquisition agreements for the period between signing and closing. While the existence of these contractual clauses alone may not be conclusive, they may be regarded as indications that the prospective buyers had the right to participate in the management of the target companies following the execution of the acquisition agreements. Whenever these indications are confirmed by actual involvement in the management

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guest column

The New Opportunity for Private Equity

In 2003, the rebounding capital markets helped to provide a real boost to the financial sponsors in the private equity world. The high-yield market, arguably as robust as it has ever been, fueled sponsor activity in a number of important ways. With yields for new LBO bonds plummeting into the 8% – and even 7% – range, and with senior loans pricing off near-historic low LIBOR rates, "other people's money" has never been cheaper for private equity firms. As a result, sponsors have been able to push debt-to-EBITDA levels to record highs. Businesses that as recently as a year ago might have struggled to achieve debt levels of 5x EBITDA, for example, can finance today at levels north of 6x EBITDA.

Just as savvy consumers have taken advantage of low mortgage rates to refinance their homes, private equity firms similarly have availed themselves of the more-than-accommodating high-yield market to refinance and to extend the maturities of their portfolio companies' debt. Pushing the exercise to its logical extreme, sponsors also have taken good advantage of the robust debt markets to recapitalize many of their portfolio companies and pay themselves handsome dividends that have often returned all of the firm's original investment, and in some cases many multiples on that original investment.

Perhaps most important, however, the robust debt markets have once again made private equity firms fierce competitors in the market for corporate control. While the inflated asset values of the technology and communications bubble years kept many financial sponsors from their traditional pursuit of buying companies outright, today's enormously robust high-yield market has enabled private equity firms to buy businesses at multiples of EBIDTA that once were available only to strategic acquirers with significant synergies. Additionally, private equity firms' increasing willingness to partner with each other in "club deals" has permitted sponsors to set their sights on much larger targets. Simply put, LBO firms can pay big prices for big companies.

Many students of private equity warn, however, that this golden era of competitive advantage for sponsors is about to end. While the argument takes many different forms, a common theme emerges. Strategic buyers, they contend, have been sidelined of late by a combination of an uncertain economic outlook, which has made valuing acquisition targets tricky, and by their own depressed stock prices, which have dampened the confidence of would-be corporate acquirers and reduced the attractiveness of their own stock as an acquisition currency.

More recently, however, with good news of economic growth that borders on stunning, sharply improving corporate profits and concomitant improvement in many potential acquirers' stock prices, strategic buyers find themselves twice blessed. These dual forces have given corporate chieftains both the weapon of a more valuable acquisition currency and the courage of their convictions with respect to bold strategic moves.

Not only will strategic acquirers be tougher competitors for financial buyers, the argument continues, but the improved public equity market itself will again "compete" against financial buyers. That is, even as financial buyers have benefited from their own ability to sell the equity of their portfolio companies into an improving equity market, the public market also serves, in effect as another competitive buyer for non-core businesses or other assets that corporates seek to monetize. A healthy equity market is a double-edged sword for private equity firms, who are, of course, both buyers and sellers of businesses.

While all of this is, of course, true, no one should assume that the improved competitive position and emboldened animal spirits of strategic acquirers will be sufficient to enable corporates to beat financial buyers at the acquisition game they have been playing so successfully of late. Why not?

First, the Federal Reserve has indicated that it will endeavor to keep interest rates low for some time. Since private equity firms typically borrow two-thirds to three-quarters of the value of the companies they acquire, continued low borrowing costs provide them with an obvious boon. So, absent an unexpected credit crunch or some broader dislocation in the leveraged finance markets, debt financing for LBOs should continue to be cheap and abundant.

Second, there is no risk that private equity firms will run out of equity capital any time soon. With more than $100 billion of committed but uninvested private equity waiting to be put to work worldwide, there is, in fact, too much money chasing too few deals. (More on that below.)

Third, and most important, financial buyers have always been quick to adapt to changes in the environment, and the current environment offers no exception. Faced with looming competition both from strategic acquirers and the public equity market, and with a supply/demand imbalance that has lowered achievable returns, private equity firms

have pursued at least four successful strategies to buy assets in ways that will enable them to compete effectively against strategic acquirers and still generate attractive returns.

Three of these strategies principally aim to avoid the intense competition fostered by auctions, where the problem of too much money chasing too few deals may cause potential acquirers to view any victory as a Pyrrhic one. The "auction-avoidance" strategies include investing in distressed debt securities to gain control of businesses, partnering with corporate sellers in joint-venture LBOs or similar structures that permit sellers to retain a portion of the upside of divested assets and taking a contrarian approach by buying assets that are either out of favor with most investors or that bring with them sufficient complexity or "hair" to scare most would-be acquirers away and thus render an auction untenable.

The fourth strategy assumes that hotly contested auctions are a fact of life, and instead attempts to enable a buyer to pay a full price, but to improve the operations of the acquired business in a way that will make it appear cheap *ex post*. In deploying this fourth strategy, private equity firms typically utilize operating partners, experienced managers – often former CEOs – who can be either permanent members of the firm or *ad hoc* partners who work on select projects to identify cash flow improvement opportunities that pure financial bidders may miss.

Each of these strategies has its merits:

1. Distressed debt investing. While a number of successful private equity firms have used investing in the distressed debt market as a way to acquire assets for years, many other firms who historically have not availed themselves of this opportunity have recently begun to see it as a chance to acquire assets cheaply and potentially as a way to avoid auctions. Additionally, firms pursuing this stratagem reason that even if an auction does ensue or another firm succeeds in acquiring the business in question, the result of that acquisition simply will be a higher price for the bonds the firm bought at distressed levels – not a bad outcome. Not for the faint of heart, playing the distressed debt market differs markedly from traditional private equity investing and requires specialized skills including a clear understanding of both bankruptcy law and out-of-court restructuring dynamics. Perhaps more important, private equity firms accustomed to the in-depth due diligence opportunities afforded them in highly structured auctions may find the notion of making a big investment based solely on public information daunting, if not an anathema.

2. Corporate partnering. The nightmare that haunts the typical private equity investor is discovering after the fact that he has overpaid for an acquisition. The nightmare for a CEO selling a major corporation's asset on the other hand, is discovering *ex post* that he has sold too cheaply. In its most painful form, this latter nightmare manifests itself in a private equity firm quickly "flipping" a recently acquired asset at an enormous profit to the obvious chagrin of the prior owner. In the hopes of striking deals designed to avoid these nightmares, a number of private equity firms have persuaded corporates to retain an ownership stake in a divested asset. In some instances, tax or accounting considerations determine the percentage retained. In others, it will be a matter of simple negotiation, and structures range from fairly simple joint ventures to reasonably complex exchanges of options to buy or sell ownership at future times, often based on triggering events. Corporate sellers benefit in these deals from avoiding embarrassing future "flips" (*i.e.*, having sold at too cheap a price); financial buyers benefit from maintaining access to corporate expertise inherent in a long-time owner's experience and, in many cases, by avoiding a full-blown auction. (The complexity and time-consuming nature of structuring a JV or a corporate partnership often means a seller will choose a single financial buyer with whom to work.)

3. Contrarian investing. "The time to buy is when the blood is in the street," as Rothschild once wisely advised. By definition, contrarian investors invest when conventional wisdom suggests that one ought not to. Through careful, in-depth study of an industry or company, contrarian investors find worthy assets with values that may be obscured temporarily by industry fundamentals the investors perceive will change or by contingent

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M&A in Wonderland: What You Don't Know About Bankruptcy M&A Will Surprise You

During the recent economic rough patch, many M&A professionals of all stripes found themselves engaging in a new type of M&A transaction: a sale or purchase of assets of a troubled company pursuant to Section 363 of the bankruptcy code. Private equity firms are likely to find some interesting targets among these offerings. At first blush, these transactions look and feel a lot like a regular M&A transaction, and many jumped in with both feet, only to be surprised by some of the unusual legal and anthropological differences in completing a transaction under these circumstances.

Troubled Co.

Let's set the stage with a fairly common situation. Assume there is a medium-sized U.S.-based company with public shareholders called Troubled Co., and that its business would be profitable but for its heavy debt service burden. Let's also assume that the debt is in the form of private notes held by a group of conservative insurance companies. The notes are secured by substantially all the assets of Troubled Co., but even still, the best estimates are that the value of the secured assets is less than the unpaid principal and interest on the notes. Troubled Co. had a small working capital line of credit, secured *parri passu* with the notes, but it has been tapped out and is not available. In terms of scale, the amount of the line of credit is dwarfed by the outstanding notes, so it is the noteholders who are calling the shots with the banks occasionally asserting themselves on a few issues. Lets also assume that prior management may have made some bad business judgments and that Troubled Co. may have had some bad luck, but there isn't evidence that management includes any crooks either, so there are no criminal investigations or significant litigation.

Now, let's assume that Troubled Co. recently informed the secured creditors that it will not make its scheduled interest payments under the notes or line of credit. The noteholders contacted each other in a fluster, appointed two or three of the larger holders to an *ad hoc* steering committee, and selected a financial advisor and a law firm to review options. On reflection, the secured lenders conclude that the business is reasonably sound, that they are most likely to recoup most of their initial loan, and perhaps some interest, if Troubled Co. were sold through a bankruptcy sale. Troubled Co., the noteholders and the bank entered into a forbearance agreement where, among other things, the noteholders agreed to waive their rights to accelerate the payments under the notes for a few months and Troubled Co. agreed to various affirmative and negative covenants relating to its operation of the business and to commence a process for selling the company.

Section 363 in a Nutshell

Here is where you come in. You receive a short offering circular from Troubled Co. informing you that Troubled Co. will be sold and asking you to make an offer. The offering circular includes a draft agreement which provides that promptly after signing the agreement, Troubled Co. will voluntarily file for bankruptcy. This does not seem very auspicious, but your legal advisor gives you the following thumbnail explanation of procedures under Section 363 of the Bankruptcy Code:

- Troubled Co. and purchaser enter into an asset purchase agreement pursuant to which the purchaser agrees to buy all or a portion of the assets of Troubled Co. as part of a bankruptcy sale. Troubled Co. then files for bankruptcy voluntarily under Chapter 11 of the U.S. Bankruptcy Code.
- The bankruptcy court is asked to approve various procedural matters relating to the sale, including orders relating to Troubled Co.'s ability to use cash that is pledged to the noteholders between signing and closing, and the rights of the purchaser to receive certain payments (described below) in connection with certain contingencies described in the asset purchase agreement.
- The court will require a "fair auction," a part of which includes an invitation to third parties to make higher or better offers.
- The court approves the sale of the assets to the winning bidder. Estimated time from start to finish: 60 to 90 days.

Why Bankruptcy M&A is Different: The Anthropological Perspective

Bankruptcy M&A is different from other M&A deals for obvious reasons. The target admits to being a troubled company, which is sometimes but not usually the case. There are also several procedural and substantive issues which make negotiating these deals a challenge, even for the seasoned private equity professionals.

The bankruptcy world is small. You will discover that in the bankruptcy world, the top professionals who work as

financial advisors, lawyers and workout consultants always seem to know each other from other transactions. Reputations matter. It's like a club, and as the new arrival you will discover that they talk to each other in code. This can be an enormous aid in getting a deal done because advisors may not need to establish their credibility or trust with the others, and can get to the meat quickly. It is also daunting to the newcomer, and you may well feel like an outsider who speaks a foreign language.

Ambiguous lines of control. In the fact pattern that we outlined above, which is not unusual, the amount of the debt exceeds the value of Troubled Co.'s assets. This means that if every penny were to be squeezed out of a sale, it is still improbable that there would be a single penny to distribute to the public shareholders. This raises the obvious question – for whom is management now working? This is a deep question. The noteholders want it to be clear that they are not managing the company – that carries a risk of their being deemed insiders and not being treated as senior secured creditors in the bankruptcy – but they are in fact the only party in interest, or very nearly. The purchaser may try to bring the noteholders to the table, but the noteholders may not be interested. Think back to high school when you were making Saturday night plans with friends, knowing that none of them would work unless mom agreed and loaned you the car. That's the noteholders' role in this transaction. The noteholders are unlikely to know the nuts and bolts of the company, but they will have very set views on issues that go to the bottom line of the deal. Negotiating with Troubled Co. is fine and appropriate, but if the noteholders aren't happy with the results, you will have to try again.

Aren't the noteholders in a hurry to get this done? Maybe not, unless the company is truly deteriorating. True, most individuals would like to have this unpleasant task behind them, but remember, in this case Troubled Co. would be healthy if it didn't have to pay interest on its debt and the secured creditors or forbearing on enforcement, so it is actually cash positive. And remember also that the secured creditor is king. There is always a chance that if the noteholders do nothing at all, Troubled Co. will get its act together sufficiently and weather the crisis, or that in the meantime, a better deal will come along. Any arrangement to which creditors agree may actually reduce their rights to take action. The most sensible thing for noteholders to do in this case may well be to sit on their hands until the deal Troubled Co. brings them is the one that they want to do. Add to this the fact that the noteholders are often a group of companies that don't normally do business with each other (although many of the individuals are likely to be acquainted through prior, similar workouts), that this is one of several similar projects for them, and that often unanimous or supermajority approval by the noteholders (voting based on percentages of senior secured debt held) is required under the relevant agreements, and it simply is difficult for them to act quickly to get necessary internal approvals and make decisions.

Why would anyone voluntarily be the stalking horse? If you are the buyer under the asset purchase agreement, you may become a "stalking horse," but it can have its advantages. The stalking horse buyer gets to do due diligence in more depth than the other bidders, and gets to have a bigger hand in shaping the deal. If there is a real auction, the stalking horse may be in a better position to determine whether to raise the initial offer or to walk away. In addition, and not unimportantly, the stalking horse buyer is also often entitled to a significant payment for its trouble if it is not the winning bidder in the end, including reimbursement of expenses and a break-up fee if another party successfully purchases the company. Courts often limit the break-up fee to 3% of the purchase price, but in a large transaction this still is a big number. In fact, prudent creditors and company management will be concerned that the stalking horse bidder is looking at, say, a cool $10 million break-up fee as preferable to actually winning the auction in the end, and will try to negotiate around that possibility as much as possible. Accordingly, the parties will negotiate the timing of payment (termination of the purchase agreement versus consummation of the new sale), under what circumstances it is paid (only if the stalking horse buyer is not the high bidder versus termination of the purchase agreement for any reason), and how easy it is for sellers to terminate. This is different from the case in a public deal where a break-up

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The noteholders are unlikely to know the nuts and bolts of the company, but they will have very set views on issues that go to the bottom line of the deal. Negotiating with Troubled Co. is fine and appropriate, but if the noteholders aren't happy with the results, you will have to try again.

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German Fund Legislation

Over the course of last year, in a series of articles appearing in *The Private Equity Report*, we have followed the progress of German legislation to modernize the regulation and taxation of funds and discussed the climate for private equity investment in Germany.[1] The legislation, known as the *Investmentmodernisierungsgesetz*, has now been enacted. And, as of January 1, 2004, new German Investment and Investment Taxation Acts are in effect.

For our private equity clients, there are some helpful changes embodied in the new laws. For example, investment management companies regulated in another EU member state and complying with the UCITS regime can now provide fund management services, including discretionary investment advice, distribution and depositary services, to clients in Germany. So non-EU based private equity sponsors with a subsidiary located, for example, in London, can provide cross-border investment services in Germany.

Outsourcing

German investment managers can retain non-German advisers to provide discretionary advice to German funds and other clients. As a result, non-European private equity managers, for example, can import their investment management services into Germany through outsourcing arrangements with a management company licensed in Germany or licensed in another EU country and having a German "passport."

Distribution of Hedge Funds in Germany

Single hedge funds (both German and foreign) can now be sold to *individual investors* as well as to institutions, but, in both instances, only through private placements. German (but not foreign) hedge *funds of funds* that meet certain diversification and other requirements can be sold to the public in Germany.

Investments Permitted for German Hedge Funds

German *single* hedge funds can invest up to 30% of their net assets in unlisted securities, including interests in non-EU private equity funds. German hedge *funds of funds* can invest in non-EU target hedge funds. However, the capital gains derived from a target fund will only benefit from German preferential pass-through tax treatment (for individuals, only 50% of dividends and capital gains will be taxable and institutional investors will be tax-exempt) if the target fund complies with reporting requirements. It is currently unclear if the target fund has to publish the required information or if it is sufficient that it provides the information to the fund of funds in order to comply with the reporting requirements. In any event, non-EU hedge fund managers can be expected to be unwilling to conform with any strict German tax reporting requirements, which would compel them to disclose, among other things, the degree of leverage, amount of short sales and other proprietary trading strategies.

Taxation of Funds

The new Investment Taxation Act only has two classifications of funds: transparent (white) and non-transparent (black) funds. The scheme that produced "gray" funds has been abolished. White funds must comply with detailed tax reporting requirements to the German authorities in order to qualify for the preferential tax treatment mentioned above. The extent to which underlying target funds would be required to make reports to German authorities is at present unclear. Funds that fail to meet the reporting requirements are non-transparent, or "black" funds, subject to full taxation *and* a penalizing tax.

Status of Private Equity and Venture Funds

Although earlier drafts of the legislation provided some guidance, the legislation as enacted failed to clarify what types of commingled vehicles are "funds" that must meet the German tax reporting requirements in order to avoid penalizing taxation in Germany. As a result, the private equity industry will continue to rely on a circular issued by the BaFin (German Supervisory Authority) in 2001. According to the 2001 circular, private equity and venture funds that assume an active role with respect to portfolio companies are not regarded as "funds" for purposes of the Investment Taxation Act. As a result, they are not subject to the penalizing tax regime, even if they do not comply with the reporting requirements.

The new laws are an important step in the right direction for the German investment management industry. But many practical issues need to be resolved through the interpretative and implementation processes. □

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1 See "Alert: Germany to Modernize Fund Laws" in the Fall 2003 Private Equity Report, "Alert: German Funds Made Easier" in the Spring 2003 issue and "Minority Investments in German Companies" in the Winter 2003 issue.

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It Was All a Bad Dream – Private Investment Funds No Longer Subject to Tax Shelter Reporting Requirements

On December 29, 2003, the IRS drastically modified the Treasury Regulations relating to "confidential transactions" that had been causing great angst among private equity fund sponsors and investors alike since their adoption in early 2003.

The old Regulations, part of an array of IRS and Treasury activity directed against abusive tax shelters, were written so broadly that they required limited partners in ordinary private equity funds to report their investment in the fund to the IRS Office of Tax Shelter Analysis (and, possibly, subject the funds and their limited partners to IRS scrutiny), unless the fund's confidentiality provisions permitted its limited partners to disclose the tax structure and tax treatment of the fund and its investments.

The old Regulations left fund sponsors with an unpleasant choice: either they could subject their investors to the reporting rules (which included record-retention requirements as well), or they could allow their investors to disclose the "tax structure" and "tax treatment" of the fund. The problem was, "tax structure" was defined so broadly that fund sponsors risked having the economic terms of their funds and portfolio investments (and other provisions sponsors rightly felt were and ought to remain proprietary or confidential) disclosed without penalty by limited partners.

The new Regulations generally exclude private investment funds (as well as most M&A and other commercial transactions) from their ambit. Happily, taxpayers may apply the new rules retroactively to January 1, 2003, the effective date of the original regulations. Accordingly, except in unusual cases:

- *Fund sponsors.* You can take those pesky "tax carve-outs" out of any pending private placement memoranda, partnership agreements and other documentation (and consider amending existing partnership agreements to delete the tax carve-out).
- *Fund investors.* You don't have to file.

We wouldn't be tax lawyers unless we ended on a cautionary note: unfortunately, it is still possible that a private investment fund (or a transaction undertaken by a fund) may be or become subject to IRS reporting requirements under another category of transactions covered by the tax shelter rules, for example, if the fund has certain types of losses (such as foreign-currency losses or losses on operating partnership investments). But for most private investment funds, it was all just a bad dream. ▢

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Upcoming Speaking Engagements

March 4-5

Franci J. Blassberg, Program Co-Chair
Special Problems When Acquiring Divisions and Subsidiaries
Negotiating the Acquisition of the Private Company
The 19th Annual Advanced ALI-ABA Course on the Study of Corporate Mergers and Acquisitions
San Francisco, CA

March 8

Paul D. Brusiloff
Gregory H. Woods
Lender Liability Issues and Answers
10th Anniversary Conference of the Community Development Venture Capital Alliance
New York, NY

April 21-22

Marwan Al-Turki
Convergence of PE Fund Terms in Europe and U.S.
How to Negotiate Lower Fees, Carries and Other Favorable Terms
Private Equity Analyst Limited Partners Summit Europe
Zurich, Switzerland

Exiting with IDSs: A New Way Out

The success late last year of the initial public offering of Volume Services America Holdings, Inc. (VSA) using a new capital markets product known as an Income Deposit Security (IDS) has caused a buzz in investment banks and private equity shops across the country – the former eager to demonstrate their prowess in structuring and marketing the new securities and the latter wondering if the indicative valuations are too good to be true.

Two issuers filed registration statements with the Securities and Exchange Commission for offerings of income deposit securities in the first half of last year, VSA and American Seafoods Corporation, which is represented by Debevoise & Plimpton LLC and is awaiting audited 2003 numbers before going to market. We have been intimately involved in the development of the product and are active participants in the recent flurry of activity as bankers emerge with their own versions of the IDS product and seek promising potential issuers for new deals.

Basic Concepts

An IDS is a unit of common stock and subordinated debt marketed as a yield-oriented hybrid security. The debt component of the unit pays monthly or quarterly interest and the issuer espouses a dividend policy under which monthly or quarterly dividends will be paid on the common stock such that substantially all of the free cash flow is distributed to the IDS holders. At a time when three- and five-year equity returns have been, to put it charitably, disappointing, and when yields in the 9-10% range are not readily available, markets appear ripe for such a security. Indeed, the valuations apparently available appear to exceed conventional exit transactions by two or more EBITDA turns.

IDSs were initially developed by CIBC as a derivative of Canadian income trusts (CITs) that own both debt and equity of a company. CITs have been extremely popular in Canada (with over C$60 billion of CIT securities outstanding) as both a retail and institutional monthly yield security. Although some U.S. companies (perhaps seven or eight) have issued securities in the CIT market in Canada, CITs have not had nearly the same success with U.S. issuers, and recently a cloud has hovered over the U.S. company version, because several accounting firms have announced that they are reevaluating key tax issues.

IDSs have a number of features in common with CITs – the units are listed on an exchange and trade in unit form, they are priced on a composite-yield basis, covenants in the senior indebtedness as well as the IDS debt have expansive restricted payment provisions that allow the cash flow of the issuer to be paid out in subordinated interest and dividends absent performance problems and the consummation of an IDS offering likely shifts management's and the company's focus from earning and growth to stable cash flow generation. However, there are important differences as well that result from U.S. tax and market considerations – differences in capitalization, unit structure, intercreditor arrangements, retained interest provisions and other matters.

In part because of its beguiling simplicity, and in part because of the CIT legacy, the IDS product tends already to be the subject of some degree of mythology and misconception. Understanding its potential requires a measured look at the current frenzy and an understanding some of the complexities.

The Fine Print

The Tax Play

An obvious feature of an IDS offering is that interest deductions on the IDS debt are intended to reduce the issuer's taxable income, but these offerings are not tax gimmicks and do not and cannot eliminate corporate income tax. The fact that the IDS debt and equity are held *pro rata* is a "negative" factor in determining whether the IDS debt should be characterized as debt rather than equity for tax purposes. This necessitates conservatism in developing the company's capital structure and care in designing debt and intercreditor terms to make sure that the attorneys and accountants can reach the desired level of comfort on the debt-equity question (the VSA and American Seafoods deals both have "should"-level tax opinions). In consequence, leverage and coverage ratios are set at about historical levels for the issuer or the sector. The resulting impact on taxable income depends in large measure on what other shelter – depreciation from recent basis step-ups, NOLs, breakage costs – is available; but it will be a rare IDS issuer that will not have some tax "leakage." The tax treatment of the IDS debt is further supported by causing the units to be readily separable and registering the separate components under the securities laws. Both the relatively conservative debt-to-equity and EBITDA ratios and the ready separability are features absent from the majority of CITs.

The Intercreditor Puzzle

The infancy of the IDS product makes negotiation of the senior debt portion of the capital structure a bit of a challenge. On the one hand, for the right credit, the senior portion should be pretty attractive because target senior leverage is only about two times cash flow. But the senior lender is not offered any principal amortization prior to maturity and, indeed, is expected to let cash flow that he might have expected to receive as principal payments go out to the equity owners as dividends. Getting all that agreed to thus far has taken a fairly intricate series of provisions including a pre-funding of initial interest and dividend payments, interest deferral features on the IDS debt, dividend stoppers that kick in prior to a senior default and acceleration forbearance arrangements. It is to be hoped that as the product matures, a more robust senior market will develop that tolerates more fluid and less Byzantine provisions.

The Valuation Equation

Bankers and sponsors structuring an IDS deal can't tarry long before getting to the central valuation issues – how much free cash flow is there and what is the likely yield that the market will require? The latter question is largely a capital markets matter, but the former has numerous structuring and negotiation nuances. Obviously the quest is for a cash flow number that can be "promised" to investors with a high degree of confidence. That requires development of a cash flow number (EDITDA, less capex, incremental administrative expenses, senior interest and other deducts), an understanding of historical numbers and cash flow risks, and also a combined marketing, pricing and structuring metric that creates some form of cushion. Basically, four approaches seem to be available: (1) price the offering at a prescribed 5-10% "holdback" or haircut off of expected cash flow, (2) persuade the sponsors to "subordinate" their rights to cash on their retained interest to the IDS equity, (3) derive a cushion from the amount by which current-year cash flow is expected to exceed trailing cash flow, or (4) market through whatever volatility risk exists. All are being talked up these days.

The Retained Interest

VSA, American Seafoods and most of the other transactions of which we are aware are sponsor portfolio transactions in which an IDS offering is proposed as an exit. Typically, however, it is a phased exit and one of the more complex groups of structuring (and capital markets) issues surrounds the "retained interest" held by the sponsor and management after the offering. The first issue is what security the retainees should hold – converting their stake to IDS may create substantial tax liability (to the extent of the debt component) while failing to do so leaves them in an inferior credit and cash flow position. The second is what governance and/or board representation rights to give the retainees, and that is an issue rendered considerably more complex in the aftermath of Sarbanes-Oxley and the various independent director requirements prescribed by the SEC and the exchanges. And the third issue is how to structure their rights to roll into IDS and exit in subsequent offerings – a path fraught with tax and securities issues that are, with one exception described below, beyond the scope of this article.

Subsequent Issuances and Fungibility

A central feature of the IDS product is the need to permit subsequent issuances of units that will trade as a single issue with the securities originally offered. This is necessary to ensure the sponsors an orderly exit and also because it safeguard's the issuers future access to capital. The problem is that while the terms of the common stock and notes underlying future IDSs will be identical to those in the initial offering, changes in interest rates or the issuer's credit spread could cause the notes issued in a subsequent IDS offering to have "original issue discount" or "OID" for tax and other purposes, and OID securities will not be fungible with non-OID securities. To deal with this problem, the IDS note indenture provides that a portion of the new OID notes will automatically be exchanged for a portion of the old notes, so that all holders end up with the same mix of OID and non-OID securities. While this is expected to achieve the desired goal of fungibility, it puts the original buyers in the position of possibly having OID (and phantom income) imposed on them whenever the issuer – or the private equity sponsor – decides to effect a secondary offering.

So Now What?

At this writing, as acronyms for IDS-type securities proliferate (to date we have heard tell of EISs, Bells, Cougars and Yous, in addition to IDSs), it's far from clear what the future holds for units of this sort. Are they a creature solely of today's yield hungry markets? Could they become a permanent and substantial feature of the landscape as CITs have in Canada? Or will they become a niche product for sectors with stable cash flow and modest growth prospects that might otherwise have difficulty accessing public equity markets? Whatever the case, in the short run we seem to be in for a wave of these transactions, and they are not as simple as they seem. ▢

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New Safe Harbor Provisions on Italian Leveraged Buy-Outs

Many European jurisdictions, including Italy, have adopted rules that prevent or limit any form of financial assistance by a corporation to third parties in connection with the purchase or subscription of the corporation's shares. These financial assistance rules, by their express terms or pursuant to their interpretation by local courts, often result in the prohibition of a quick merger between a leveraged vehicle and the acquired target, thus precluding the maximization of tax and financing efficiencies.

Recent legislation, enacted in Italy as part of a large reform of company law, and applicable as of January 1, 2004, has created a general safe harbor for leveraged acquisitions. Mergers between a leveraged vehicle and the acquired target, where the target acts as a general guarantee for, or the source of reimbursement of, the debt incurred by the vehicle, will now be permitted, subject to certain requirements.

These requirements include:

- That the merger plan must contain (in addition to the customary items, such as the new articles of association, the exchange ratio for shares of each company, etc.) a description of the financial resources expected to be used by the merged company to fulfill its obligations;
- That the report customarily prepared by the directors of each merging company must specifically indicate the reasons justifying the merger, a business and financial plan identifying the expected financial resources, and the objectives that are expected to be accomplished as a result of the merger;
- That the financial expert's opinion delivered in connection with a merger, customarily focused on the fairness of the share exchange ratio, must also confirm the reasonableness of the directors' reports; and
- That a report prepared by external auditors, if either or both of the merging companies are subject to external audit (*i.e.*, in the case of listed companies or companies that have shares held by a large number of investors), must substantiate the directors' report and be annexed to the merger plan.

The company law reform also included the streamlining of procedures for mergers between a parent company and a 90%-to-100% directly owned subsidiary. These procedures, however, will not be applicable to mergers between a leveraged vehicle and the acquired target.

One note of caution should be added. The new rules introduced new provisions on "group misdirection": controlling companies may be held liable for damages caused to minority shareholders and creditors of controlled companies as a result of breaches, at the controlling-company level, of the duty of proper corporate and business management. While it is true that the newly enacted rules largely reflect previous Italian case law, which was based on general principles of civil liability and conflict-of-interest rules, the introduction of specific language on the matter into Italian company legislation will likely increase the level of scrutiny of all corporate reorganizations, including intra-group mergers.

In addition, certain new specific language extends liability for "group misdirection" to those who have participated in the alleged misconduct or have knowingly profited from such misconduct. This could affect the level of scrutiny of all parties to the transaction, arguably, including private equity sponsors.

All in all, however, the recent legislation is a positive step towards the further opening of the Italian marketplace for private equity investments. ▢

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Mergers between a leveraged vehicle and the acquired target, where the target acts as a general guarantee for, or the source of the reimbursement of, the debt incurred by the vehicle, will now be permitted, subject to certain requirements.

SEC Sends Message to Private Fund Advisers: Adopt Compliance Policies and Procedures Now !

Last December, the SEC set a new enforcement precedent and sent a strong message to all private fund advisers by bringing its first failure-to-supervise action under the Investment Advisers Act against the principal of an unregistered hedge fund adviser. Previously, the SEC had brought such actions only against registered advisers. The SEC also proceeded against the adviser's director of investments for fraud under various federal securities laws.

The director of investments materially misrepresented the funds' performance – even reporting a year-to-date gain for a fund with a year-to-date performance of negative 28% – and misrepresented the funds' management structure and risk management techniques. He also redeemed the investments of two substantial investors at inflated values following dramatic fund losses without disclosing the losses to other investors until months later. The principal of the hedge fund adviser shared office space with the director of investments and had an ongoing opportunity to supervise his activities. However, the principal failed to do so and instead relied entirely on the director's representations with no independent oversight.

The SEC found not only that the principal had failed to take reasonable supervisory actions, but, more importantly, that he had failed to create or implement procedures to independently verify the director's representations or detect violations of the securities laws. Such procedures could have included: maintaining accurate records of investments and redemptions, reviewing trade confirmations and statements, and properly and independently calculating fund performance.

This action suggests that the SEC expects *all* investment advisers – registered or not – to develop and implement compliance policies and procedures consistent with their fiduciary obligations and appropriate for their advisory firms, particularly those that advise private funds. Given that that the SEC has recently adopted a rule requiring registered investment advisers to maintain compliance policies and procedures, annually review such policies and procedures and designate a chief compliance officer, unregistered advisers might be wise to take these standards into consideration when gauging the adequacy of their own compliance system. Although the SEC does not have inspection authority over unregistered investment advisers, this action is a reminder to all private fund advisers that the SEC takes very seriously registered *and unregistered* advisers' responsibilities to supervise employees with a view toward preventing federal securities law violations.

If you have any questions about this recent action or about the adequacy of your own oversight or compliance program, please feel free to contact any of us. ▢

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This action suggests that the SEC expects all investment advisers – registered or not – to develop and implement compliance policies and procedures consistent with their fiduciary obligations and appropriate for their advisory firms, particularly those that advise private funds.

the partnership agreement (and any amendments), the management and advisory agreement, the subscription agreement, any personal guarantees of the general partner's clawback obligations, side letters, corporate, tax and other opinions issued in connection with the original investment, and financial information (such as audited financial statements and tax returns).

Key Points to Review

Identify transfer restrictions. In nearly all cases, a partnership interest may not be transferred without the consent of the general partner. Occasionally, all of the limited partners will have rights of first refusal and, very rarely, partnership agreements will require that all the limited partners of the fund approve a transfer. In connection with transfers of portfolios of investments in operating companies, the buyer also needs to consider whether the proposed transaction will raise operational level consent issues, such as those arising under credit agreements or executive employment arrangements or trigger rights of first refusal or co-sale.

Liability issues. It is important to determine whether the partnership agreement requires the limited partners to return all or a portion of prior distributions received from the fund. If the partnership agreement contains such a limited partner "clawback" and there have been significant distributions, a buyer who assumes all the liability of a seller may be liable to return distributions it has never received. Even if the partnership agreement does not contain a contractual right to clawback prior distributions, the general partner may use current assets of the fund to pay liabilities incurred with respect to transactions that occurred prior to the transfer of the partnership interest. As discussed below, the buyer will likely require an indemnity from the seller against such a liability. However, especially in a case of a distressed seller, such an indemnification is of questionable value. Sales of underlying portfolio companies, either public offerings or private sales, recapitalizations of portfolio companies in distressed situations or simply sitting on the board of directors of portfolio companies may generate liabilities for which the fund ultimately will be responsible. While it is important to identify the contractual obligations, such as a limited partner clawback, it is equally important for the buyer, through discussions with the general partner and a review of the financial statements and the general activities of the fund to date, to identify contingent liabilities.

Size of uncalled capital commitment. Partnership agreements often allow the general partner to recall the capital portion of distributions relating to investments sold within 12-18 months or distributions relating to bridge investments. One cannot simply subtract the drawdown capital from the original capital commitment to determine the unfunded capital. Buyer's counsel should determine whether the partnership agreement contains such reinvestment rights, so that a prospective buyer may quantify the actual amount of capital subject to call by the general partner. The buyer should also determine whether management fees are paid out of the partnership assets or by the limited partners in addition to their capital commitments. If the latter, the buyer's potential obligations will be increased by projected management fees.

Economics. The prospective buyer will need to determine the amount of the general partner incentive fee – the carried interest – which may be of the ratio 80/20 or 75/25 or even 70/30 between the limited partner and general partner, respectively, as well as the size of the management fee in order to determine the purchase price.

Regulatory issues. Each buyer has its own set of unique regulatory issues. For example, a U.S. private pension plan may only purchase investments in partnerships that are "venture capital operating companies" or otherwise "ERISA-safe."

Business due diligence. While the lawyers conduct legal due diligence on the private equity fund, the buyer will conduct a financial review of the underlying portfolio companies and often attempt to meet with management of the more important portfolio companies. Such reviews and meetings with management are nearly impossible without the active cooperation of the general partner. Generally, the seller has access to very limited information regarding portfolio companies and no direct access to management. Often the general partner will decline to make management available to a prospective transferee of a limited partnership interest and the buyer is forced to make its investment decision with incomplete information.

Documenting the Deal

Confidentiality Agreement

The first document to be negotiated, often even before the names of the funds are revealed by the seller, is the confidentiality agreement. Generally, a seller is required (under the relevant partnership agreement) to keep the fund's financial and underlying portfolio information (the information a buyer will request as part of its due diligence) confidential without the prior consent of the general partner or the agreement by the recipient to keep such information confidential.

Term Sheet and Letter of Intent

Often the parties will dispense with a term sheet, especially in an auction where the seller will submit a form of purchase agreement as part of the bidding process. In an individually negotiated sale, the prospective buyer often requires a letter of intent, which includes a provision restricting the seller from offering the relevant partnership interests to other persons (a "no-shop clause") for a specified period of time while the prospective buyer completes its due diligence and the parties negotiate a purchase agreement.

Purchase Agreement

The purchase agreement will generally contain the following:

Purchase price. The stated purchase price is generally based on the seller's capital account and is adjusted upward by the amount of any capital contributions made by the seller since the valuation date and reduced by the amount of any distributions (valued at the valuation assigned by the general partner in the case of in-kind distributions) since the valuation date.

Representations and warranties of the seller. The seller's representations will typically include, among other things, due authorization and authority to enter into the purchase agreement; good title to the partnership interest, free of any encumbrances other than transfer restrictions contained in the partnership agreement; size of the seller's capital commitment and amount contributed to date; and confirmation that the seller has funded all capital calls when due, has not opted out of or been excused from any portfolio investment and is not in default under the partnership agreement. In addition, a prospective buyer often will require a representation that the seller has supplied complete copies of the partnership agreements, subscription agreements, side letters, opinions and other agreements applicable to the transferred interests. While the list may appear rather straightforward, it is often very time consuming for the seller to gather all these documents, especially where multiple partnership interests are being transferred. Representations regarding the underlying investments themselves are unusual if only limited partnership interests will be transferred to the buyer.

Representations and warranties of the buyer. The buyer's representations will typically be more limited, including among other things, due authorization and authority to enter into the purchase agreement and a series of private placement representations.

Closing conditions. Generally at closing the representations are brought up to date by both the seller and buyer. If there is expected to be a significant time period between the signing of the purchase agreement and actual closing, the prospective buyer often requests the inclusion of a closing condition that no material adverse change has taken place with respect to any partnership being transferred during this interval. If multiple interests are being purchased, the seller and buyer need to determine whether all interests are to close at the same time or transfers may take place serially as general partner consents are obtained.

Indemnification. The seller usually will indemnify the purchaser against liabilities arising out of events prior to the transfer, including clawback of distributions made prior to such date, breaches of any obligations or representations made by the seller under the purchase agreement, the partnership agreement or ancillary documents, and any transfer fees. The buyer will typically indemnify the seller against liabilities arising out of events after the transfer and breaches of any obligations or representations made by the purchaser under the purchase agreement.

While the lawyers conduct legal due diligence on the private equity fund, the buyer will conduct a financial review of the underlying portfolio companies and often attempt to meet with management.... Such reviews and meetings with management are nearly impossible without the active cooperation of the general partner.

Expenses. The purchase agreement generally provides that each party will be responsible for its own costs (including legal fees) in connection with the purchase, sale and transfer as well as which party will be responsible for any transfer costs in connection with the funds themselves. General partners sometimes expect either the seller or buyer to cover their expenses (including legal fees) in connection with transfers.

Assignment and Assumption Agreement. Pursuant to the assignment and assumption agreement, the seller transfers it's interest in the partnership and the buyer assumes the obligations of the seller with respect to the transferred interest. From the buyer's perspective, it is important that it only assume seller's obligations as a limited partner under the partnership agreement (a copy of which was supplied pursuant to the purchase agreement) and specified ancillary documents. A broad assumption of all obligations of the seller with respect to the transferred interest could technically include, for example, obligations to third parties such as taxing

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authorities. The general partner will generally require that the buyer agree to be bound by the terms of the partnership agreement and to make customary representations (such as to the status of the buyer and money laundering information). In addition, the general partner may ask that both the seller and the buyer indemnify the general partner against any liabilities resulting from the transfer. Each of the seller and buyer usually will only agree to indemnify the general partner against liabilities resulting from the actions or omissions of such party and not for the actions or omissions of the other or of the general partner. This compromise is usually acceptable to general partners.

Occasionally, and particularly if only one asset is being transferred, the parties will dispense with a purchase agreement and sign and close simultaneously by executing an assignment and assumption agreement. In such case, such agreement will contain many of the representations and indemnification provisions normally found in the purchase agreement.

General Partner Consent

As discussed above, the buyer cannot be admitted to the partnership without the consent of the general partner of such partnership. Such consent is documented in the assignment and assumption agreement or in a separate consent letter. In addition to receiving the written consent of the general partner to its admission as a limited partner of the partnership, the buyer will often ask the general partner to confirm that all transfer conditions have been satisfied or waived and the amount of the seller's original capital commitment and uncalled capital commitment. The seller may ask the general partner to release it from any and all liabilities under the partnership agreement; otherwise, if the buyer defaults on a capital call, the partnership may still have a claim against the seller. Finally, if the seller has defaulted on a capital call, the buyer will ask the general partner to confirm that, upon payment of the missed capital call, it will be in good standing and not subject to any default penalties with respect to such missed capital call.

Tax Considerations

The principal tax issue in secondary transfers is whether the transfer will cause the fund to become a "publicly traded partnership" taxable as a corporation for U.S. federal income tax purposes. A fund would be a publicly traded partnership if interests in the fund were traded on an established securities market (such as the New York Stock Exchange or Nasdaq) or were regularly traded on a secondary market (or the substantial equivalent thereof) unless 90% or more of the fund's income for each year consists of certain types of passive income. In most cases, the secondary transfer will be a private transfer negotiated between the seller and buyer and would not be considered a trade on a prohibited public or quasi-public market. In addition, there are a number of regulatory "safe harbors" protecting against interests in a fund being considered to be regularly traded on a secondary market (or the substantial equivalent thereof). These safe harbors include transfers of interests in funds where interests were issued in a private placement and that do not have more than 100 partners (which is frequently applicable), and funds that have transfers of interests in capital or profits totaling less than 2% of total interests in capital or profits per year.

A second tax issue is the method of allocating the fund's taxable items of income and loss for the taxable year between seller and buyer. The "closing-of-the-books" method allocates all of the items through to the date of transfer to the seller and all of the items after the date of transfer to the buyer. Alternatively, the seller and buyer each can take a *pro rata* share of all of the fund's income and loss based on the portion of the taxable year that has elapsed prior to the transfer, or determined under any other method that is reasonable. If the fund has had a significant gain prior to the date of transfer, the buyer may request the "closing-of-the-books" method in order to avoid phantom income.

Secondaries Involving a Transfer of Operating Companies

As noted above, an increasingly common form of secondary involves the transfer of a seller's interests in several direct private equity investments to a newly formed partnership that is often run by the former managers of the seller's private equity portfolio. These transactions present several issues in addition to those raised above.

Co-investors in the direct investments being transferred to the new partnership may have rights of first refusal or co-sale. Additionally, the transaction may trigger defaults under a variety of operational agreements relating to the underlying portfolio companies. Identifying these issues may be difficult, especially if the seller has limited access to the documents of the portfolio companies. Although the former managers of the seller's private equity portfolio may be aware of certain material consents, this will be of limited comfort to the private equity investor supporting the managers in their acquisition.

Additionally, the buyer may want to obtain representations and indemnities regarding the portfolio investments. Most sellers should be willing to provide representations that the seller owns a specified number of shares in the portfolio investment and perhaps that the shares represent specified percentages of the portfolio companies. These matters clearly go to the heart of the buyer's investment decision. The buyer will also likely seek representations regarding third-party consents. But if the representations sought by the buyer extend to other operational matters involving the portfolio investments, such as financial statements or material, contingent liabilities, the seller may well resist. This is especially the case if the seller is a financial institution which has relied on the managers (who now may be associated with the buyer) to monitor the portfolio or if the seller's interest in the portfolio companies is only a minority position. The buyer will certainly negotiate these issues with the seller but, in the end, it may to some degree be left to its own business, financial and legal due diligence to obtain comfort on certain matters (recognizing that the parties may or may not have complete access to the management of the underlying portfolio companies).

While the above issues are being negotiated with the seller, the former managers may be engaged in structuring the new investment partnership to serve as the buyer and negotiating the terms of such partnership with prospective investors who are financing the acquisition.

As this brief discussion should indicate, buyers seeking to catch the secondary wave should realize that they are wading into an area with unique opportunities and risk. Advance planning and understanding of the potential pitfalls is essential to executing these types of transactions. ▢

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M&A in Wonderland: What You Don't Know About Bankruptcy M&A Will Surprise You (cont. from page 9)

fee might be paid if the board or shareholders reject a contract or accept a better offer, if only because an auction is certain to occur and so there is a higher chance of the break-up fee being owed.

Why Bankruptcy M&A is Different: The Deal That Isn't a Deal, Maybe

A negotiation for an asset purchase agreement in anticipation of a Section 363 sale is also likely to take on different characteristics than a more typical M&A negotiation.

The deal isn't a deal. The most obvious difference in negotiating the asset purchase agreement in a Section 363 sale is that it might not be a real deal. It might be only a starting point for future negotiations. A key element in the Section 363 sale is that others will be invited in to make higher and better offers. Therefore, a prudent seller or secured creditor will be looking to keep the provisions simple, straightforward and capable of being bid against. Price in the stalking horse deal, for example, is evaluated not only in terms of dollars but also in terms of whether others will be encouraged to enter the fray and try to raise it. But this situation naturally limits the amount of time a sensible buyer will invest in the deal and encourages the buyer to protect itself by building into the agreement reimbursement of its expenses and the payment of a break-up fee if another party wins the auction. Now, given that the asset purchase agreement, like any other contract, could be rejected by the debtor in bankruptcy, none of this will work if the court doesn't generally approve these arrangements, and there is a lot of lore and law on when and what should be acceptable to the court. All of this needs to be weighed and evaluated as part of negotiating the asset purchase agreement.

Due diligence: how much and what's important? One reason to run a company through bankruptcy is to shed unpleasant contractual obligations and liabilities. Under Section 365 of the Bankruptcy Code, contracts that require future performance (so-called *executory contracts*) can be "rejected" by Troubled Co, meaning that Troubled Co. can elect not to perform under that contract, and the other party is then left with a claim for damages as a consequence of such non-performance. This right of the debtor to reject contracts applies in the case of sales pursuant to Section 363 as well. Contracts that are unattractive can be left behind, including any claims for damages for breach. Environmentally

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The most obvious difference in negotiating the asset purchase agreement in a Section 363 sale is that it might not be a real deal. It might only be a starting point for future negotiations.

contaminated pieces of real property, unless posing an immediate threat to human life, can be abandoned. These open issues need to be sorted out as part of winding up the bankruptcy process, but the buyer doesn't need to worry about them. Therefore, while the buyer may do the usual due diligence as to cash flow and the business, the due diligence on contracts, leases and environmental matters is often limited to just enough research to say: do we want or need this, and could we negotiate something better when we own the company after the bankruptcy? And there is always a question about how much of an investment the buyer wants to make when ultimately the deal might not actually be his. Even if some or all of the out-of-pocket costs are reimbursed as part of the break-up fee agreement, the time spent on this project that could have been spent differently is gone forever.

What are the hot issues in the asset purchase agreement? Price and closing conditions. A seller and its creditors should focus on two things: what is the recovery and what is the risk that they don't get it? Just about the worst case scenario for the creditors would be to have the stalking horse buyer tagged by the court as the winner, but then have the stalking horse refuse to close because closing conditions have not been satisfied. This could give the buyer the opportunity to try to renegotiate the deal at a time when Troubled Co. is already in bankruptcy, already has completed the auction process and may have very few other alternatives. On the other hand, a sensible buyer should realize that if something goes wrong, if Troubled Co. is not in the condition represented or similar issues arise, the buyer will have no recourse other than not to close. Troubled Co. will already be in bankruptcy and unless special provision is made for an escrow or representation and warranty insurance, there will be no practical way to be made whole.

Exclusivity. A sensible buyer might seek an exclusive right to negotiate with Troubled Co. for a period of time. Prior to filing for bankruptcy, Troubled Co. can oblige to the same extent any other seller could. It is simply a matter of contract. Once Troubled Co. files for bankruptcy, however, exclusivity becomes elusive. The auction process is built into the 363 sale procedure, so clearly once the auction process starts there is no exclusivity. But what about the period between filing and start of the auction? It is not clear what the answer to this question is until the bankruptcy court tells you. But a sensible buyer should not count on exclusivity after the filing even if it is set forth in the purchase agreement.

Financing. One of the hot issues in negotiating these types of acquisitions for the buyer is financing. Obviously, the seller and its creditors would prefer the certainty of a transaction with no "financing out." But the reality is that a lot of buyers will need some sort of financing, and it is also the reality that banks don't make ironclad commitments to provide financing in advance. As already noted, sellers and creditors are looking for certainty, and the question about when the ability to obtain financing ceases to be a condition to buyer's obligation to close will be negotiated: At the time of the filing of Troubled Co. in bankruptcy? At the conclusion of the auction process? At closing? Also to be negotiated, what if the buyer is looking to the public markets for financing, for example in a high-yield offering? Certainly the buyer may be reluctant to begin work on a debt offering memo until it knows it is the successful bidder, and it will not know if it is the successful bidder until the end of the auction. Given the time necessary to launch the public debt offering, this will delay the closing for at least 30 days after the end of the auction. Delay shifts some risk to the seller and its creditors that something could go wrong, and if something does go wrong, that the transaction will not close and the creditors and Troubled Co. will be we be where they do not want to be – in bankruptcy without a buyer or a clear way out. All of these concerns will need to be addressed carefully in the purchase agreement.

Conclusion

This article only touches on some of the issues that you will run across if you step into a Section 363 sale process. The point, though, is this: M&A in the bankruptcy context is different from regular M&A in a lot of subtle and not so subtle ways. Understanding the M&A issues and the anthropology of the parties, as you would in any deal, is of course important, but equally important is understanding the variables that the bankruptcy process creates and how the relative weight of important and unimportant issues and deal drivers shifts as a consequence. And perhaps surprisingly, that buzz you get when you have successfully completed a negotiation just isn't the same – the purchase agreement is signed, the hand shakes are done but instead of clinking champagne glasses, Troubled Co. goes to the courthouse and files for bankruptcy. It just isn't the same. □

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followed during transactions with affiliates. While it is not clear that fiduciary duties can be entirely eliminated, they clearly may be restricted, and some claims can be barred by a well-drafted partnership agreement.

Several important principals govern any restriction of a general partner's fiduciary duties. First, the provisions must be clearly drafted and explicitly override the default fiduciary duties of care and loyalty. One recent case, *Miller v. American Real Estate Partners, L.P.*, held that a real estate partnership controlled by Carl Icahn was subject to fiduciary duties because the sole discretion provision in the partnership agreement did not expressly supplant the default fiduciary duty standards. A related point is that courts tend to interpret ambiguities in the partnership agreement against the general partner. This is particularly true where the limited partners took no part in drafting the limited partnership agreement.

Guidelines for Minimizing Risk

The second step in minimizing the legal risks is to implement safeguards. Of course, business practices such as maintaining good relations with your limited partners and enabling assignments of limited partners interests can also help avoid lawsuits. Following is a list of suggested safeguards:

Draft organizational documents clearly. The key provisions dealing with general partner duties in the partnership agreements need to be clearly drafted. Traditional fiduciary principles will be supplanted only by express provisions that cannot be reconciled with the application of the default fiduciary principles. These include the standard for duties owed to the partnership and limited partners set forth in the limited partnership agreement; exculpation and indemnification provisions, where default duties of loyalty and care may be modified; and conflict provisions, where certain actions can be permitted and procedures established. The general partner will be protected from liability if it acts in good-faith reliance on the provisions of the partnership agreement.

Comply with relevant standards. The general partner must carefully consider which provisions of the limited partnership agreement govern a particular action and comply with the relevant standards of conduct. The general partner should consult with counsel to ensure it is following the standards set forth in the agreement and should interpret any ambiguities in the language in good faith (and not to its own benefit).

Process counts. The general partner must establish the proper level of care in making its determinations. This involves being fully informed of all material information reasonably available (and fully informing other decision-makers as well) and deliberating over a reasonable period of time. As a practical matter, courts will be far more inclined to support the judgments of decision makers who act with appropriate care.

Use more care with conflicts. Conflict of interest transactions attract scrutiny and litigation. If the entire fairness standard under Delaware corporate law applies, directors bear the initial burden of proving that both the process and the price were fair to minority stockholders. Likewise, if the limited partnership agreement does not restrict the standard of care, a general partner and its directors may be required to show that a conflict transaction was fair to the partnership and the limited partners. A market check, third-party fairness opinion or consultation with the fund's advisory committee may help to establish that the process and/or price were fair.

Maintain a record. A corollary to good process is the ability to prove it. Minutes should indicate when and for how long decision-makers met and generally what was discussed. However, minutes should not editorialize or enumerate the details of discussions.

D&O insurance. Premiums have increased significantly over the past few years in the wake of numerous corporate scandals, but most funds consider it advisable to insure against the risk of investors' claims. Insurance is not a replacement for good corporate governance, however, for several reasons. In addition to the negotiated deductibles and policy limits, D&O policies typically have important exclusions for bad acts such as willful violations and gaining an improper profit or advantage.

Full disclosure. Remember that certain standards of behavior cannot be negotiated away. For example, a claim of misleading statements or omissions under the anti-fraud provisions (Rule 10b-5) of the Securities Exchange Act of 1934 can apply to disclosure provided in the private placement memorandum, notwithstanding any modification of duties in the partnership agreement. □

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Of course, business practices such as maintaining good relations with your limited partners and enabling assignments of limited partner interests can also help avoid lawsuits.

through the exercise of the rights resulting from such clauses, the prospective purchaser may be seriously at risk if the transaction collapses and the target company then goes bankrupt. In practice, this risk can be controlled to a great extent by focusing on the management restrictions that really matter, and by having information rather than veto or affirmative authorization rights.

Other clauses in U.S.-style agreements would technically work under French law, but they are not regarded as market practice, and sometimes are difficult to "sell" to the other side precisely because they are believed to be derived from the U.S. practice. At the top of the list is the sort of "10b-5" representation that a buyer often wants to receive from the seller, under which the seller represents that the acquisition agreement and generally all documents furnished by the seller do not contain any untrue statement of a material fact or omit to state a material fact necessary, to make other statements made in the agreement and these documents, not misleading. Even though this sort of representation may not be very common in private transactions in the U.S., it has somehow become a popular request among buyers in French transactions. However, while the existence of fairly detailed representations and warranties in acquisition agreements has now become standard practice in France, there is still a lot of resistance to adding this sort of catch-all representation whose effect, incidentally, is untested in French courts. In the same category are the representations and warranties that are sometimes expected from a buyer. In a cash transaction, buyers will very often sneer at sellers' requests for these representations and warranties, on the theory that cash has an objective value that hardly needs to be protected by contract. In addition, a buyer will typically say that if the real concern relates to the buyer's ability to pay the acquisition price, the buyer's representations and warranties would be redundant with the buyer's commitment to purchase and pay the agreed upon price that is the essence of the agreement. In practice, however, buyers' representations and warranties are often reluctantly accepted by buyers with comments to the effect that they do not really understand what sort of benefit the sellers are expecting from them.

Best Efforts

Best efforts is an obligation qualifier that was virtually unknown in French M&A practice 20 years ago, and has met with remarkable success. It is a very popular tool for the ultimate concessions that exhausted negotiators often make when the sun rises after a night-long session, thinking that they are not giving out too much after all since "best efforts" would essentially mean a less stringent standard than for an unqualified obligation.

Yet, under French law, the analysis of a "best effort" obligation may not quite match this vision. In essence, French law recognizes two standards for legal obligations: one is where the obligor commits to procure a defined result, and is liable even without a fault on his part if this result is not procured (*e.g.*, the safety obligation a public transportation carrier owes to the passengers), and the other is where the obligor only commits to use all possible means to procure the desired result, without committing to achieving it, and is liable if it can be shown that he did not use the means a reasonable man in a similar situation would have used (*e.g.*, this type of standard is used for medical malpractice cases). In legal terms, the first type is called *obligation de résultat*, and the other *obligation de moyen*. In many ways, an *obligation de moyen* is a sort of statutory reasonable efforts obligation. What is then the effect of adding the "best efforts" wording to an *obligation de résultat*? While this does not seem to have been tested in French courts, the likely answer is that the words "best efforts" set a slightly higher standard of obligation than for a simple *obligation de moyen*, because this expression tends to set an absolute standard ("best") for the means the obligor is expected to use to procure the desired result, whereas in the absence of this expression the standard would default to what a reasonable man would do. "Best efforts" would therefore be the exact opposite of what most users may think this expression means. It is definitely not a wording that should be used casually on the belief that there would be no real consequences to a "best efforts" obligation.

At the risk of stating the obvious, a contract does not exist in a vacuum, but it draws its legal effect from the legal system on which it is based. This legal system also underlies to some degree virtually all the words and clauses in a contract. While U.S.-style acquisition agreements have brought a lot to the French M&A practice in terms of deal techniques and detailed drafting, French practitioners should bear in mind that these benefits can only exist if they make the effort of adapting these agreements where necessary to make them operational under French law. Similarly, U.S. investors in France should not expect that because all parties have agreed to use English-language agreements for a transaction, the respective agreements are going to be identical to those that are used to for U.S. transactions. □

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liabilities that the investors understand or perhaps can contain better than others.

4. Use of operating partners. Recognizing that an auction still represents the sale mechanism of choice for many sellers of corporate assets, private equity firms that employ operating partners still try to avoid auctions wherever possible, but have concluded that financial engineering, while a necessary feature of any LBO, may no longer be sufficient. Good operating partners, steeped in the real-world experience of running businesses, afford private equity firms advantages both before buying an asset and after. Prior to purchase, operating partners can help buyers to do better due diligence. Sometimes experienced operating partners uncover subtle risks, hidden costs or underestimated liabilities that cause their firms to bid less for an asset than a pure financing engineer might, but, equally often, operating partners see opportunities for cost cutting or better cash flow management that encourage their firms to pay more. In both cases, the firms employing operating partners believe they have made good, informed decisions: avoiding over-paying in the first instance and paying up to capture an asset they know will appear cheap in hindsight in the second.

Skeptical market observers and participants alike may dismiss all of these strategies as insufficient to overcome the overarching supply/demand imbalance of too much money chasing too few deals. Even for these skeptics, however, there is reason for optimism, for a number of important trends are conspiring if not to overcome the supply/demand problem then at least to ameliorate it. Each of these trends has increased the availability of assets suitable for purchase by private equity firms.

First, many public-company CEOs have decided that the costs of being a public company (recently exacerbated by the demands of Sarbanes-Oxley) outweigh the benefits. Many small- and mid-cap companies have begun to feel "orphaned" by the public equity markets. Their public float simply may be too small to attract investors with a predilection for liquid stocks or too small to encourage broad interest among an increasingly cost-conscious equity-research community. Whatever the reason, many public companies recently have turned to LBO firms to help them go private, and many more like-minded companies are in various stages of the process of going private. Of course, by putting themselves "in play" through the going-private process, these firms may put themselves at risk of being acquired by competitors, but the recent experience of successful public-to-privates including Nortek, Dole and Quintiles should give courage to management teams that may be contemplating going private.

Second, a renewed focus on core competencies (and core businesses) among corporates continues to generate a steady supply of non-core assets for the divestiture market, particularly in Europe, where the advent of the EU has helped spur the kind of restructuring that many U.S. companies went through in the 1980s and 1990s. Suez's divestiture of Nalco and Vivendi's sale of Houghton-Mifflin are but two recent examples of European businesses divesting significant assets to private equity firms. Even in the U.S., however, tectonic shifts occurring across a number of industries continue to spur significant asset sales. As an example, within the last year or so, private equity firms acquired virtually the entire global yellow-pages industry largely as a result of pressures on their erstwhile owners in the telecommunications industry.

Third, secondary buyouts (where one LBO firm buys a business from another LBO firm), once believed to be taboo in the private equity world, are becoming commonplace. In years past, LBO firms typically would not buy a business from a competitor, presuming that the previous owner would have "squeezed all the juice out of the lemon" by wringing out whatever cost savings or cash flow improvements were available. In today's environment, however, the wildly ebullient high-yield market permits a new buyer to finance a pre-owned asset – to borrow a handy euphemism from used car dealers – at more aggressive levels than were available to the prior owner. This happy feat of financial engineering means that the new buyer can pay a higher multiple of cash flow than the prior owner did without necessarily having to make heroic assumptions about improving the business. Equally important, however, recent signs of incipient economic recovery have given financial buyers the courage to assume that, in buying a business from another LBO firm, they will be riding a new wave in the economic cycle. Valuations that seem pricey today, these buyers reason, will look cheap in hindsight if the economy continues to improve as sharply as current indicators imply it will.

Some wags have suggested that secondary buyouts may solve the private equity supply/demand imbalance forever by creating the investment analog of a perpetual motion machine, with LBO firms constantly trading the same small group of companies among themselves *ad infinitum*. At a minimum,

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NASD Relaxes Ban on Use of Related Performance Information

Last fall, the National Association of Securities Dealers, Inc. threw a wrench in fund sponsors' marketing activities when it formally advised NASD members they could not use "related performance information" – that is, performance data of a predecessor or similar fund – in hedge fund sales material, including flip books. Following a flurry of informal communications with the NASD prompted by its formal advice, most understood the prohibition to apply to private equity funds as well as hedge funds, although not to apply to related performance information that appeared in private placement memoranda.

Although the NASD has long prohibited the presentation of such information in mutual fund "sales literature" – labeling such presentations as potentially misleading – it came as a real surprise when the NASD imported this prohibition into the private fund context, first informally through spot checks of member firms' marketing materials and then formally through interpretive guidance issued October 2, 2003.

Just in time for New Year's celebrations, the NASD retreated from this position. Responding to a letter submitted on behalf of CSFB, the NASD stated that, as a general matter, it would not object if an NASD member (*e.g.*, a fund placement agent) included related performance information in sales materials for Section 3(c)(7) funds, provided that the member "ensures that all recipients of such sales material are 'qualified purchasers'" within the meaning of the Investment Company Act. Most large private funds raised today in fact rely on the exemption from Investment Company Act registration provided by Section 3(c)(7) of that Act. Accordingly, this is meaningful relief and such funds may now include the track records of predecessor funds in their flip books and other sales materials.

However, some private funds, such as so-called "friends and family" funds, still rely on the Section 3(c)(1) exemption under the Investment Company Act. The letter does not, however, provide any general relief for these Section 3(c)(1) funds. (Note that some of these funds may not necessarily be marketed using an NASD member (*e.g.*, a placement agent)).

The recent advisory letter expands somewhat on the concerns underlying the NASD's October letter, noting in particular its concern that related performance information would be used "where the audience for such sales material could be retail investors." It is unclear whether the NASD will expand on the types of investors (*e.g.*, institutional investors in Section 3(c)(1) funds) to whom related performance information may be provided.

The NASD also took the opportunity in its year-end letter to remind members that private fund sales materials remain subject to the applicable standards of NASD Rule 2210, as well as applicable securities laws and regulations. Communications with the public must, as before, among other things, be based on principles of fair dealing and good faith, be fair and balanced, and may not predict or project performance or imply that past performance is any indication of future performance. ▢

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The New Opportunity for Private Equity (cont. from page 23)

secondary buyouts represent a source of assets once thought unavailable to buyout firms.

Finally, for those with an outlook long enough to span the inevitable ebb and flow of the business cycle, today's aggressive high-yield market, in a perverse sense, may well be creating tomorrow's distressed debt opportunities for private equity firms. This view will hold particular appeal for cynics, but history has taught us to expect that some meaningful portion of those companies enjoying the fruits of a more than bountiful high-yield market inevitably will turn out to have incurred more debt than they could support. Be assured that private equity firms will be waiting to take advantage of the opportunities inherent in those companies' misfortunes.

2004 looks promising for private equity investment. All indicators seem to point to a resurgence of M&A activity. With private equity firms' unique strategies and special competencies, financial sponsors are well positioned to avail themselves of these new market opportunities. ▢

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