Debevoise & Plimpton

Private Equity Report

Volume 4 | Number 3 | Spring 2004

Business Development Companies and the New Public Market in Mezzanine Funds

Several high-profile private equity fund sponsors have entered the public fund arena this spring by sponsoring publicly offered funds focused on making mezzanine investments. (These investments generally consist of subordinated debt securities that are often issued with related warrants, options or other equity securities and are acquired in privately negotiated transactions.) Apollo Management raised $930 million in a mezzanine fund IPO that priced on April 5. Close on Apollo's heels, a number of other private fund sponsors filed registration statements for similar investment vehicles that would raise an additional $5 billion. Although the business press has followed this development in the private equity landscape, we hope to compare and contrast these investment vehicles not only with their cousin, the closed-end mutual fund, but also with the private funds that have become the norm in the private equity arena.

Each of these new investments vehicles is structured as a closed-end investment company that has elected to be regulated as a business development company, or a "BDC," under the Investment Company Act of 1940. A BDC is subject to certain, but not all, provisions of the Investment Company Act as well as certain other requirements specific to BDCs.

What makes the BDC an attractive vehicle for mezzanine fund sponsors? First, a BDC has access to a wider pool of investors than the typical private fund. Private mezzanine funds offer interests in private placements to a limited pool of sophisticated institutions and high-net worth individuals. They do this in part to avoid regulation under the Investment Company Act and other federal securities laws. By contrast, a BDC offering is generally registered under the Securities Act of 1933 and can market its interests to the general public.

Second, unlike the typical registered investment company, a BDC is permitted to charge its investors an incentive fee that is somewhat similar (although not identical) to the carried interest charged by private equity funds. The Investment Advisers Act permits a BDC to charge an incentive fee of up to 20% of realized gains over a specified period, net of realized capital losses and unrealized depreciation.

Thus, the sponsor of the BDC may charge a performance fee (like a private fund but unlike a registered investment company) and may offer its interests to the general public (unlike a private fund but like a registered investment company).

Finally, when a BDC disposes of an investment, it typically does not return the capital invested to investors. In addition, many BDCs offer dividend reinvestment programs (DRIPs) that permit shareholders to automatically reinvest dividends and other distributions in shares of BDC

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"We're doing a road show for a family of business development companies to invest in debt securities—we're calling it 'Les Mezz.'"

letter from the editor

2004 has proved to be a year of innovation in the private equity industry. In the last issue, we alerted you to the new use of income deposit securities as an exit strategy. This time on our cover, we discuss the emergence of a public market for mezzanine funds offered by private equity sponsors structured as business development companies.

Following a brief hiatus, during which we added another 160 funds to our database, we are delighted to have the Trendwatch column return in this issue. Geoff Kittredge uses this data to update our earlier findings on trends in European funds and considers how certain terms of European funds have evolved and where they may be headed.

For those of you active in cross-border transactions, we have several articles of interest. First, Thomas Schürrle and Elisabeth Huber-Sorge discuss how two recent decisions by the European Court of Justice should make it easier for investors to select friendly jurisdictions for the incorporation of investment vehicles. Elsewhere, we remind investors of the importance of thinking through dispute resolutions buried in the back of those acquisitions agreements in cross-border deals in order to avoid the unpleasant surprise of having to litigate a claim later in an unfriendly jurisdiction. Finally, we alert you to several improvements in the European merger control process.

In our Guest Column, Stephen V. Kenney, Chief Investment Officer and a Managing Director at SCS Financial, a wealth-management firm providing investment management services in both traditional and alternative categories, counsels private equity professionals and other sophisticated investors on how to construct an investment portfolio with real growth potential in light of possible rising interest rates and inflation.

Elsewhere in this issue, Michael Harrell and Jennifer Spiegel review the recent debate over industry-wide standardization of valuation standards for private equity funds, including the pros and cons of adopting a more rigorous fair-value standard. We also offer guidance on avoiding traps for the unwary in structuring transactions to be VCOC compliant. In addition, we alert you to recent developments in the IDS marketplace and to proposed changes that would close various HSR filing loopholes.

As always, we remind you that the *Private Equity Report* is available on line at our Web site and by e-mail by contacting Dan Madden at djmadden@debevoise.com. We welcome any suggestions you may have on how we can make the publication more useful to the private equity community.

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alert

Pending Legislation Could Increase Administrative Costs for Private Funds

Legislation is pending in both the Senate and the House of Representatives that, if enacted, would require private equity funds (and other partnerships) to adjust the tax basis of their assets upon certain transfers of an interest in the fund and upon certain distributions to partners. The rules would require a private equity fund to revalue its assets upon these events and increase tax compliance costs. As a result, the rules may cause some funds to further limit transfers by LPs.

Background

A partner's tax basis in its partnership interest is referred to as the "outside basis" and a partnership's basis in the partnership's assets is referred to as the "inside basis." In general, the transferee of a partnership interest succeeds to the transferor partner's share of the partnership's inside basis. Under current law, a partnership is permitted (but is not required) to elect to adjust the inside basis of its assets (a "754 election") so that the inside basis associated with the transferred partnership interest is equal to amount the transferee paid for the partnership interest (*i.e.*, so that the inside basis and the outside basis are the same).

What Congress is Worried About

Suppose that a taxpayer (S) contributes $100 to a partnership and the partnership buys a security that declines in value to $40. Upon a sale of the partnership interest, S would recognize a $60 loss in its partnership interest. If the partnership does not have a 754 election in effect, then the partnership will continue to have a $100 tax basis in the security and upon a sale of the security for $40, the buyer of the partnership interest (B) would be allocated a $60 tax loss from the partnership even though B has not experienced an economic loss. B's tax loss would be reversed upon the liquidation of the partnership. Although the "doubling" of the loss is temporary, it is perceived as abusive.

As described below, the fix is to require partnerships to adjust the tax basis of their assets (the inside basis) upon certain transfers and distributions. If a section 754 election were in effect in the example above, the partnership would have been required as a result of the transfer to reduce its tax basis in the security from $100 to $40 (but only for purposes of computing B's income and loss). As a result, upon a sale of the security by the partnership B would not have been allocated a $60 tax loss.

The Legislation

The proposed legislation would require a partnership to adjust the inside basis of its assets regardless of whether or not a 754 election was made upon certain events. As a result, a partnership would be required to value its assets each time an interest in the partnership was transferred. Historically, many private equity funds have been averse to valuing their investments.

Although the value of the partnership's assets is one of the drivers in adjusting the partnership's basis, the analysis is actually far more complicated and needs to be tracked separately for each transferee partner. Also, since analysis takes into account a transferee's tax basis in the acquired partnership interest, the transferee partner will be required to disclose the purchase price of the partnership interest to the partnership.

The administrative burden increases considerably as it relates to a partner in a partnership that is itself treated as a partnership for U.S. income tax purposes (an "upper-tier partnership"), *e.g.*, a fund of funds. Upon the transfer of an interest in an upper-tier partnership, both the upper-tier partnership and the lower-tier partnership would need to adjust the inside basis of their respective assets with respect to the transferred interest in the upper-tier partnership.

Status

It is far from clear whether and when a form of this legislation will be enacted. There is currently a lobbying effort underway to exclude private equity funds from the ambit of the legislation.

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The *Inspire Art* Judgment of the ECJ: New Ways to Structure Acquisitions in the European Union

Private equity firms now have more flexibility in structuring and financing transactions in the EU by utilizing flexible entities formed in "friendly" jurisdictions. In two recent decisions, *Uberseering* of November 2002 and *Inspire Art* of September of last year, the European Court of Justice ruled that a company formed under the laws of one member state of the EU may reestablish its entire operations in any other member state and that state may not impose any restrictions on the company or deny its legal capacity, even if it has no operations in the member state in which it was formed. The Court expressly stated in *Inspire Art* that this principle applies even if the purpose of founding a company in one member state was to avoid application of more restrictive company laws in the member state in which the company would actually operate. The Court acknowledged that an EU member state may restrict the ability of a company founded in that state to conduct operations in another member state, as decided in the Court's *Daily Mail* decision some years ago. But many member states, such as the UK, do not impose such restrictions.

Given the relative rigidity of the company laws of many EU member states, investors may find resorting to a company founded under the laws of another member state – for example, an English limited liability company – an attractive option in certain circumstances.

Immediate Consequences

With the *Uberseering* and *Inspire Art* decisions, the Court has effectively overruled the legal principle applicable in some of the EU member states that companies with an administrative and economic seat (as opposed to the formal, statutory seat for registration purposes) that is primarily located in a member state different from the state of their incorporation must be re-incorporated and registered in the member state of their economic seat as well, thus making them subject to such member's states laws and regulations applicable to the form of company chosen.

Germany, for instance, did not permit a Dutch BV to operate entirely within Germany unless it was re-incorporated as a German limited liability company or corporation. As a result of such reincorporation, certain features of German company law, such as the rules on preservation of capital and on workers' codetermination rights at the board level (*Mitbestimmung*) would become applicable to the reincorporated entity. If the reincorporation did not occur, the company was deemed a civil law partnership, with sometimes disastrous consequences for the shareholders (for example, unlimited liability for the debts of the company).

As an immediate consequence of the Court's judgments, an English limited liability company or a Dutch BV operating exclusively in Germany must now be recognized as such, and only the laws of the state of incorporation, that is, English or Dutch law, will govern its corporate existence and administration. In addition, after *Inspire Art* it is fairly clear that an English limited liability company or a Dutch BV operating exclusively in Germany should be treated as a German corporation for German income and trade tax purposes, including the availability of tax consolidation.

The two Court rulings also pave the way to avoid certain issues that may arise out of mandatory provisions of European continental company laws that may not be desirable in a given case or problems in structuring financial instruments or joint-venture arrangements due to the relative inflexibility of continental company law. In Germany, for example, foreign investors have been unpleasantly surprised by several German company law provisions: the relatively rigid procedures for issuing share capital (particularly in-kind contributions) and the strict rules on capital maintenance that often create structuring and financing hurdles. The law regarding workers' representation (so-called codetermination) at the supervisory board level for companies with more than 500 employees – and particularly the requirement that 50% of the members of the supervisory board of a company with 2,000 or more employees be selected by employee's representatives – can create problems, especially in less than wholly owned companies. Another problem area of German company law is, in the context of joint ventures and convertible debt or preferred stock instruments, the 75% supermajority vote required for capital increases, mergers and certain other fundamental corporate actions (other continental jurisdictions provide similar minority blocking rights).

German capital maintenance rules for a GmbH or GmbH & Co KG, two of the most common company forms, strictly prohibit repayment of the stated share capital (that is, the aggregate nominal value of issued shares), including indirectly by means of loans to shareholders or guarantees of shareholder or sister-company debt, thereby considerably impeding the flexibility of

financing structures in leveraged acquisitions and private equity and venture investments. Moreover, shareholder loans or leases of assets to a German company can become non-terminable, with all payments of interest or rentals thereon prohibited, if the shareholder's equity of the German company falls below its stated capital or if the company experiences a financial crisis and the shareholder unduly delays terminating the loan or lease. English company law is far less restrictive in this respect, and the availability of so-called "whitewash" procedures for upstream guarantees and loans by English private limited liability companies can provide company management, shareholders and lenders with greater certainty as to the validity of a given financial structure.

German company law also makes it close to impossible to issue redeemable or convertible preferred stock on terms comparable to U.S. or UK standards. Often, complicated shareholders' agreements are required, and the redemption or conversion may require an additional shareholder vote. In some cases, redemption simply is not possible. If, on the other hand, an English limited liability company is used as the vehicle for a German investment, a far greater variety of convertible or redeemable equity or debt instruments become possible.

As far as worker's codetermination, an historical cornerstone of German labor policy, is concerned, many German commentators had expected that the German federal government would propose new legislation to counter the Court's judgments in *Uberseering* and *Inspire Art*. Even though workers' codetermination exists in varying degrees throughout the EU (except in the UK), the German codetermination rules have been perceived by foreign entrepreneurs as particularly cumbersome when it comes to internal reorganizations and corporate restructurings. Because the current German codetermination law is applicable only to specified forms of German companies, but not to foreign forms of companies, it was widely expected that Germany would quickly amend its application to foreign company forms. However, that now seems unlikely, since a representative of the Federal Ministry of Justice announced on January 15, 2004 that Germany will accept the consequences of the Court's judgments and is thus not considering extending the German codetermination laws to foreign corporations with their economic seat in Germany.

Structural Implementation

Against this background, certain investments in, or restructurings involving, German businesses could be more closely tailored to investors' objectives by using non-German companies. Indeed, *Inspire Art* could conceivably open the door to competition among member states to provide the most flexible corporate form, much as Delaware became the preferred state for the incorporation of U.S. companies.

In the case of a new start-up company or the acquisition of an existing business by a new acquisition vehicle, investors are of course free to choose the optimal corporate form. It may also be possible through various means, such as a spin-off of assets, to transfer the local assets of an existing company to a foreign company. Such a transfer may have potential advantages. For instance, if a German company with limited liability, a GmbH, with almost 500 employees, which is 100% owned by a (foreign) holding company that is not subject to the German codetermination rules, intends to acquire by way of an asset purchase a German business with another 1,600 employees, the acquisition of this second business may result in the obligation to establish a codetermined supervisory board at the level of the GmbH. In light of *Inspire Art*, it might be possible to avoid such a consequence by transforming the GmbH into an English limited liability company, which is relocated into Germany.

Other principles of German labor law, in particular the establishment of a workers' council with certain information and consultation rights under the German Works Constitution Act at the level of each business unit, could not be avoided by establishing and/or converting a German corporate entity into a foreign corporate entity, because these are provisions of labor, rather than company law.

Issues to be Considered

Despite the many potential advantages of using a non-continental corporate form, many legal uncertainties, which will surely be subject to further court decisions at the national and European levels, remain.

In *Inspire Art*, the Court stated that all questions relating to the company's status (such as liability of managing directors and capital requirements) must be governed by the law of incorporation of the company. Although company law standards have been made uniform in certain limited respects by a variety of EU directives, there remain significant differences in the scope of company laws in various member states. Consequently, questions of shareholders' and/or management duties and liabilities, which in one member state are governed by company law, may in another member state be governed by civil, labor or insolvency law. This may lead to unexpected results. In some cases, the company could be subject to two conflicting laws:

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VCOC Traps for the Unwary: Will Your Deal be VCOC Compliant?

Most private equity funds that include U.S. pension plans (or other entities that hold pension plan assets) as investors are intended to qualify for the venture capital operating company (VCOC) exemption under ERISA. The fund's qualification as a VCOC enables the general partner of the fund to negotiate its management-incentive fee arrangements without regard to the technical requirements under ERISA governing compensation arrangements for pension plan fiduciaries. Moreover, the fund's status as a VCOC will generally exempt the fund from the complex prohibited transaction rules under ERISA.

Conversely, the failure of a fund to achieve and maintain VCOC status could result in the fund's assets being treated as "plan assets" subject to ERISA (in the absence of any other ERISA exemption), thereby subjecting the fund and its general partner to the fiduciary requirements and prohibited transaction rules under ERISA. If a fund that is deemed to hold plan assets fails to comply with the fiduciary requirements and prohibited transaction rules under ERISA, the general partner of the fund and the fiduciaries of the pension plan investors who authorized the pension plans' investment in the fund may be subject to substantial penalties and excise taxes under ERISA and the Internal Revenue Code.

Because of the potentially onerous consequences that could result from a fund's failure to qualify as a VCOC, pension plan investors will typically seek protections within the fund agreement regarding continued VCOC compliance. These protections may include a covenant from the general partner to operate the fund as a VCOC, a requirement to deliver an opinion of counsel as to the fund's qualification as a VCOC in connection with the fund's first portfolio investment, annual certifications from the general partner as to continued VCOC compliance and the right of the pension plan investor to withdraw from the fund if the fund fails to qualify as a VCOC.

The Department of Labor (DOL) regulations governing VCOCs are somewhat technical and not completely logical. Since the DOL has issued very limited guidance regarding the VCOC regulations, and the regulations have never been judicially tested, most ERISA lawyers advise their fund clients to follow closely the "letter of the law" as it applies to VCOCs. While the VCOC regulations, on their face, appear relatively straightforward, it is easy to overlook some of the more technical details.

The Basics

In general terms, to qualify as a VCOC, a fund must invest at least 50% of its assets, valued at cost, in "operating companies" with respect to which the fund obtains (and annually exercises) contractual "management rights."

The "50% test" must be satisfied on the date of the fund's first long-term investment and on at least one day during the fund's 90-day "annual valuation period." The annual valuation period can be any 90-day period selected by the fund at the time of its first long-term investment, provided that the first such period must begin no later than the first anniversary of the date on which the fund makes its first investment.

An "operating company" is defined in the VCOC regulations as an entity primarily engaged (directly or through a *majority*-owned subsidiary or subsidiaries) in the production or sale of a product or service other than the investment of capital.

While the VCOC regulations do not clearly define the term "management rights," the *contractual* right to designate a director to serve on the portfolio company's board is generally considered to be a "safe harbor" form of good management rights. In the absence of a director right, the contractual right to appoint a board observer and/or the right to advise and consult with management of the portfolio company usually will suffice. Management rights must be exercised at least once annually (ideally on a regular basis) with respect to at least one of the fund's investments.

Because the "50% test" must be met on the date of a fund's first long-term investment, it is imperative that this first investment be "VCOC-compliant" (*i.e.*, it must be an investment in an operating company with respect to which the fund obtains contractual management rights). *If the fund's first long-term investment is not VCOC-compliant, the fund will forever be precluded from qualifying as a VCOC.* After the fund makes its first VCOC-qualifying investment, it must thereafter satisfy the "50% test" on at least one day during each of the fund's subsequent annual valuation periods.

The Devil is in the Details

It is easy to fall into the trap of taking VCOC qualification for granted. After all, a fund sponsor may reason, "Why should we need to think about VCOC compliance when we fully expect the fund to invest in operating businesses where we will have at least one member on the board of directors if not control of the board?" Unfortunately, it is all too common to come across fund investments that, at first glance, appear to qualify as "good" investments for VCOC purposes, but in fact raise difficult compliance issues

because of the highly technical nature of the VCOC regulations. An investment that a layman considers to be in an operating business may not constitute an investment in an "operating company" within the meaning of the VCOC regulations. Similarly, the mere existence of management rights in the layman's sense, such as the *de facto* right to a board seat, with respect to a particular investment may not satisfy the "management rights" requirements set forth under the VCOC regulations.

Frequently, the "structural details" of VCOC compliance may be overlooked when a fund is negotiating the terms of a portfolio investment. Even seasoned ERISA lawyers negotiating the terms of an M&A deal for a fund client may fail to spot a VCOC problem for the fund since their primary focus will be on ERISA issues pertaining to the target portfolio company. The danger of missing a potential VCOC issue may be particularly acute when the fund's M&A deal counsel is not the fund's regular counsel.

Here are a few common scenarios to watch out for when doing a VCOC compliance check with respect to a proposed portfolio investment by a fund that is intended to qualify as a VCOC:

Indirect minority investments. In certain circumstances a fund will invest in a holding company (which could be an LLC, a partnership or a corporation) with one or more co-investors, including an affiliated co-investor such as an employee fund or other parallel fund. In these circumstances, problems arise if the holding company takes a minority position in the portfolio company. For example, a fund could contribute 80% of the funds to a holding company, with a co-investor (who may or may not be an affiliate of the fund) providing the remaining 20%. The holding company will then acquire a minority stake in a portfolio company (and will not hold any other investments).

Based on available guidance from the DOL, this investment will not qualify as a good VCOC investment. The problem is that the fund has not invested in an operating company. The holding company cannot be considered an "operating company," because it is not engaged (primarily or through a *majority-owned* subsidiary or subsidiaries) in the production or sale of a product or service other than the investment of capital. If the fund owned 100% of the holding company, the holding company could be disregarded for VCOC purposes and the fund would be treated as if it invested directly in the operating company. But in our example, the fund only owns 80% of the holding company (even if the fund and the co-investor are affiliates, they will be treated for VCOC purposes as separate investors). Accordingly, the holding company cannot be disregarded, and the VCOC fund will be viewed as having invested in the holding company, rather than in the operating company below. Therefore, regardless of any management rights that the fund may obtain with respect to the holding company or the underlying portfolio company, the structure of the investment will preclude its qualification as a good VCOC investment.

Lesson: Where the fund proposes to acquire a minority interest in an operating company, it must make the investment directly into the operating company or through a holding company that is 100% owned by the fund.

Umbrella holding companies with substantial non-majority interest holdings. A variation of the "indirect minority investment" issue described above may arise if the fund invests in an umbrella holding company that owns multiple chains of operating subsidiaries, some of which are majority owned and others of which are either minority owned or exactly 50% owned. The issue here is whether the umbrella holding company will meet the definition of an "operating company" as defined in the VCOC regulations (*i.e.*, an entity that is *primarily* engaged, directly or through a *majority*-owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital). There is no clear guidance under the regulations regarding how to assess whether an entity is *primarily* engaged directly or though majority-owned subsidiaries in operating activities. One reasonable approach to this issue would be to measure the relative value of the umbrella company's majority-owned subsidiaries as compared to its non-majority owned subsidiaries. If most of the company's value is attributable to its majority-owned operating subsidiaries, a strong argument can be made that the umbrella company is in fact "primarily" engaged through its majority-owned subsidiaries in operating activities. If most of the umbrella company's value is attributable to its minority and 50% owned holdings, there may be other rationales to support the umbrella company's status as an operating company (*e.g.*, if the umbrella company is actively involved in the "business" of managing its non-majority owned subsidiaries).

Lesson: Don't assume that a conglomerate entity is an "operating company" if it includes substantial non-majority interest holdings.

Management rights assigned to investor group. Occasionally, a fund may invest directly in a portfolio company with a related fund (*e.g.*, a parallel fund). Or, a fund may invest through a holding

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Proposed HSR Rules May Mean Filings for Partnerships and Other Non-Corporate Entities

The Federal Trade Commission has proposed sweeping changes to the rules for pre-merger notification filings under the Hart-Scott-Rodino (HSR) Act that would eliminate the so-called partnership loophole and impose filing requirements for partnerships and other non-corporate entities that are similar to the requirements that already exist for joint-venture corporations.

The existing HSR regime has separate rules for joint-venture corporations, partnerships and limited liability companies (LLCs) – and no specific rules for other types of non-corporate entities. Generally, there must be a filing for the formation of a joint-venture corporation if the size-of-person and size-of-transaction tests are met. Accordingly, a filing is required if an investor in a newly formed corporation will acquire in excess of $200 million worth of voting securities. Alternatively, the size tests are met if an investor acquires in excess of $50 million of voting securities and (1) that investor and another are $10 million persons and the joint venture will have assets of at least $100 million, or (2) the investor making the $50 million investment is a $100 million person and another investor and the joint venture are $10 million persons.

By contrast, as matters now stand, the formation of a partnership is never reportable: that's the partnership loophole. Similarly, the acquisition of a partnership interest is treated as the formation of a new partnership, which is to say that such acquisitions are also exempt from reporting requirements. The only exception to this rule is when the acquiring person will hold all of the partnership interests. In that case, the acquisition is viewed as an acquisition of the assets of the partnership and a filing is required if (1) the size of the transaction exceeds $200 million, or (2) the size of the transaction exceeds $50 million, the acquiring person or the partnership is a $100 million person and the other is a $10 million person.

For the formation of an LLC, the FTC takes a third approach. Such a formation is exempt from reporting requirements unless it will result in the combination of two or more pre-existing businesses under common control. As is the case with partnerships, an acquisition of an interest in an LLC is exempt unless the acquiring persons will hold all LLC interests, in which case a filing is required if the size-of-person and size-of-transaction tests are met.

How could three forms of joint ventures come to have three different sets of filing requirements under the HSR Act? The FTC's hands-off approach to partnerships was based, at least initially, on two notions: (1) that the federal authorities should be wary of regulating partnerships too closely because their forms vary among the different states and (2) that the antitrust implications of transactions involving partnerships likely are less significant than the implications for transactions involving corporations. Those same notions applied to some degree to LLCs, although the FTC recognized that some LLC transactions, namely those combining existing businesses, had potential antitrust implications and, therefore, should be subject to reporting.

The current proposal appears to be spurred by the FTC's recognition that the use of unincorporated entities, particularly in connection with transactions to acquire interests in other businesses, is increasing. In the materials accompanying its proposal, the FTC noted an increase in partnership tax filings, as well as an increase in partnerships and LLCs formed in Delaware. The FTC also observed that corporations are being replaced by LLCs which, in turn, may be supplanted by limited liability partnerships. Because of these developments, the FTC is seeking a uniform approach to reporting requirements for non-corporate entities that does not depart markedly from the existing rules for joint-venture corporations.

Under the proposed rules, the formation of an unincorporated entity will be potentially reportable if an acquiring person will gain control of the new entity: that is, the right to 50% or more of the profits of the entity or, in the event of dissolution, the right to 50% or most of the entity's assets. The size-of-persons test is similar to that for corporate joint ventures but not the same, because the size of other investors is not relevant. Thus, the size-of-persons test is met, and a filing is required, if the controlling investor will hold in excess of $200 million in voting securities or in excess of $50 million, so long as either the acquiring person or the joint venture is a $100 million person and the other a $10 million person.

Control will also be the triggering event for acquisitions of non-corporate interests. An acquisition of a controlling interest will be reportable if the size of the acquisition (as measured by the

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Lost in Translation: Dispute Resolution Considerations in Cross-Border Deals

The last thing on the minds of private equity investors in cross-border deals are dispute resolution provisions that only prove relevant if the deals goes bad. But if the deal does go sour later, an unwary U.S. investor may find itself being sued abroad, "lost" in an unfamiliar foreign court or legal system, translating thousands of pages of documents into the local language and generally getting bogged down in numerous procedural disputes about everything from proving the investor's identity to registering the investor's fund in the country.

So what can a U.S. private equity fund do? There are several steps you can take when negotiating the original deal to speed up the process and reduce the pain if, in fact, a claim does need to be brought or defended, recognizing, as always, that the ability to prevail on these issues will depend on bargaining leverage, cultural sensitivities and a host of other transaction-specific factors.

Choose a Familiar and Established Governing Law

A U.S. private equity fund should generally insist upon a law, such as English or New York law, that is well-developed and hence predictable, and that will give effect to the document as written if a dispute arises. Foreign parties often insist instead on their home country law, for a variety of reasons, including familiarity, nationalism and the burden of hiring an English or New York lawyer. It is critical that, before agreeing to the application of any given law, the U.S. investor identify all differences that may have an impact on the interpretation of the contract. For example, civil law systems frequently incorporate by law certain code provisions into contracts and, generally speaking, civil law systems permit less strict construction of contract language. As another example, seemingly familiar terms of art, such as "arm's length" or "best efforts," may not exist in certain jurisdictions, or have less precise meanings. Approach with caution any proposal to use, a "neutral" governing law, such as Swiss law in a given transaction, because the substantive provisions may in fact not be "neutral" from the standpoint of the parties' expectations. In any event, a choice of a governing law other than New York or English law should be made only after discussion with counsel in the relevant jurisdiction.

Repress the Urge to Short-cut Documentation

Regardless of the choice of governing law, a U.S. investor should seek to use comprehensive documentation leaving less room for interpretation. While such an approach may run counter to commercial practice in the foreign party's country, particularly in jurisdictions in which contracts incorporate statutory provisions, a comprehensive contract is likely to make it easier for a U.S. investor to compromise on choice of governing law issues, particularly if statutory provisions can be waived. Most important, of course, comprehensive documentation better ensures a meeting of the minds on the deal. However, there are perils of blindly using U.S.-style documentation in deals governed by foreign law, see "The Pitfalls of Using an English Language, U.S.-Style Acquisition Agreement in Transactions Governed by French Law" in the Winter 2004 issue of this publication.

Arbitrate if You Can

The longstanding debate over litigation versus arbitration is trumped in cross-border deals by the greater prospect of enforcing a foreign arbitral award than a foreign judgment against the local party. Most countries are party to at least one of the international arbitration conventions that generally require foreign arbitral awards to be enforced locally; there is no counterpart of comparable scope for foreign court judgments. While enforcement still depends on the willingness of the courts where assets are located to take these arbitration conventions seriously, the widespread adherence to them and the actual practice in many jurisdictions makes the odds of enforcing an arbitral award considerably greater.

Choose a Neutral Arbitral Site

An international arbitration can be held anywhere in the world, including the foreign party's home country. Because the courts in the place of arbitration will have jurisdiction to supervise (and hence interfere with) the proceeding, and also have jurisdiction to entertain an application to vacate the award (including on local law grounds), arbitrating in the foreign party's home court can be dangerous. The conventional seats, including New York, London, Paris and Geneva, are usually preferable, although there are some circumstances in which arbitration in the foreign party's home jurisdiction may be desirable.

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guest column

Bonds – No Longer a Safe Haven?

Private equity professionals are different from other investors. They invest heavily in their own business, the success of which is highly correlated with the strength of the public capital markets. Personal investment strategies often balance high-risk, long-term and illiquid private equity interests with significant holdings in asset categories at the other end of the risk-and-return spectrum: low-yielding bonds or money market cash instruments. This "barbell" approach to investing has been a sound investment strategy for the past two decades. But it may not last. Private equity professionals and other sophisticated investors should be asking, "How do I construct an investment portfolio that will grow in real terms in the face of a possible environment of rising interest rates and inflation?"

Since the early 1980s, the twin forces of declining inflation and interest rates have fueled a nearly uninterrupted cycle of strong returns for private equity investments. This economic backdrop also has resulted in bond indices generating annual returns of almost 10% since 1995, versus the 5.5% long-term average.

Many strategists see a far different outlook for bonds in the years ahead. PIMCO, the major west coast bond-management firm, is revising its portfolio strategy for 2004, stating that, "The bond market in 2004 will be challenging, with upward pressure on rates and full valuations in Treasuries." Mike Even, Chief Investment Officer of the Citigroup Private Bank recently wrote, "So, while bonds have traditionally been a 'safe haven' for investors seeking both income and low volatility, we think those days are over. Not only are current yields low, but future returns are uncertain, giving bonds a poor risk-return ratio."

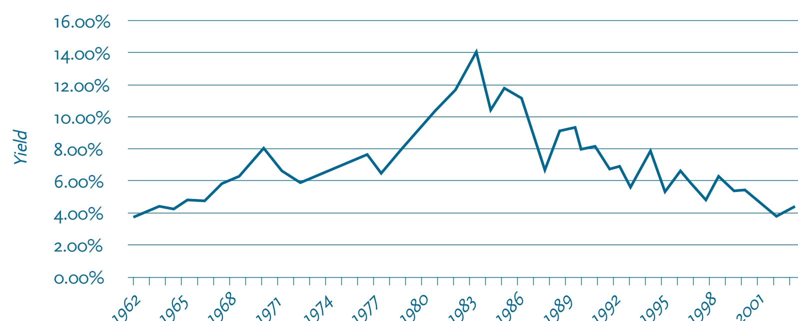
The question is not *whether* interest rates will rise, but when? Despite repeated assurances to the markets that interest rates will remain low indefinitely, Federal Reserve Chairman Alan Greenspan recently made the statement that "such a policy stance [of maintaining 1% borrowing rates] will not be compatible indefinitely with price stability and sustainable growth; the real federal funds rate will eventually need to rise toward a more neutral level."

Rising interest rates and inflation pose dual challenges for private equity professionals: the possibility of slower economic growth and possibly reduced IRRs on private equity funds, plus pressure on the returns of bonds and other financial assets.

No matter what lies ahead in the markets, the most sophisticated way to protect and grow wealth is to diversify broadly across asset classes that have returns that have a low correlation to each other. That means considering strategies that have returns that are not tied to the same influences in the market, whether interest rates, inflation or currency fluctuations.

The best solution is one that takes into account the total wealth management picture: cash flow, tax, estate planning, philanthropy and other considerations. A cash-flow and capital-needs analysis can determine what level of low-risk, highly liquid investments are necessary to fund household and capital expenses. In most cases, an allocation to high-grade municipal bonds is appropriate to fund these expenses and to "anchor" the portfolio in a low-risk asset class. An over-allocation to low-yielding bonds, however, could leave the portfolio producing an unacceptably low rate of return. In fact, returns for many short-term bonds today are below the rate of inflation, producing a negative real return.

Next, an analysis of the risk-and-return tradeoffs for a broad menu of asset classes will help determine what strategies will best meet the long-term growth objectives for the portfolio. Some examples of strategies that could help diversify a portfolio of private equity investments and bonds include:



- *Low volatility hedge fund strategies.* Managers who excel at taking advantage of mispricings of securities can contribute meaningful return to portfolios. Importantly, these strategies tend to have a very low correlation to bond and equity market returns. Examples include a "relative value" style of equity investing, fixed income and capital market arbitrage strategies, and investing in the equity and bonds of distressed companies. These are complex strategies and should be executed only by experienced professionals.

- *Investments in hard assets.* Commodities, real estate, energy and other types of natural resource or "hard-asset" investments traditionally have served as effective "hedges" against rising inflation. Depending upon portfolio objectives, diversification among public and private equity investments ranging from managed commodity futures, precious metals and energy contracts to timber and real estate may be appropriate.

- *Floating-rate instruments.* Lenders protect themselves against rising interest rates through variable or floating-rate instruments. For the investor, floating-rate investment opportunities are an excellent means of participating in a rising rate environment.

Further, all asset allocation decisions should be made in the context of the family estate plan. The estate plan will drive decision-making around the style of investments appropriate for family portfolios. Children's trusts, for instance, may be invested with an eye toward long-term capital appreciation without regard to current cash yield. Liquid assets with high growth potential are good candidates for a wealth transfer technique known as a Grantor Retained Annuity Trust. These trusts can pass the appreciation of an investment portfolio to the younger generation with advantageous gift tax consequences. Charitable trusts can generate current income for the family while providing a future gift to a chosen charitable organization. Private equity and interests in closely held businesses work well in family partnerships and LLCs. (For a discussion of estate planning for private equity fund interests see Jonathan Rikoon's article, "Estate Planning for Carried Interests" in the Fall 2000 issue of this publication.)

The most recent interest-rate cycle has had a dramatic influence on financial asset returns. From 1962 to 1982, interest rates rose markedly and had a dampening effect on investment portfolios. From 1982 to 2004, rates steadily declined giving a tremendous lift to the economy as well as bond and stock prices. The core question is, "Looking forward, what is the most likely capital market scenario and how do I adjust my asset allocation to protect and grow wealth?" A sound wealth management plan for busy private equity professionals not only makes good sense, but can bring peace of mind, allowing for complete focus on the business at hand.

—Stephen V. Kenney
Chief Investment Officer and Managing Director, SCS Financial

Upcoming Speaking Engagements

May 26-27

Andrew Ostrognai
Strategies to Exit Investments: Private Equity & Venture Investment in North Asia
Asia Pacific Venture Capital Association
New York, NY

June 2

Sherri G. Caplan
Investing in a Real Estate Private Equity Platform
Fifth Annual Real Estate Opportunity & Private Fund Investing Forum
New York, NY

June 17-18

Franci J. Blassberg, Moderator
Leveraged Buyout/Management Buy-out Transactions
International Bar Association
Third International Mergers and Acquisitions Conference
London, England

June 24-25

Jeffrey J. Rosen
Case Studies

Peter Furci
Structure and Tax Analysis

Advanced Forum on Income Deposit Securities (IDSs), Enhanced Income Securities (EISs) and Similar Products
New York, NY

Tyranny of the Minority?

A number of recent Delaware cases have questioned the unfettered ability of majority shareholders of public companies to sell their controlling interests, either directly or through causing a sale of the entire company. In the latest such case, *Hollinger Int'l, Inc. v. Black,* the court enjoined Conrad Black from selling a holding company through which he controlled newspaper publisher Hollinger International – largely because the court found Black had "persistently and seriously" breached his fiduciary and contractual duties to Hollinger International.

Does this signal a fundamental change in the balance of power between majority and minority shareholders? We think not. The case turns on its special facts, in particular Black's agreement with the company limiting his freedom to sell the holding company. But the case is a useful reminder that Delaware courts will use their equitable powers to enforce commitments majority shareholders make to their controlled subsidiaries, as well as to police the fiduciary duties that directors of a controlled company have to all shareholders – not just to the controlling shareholder that may have nominated them. These are important lessons for private equity firms that take control positions in publicly traded companies, and for their representatives on the boards of those companies.

Conrad Black, faced with a special board committee conclusion that he had received millions in unauthorized payments from Hollinger International, entered into a written agreement in which he promised to repay Hollinger International, to resign as CEO (though he remained a director) and to support a process to consider strategic alternatives for Hollinger International. He also agreed to sell control only as part of a transaction that equally and ratably benefited the other stockholders, and not to support any transaction involving shares of the holding company unless necessary to enable the holding company to avoid a material default or insolvency – and then only with as much advance notice to Hollinger International as reasonably possible.

Black failed to make the required payments, and immediately began to undermine the strategic process by secretly negotiating a sale of the holding company through which he controlled Hollinger International to the Barclay brothers, investors who had expressed a strong interest in acquiring *The Daily Telegraph* from Hollinger International. Black, who did not inform the board of the Barclays' interest in the *Telegraph*, convinced the Barclays that by buying the holding company, they could gain control of the *Telegraph* without having to participate in a strategic process with other bidders. Worried that Hollinger International might sell the *Telegraph* out from under him, Black caused the holding company to sign a shareholder consent amending Hollinger International's by-laws to eliminate the special committee and to require unanimous board approval for a merger or material asset sale – effectively giving Black a personal veto over any such transaction.

When the special committee adopted a poison pill to block the deal with the Barclays, litigation ensued.

Vice Chancellor Strine, noting that he found Black "evasive and unreliable" and that "[h]is explanations of key events and of his own motivations do not have the ring of truth," determined that Black had repeatedly breached his duty of loyalty to Hollinger International by failing to tell Hollinger International's board about the Barclays' interest in buying the *Telegraph*, misleading the board about his dealings with the Barclays, using confidential information about Hollinger International (including the financial adviser's valuation analysis) to further the Barclays transaction and urging the Barclays to try to subvert the loyalty of the financial adviser to the special committee. Strine also held that Black had violated his agreement with Hollinger International, finding that the Barclays transaction, by deterring other buyers of Hollinger International or its assets, negatively affected the strategic process and was not necessary to avoid a material default or insolvency at the holding company. In light of Black's conduct, Strine enjoined the Barclays transaction, invalidated the by-law amendments and upheld the poison pill.

Although the court, based on the facts before it, enjoined Black from selling his control position, Strine's opinion includes language that supports the notion that, in most circumstances, controlling shareholders are free:

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alert

Update on European Merger Control

Private equity investors and other acquirers of significant European businesses will be pleased by various improvements in the EC merger control process. As of May 1, 2004, the new European Community Merger Regulation (ECMR) came into effect, and 10 additional countries joined the European Community (EC).

The most important benefit of the new regulations is the extension of "one-stop" EC merger control (for those transactions having a sufficient Community dimension) to the 10 new Member States. Other benefits include: (1) a provision intended to decrease the number of transactions subject to national-level merger review in three or more Member States, (2) the possibility of filing a Form CO before a binding agreement is signed, (3) some increased flexibility as to when undertakings (*e.g.*, divestiture commitments) can be submitted, and (4) the recognition of merger-generated efficiencies as a valid basis for counteracting a transaction's negative effects on competition. Viewed more broadly, the new ECMR also makes limited changes to the filing requirements and review procedures applicable for most transactions.

The following list highlights the principal changes likely to be of interest to private equity investors or advisors active in European M&A. A number of more technical items have not been listed.

Principal Improvements:

- The 10 accession states (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) will come within the scope of "one-stop" EC merger control for all transactions that qualify for a Form CO filing in Brussels.
- Parties to a proposed transaction that does not otherwise qualify for a Form CO notification, but which does qualify for merger control review in three or more EC Member States, may elect to file a Form CO "one-stop" notification if none of the involved Member States objects.
- The Form CO may be filed before a binding agreement has been signed, if the parties demonstrate to the Commission the existence of a good-faith intention to conclude an agreement (for example, where there is a signed letter of intent) or if there is an announcement of an intent to make a public bid.
- Efficiencies expected to be generated by the concentration may be used to help justify clearance provided the efficiencies will benefit customers and are merger-specific and verifiable.
- Where a proposed concentration has a Community dimension, but may significantly affect competition in a distinct market within a Member State, the notifying party may request referral of all or the relevant part of such concentration to the Member State for review. (The new ECMR also carries forward the right of a Member State to request a referral to such Member State in certain circumstances.) Assuming the Member State does not object, the Commission has discretion to proceed with the referral.
- The new ECMR expressly recognizes the duty of the Commission, if the notifying party so requests, to review and assess ancillary restraints if they involve novel or unresolved questions.

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The most important benefit of the new regulations is the extension of "one-stop" EC merger control (for those transactions having a sufficient Community dimension) to the 10 new Member States.

To Standardize or Not to Standardize: Recent Developments in the Private Equity Valuation Debate

Although the idea of a uniform, industry-wide standard for private equity valuations has been discussed for years, the topic has received a great deal of attention in the past six months, with some groups issuing, reviewing or updating proposed and existing valuation guidelines.

While uniform (but different) valuation standards are generally followed in the UK and Europe, there is no accepted uniform set of valuation standards for private equity funds in the U.S. Even though almost all U.S. private equity funds prepare their financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP) – which require that private funds report the "fair value" of their investments – U.S. GAAP currently provides little guidance in determining fair value. U.S. private equity firms use a number of different approaches to valuing their holdings. Thus, two or more private equity firms with investments in the same portfolio company may assign dramatically different values to those investments.

In the first part of this article, we review some of the views expressed by proponents and opponents of the use of industry-wide valuation standards. In the second part of this article, we review some of the different views on the use of a "fair-value" standard for valuing private equity investments. Finally, in the third part of this article – and in the accompanying chart – we review and compare existing valuation standards and recent proposals for new, uniform valuation standards.

The Standardization Debate

Valuation of private equity holdings has always been an important issue for investors. Valuations are relevant not only in the reporting context, but also (1) when calculating the amount of carried interest distributions when funds make "in-kind" distributions of securities and (2) for funds that pay out carried interest on a "deals realized to date" basis, when determining whether a fund has unrealized losses that should reduce carried interest payments (as is common in buyout funds) or has satisfied a fair value cushion condition to carried-interest payouts (as is seen in many venture funds).

Still, pressure to adopt uniform valuation standards was not significant during the boom years of the late 1990s, what with valuations and IRRs generally rising. However, after the technology bubble burst, valuations of public tech companies fell while private equity tech investments were not always marked down promptly or at all. This led many private equity investors (and fund sponsors) to focus on valuation standards. In addition, the trend toward greater transparency in the private equity industry, including increasing disclosure of fund performance in response to Freedom of Information Act requests, generally has led some industry participants and observers to focus on valuation issues.

Despite a growing concern over valuations, neither investors nor fund sponsors in the U.S. agree on whether a single valuation standard should be developed for use by U.S. private equity firms. Summarized below are some of the various arguments that have been articulated both in support of and against the creation of a uniform U.S. private equity valuation standard:

Proponents of Valuation Standards

Proponents of a more uniform approach to private equity valuation cite a number of reasons for standardization:

Harmony with international standards. A single U.S. standard for valuation, consistent with international guidelines such as those of the British Venture Capital Association (BVCA) and the European Private Equity and Venture Capital Association (EVCA), would facilitate greater cross-border investing and cross-border performance comparisons.

Limited partner (LP) confidence in valuations. Consistent valuations across funds, which can only be achieved through application of a single standard, foster greater confidence among LPs in their funds' general partners (GPs), particularly important at a time when GP-LP relationships are under stress.

Preempt regulatory interference with valuation. Valuation standards may preempt potential demands for greater transparency and uniformity from regulators. With various corporate and hedge fund scandals and ensuing changes in the regulatory climate, some are concerned that regulators such as the SEC may eventually extend their focus beyond hedge fund valuations to private equity fund valuations.

Greater comparability of performance among funds. Standardization of private equity valuations enables institutional investors to compare more readily the

performance across the private equity funds in their portfolios, and of private equity funds to the performance of the public markets.

Fueling the secondary market. A uniform standard could help create a more dynamic secondary market by enabling secondary purchasers to compare more readily the purchase price of one secondary fund interest with another.

Critics of Valuation Standards

Some fund investors and sponsors (and other market participants whose livelihoods depend in part on market inefficiencies) have also expressed opposition to, or at least skepticism concerning, the development of uniform valuation standards:

Valuation is an art, not a science. Private equity is an illiquid asset class and, as such, it is impossible to eliminate the subjective element inherent in valuation. Even the development of a single global standard would still require that GPs make subjective judgment calls in implementing any such standard. Thus, disparities would still exist; yet investors might be misled into believing that consistency had been achieved.

Valuation standardization could incite legal action. At present, investors understand that private equity valuations are subjective. Too much emphasis on standardization of valuations and the existence of a single "correct" value of an investment could lead to lawsuits against those firms that do not report the "correct" value of an investment.

Valuing GPs' subjectivity. Many investors choose a particular fund manager because of their confidence in such manager's unique judgment in respect of market investment opportunities as well as valuation, *i.e.*, a manager's subjective view of the value of a portfolio company is an element of the expertise for which such manager has been selected. Following a uniform standard might fetter such manager's ability to exercise its discretionary judgment.

Others have approached the valuation debate from a different perspective, by questioning whether the more standardized approach to valuation used in public markets really produces more accurate or reliable valuations. Jesse Reyes, vice president of Venture Economics, questioned:

> At one point, Amazon shares were priced at $175 dollars. Was that a good valuation? Probably not. But it was a real price. The idea of a good valuation is a slippery notion whatever you're talking about. People say that private equity valuations must be bogus because they aren't based on reality. But there have been plenty of things based on reality that turned out to be pretty bogus.[1]

Instead, he suggests, investors need to accept that valuing private equity necessarily involves guesswork.[2]

The Fair-Value Debate

The debate over standardization has been accompanied by an equally intense debate over the use of "fair value" in valuation standards. U.S. GAAP and many existing and proposed valuation standards require that private equity funds "fair value" their holdings. Harmonization of valuation standards is not likely to be achieved before a consensus is reached on the meaning of, and the appropriate techniques to determine, fair value.

Fair value is generally defined as the amount at which an investment can be sold in a current transaction between willing parties, other than in a forced liquidation or sale, although the exact definition may vary depending on the source. Some private equity funds have historically taken the view that private equity holdings should be carried at cost for as long as possible, arguing that, in light of the illiquid nature of private equity investments and principles of conservatism, cost is the best measure of "fair value" absent almost any event short of a complete or partial sale. (In this article we refer to this as a "conservative" valuation standard). Others have taken the view that a less conservative fair-value standard should be applied. They argue that a variety of techniques (*e.g.*, valuing by looking at earnings multiples, discounted cash flows) should be applied to arrive at what they believe will be a more "accurate" fair value. (In this article we refer to this as a "more rigorous" fair-value standard.)

Proponents of a "More Rigorous" Fair-value Standard

Proponents of a move away from carrying investments at cost to more rigorous fair valuing cite a number of reasons for standardization:

LPs want to measure performance. Investors want to understand how their portfolios are performing, and cost-based conservative valuations do not reflect current performance adequately.

Fund sponsors market their funds based on interim performance. A private equity firm marketing a new fund may use a "more rigorous" standard to value predecessor fund holdings at their "true" values, and not at cost, even if

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1 *"Benchmarks: Private Equity's Benchmark Blues," Global Investor, May 1, 2002.*

2 *Ironically, at least one new fund has been developed that takes the reverse approach to valuation by applying traditional private equity valuation techniques to investments in the public markets ("Schroders Bridges a Private/Public Divide," Financial Times, July 31, 2003).*

 (cont. from page 17)

Comparison of Valuation Methodologies

	NVCA	BVCA	AIMR
Measure of Value	Valuation presumption: investment cost. Fair Value is not defined.	*Fair Value*: "[T]he amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction." At-cost valuation permitted *only* where Fair Value cannot be reliably measured.	*Fair Value*: "The amount at which an asset could be acquired or sold in a current transaction between willing parties in which the parties each acted knowledgeably, prudently and without compulsion."
Valuation Methodology	Valuation should be adjusted to equate to a subsequent significant equity financing that includes a sophisticated, unrelated new investor.	• Methodology Hierarchy for "Unquoted Instruments" – Earnings Multiple: Primary – Price of Recent Investment: Primary – Net Assets: Primary – Discounted cash flows or earnings (of underlying business): Secondary – Discounted cash flows (from investment): Secondary – Industry valuation benchmarks: Secondary • "Quoted Instruments" are valued at market price.	• Methodology Hierarchy – Market transaction: most recent independent third-party transaction involving a material investment. – Market-based model: in the absence of such market transaction, may calculate using market-based model (*e.g.*, free cash flow) and market-based assumptions; the method that involves the least number of estimates is preferred. – Discounted expected future cash flows: the present value of expected cash flows (incorporating risk uncertainty), discounted at the risk-free rate adjusted for creditworthiness.
Impaired Investments	Value should be reduced if a company's performance and potential have significantly deteriorated.	*Fair Value*: If at-cost value is used, it should be reduced to reflect estimated extent of impairment. Examples: failure to meet significant milestones or service financial instruments; breach of covenant; deterioration in forecast performance; significant adverse changes in company's technological, market, economic, legal or regulatory environment; market conditions deteriorate generally.	"All valuations must, at a minimum, recognize when assets have suffered a diminution in value." Examples: breach of covenant, failure to service debt, filing for bankruptcy, major lawsuit or loss/change of management.
Liquidity Discount for Publicly Traded Stock	Yes. 10% discount recommended if a high number of shares is held; 30% discount recommended for public securities that are restricted.	Yes. Recommended range of 10-30% in increments of 5%. Discount required if there is a risk holding might not be sold immediately or there is a formal restriction on trading.	No.
Additional Notes		• GAAP-compliant with exceptions; advises against overly conservative valuation. • Methodologies should be applied consistently from period to period, except where a change would result in better estimates of Fair Value.	• Basis of valuation must be logically consistent and applied rigorously. • Any change in valuation principle or methodology from one period to the next must be explained.

EVCA	PEIGG
Two types of valuation: 1. *Conservative Value*: Value at-cost unless (a) a new financing round or partial sale ("arm's-length") has taken place in which case value should be based on transaction price or (b) there has been a material and permanent diminution in value (see "Impaired Investments" column). 2. *Fair-Market Value*: "[T]he estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."	*Fair Value*: "The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."
• Methodology for "Unquoted Investments" (two valuations are recommended) – *Conservative Value*: See "Measure of Value" column – *Fair-Market Value*: Market-based model or Earnings Multiple approach may also be applied where no transaction has occurred and where the investment has revenues and either profits or positive cash-flow • "Quoted Investments:" Market price.	• Methodology should be used consistently until a new methodology will provide a better approximation of value. • At-cost/latest round of financing may be appropriate. However, if manager's review indicates circumstances such that a "material change in value" has occurred, fair value should be approximated. Examples of changes in circumstances: – The current performance of the company is significantly above or below expectations at the time of the original investment; – Market, economic or company-specific conditions have significantly improved or deteriorated since the time of the original investment; or – Substantial decreases in the value of public debt, defaults on any obligations of the company, a bankruptcy filing, significant ownership dilution caused by recapitalization or long term liquidity concerns. • Fair value should be approximated using the following methodology hierarchy: – Comparable Company Transactions: examination of third-party investments/transactions in comparable equity securities – Performance Multiple: application of most appropriate and reasonable multiple derived from market-based conditions or recent private transactions – Other Valuation Methodologies: Discounted Cash Flow, Net Asset Value and Industry Specific Benchmark methodologies may also be appropriate in certain circumstances.
Written down only in increments of 25% once there has been a "material and permanent" diminution in value below cost. Such material and permanent diminution in value may result from: a breach of covenant, failure to service debt, a filing for creditor protection or bankruptcy, a major lawsuit (particularly concerning intellectual property rights), loss or change of management, fraud within the company, substantial changes in market conditions, significant lowering of profitability margin, performance substantially below expectations.	Fair value/GAAP compliant methodology.
Yes. Value adjusted for lack of marketability when quoted investments are restricted.	Yes. A marketability discount of 0-30% may be taken only when a restriction (within meaning of GAAP) on sale exists.
• Guidelines emphasize transparency and disclosure. • Any changes in valuation method from period to period, and the effect of such change, should be clearly stated. • All valuations should be calculated to account for the dilution resulting from the exercise of ratchets, options or other incentive schemes.	Valuation adjustments should be based on actual positive and negative events, not upon expectations.

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they use cost for financial reporting and purposes other than marketing. Some feel this phenomenon shows that these private equity firms believe that cost in fact does not reflect the fair value of those holdings. Proponents of a "more rigorous" fair value argue that firms should be able to use these more "accurate" valuations without creating inconsistencies with reporting conventions typically followed.

Harmony with UK and European standards. A more rigorous fair value approach enables investors to compare the performance of a U.S.-based fund more readily with European and U.K. funds.

Secondary market reliance on valuations. Both buyers and sellers in the growing secondary market, many of which are not distressed, need a more accurate and current valuation than a conservative cost-based valuation.

Critics of a "More Rigorous" Fair-value Standard

Proponents of a more conservative, cost-based approach to fair value cite a number of concerns over proposals to adopt more rigorous fair-value standards:

Volatility. More rigorous quarterly fair values for investments may lead to more volatility in carrying values and may prove misleading when a write-up does not prove substantiated upon disposition of an investment.

Impracticality for early-stage investments. A more rigorous fair-value approach may not be practical for some venture capital firms because identifying public company comparables for an early stage company with little operating history may be too difficult, if not impossible.

Impracticality for minority investments. More rigorous fair valuation methodologies may not be practical for a venture capital fund or a private equity fund with a large number of minority investments for which the fund has few or no board seats and, as a result, only very limited information on which to base its valuations.

Incentive to overvalue. A more rigorous fair value approach is dangerous because firms are encouraged to write up, even in the absence of a third-party valuation event to validate the write-up. Such write-ups can affect carried interest payouts, which can be problematic, as many LPs have faced difficulties in recent years enforcing GP clawback provisions.

Conservative is better. A conservative, cost-based approach to valuation can lead to fewer negative surprises to investors and reduce the likelihood of needing to rely on GP clawback provisions – if one assumes that a conservative approach to valuation discourages write-ups but does not discourage write-downs (which may not be the case). This is not a problem faced in the U.K. and European markets where fund terms historically have required repayment of all invested capital before any carried interest payments can be made.

Cost and effort. More rigorous fair value determinations, especially if done on a quarterly basis, can be costly and time-consuming and still not lead to more accurate determinations of fair value. Not every firm can afford to undertake such an exercise, and even those who can may be diverting resources away from other more important investment activities.

The Current and Evolving Valuation Landscape

Certain provisions of the existing and proposed valuation guidelines discussed below are summarized in the chart on page 18.

United Kingdom

The BVCA, founded in 1983, is the representative body for the private equity industry in the UK. The vast majority of private equity forms organized in the UK are BVCA members. The BVCA published its first valuation guidelines in 1991. The second version of these guidelines was updated and endorsed in June 2003.

The BVCA guidelines rely on "fair value" as their core valuation principle, requiring the basis of a valuation to be fair value "except in rare occasions when Fair Value cannot reliably be determined." The BVCA divides the methodologies to be used to determine fair value into "primary" and "secondary" methods. Among the primary methods are earnings multiples, the price of recent investment and net assets. Among the secondary methods are discounted cash flows or earnings of underlying businesses, discounted cash flows from the investments and industry valuation benchmarks. The BVCA guidelines are intended to be consistent with International Accounting Standards (IAS), with a notable exception for the BVCA recommendation of discounts for publicly traded instruments, which is prohibited by IAS 39.

Europe

The EVCA, also formed in 1983, represents the interests of the private equity industry in Europe by promoting private equity investing to, and educating, investors, policy makers and

entrepreneurs. The EVCA currently has over 950 members. The EVCA published its first valuation guidelines in 1993, which were later updated by the EVCA's Task Force on Valuation in 2000 and adopted in 2001.

The EVCA's valuation principles are based on surveys indicating that investors wish to see two separate valuations: (1) a conservative valuation (based on cost or the last round of financing), to be used for capital account purposes and (2) a more rigorous fair value determination, to be used to determine the future value and prospects of an investment. In determining fair value, the EVCA recommends (in the absence of any third-party transaction) using (1) comparable companies with established valuations and (2) earnings multiples with an illiquidity discount of at least 25%. The EVCA also recommends discounts for publicly traded instruments, regardless of whether the instruments are subject to restrictions. The EVCA guidelines have served as the base for other regional guidelines within Europe, such as those of the Association Française des Investisseurs en Capital (AFIC) in France.

United States

The majority of U.S. private equity funds tend to use conservative cost-based valuation principles. Some argue that cost-based valuations are not always consistent with a fund's obligation under GAAP to report the fair value of an investment because, at a certain point, cost may be a stale measure of a portfolio company's worth. Still, many U.S. firms take the view that in light of the illiquidity of private equity holdings and principles of conservatism, private equity investments should be carried at cost until a disposition or third party investment. They take this view in an environment where the accounting profession and GAAP have not yet provided sufficient guidance for U.S. firms on how to determine fair value in the private equity context. However, the Financial Accounting Standards Board (FASB) is now in the midst of a fair-value project from which more detailed guidance on fair-value methodologies is expected to emerge.

Attempts at standardization. Efforts to standardize private equity firms' approaches to valuation in the U.S. began in the late 1980s when an Ad Hoc Committee of the National Venture Capital Association (NVCA) proposed the first private equity valuation standards in the U.S. In 1989, the NVCA presented these standards in an all-member forum but after a heated debate chose not to take a position on the standards or to adopt them formally. Ironically, the guidelines considered by the NVCA – which it refers to only as the "Proposed Venture Capital Portfolio Valuation Guidelines" (NVCA Guidelines) – have been the most widely followed valuation guidelines among U.S. private equity firms over the last 15 years.

Not long after the NVCA Guidelines were drawn up, Venture Economics introduced the first systematic performance measurement report with long-term statistics on private equity, leading to greater transparency among private equity firms. In 1994, the Subcommittee on Private Equity Presentation Standards of the Association of Investment Management Research (AIMR), a global industry association comprising both investment professionals and financial analysts, recommended that standard guidelines be used for private equity valuation and, in 1999, adopted its first version of the Global Investment Performance Standards (AIMR GIPS). In January 2004, the Subcommittee published amended AIMR GIPS guidelines to become effective in January 2005. Meanwhile, in late 2003, the Private Equity Industry Guidelines Group (PEIGG), a voluntary group of industry representatives formed in 2002, issued guidelines with a marked emphasis on "more rigorous" fair value. (These amended AIMR GIPS guidelines and PEIGG Guidelines are discussed below.)

AIMR's new GIPS principles. The AIMR GIPS Principles introduce a hierarchy of fair-value methodologies to enable firms to derive fair values. At the top of the hierarchy is the use of relevant public data, such as comparable public company transactions, followed by market-based multiples (*e.g.*, price to earnings, enterprise value to EBIT and enterprise value to EBITDA) in the middle tier and then discounted expected future cash flows at the bottom of the hierarchy. AIMR recommends that valuations be reviewed by an independent party, such as an independent advisory board.

The new AIMR GIPS Principles offer a bit more detail than PEIGG's guide-

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Although the traditional assumption in the U.S. has been that conservative valuation is good, PEIGG now aims to replace the concept of conservatism with that of prudence . . . The valuation guidelines are intended to comply with U.S. GAAP, which requires that private equity investments be carried at fair value.

lines, although they fall short of the level of detail offered by their UK and European counterparts. While AIMR is considered by most to be the leading U.S. industry association for buy side and sell side equity analysts and mutual fund managers, AIMR is generally considered a less influential voice in the private equity world.

The new PEIGG valuation guidelines. Although the traditional assumption in the U.S. has been that conservative valuation is good, PEIGG now aims to replace the concept of conservatism with that of prudence. Thus, the new PEIGG valuation guidelines released in late 2003 recommend that investments be fairly valued on a "prudent and consistent" basis. The valuation guidelines are intended to comply with U.S. GAAP, which requires that private equity investments be carried at fair value.

PEIGG recommends updating valuations when a "material change in value" has occurred in a portfolio company. Examples of changes might be a company's success or failure to achieve certain milestones or technology breakthroughs or materially exceeding or failing to meet budget limits. In addition to company-specific events, the PEIGG Guidelines also suggest that private equity firms take into consideration the improvement or deterioration of general market, economic or industry conditions as compared with the date of the original investment. The Guidelines also recommend that valuations be updated quarterly.

Among the valuation methodologies recommended are comparable public company transactions or earnings multiple methodologies. Different firms co-investing in a single portfolio company are encouraged to consult each other to establish a single valuation for that company. (Some suggest these conversations occur infrequently because of misplaced fears of consequences under anti-trust laws.)[3] In addition, the PEIGG Guidelines suggest that private equity firms organize semi-independent valuation committees to establish valuation standards to be followed by a fund's GP. However, the GP of a fund retains the discretion as the ultimate judge of a portfolio company's valuation.

Fund managers are entitled to retain their existing valuation methods for "some period of time" before switching to the fair value method. Establishing an exact period of time for transition was a contentious issue among PEIGG members, as a venture fund might consider six months to be a long period whereas a buy-out fund might consider two years as a long period.

The PEIGG Guidelines eliminate the liquidity discount taken on the stock price of a portfolio company taken public. Typically, private equity firms discount the price of publicly held stock during any mandatory hold or lock-up period or when the firm holds a large block of such stock. Note that the FASB currently prohibits a liquidity discount for publicly traded stock unless the stock is restricted by a governmental or contractual limitation exceeding one year in duration.

Reception of the new PEIGG Guidelines has been mixed, with three member firms of PEIGG indicating they would not be adopting the guidelines. In his initial reaction to the PEIGG Guidelines, NVCA chairman Jim Breyer echoed this concern: "The troubling issue is the suggestion that, on a quarterly basis or an annual basis, there should be write-ups of portfolio-company valuations without third-party validation. That's a slippery slope because it just leads to *more* arbitrary valuations when it comes to write-ups" (emphasis added).

The NVCA has maintained its neutral position in the private equity valuation debate by declining to endorse the new PEIGG Guidelines. Instead, the NVCA recommended that its members "create, follow and communicate clearly the specific procedures and methodologies used for valuing their portfolios." This recommendation is consistent with findings of the Center for Private Equity and Entrepreneurship of the Tuck School at Dartmouth, which suggest that for most investors clearer and more detailed explanations of the valuation methodology used is more important than consistency of valuations.[4]

Conclusion

Although reception of the new PEIGG and AIMR guidelines has been mixed, they have focused and enlivened the debate over standardized valuation and the techniques to be used to determine fair value. We hope to apprise you of future developments in the continuing debate over private equity valuation, including reporting on the results of the FASB's fair-value project later this year.

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3 Private Equity Valuation and Reporting Conference Proceedings, pp. 34-35, June 2003, Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth.

4 Proceedings.

stock. Thus, a BDC can recycle its capital and reinvested earnings indefinitely rather than being faced with the prospect of liquidation once it has realized on its initial investments.

BDCs have had an interesting history. In 1980, in order to promote capital formation for small businesses and "democratize" venture capital investing, Congress amended the Investment Company Act to establish a special regulatory framework for venture capital pools. These provisions are primarily designed to ensure that a BDC's investments are generally limited to venture-stage or financially troubled companies and that the BDC offers to play an active role in the management and policies of the portfolio companies in which it invests.

Historically, the BDC structure has not always proven to be an especially attractive alternative to traditional private buyout and venture capital funds. (In 2000, one journalist found that of the 58 BDCs organized since 1980, 40 were no longer around or actively traded and 10 were "microscopic.") Perhaps because the portfolio investments held by such funds are often held at cost for five or more years until they are finally realized, and because investors do not receive any profits until such time, an active trading market for a BDC may not develop. Consequently, interests in buyout and venture capital funds structured as BDCs have tended to trade at a discount to net asset value. Mezzanine funds, however, produce a regular yield, which may facilitate development of a more active trading market.

Several noteworthy provisions of the Investment Company Act applicable to BDCs are discussed below. A private fund sponsor studying whether to launch a BDC will need to consider these requirements and whether it is prepared to take on the additional regulatory requirements.

Independent Board And Corporate Governance

At least 50% of the board of directors of a BDC must be independent and will be subject to many of the corporate governance provisions mandated by the Sarbanes-Oxley Act of 2002. The independent directors will typically have their own counsel.

Investment Advisers Act Registration

Many private fund sponsors prefer not be registered under the Investment Advisers Act. If the sponsor wants to manage a BDC, it will have to register.

SEC Examinations

BDCs (and their advisers) are subject to periodic examinations by the SEC. The SEC will examine books and records, including e-mails, and interview portfolio managers and other personnel to determine if applicable regulatory requirements are being complied with.

Recently, the SEC adopted a rule that requires BDCs (like other registered investment companies) to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the BDC. Under the rule, the BDC must have a Chief Compliance Officer (CCO) responsible for the administration of these policies. The CCO's designation and compensation must be approved by the BDC's board of directors, including a majority of the independent directors. Moreover, only the BDC board will be able to remove the CCO from his or her position. It is likely that the SEC will focus on the implementation of this rule in its future examinations, since it is viewed as a key initiative to addressing many of the compliance issues facing investment companies.

Public Reporting

BDCs are subject to the periodic reporting requirements required of all public companies under the Securities Exchange Act of 1934. These reports, which are publicly available, will contain relatively detailed disclosures concerning the BDC's operations. Preparation of the financial statements will also require judgments to be made concerning the value of investments, and disclosure of those valuations. Investments for which there is no market quotation (in other words, most of the BDC's investments) must be valued at "fair value."

Investment Advisory Agreement

The BDC sponsor will enter into an investment advisory agreement with the BDC that will specify, among other things, the investment advisory fee. The Investment Company Act requires that the investment advisory agreement must provide, in substance, that it may be terminated at any time, without the payment of any penalty, by the BDC's board of directors or by vote of a majority of the BDC's outstanding common stock on not more than 60 days' written notice to the investment adviser. While termination of the investment advisory agreement is relatively uncommon, it is still probably on a different order of magnitude than that faced by the general partner of a private equity fund, who may have provisions that provide it may only be replaced for cause or by super-majority vote.

Qualifying Assets

Most of a BDC's portfolio investments must be in certain qualifying assets set forth under the Investment Company Act, which include securities of private or thinly traded public U.S. companies,

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cash, cash equivalents, U.S. government securities and high quality debt investments that mature in one year or less. A BDC may not acquire any security unless, after such acquisition, at least 70% of the BDC's assets are invested in such qualifying assets. Up to 30% of a BDC's assets may be in non-qualifying assets such as securities of publicly traded companies and non-U.S. issuers.

Managerial Assistance

A BDC is required to offer, and to provide upon request, "significant managerial assistance" to any portfolio company whose securities are counted in the 70% qualifying asset basket described above. The standard for what constitutes managerial assistance for purposes of the Investment Company Act is similar to the standard of "management rights" required in connection with maintaining a private equity fund's status as a venture capital operating company. (For a discussion of these rules see "VCOC Traps for the Unwary: Will Your Deal Be VCOC Compliant?" appearing on page eight of this issue.) Under the Investment Company Act, managerial assistance may involve, among other things, any arrangement whereby the BDC, through its directors, officers, employees or general partners, offers to provide, and, if accepted, does provide, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company. It may also involve the exercise by the BDC of a controlling influence over the management or policies of the portfolio company by the BDC acting by itself or as part of a control group.

Leverage

A BDC is subject to limits on leverage. Generally, a BDC's asset coverage must equal at least 200% after any borrowing.

Limits on Transaction With Affiliates

Like registered investment companies, BDCs are subject to limits on their ability to engage in transactions with affiliates. While the affiliated transaction provisions applicable to BDCs are somewhat less onerous than those applicable to registered investment companies, they can still present challenges. For example, if the sponsor expects the BDC to coinvest with its private funds that have similar investment objectives, it will be required to seek an SEC order permitting co-investment. Such an order, if it is forthcoming, may be subject to significant conditions (such as prohibitions on coinvestments in companies in which the private fund has an existing investment).

Other Ongoing Requirements

A BDC is subject to various other requirements under the Investment Company Act, including the retention of a custodian to hold all the BDC's securities, and to purchase a fidelity bond. In addition, BDCs are subject to the periodic filing requirements required of all public companies under the Securities Exchange Act of 1934.

RIC for Tax Purposes

Recently organized BDCs have elected to be treated as regulated investment companies, or "RICs," for federal income tax purposes, so that the BDCs will not be subject to U.S. federal income tax on realized capital gains distributed to the company's shareholders. Furthermore, the character of a RIC's earnings as long-term capital gains or qualifying dividend income may be passed on to the RIC's shareholders so that they may be subject to a reduced tax rate. To qualify as a RIC, a BDC must meet certain requirements, including the following:

Distribution requirements. A RIC must distribute 90% of its ordinary income and net short-term capital gains each year.

Income test. A RIC must derive at least 90% of its annual gross income from dividends, interest, payments with respect to certain securities loans, gains from the sale or other disposition of stock or securities, or foreign currencies, or certain other income (including gains from options, futures and forward contracts) derived from the business of investing in such stock, securities or currencies.

Diversification test. As of the close of each fiscal quarter, (1) at least 50% of the value of a RIC's assets must be represented by cash, cash items (including receivables), U.S. government securities, securities of other RICs, and, subject to certain limitations, a diversified portfolio of other securities (including, for example, mezzanine investments) and (2) not more than 25% of the value of the RIC's assets may be invested in the securities of any one issuer (other than U.S. government securities or securities of other RICs) or two or more issuers controlled by the RIC and engaged in the same, similar or related trades or businesses.

The public offering of mezzanine funds structured as BDCs is a significant new trend impacting the private equity arena. We will continue to monitor this trend, and its effects on the private equity industry, as it develops.

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The *Inspire Art* Judgment of the ECJ: New Ways to Structure Acquisitions (cont. from page 7)

the company law of its state of incorporation and the labor law or insolvency law of the state of operations, for example.

In addition, the member state's tax laws are not uniform and are not readily adapted to the situation of relocation of companies. For instance, the criterion for the determination of a company's residency for tax purposes tends to be, in the first instance, the place of incorporation. The company may, however, be considered to be resident in another jurisdiction from which it is managed in addition to, or in substitution for, the jurisdiction of incorporation, depending on the domestic tax rules of each jurisdiction and the terms of any double-tax treaty between them. The tax residency of the company may also change during its life as a result of change of law or the way in which the company is managed. These issues require careful consideration and monitoring if undesirable tax costs are to be avoided.

Lastly, local managers often are not acquainted with the rules governing foreign companies. The same applies to the courts, which are not readily in a position to render judgments on company law issues governed by other member states' laws.

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company with a related co-investor, and then the pooled investment vehicle may take a majority position in a portfolio company (so, the "indirect minority investment" problem discussed above does not exist). So far, the investment is sound for VCOC purposes. However, if the management rights obtained with respect to the operating company are provided jointly to the related investor group (*i.e.*, they "share" the rights), the "group rights" can be problematic for VCOC purposes. This "group rights" scenario may arise, for example, if the fund and its affiliated co-investor are collectively defined in a shareholders agreement as the "Investor" and the agreement then conveys the management rights to the Investor, rather than to the fund alone.

Under the VCOC regulations, when an individual investor has a right to participate in collective decisions with respect to the group's management rights, that investor has not obtained direct contractual management rights that would qualify under the VCOC regulations. To resolve a "group rights issue" in circumstances where members of a related group of investors are granted group rights, typically the members enter into an agreement that provides that one member of the group will be the "lead investor" with respect to that right. Or, for example, if various rights are obtained (such as more than one director), the rights could be "divided up," with some going to one fund and some to the other fund.

Lesson: Where the fund is co-investing with a consortium of other investors in a portfolio company, each fund that is intended to qualify as a VCOC should obtain its own unilaterally exercisable management rights.

Management Rights Must be Contractual Rights. Sometimes a fund incorrectly assumes that, because of its majority ownership, it has sufficient rights (such as the right to elect directors) that derive merely from its shareholdings. Unfortunately, rights that derive merely from share ownership may not qualify as "management rights," because they are not direct contractual rights under the VCOC regulations. Direct contractual rights are usually found in a shareholders' agreement, a subscription agreement, a partnership agreement, an LLC operating agreement or a separate management rights agreement, signed by the fund and the operating company. Such rights may include rights to appoint directors of the portfolio company, rights to advise and consult with management and rights to receive information from the portfolio company.

Lesson: Management rights must be written, contractual rights pursuant to an agreement signed by both the fund and the operating company in which it is investing.

Management Rights Must Flow Directly to the Fund. The VCOC regulations require that management rights flow directly from the operating company to the fund. Occasionally, a transaction is structured so that the fund invests in an operating company through a special purpose vehicle (*e.g.*, a holding company). If the governance documents provide that the board seats or other management rights go to the special purpose vehicle rather than to the fund itself, then the requirement for "direct" management rights will not be satisfied. In order to avoid this problem, there needs to be a specific contractual acknowledgement that the special purpose vehicle will exercise its rights on behalf of the fund, or the governance documents need to include the fund as a party and provide for the rights to be given to the fund.

Sometimes, portfolio investments are "warehoused" and then transferred to a fund. In these circumstances, it should be made clear that the management rights obtained in the warehoused investment are transferred to the transferee fund following the transfer. It is helpful to have the transferor entity, the fund and the portfolio company enter into an acknowledgment that the management rights formerly held by the transferor have been transferred to, and are now directly exercisable by, the transferee fund.

Lesson: Make sure that the management rights inure directly to the fund even if additional language needs to be inserted into the agreement conveying the management rights (or a separate agreement is required).

Consult with an ERISA Lawyer

Probably the most important lesson to take from the above illustrations is to consult with an ERISA lawyer regarding the VCOC ramifications of a proposed investment if there is any question as to whether the investment will be VCOC compliant. Many of the VCOC "structural detail" problems that can creep up can be easily managed if they are identified early on in the transaction negotiations.

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Lost in Translation: Dispute Resolution Considerations in Cross-Border Deals (cont. from page 11)

Don't Litigate in Foreign Courts

If the parties choose litigation, keep in mind that the foreign courts, particularly in emerging markets, may not have much experience in interpreting complicated documentation, and there may also be a home-court advantage for the local party. Although an investor ultimately may have to go into the local courts to enforce a judgment or foreclose on collateral, the merits of the case should generally be litigated outside of the local courts. Sometimes just the risk of litigating in the local courts could force a U.S. investor to compromise or entirely forego a claim that it would otherwise pursue.

Choose Exclusive Jurisdiction

Where arbitration is chosen, it should be exclusive, with resort to courts only for prejudgment remedies, to enforce the agreement to arbitrate or to enforce the arbitration award. Where a judicial forum is instead designated, it would still usually be preferable to achieve the certainty that comes with exclusivity, rather than try to preserve the flexibility to sue in the forum that seems best at the time the dispute arises. As another example, a party more likely to be the defendant (such as a seller in an M&A transaction) may wish to maximize protection against suit in a hostile forum. Although U.S. courts are generally required by statute to enforce foreign-country money judgments if certain requirements are met, enforcement would generally not be required if the foreign judgment was obtained in violation of a valid forum-selection clause. Various options, like waivers of jury trials in U.S. courts or selection of particular branches or divisions of the local judiciary, should also be considered when selecting courts as the dispute resolution mechanism.

Consider Investment Vehicle Nationality

The nationality of the investment vehicle will typically and appropriately be driven by tax, management or other priorities. However, the nationality of the investment vehicle may have important jurisdictional consequences if a dispute arises. Investors will be barred from U.S. Federal courts if they fail to satisfy the requirements for diversity jurisdiction. And investors of certain nationalities have protections under international law against foreign State mistreatment of their investments under bilateral investment treaties. Two recent decisions by the European Court of Justice should allow for broader choices of where to incorporate investment vehicles and thus allow for greater protections afforded by certain jurisdiction's company laws. See, "The *Inspire Art* Judgment of the ECJ: New Ways to Structure Acquisitions in the European Union," elsewhere in this issue.

Avoid Last-Minute Compromises

Dispute resolution issues should be addressed early in the negotiations, so that they do not become "deal points" at the 11th hour. Given the typical pressure to complete the deal, extraneous constraints may otherwise prevent the U.S. investor from getting the protection it should have (*e.g.*, foregoing New York or English law because the foreign party has not retained New York or English counsel) or cause inadequately considered compromises (*e.g.*, a choice-of-law/choice-of-forum trade-off that results in arbitration in an unsuitable jurisdiction).

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Proposed HSR Rules (cont. from page 10)

acquiring person's total investment in the unincorporated entity) and the size of the parties to the transaction meet standards similar to those set forth above.

The FTC will accept comments on the proposed rule-making until June 4, 2004. Adoption is considered likely. One reason is the prospect of added revenue; the new rules will result in additional filings – and additional filing fees. The rules are also likely to be supported because they appear to bring greater logic and consistency to HSR filing requirements for joint ventures.

We will update you on the status of the proposed rules later this year.

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alert

Update on Exiting by IDS

In the last issue of *The Private Equity Report* we gave an overview of the new IDS product and reported stirrings of activity among sponsors and investment bankers. Since then, there have been important developments. In short order, each of the major accounting firms found itself considering several transactions in which these yield-based units consisting of common stock and subordinated notes were to be issued, and they began to raise concerns as to whether it would be necessary to book a reserve for taxes to cover the risk that the IRS might seek to recharacterize the notes as equity. Ultimately, the accountants promulgated a nearly uniform series of structural requirements that would have to be met for them to consent to filings with the SEC. Most important, they indicated that it would be necessary to place at least 10% of the debt separately; that is, not in unit form. In addition, they required 10% of the equity to be held outside of the units for a minimum period of two years. More than a dozen deals were swiftly restructured and are now on file, two quite close to market at press time. In addition, faced with such substantial deal volume, the SEC is also taking a fresh look. The details of all of this are still being worked out, but there is every reason to expect a flurry of deals in the marketplace by the summer solstice.

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Tyranny of the Minority? (cont. from page 14)

- to dispose of their shares as they see fit, without interference from the subsidiary board and
- to approve by-law amendments that are not inconsistent with Delaware corporate law, even though they may substantially impinge on the autonomy of the board.

Strine acknowledged that "[i]n the typical case, the parent owes no contractual or fiduciary obligation to permit the subsidiary to proceed" with an asset sale. But in this case, Black had undertaken those duties, in light of his agreement to support the strategic process. Similarly, although Strine found that the by-law amendments were not inconsistent with Delaware law, he also found they were "clearly adopted for an inequitable purpose and having an inequitable effect" (namely, to enable Black to breach his fiduciary and contractual obligations to the company), and were therefore invalid – although he noted that "it is no small thing to strike down bylaw amendments adopted by a controlling stockholder."

With regard to the poison pill, Strine recognized that "fiduciary duty principles ought to take into account the legitimate expectations of controlling stockholders in evaluating directors' use of a rights plan." Strine also expressed his belief that, in the ordinary case, the argument that "it is perverse that a subsidiary's independent board would use a poison pill to keep its parent corporation from selling itself" would generally be a decisive one. However, Strine held that the adoption of the pill was a reasonable response to the imminent threat the Barclays transaction posed to Hollinger International's strategic process, although he also noted that once the board completes the strategic process, the continued use of the pill "would be suspect, absent further misconduct justifying its continued use."

The bottom line: controlling shareholders retain considerable freedom in dealing with their shares and in exercising their rights as shareholders. However, they may limit that freedom as a result of promises they make to the subsidiary, and if they engage in inequitable conduct, they should expect that the Delaware courts will be willing to step in to protect the interests of the minority shareholders.

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