Debevoise & Plimpton
Private Equity Report

Volume 5 | Number 1 | Fall 2004

Caveat U.S. Emptor: Doing Private Deals in the UK? Beware the Differences Between U.S. and UK Law and Practice

Same language. Common law legal systems. How different can your typical private acquisition agreement be in the UK? The first part of this article breaks down a typical acquisition agreement and identifies certain differences in market standards between U.S. and UK private M&A. The second part focuses on differences in certain discrete areas of English and U.S. law which can cause a nasty surprise to the unwary U.S. buyer.

Acquisition Agreement

A U.S. buyer of the shares or assets of a UK company will not unreasonably expect the same buyer protections that he would receive in a domestic U.S. transaction. However, the seller of a UK target and, by extension, the seller of a non-UK target advised by a UK law firm, may have different expectations as to the degree of risk which the buyer should assume. The buyer who insists on a "U.S.-style" agreement may find himself at loggerheads with the seller from the very start of a transaction.

Note that we are talking here about U.S.-*style* agreements, not U.S. *law* agreements. In theory, choice of law (English, New York or any other state of the U.S.) should not be a significant issue, because all are respected legal systems. However, playing at home still has its advantages, not only because of familiarity with the legal system, but also because the governing law of the agreement will often set the tone of the document and the benchmark against which the fairness of the first draft will be judged. If the deal is to be governed by New York law, the U.S. buyer will need to be sensitive to how the document will be perceived by a UK seller. If the deal is to be governed by English law, the U.S. buyer will need to understand how his position is affected *vis-à-vis* a domestic U.S. deal. The message for any U.S. buyer is to familiarize itself with the main differences in law and practice before embarking on negotiations. Forewarned is forearmed. We discuss below some of the key differences.

Closing Conditions. Closing conditions will be a matter of intense debate in any deal. A certain degree of conditionality is to be expected in the UK (*e.g.*, UK or EU merger clearance, if relevant). However, U.S. buyers typically expect a greater degree of conditionality than UK buyers. Conditions relating to material adverse change (MAC) are strongly resisted in the UK. In the U.S., they appear to be more common, with the debate focusing instead on the precise formulation of the MAC clause. Similarly, the typical U.S. condition that no law or court order shall be in existence prohibiting consummation of the transaction is viewed with suspicion in the UK. In the UK, the seller's counsel rarely delivers enforceability legal opinions to the buyer. It is also relatively uncommon in the UK to make the bring-down of the representations and warranties a condition to closing. However,

continued on page 21

What's Inside

3 UK Income Deposit Securities
4 That's Substantially All, Folks
5 Transfers by Investors in Private Equity Funds: Bad News and Good News Under the New U.S. Tax Bill
6 U.S. Congress Approves Sweeping New Rules on Deferred Compensation
7 Mezzanine Financing — The European and U.S. Experience
10 Guest Column: Spinning Out of an Institutional Private Equity Manager — a Personal Perspective
11 Seven Key Issues Under Senior Debt Commitment Letters
13 Alert: Reopening the Lockup
14 SEC's Proposed Hedge Fund Adviser Registration Rule Sparks Concerns Among Private Equity Advisers
15 Alert: Private Equity Offerings May Face Prospectus Requirements in Germany
16 Russia: Private Equity Update
18 French Acquisition Financings — Key Structuring Issues

© 2004 Marc Tyler Nobleman / www.mtncartoons.com

"Sharon tells me you're an English major."

letter from the editor

The market for private equity deals in Europe has experienced exponential growth over the last few years, with between €60 and €80 billion of completed transactions in the first nine months of 2004 alone. In this issue, we focus on Europe from several perspectives.

First, on our cover, Geoff Burgess and John Morgan describe how the process of negotiating acquisition agreements in the UK differs for those accustomed to purely U.S.-style agreements. We examine the potential for the income deposit security in Europe as a follow-up to our discussion in recent issues of the complex and tumultuous creation of this product in the U.S.

We have two offerings on European finance — a comparison of the mezzanine market in Europe and the U.S. (which includes a nifty cheat sheet on page 7) and a discussion of the legal environment for leveraged lending in France.

In our Guest Column, Hugh Richards reflects on the issues facing private equity professionals interested in spinning out of large institutional management firms to create their own small, highly focused shops, following his recent experience in creating Exponent Private Equity LLP with three other partners.

Continuing with our European focus, elsewhere in this issue, we update our reporting on changes in German regulation of private equity funds; this time focusing on potential prospectus delivery requirements for funds offered in Germany. We also provide an update on the climate for private equity in Russia.

The private equity scene may be more active in Europe than in the U.S., but there are a number of developments in the U.S. as well. We included two articles explaining how the new American Jobs Creation Act of 2004 will have unexpected but dramatic impact for private equity in the areas of transfers of fund interests and structuring of deferred compensation. We also alert you to a recent case in Delaware that suggests that the utility of lockups may not be as limited as contemplated by the Delaware Supreme Court's controversial Omnicare decision last year and another one that clarifies how to define a sale of "substantially all" of a company's assets for purposes of the shareholder approval requirement.

As you may know, we are launching concurrently with this European-focused issue of the *Debevoise & Plimpton Private Equity Report*, the publication of *The Debevoise & Plimpton European Private Equity Handbook*. *The Handbook* includes our "top ten list" of differences between private equity funds and transactions in Europe and the U.S. If you would like a copy of the Handbook, please let us know.

We hope the focus on Europe will prove interesting to those of our clients investing or contemplating investing in the UK or on the Continent. Please let us know if there are any other regions or issues which you would like us to address in future issues.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of
Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
1 212 909 6000

www.debevoise.com

Washington, D.C.
1 202 383 8000

London
44 20 7786 9000

Paris
33 1 40 73 12 12

Frankfurt
49 69 2097 5000

Moscow
7 095 956 3858

Hong Kong
852 2160 9800

Shanghai
86 21 5047 1800

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

All contents ©2004 Debevoise & Plimpton LLP. All rights reserved.

Franci J. Blassberg
Editor-in-Chief

Ann Heilman Murphy
Managing Editor

William D. Regner
Cartoon Editor

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

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

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

Mergers & Acquisitions
Andrew L. Bab
Hans Bertram-Nothnagel – Frankfurt
E. Raman Bet-Mansour – Paris
Paul S. Bird
Franci J. Blassberg
Colin W. Bogie – London
Richard D. Bohm
Geoffrey P. Burgess – London
Margaret A. Davenport
Michael J. Gillespie
Gregory V. Gooding
Stephen R. Hertz
David F. Hickok – Frankfurt
James A. Kiernan, III – London
Antoine F. Kirry – Paris
Marc A. Kushner
Li Li – Shanghai

UK Income Deposit Securities

In the previous issue of the Private Equity Report we discussed the emergence of a new capital markets product in the U.S. known as the Income Deposit Security (IDS). In October, the first U.S. IDS issuance in over a year — by B&G Foods Holding Corp. — was completed, following an extended period of SEC review of the product and cancelled offerings by other companies. In Europe, the market for IDS is still in its early stages, having seen just one "high yield IPO" so far, by Findexa, a private equity portfolio company with operations mainly in Norway. We provide below an overview of the IDS structure as it may evolve in Europe, and particularly the UK.

The IDS in the U.S.

As our previous articles have discussed, an income deposit security is a relatively new capital markets product designed to maximize the value achieved in an IPO by certain types of issuers by combining high yield debt with the equity in a single unit. IDSs developed from Canadian income trusts, in which a publicly-traded trust that owns the debt and equity of Canadian operating companies passes on the interest and dividends received from those operating companies as monthly trust distributions to its interest holders. In the U.S., tax, securities laws and other considerations have led to the development of a structure involving the public offering of units consisting of equity and subordinated debt of the issuer. Although only the unit itself is listed on an exchange initially, holders beneficially own both the underlying equity and high yield debt that is issued, and can separate the unit after a brief initial period. In order to optimize the tax treatment and marketability of the units, several structural enhancements have emerged: at least a 10% tranche of the subordinated high yield debt must be placed with third parties; a portion of the equity must be retained by existing investors for a specified period of time; and, in order to address U.S. tax issues regarding fungibility of debt, future issues must be "homogenized" with the original issuance through the automatic exchange of *pro rata* tranches of the debt security.

Although the U.S. structure that has evolved is complex, it is viewed as a more reliable structure from a tax and capital markets standpoint. In addition, since holders beneficially hold both the underlying equity and high yield debt, it offers holders the benefits that come through direct ownership of those securities.

Structuring a European IDS

Creating a viable structure for a European company considering an IDS will largely be driven by tax and legal considerations in the company's home jurisdiction, as well as requirements of the exchange where the security is to be listed. In particular, will the structure in question provide the necessary level of comfort that the tax characteristics of the debt will be recognized? If a unit of two securities is issued, will the listing authorities allow it? In addition to these questions, technical clearance and settlement and other technical issues need to be considered.

The Norwegian Experience: The "High Yield Share"

Norwegian directories business Findexa was the first European company to come to market with what market participants have labeled a "high yield share." More like the Canadian trust structure than the IDS structures in the U.S., Findexa offered only equity to investors, from a Jersey holding company to maximize tax efficiencies, with the high yield feature coming through an inter-company loan: interest from the loan plus any dividends from the operating company are indirectly passed to shareholders as dividends from the holding company. This structure was simpler than the U.S. counterpart, and satisfied local tax requirements (Norwegian tax counsel to both the issuer and the underwriters provided opinions that the notes will be treated as debt for Norwegian tax purposes); however, since their investment is only in the equity of the holding company,

continued on page 25

Holly Nielsen – Moscow
Robert F. Quaintance, Jr.
Jeffrey J. Rosen
Kevin M. Schmidt
Thomas Schürrle – Frankfurt
Andrew L. Sommer – London
James C. Swank – Paris
John M. Vasily
Philipp von Holst – Frankfurt

Leveraged Finance
William B. Beekman
Craig A. Bowman – London
David A. Brittenham
Paul D. Brusiloff
Alan J. Davies – London
Peter Hockless – London
A. David Reynolds
Gregory H. Woods III

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

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

Trust & Estate Planning
Jonathan J. Rikoon

That's Substantially All, Folks

Acquisitions of divisions or subsidiaries of large public companies are a staple of private equity M&A activity. These transactions involve special issues that acquisitions of entire public companies do not. But they can be easier to execute than acquisitions of whole companies, in large part because they generally do not implicate the same fiduciary duty issues on the part of the target company's directors and do not require approval of the target's stockholders.

However, those factors go out the window when the subsidiary or division being sold constitutes "all or substantially all" of the company's assets. In that case, stockholder approval will be required, and, at least for corporations organized in Delaware, the Board will be subject to a "*Revlon*" duty to obtain the highest value reasonably available.

The question of what constitutes "substantially all" of a company's assets can be a murky question, especially in Delaware, where the courts consider both quantitative and qualitative aspects of whether there is a sale of substantially all of a corporation's assets. In a recent decision (*Hollinger Inc. v. Hollinger Int'l, Inc.* [July 29, 2004]) involving Conrad Black's efforts to block the sale of *The Daily Telegraph* by Hollinger International, a company Black controls through holding company Hollinger Inc., Vice Chancellor Leo Strine rejected the claim that the *Telegraph* constituted "substantially all" of Hollinger International's assets, so that the sale would require stockholder approval — a vote Black would have controlled.

The question of what constitutes "substantially all" of a company's assets can be a murky question, especially in Delaware, where the courts consider both quantitative and qualitative aspects of whether there is a sale of substantially all of a corporation's assets.

Strine acknowledged the unpredictability of previous case law applying Delaware General Corporation Law § 271. He noted that some Delaware decisions "appear to deviate from the statutory language in a marked way" — singling out the 1981 *Katz v. Bregman* case, in which a sale of assets constituting 51% of asset value, 44.9% of sales and 52.4% of pre-tax operating profits was held to require a stockholder vote. Strine asked whether the judiciary has "transmogrified the words 'substantially all' in § 271 of the into the words 'approximately half.'"

Strine had no difficulty concluding that the answer is no. First, as a quantitative matter, the *Telegraph* did not constitute substantially all of Hollinger International's assets: it represented less than half of Hollinger International's revenues, book value and EBITDA. Moreover, after the sale, Hollinger International could continue as a viable, profitable entity, with other significant assets — including the *Chicago Sun-Times*. According to Strine, "[Hollinger] International is not a human body and the *Telegraph* and the Chicago Group are not its heart and liver."

Strine questioned whether the qualitative test adds much to the analysis, since if the assets are not quantitatively vital, "it is not altogether apparent how they can 'substantially affect the existence and purpose of' the corporation." Applying the test, Strine focused on economic quality, rather than "aesthetic" quality, and "whether the transaction leaves the stockholders with an investment that is qualitatively different from the one they now possess." Although Hollinger Inc. argued that the *Telegraph*'s journalistic quality and its social importance in Great Britain — that owning the *Telegraph* means "you can have dinner with the Queen" — are such that its sale would qualitatively transform Hollinger International, Strine found that whatever economic benefits were derived from those factors were already reflected in the *Telegraph*'s cash flows, and in the bids received from potential buyers.

Strine's decision doesn't mean that private equity firms won't occasionally face uncertainty as to whether a given acquisition represents substantially all of the target company's assets. But it does provide solid ammunition for deal parties to argue that the analysis should focus on financial significance, and not on the more abstract elements of a qualitative test.

— Meredith M. Brown
mmbrown@debevoise.com

— Gary W. Kubek
gwkubek@debevoise.com

—William D. Regner
wdregner@debevoise.com

Transfers by Investors in Private Equity Funds: Bad News and Good News Under the New U.S. Tax Bill

The recently enacted American Jobs Creation Act of 2004 seems certain to create a number of jobs for tax advisors.

One provision of the Act requires private equity funds (and other partnerships) to adjust the tax basis of their assets upon a transfer by a partner of an interest in the fund if the fund's tax basis in its assets exceed the fair market value of its assets by more than $250,000 (a so-called "substantial built-in loss"), unless an exception for "electing investment partnerships" applies. This provision can affect both private equity fund sponsors and private equity investors.

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 prior law, upon a transfer of a partnership interest, the partnership was permitted (but was not required) to adjust the inside basis of its assets under section 754 of the Internal Revenue Code (a so-called "754 election") so that the inside basis associated with the transferred partnership interest was generally equal to the amount the transferee paid for the partnership interest (*i.e.*, so that the inside basis with respect to the transferee and the transferee's outside basis were the same).

What Congress Was Worried About. Suppose that a taxpayer (S) contributes $1 million to a partnership and the partnership buys a security that then declines in value to $400,000. Upon a sale of the partnership interest to a buyer (B), S would recognize a $600,000 loss. Under prior law, if the partnership did not have a 754 election in effect, the partnership would continue to have a $1 million tax basis in the security. Accordingly, if the partnership sold the security for $400,000, B would be allocated a $600,000 tax loss from the partnership even though B had not suffered any economic loss and S had already recognized a $600,000 loss. Although B's tax loss would be reversed upon the liquidation of the partnership, the temporary "doubling" of the loss was viewed as abusive.

If a 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 $1 million to $400,0000 (B's tax basis in his partnership interest) for purposes of computing B's income and loss. As a result, upon a sale of the security by the partnership for $400,000, B would not have been allocated any income or loss.

Some Bad News. The Act eliminates the doubling of the loss by generally requiring partnerships to adjust the inside basis of their assets, regardless of whether or not a 754 election has been made, upon a transfer of an interest in the partnership if there is a "substantial built-in loss" and upon certain distributions.

Thus, each time a partner transfers an interest in a fund, including a transfer to an affiliate, the fund will generally be required to ascertain whether the fund has a substantial built-in loss (*i.e.*, whether the tax basis of the fund's assets exceed the fair market value of the fund's assets by more than $250,000). Note that, for purposes of determining whether there is a substantial built-in loss, it does not matter whether the fund has generated net gains. Rather, the existence of a substantial built-in loss is determined by reference to the value and tax basis of the fund's assets at the time of each transfer. If there is a substantial built-in loss at the time of a transfer, the fund will generally be required to determine the fair market value of each of its investments and other assets in order to compute the tax basis adjustment.

Historically, some private equity funds have maintained their books on a tax basis and have not been required to revalue their assets. Also, while the value of the partnership's assets is one of the drivers in adjusting the partnership's inside basis, the adjustment mechanism is actually quite complicated and needs to be tracked separately for each transferee partner. Moreover, since the analysis adjusts the partnership's "inside basis" to match the transferee's "outside basis," the partnership will need to require the transferee partner to disclose the purchase price of the partnership interest to the partnership.

Depending upon how the IRS interprets the new provision, the administrative burden could increase considerably in the case of tiered-partnership arrangements, such as where a fund-of-funds partnership invests in a private equity fund. The IRS has previously ruled that if both an upper-tier partnership and a lower-tier partnership have a 754 election in effect, a transfer by a partner of the upper-tier partnership requires a tax basis adjustment by both the upper-tier partnership and the lower-tier partnership. The IRS may expand this ruling to include circumstances involving tiered partnerships that have a substantial built-in loss but no 754 election. If the IRS takes this approach, then a transfer of an interest in an upper-tier partnership (*e.g.*, a fund of funds) may necessitate a tax basis adjustment by both the upper-tier partnership and the lower-tier private equity

continued on page 28

U.S. Congress Approves Sweeping New Rules on Deferred Compensation

The American Jobs Creation Act of 2004, enacted in October, includes an overhaul of the rules pertaining to any nonqualified deferred compensation payable to an individual or an entity that performs services. Passage of the Jobs Act means that every circumstance in which compensation is deferred — including both employee and non-employee arrangements not typically regarded as "deferred compensation" in the traditional sense — should be carefully scrutinized to assure compliance with these new rules. This is because failure to comply will not only result in current recognition of income with respect to the amounts intended to be deferred, but also in the imposition of an additional tax of at least 20% on the service provider.

This new legislation can have a particular impact on private equity funds in two ways: (1) it will severely limit the ability to provide a tax efficient "rollover" of compensation payable by the seller in connection with the fund's acquisition of the portfolio company (or by the portfolio company itself in an exit), and (2) it may affect the timing and amount of income recognition applicable to the fund manager(s) under the applicable fee arrangements.

Portfolio Companies. The biggest potential impact of the new law on portfolio companies relates to equity-based compensation. Ordinarily, the money stock options that vest either over time or upon the occurrence of certain events will not be subject to the new law. But, because of the conditions newly imposed on deferral elections and changing such elections, the ability to restructure an arrangement to permit deferral of option gain upon a sale of the portfolio company would be eliminated if the employees need to consent to such deferral or if they would, absent any change, be entitled to receive a current distribution of the compensation in connection with the transaction. For example, if options are to vest and be cashed at the time of a sale, it will be impossible to restructure the option gain into deferred equity interests or another deferred account with the buyer. The new law should not preclude a rollover of options in the portfolio company into options in the stock of the buyer or its parent, but such a rollover can be problematic if the buyer is another fund (due to the potential dilution), or the buyer is a public company (because the employees at the portfolio company might not be eligible for an option grant with the buyer under its standard compensation practices).

Additionally, under prior law, it was possible to structure arrangements to provide for a tax efficient "rollover" — that is, without a current income tax inclusion — of compensation that would otherwise be payable at the time of the fund's acquisition to the executives who will manage the portfolio company. These arrangements would often be used to afford these managers an indirect or phantom equity interest in the portfolio company, using the pre-tax dollars that were otherwise payable in respect of their services with the seller or the portfolio company prior to the fund's acquisition. Given the restrictive rules the new law establishes regarding deferral elections and changing such elections, it may become impossible to avoid current taxation under the new legislation. Trying and failing would also subject the managers to the additional "penalty" tax built into the law. As a consequence of not being able to continue the deferral of income, these managers will have fewer dollars (that is, only after-tax, rather than the gross, amount) to invest in the portfolio company.

Of course, any traditional deferral programs sponsored by the portfolio companies will also have to conform to the new law for deferrals occurring after 2004. This would be true of any bonus deferral arrangement that allows the management to acquire phantom interests in the portfolio companies on a tax deferred basis. Thus, any such arrangements would have to satisfy the restrictive election periods for new deferrals (generally in the calendar prior to the year in which the services are to be performed, and in all cases at least six months before the end of the year for which the bonus is payable) and permit distributions only upon the events (*e.g.*, death and other separation from employment) and times (such as a fixed rate or on a fixed schedule) permitted under the new law.

Private equity funds have also often used stock appreciation rights ("SARs") as a means of conveying an interest in the business to a larger group of employees. The application of the new law to SARs is unclear at the moment. The Conference Committee Report allows the IRS to establish specific rules for SARs. This provides some hope that SARs based on the grant date value of the underlying stock will not be subjected to the new

continued on page 24

Mezzanine Financing — The European and U.S. Experience

'Mezzanine financing,' the term used to describe the piece of the capital structure between the senior secured bank debt and the equity, has always been something of a term of convenience, a short-hand term for a type of financing whose precise characteristics vary and have continued to evolve. Over the past few years, a number of these evolutionary changes, driven by a deepening of the universe of mezzanine providers and shifting demand from private equity sponsors and other borrowers, as well as interaction with the high yield bond market, have changed the meaning of 'mezzanine financing' yet again. These developments and recent trends of interest are summarized below.

A Brief History of the Mezzanine Financing Market

The U.S. The origins of mezzanine financing go back to the 1970's, when it was offered by a limited number of institutions (mostly insurance companies and savings and loan associations) in the U.S. as both an alternative and an addition to traditional senior secured bank financing. By the 1990s, investment funds specializing in mezzanine lending (including several with more than $1 billion in committed capital) entered the mezzanine lending market. Today, U.S. mezzanine investors also include pension funds, hedge funds, as well as banks that have established stand-alone mezzanine efforts. While the supply of mezzanine capital and the field of providers has also deepened in the U.S., mezzanine lending in the U.S. is still largely confined to the middle market. Mezzanine deals in the U.S. seldom exceed $50 million, and are often significantly smaller. While some traditional U.S. money-center banks have established mezzanine arms, one-stop shopping for syndicated bank loans and mezzanine lending is not typical.

Europe. Mezzanine financing was introduced to Europe from the U.S. in the late 1980s, originally sourced by a limited number of investment funds specializing in mezzanine lending. The European mezzanine market has matured considerably over the past few years, both in terms of the number of deals and their size (mezzanine tranches now range from the very small to several hundred million Euros or equivalent in size). The European mezzanine market has now shown itself capable of funding very large transactions (some Euro 300-400 million mezzanine tranches appeared in 2003 and the largest mezzanine deal in Europe so far this year is £400m ($712 million)). The universe of mezzanine providers and investors has widened as well. The specialist mezzanine investment funds have been joined by the investment banks (who arrange and underwrite the entire leverage financing package as a 'one stop shop' — sometimes having their own sponsored mezzanine fund) and a community of institutional investors (including CDO's and hedge funds).

Mezzanine Terms and Structure — Europe vs. U.S.

European mezzanine is generally secured floating rate debt mostly lent at the same level in the financing structure as the senior secured bank debt and benefiting from the same security/collateral package as the senior banks (but on a second-ranking and subordinated basis). This is a fundamental difference from traditional U.S. mezzanine, which is generally fixed rate debt, only contractually subordinated, and typically does not benefit from any security/collateral.

On the next page is a summary of key terms typical to European and U.S. mezzanine financing, noting some other key differences between European and U.S. mezzanine.

The Market for Intermediate Capital in Leveraged Financings — Mezzanine vs. High Yield in Europe and the U.S.

Europe. In Europe, due to a number of historical and structural factors, mezzanine competes with a high yield market that is smaller and much less mature than the U.S. high yield market. While a number of structural developments in the European high yield market (such as second lien positions or other claims on operating company assets) have enabled a recent resurgence in the European high yield market after the fallow period following the spate of failed telecommunications company high yield issuances of the 1990s, European mezzanine remains a more established market than European high yield, and is a market that has evolved to accommodate the preferences of private equity sponsors in large sponsored transactions (see "Recent Developments and Trends" below). In Europe, mezzanine fully vies with European high yield as the intermediate capital of choice for private equity sponsors.

The U.S. In the U.S., with its generally lower capital costs, deeper capital pool and greater covenant flexibility, high yield has been and remains the intermediate capital of choice for private equity sponsors, when available, with mezzanine financing confined to the middle market and to

continued on page 8

 (cont. from page 7)

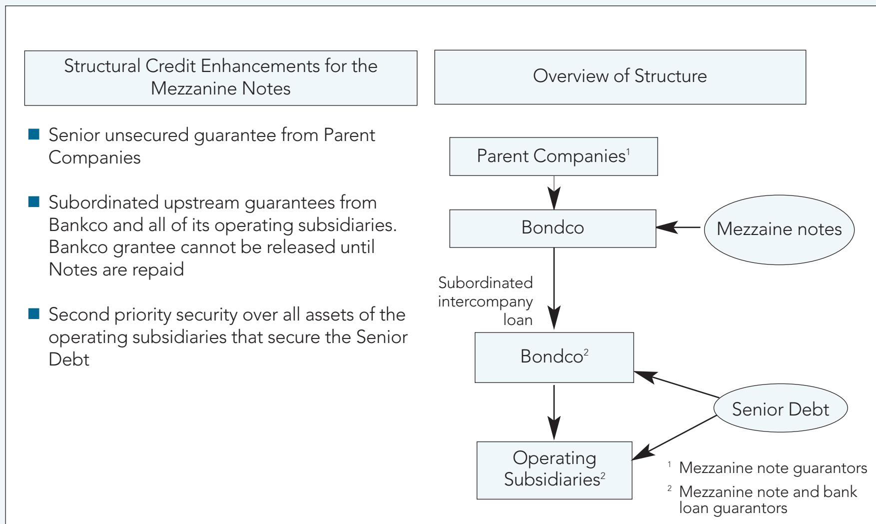
Europe	U.S.
Ranking ● Generally treated as second secured bank debt with same guarantees and security as senior debt (but on a subordinated basis).	● Generally guaranteed but not secured.
Amount ● Usually 10-25% of total debt facilities arranged, typically in the euro 24 to 150 million range, but much larger mezzanine facilities can be arranged.	● Mezzanine loans seldom exceed $50 million in size, and are often significantly smaller.
Interest ● Floating rate (LIBOR/EURIBOR), often a mixture of cash pay and PIK (rolled up interest).	● Generally fixed rate, often a mixture of cash pay and PIK.
Call Rights ● Moderate prepayment penalties, *e.g.*, 3% in year one, 2% in year two and 1% in year three.	● Higher prepayment penalties designed to compensate lenders for expected fixed-rate return.
Financial Covenants ● Financial covenants often set at same level as those for senior debt, but sometimes set at approximately 10% lower.	● Financial covenants generally include a 'cushion' vis-à-vis those for senior debt (typically ranging from 10-25%).
Standstills ● Typical standstills on enforcement are 90 days for non-payment, 120 days for breach of a financial covenant and 150 days for other breaches.	● Typically one standstill period. Length ranges from 60 to 180 days but usually between 90 and 150 days.
Payment Block ● Senior lenders can generally block mezzanine debt payments for up to 150 days, by giving notice following a senior debt default.	● A senior debt payment default typically blocks mezzanine debt payments indefinitely. ● A senior debt covenant default will block mezzanine debt payments only for a semi-annual period, and often subject to other limitations on the number or length of blockage periods.
Amendments ● Tight restrictions on amendments of senior documents without mezzanine lender consent. Tight restrictions on amendment of mezzanine documents without senior lender consent. Some headroom allowed for future senior debt - typically 10%.	● Senior lenders limit right to amend subordinated debt to make it more restrictive. Subordinated lenders' right to limit negotiated on a deal by deal basis, but are typically narrower than the senior lenders' corresponding right (often limited to pricing-type amendments).
Intercreditor ● Standardized intercreditor arrangements and documentation.	● Less standardized intercreditor arrangements. Negotiated on a deal by deal basis.
Interest Monitoring ● Often accompanied by board observer rights.	● Same for VCOC (Venture Capital Operating Company) reasons.
Buy-Out of Senior ● Mezzanine lenders typically given the option to purchase all senior debt if senior lenders accelerate or take enforcement action.	● No equivalent rights generally granted to U.S. mezzanine lenders.
Warrants ● Smaller deals normally have warrants. The majority of larger buy-out deals are warrantless or there is a mixture of cash interest, PIK and/or warrants.	● While the portion of deals with warrants has been declining due to market conditions, the majority of deals have warrants or at least an equity component (*e.g.*, through a co-investment), as investors typically still desire an equity return to achieve overall targeted returns.

other deals too small in size for the high yield market.

Recent Developments and Trends

Europe. In addition to the deepening of the market and the prevalence of larger mezzanine tranches, recent developments in European mezzanine have seen the emergence of 'warrantless' mezzanine, with more than half of new mezzanine deals in 2003 being 'warrantless.' Traditionally, European mezzanine providers insisted on obtaining an 'equity kicker' in the form of warrants as a means of enhancing their overall return, and giving them access to board observer rights. However, with the emergence of large financial buy-outs sponsored by U.S. and European private equity houses, sponsors and arrangers have succeeded in completing mezzanine transactions without warrants. This change in approach has been supported by and coincides with the emergence of a new class of 'institutional' mezzanine investor, who views mezzanine as a 'current pay' asset and evaluates investments based on coupon, and is not as concerned about equity upside or board observer rights.

Another new product in European mezzanine, which represents a convergence between high yield and mezzanine terms, is the 'mezzanine note.' Mezzanine notes are issued by the holding company of the senior debt borrower (as for a high yield issue), have high yield style covenants and benefit from subordinated upstream guarantees from the senior debt borrower and its operating subsidiaries (as for high yield following recent structural enhancements), but have mezzanine call protection (*i.e.*, protection in years 1-3 but none thereafter, in contrast to high yield which is



often non-callable (or callable only upon payment of a make-whole premium) for the first half of its life) and also have second ranking security from the senior debt borrower and the operating companies (as in standard mezzanine). One disadvantage of mezzanine notes (shared with high yield bonds) is that they are issued in a full-on securities offering, which is more costly and time-consuming than a traditional European mezzanine financing, which can be syndicated and completed on a much shorter time-line.

The U.S. In the U.S., the over-supply of committed mezzanine capital in recent years has also resulted in some departures from the 'traditional' U.S. mezzanine model. While equity continues to be an important part of mezzanine lenders' return expectations, competition for deals has resulted in a significant number of deals where the equity is in the form of a cash co-investment, rather than in the form of warrants typically carrying a nominal exercise price. For a particularly attractive investment, or in deals involving prominent private equity investors, some mezzanine investors have been willing to forgo equity altogether. Although call protection remains a fundamental feature of U.S. mezzanine lending, deals with shorter call periods and/or lower call premiums are becoming more prevalent. Competition among mezzanine lenders has also resulted in a more friendly negotiating environment for borrowers and bank lenders, with many mezzanine deals including covenant flexibility extending beyond the traditional 'cushion' *vis-à-vis* the bank covenants and intercreditor agreements that afford more flexibility to the borrower and the senior lenders. If the currently stalled entry of "business development corporations," into the mezzanine market revives, the supply vs. demand imbalance could shift even further.

Another significant recent development in the U.S. mezzanine market is the growth of the second-lien loan market as an alternative to 'traditional' mezzanine. While still a small 'niche' market compared to the overall syndicated loan market, with a relatively limited number of investors (typically hedge funds), the U.S. market for second-lien loans represents an attractive alternative for borrowers to 'traditional' mezzanine, offering many of the comparative advantages of the European mezzanine model (*e.g.*, a lower interest rate, lower call premiums), while providing investors with a second priority lien, giving them a preferred position in relation to trade and other unsecured creditors, together with a higher yield than traditional senior secured debt.

Conclusions

In Europe, the intermediate capital tranche of the leveraged finance package continues to evolve and increasingly subordinated debt tranches are being tailored to satisfy the investment criteria of the growing number of institutional investors who wish to participate in mezzanine's attractive returns. In the future, sponsors will have more flexibility to mix and match mezzanine tranches to the requirements of investors according to supply and demand at the time of issue.

In the U.S., while high yield financing remains the subordinated debt of choice for larger leveraged financings, recent market dynamics have created an attractive environment for sponsors seeking financing from the middle market to fill the gap between the equity and the bank debt. In addition, the impact of the developing market for second-lien loans, while uncertain in the long-term, has increased the choices and flexibility available to sponsors in the near-term.

— Peter Hockless, London
phockless@debevoise.com

— Sung Pak, New York
spak@debevoise.com

guest column

Spinning Out of an Institutional Private Equity Manager — a Personal Perspective

Exponent Private Equity Partners, LP held its final closing in mid-August 2004 with £400 million of commitments from a diverse group of investors. It took only a little under five months from launch for this first-time fund to reach its maximum fund size. I attribute that success in large part to the fact that our fund's offering differed from that of many of its competitors.

Exponent's four founder partners previously worked together for many years at 3i, the pan-European investment trust[1] headquartered in the UK. At 3i, we worked together on a number of headline deals in the UK, including Go-Fly, the low-cost airline which was spun out of British Airways, Pinewood-Shepperton Studios, which successfully floated on the London Stock Exchange in May of this year, and YBR Group, the telephone directories business recently refinanced through a high yield bond issue.

At the beginning of this year, we decided to leave 3i to establish our own private equity firm focused on UK mid-market buyouts. In Europe, most spinouts of private equity teams have gone hand in hand with the divestment of private equity portfolios by financial institutions seeking to decrease their exposure to the asset class. In our case, we were motivated by a desire to achieve greater independence and financial autonomy. This seemed to resonate with our investors. It is interesting to speculate whether our success on the fund-raising trail will lead to teams at other institutional private equity managers in Europe to follow in our footsteps.

[1] *An investment trust is a tax favored English corporation that is required to be listed on the London Stock Exchange.*

In general, a small team of experienced principals spinning out of a large institution to set up on their own makes a compelling story. Many investors and practitioners share the view that small teams, especially when focused along core geographic or sector specific lines, are able to execute their strategy in a more coherent manner, whilst retaining a more personal degree of accountability to their investors — something which is more difficult for larger institutional managers.

More importantly, the private equity industry is an entrepreneurial one. It is populated with ambitious, driven individuals who are more likely than most to feel the need to establish their own business, especially when they spend most of their waking hours telling others how to run theirs.

However, the pity is that, in practice, it is much more difficult successfully to spin out of an existing private equity business than from a financial institution. The natural breeding ground for spinout teams, the large investment houses and financial institutions, do not consistently staff transactions with teams with clearly defined responsibilities. It is more usual for executives to be brought together in an *ad hoc* manner, and as a consequence, teams of experienced principals with a combined track record are relatively hard to find.

Personal motivation is also varied. As the Exponent team knows from its own experience, and from its recruiting activity in the London market, there is no shortage of European private equity executives who are frustrated in their present positions. Common complaints include a lack of management autonomy and a concentration of carried interest among the most senior executives. However, in general terms, many of these executives are well compensated and carried interest vesting arrangements act as golden handcuffs in preventing executives who would otherwise leave from doing so. The Exponent team was in an unusual position in this regard because we were able to point to a successful collective track record of senior executives, and we were not financially constrained from leaving since, because of the largely historical peculiarities of the institution we worked in, we were generally compensated at levels below the industry norm.

In addition, there are many practical hurdles to overcome in setting up on your own. Psychologically, the most difficult of these is the inability to gauge investor appetite before making the decision to leave your current firm. This means that a real leap of faith is required, and perhaps leaves the option open to only the most senior executives who are confident of their reputation in the market and who have the most successful track records. In addition, English contracts of employment for private equity executives often contain onerous notice periods and restrictive covenants. It is therefore usually difficult to approach an employer's existing capital providers for purposes of funding a new venture, and the executives' existing deal flow is likely to be off limits.

In the UK, detailed information relating to the track record of the team is legally the property of the employer and not the team. As a consequence, when a team spins out without the cooperation of the employer, obtaining

continued on page 27

Seven Key Issues Under Senior Debt Commitment Letters

Senior debt commitment letters are ubiquitous in the world of private equity and they run a close second to letters of intent in determining the tone of early negotiations and the ultimate success of many deals. In this article we discuss recent market developments with respect to seven key issues associated with the negotiation of these letters.

1. The Parties

A threshold question in any commitment paper negotiation is whether the private equity sponsor, the acquisition vehicle or both should be party to the commitments. This issue can be an emotional one since many sponsors feel strongly about preserving the distinction between their portfolio companies' operations and commitments, on the one hand, and their own on the other.

The seller will — or at least should — insist that the acquisition vehicle be a party so that the seller's rights under the acquisition agreement with respect to the commitments can be enforced by its counter-party under the acquisition agreement. But because the acquisition vehicle is likely to be an empty shell at the time the commitments are made, the lenders may also want the sponsor to sign on to the commitment papers. This would ensure that the lenders have recourse against a solvent obligor if the deal falls through and they are entitled to an expense reimbursement or indemnification.

Whether or not a sponsor can resist becoming a party to the commitment papers is ultimately a question of commercial leverage. However, the issue should be largely academic because even where a sponsor is not legally obligated to the lenders, it will likely cause the shell to make good on its obligations under a commitment letter in order to preserve its goodwill with this and other potential financing sources. Where a sponsor does become a party to the commitments, the sponsor should insist that, once the closing has occurred, the lenders look only to the target for recourse and release the sponsor from all liabilities relating to the commitment.

2. Market Flex

So-called "market flex" provisions have emerged recently as perhaps the most heavily negotiated provision in senior commitment papers, in large measure because an increasing number of senior credits are syndicated after the financing is completed, rather than before it is consummated, as was the norm historically. In their broadest formulation – which, not surprisingly, is usually the formulation that shows up in a bank's first draft – a market flex clause gives a lender the unilateral right, for a specified period of time up to and following closing, to change any of the terms of the financing to the extent necessary to successfully syndicate the loan. To state the obvious, these clauses are problematic for sponsors because they engender uncertainty as to the precise terms of the senior financing even after the deal has been completed.

Unfortunately, a "just say no" response to a market flex clause can boomerang because the bank may take the position that, to ensure syndication, the only alternative to a market flex clause is to impose exceedingly lender friendly terms at the outset. As a result, negotiations over market flex clauses tend to revolve around the scope and duration of the market flex rather than whether or not the clause is included at all.

One common compromise is to provide that the market flex extends to the structure of the loan and to the affirmative and negative covenants but not to pricing or amortization. In the event the lender insists on some ability to flex pricing or amortization, a sponsor may be able to at least negotiate for caps so to limit the impact of any changes on the core economics. Indeed, a sponsors' best defense against these clauses is probably to take the time to methodically review, and to require that the lender methodically review, the committed terms with an eye towards identifying with precision where flex is appropriate and why. This process can be cumbersome and time consuming, but it is the best way to put the bank on the defensive in this context.

Other ways of mitigating exposure to market flex clauses include (1) imposing a maximum duration for the post closing flex (60 to 90 days is not unusual), (2) defining "successful syndication" such that the market flex sunsets (such a definition would usually be tied to the time when the initial lender has syndicated some negotiated portion of the commitments), and (3) requiring that the lender act reasonably in exercising the flex or consult with the borrower prior to invoking the clause as opposed to being able to do so in its "sole discretion."

In the end, however, sponsors should be mindful that there are no standardized terms for market flex provisions and that the provision, in its negotiated form, tends to vary widely based on the attendant circumstances.

3. Financial Performance Tests

Increasingly, senior debt commitments are being conditioned on the satisfaction of financial performance tests. The two most prominent forms are EBITDA tests, subjecting the commitment to a requirement that the target have a specified amount of EBITDA for a

continued on page 12

certain reference period or periods, and leverage ratio provisions, subjecting the commitment to a *pro forma* leverage test as of the closing of the proposed transaction.

From a private equity sponsor's perspective, a leverage ratio test is likely to be preferable to an EBITDA test since the sponsor has the ability to augment the equity component of the financing and, thus, controls the fulfillment of the condition. For this reason, if the commitment letter is conditioned on the satisfaction of a leverage test, the buyer's *equity* commitment letter should include a cushion that would allow such augmentation.

EBIDTA tests, in contrast, are typically less desirable for financial sponsors. For one, EBITDA tests turn solely on the performance of the target's business during the relevant test period and thus, unlike the leverage ratio test, are outside a private equity sponsor's control. For another, they present the typical array of issues that arise when negotiating and calculating EBITDA in connection with the definitive covenant package, including establishing the appropriate cash and non-cash add backs. If an EBITDA test cannot be avoided, the calculation of EBITDA should be as clear and empirical as possible. A definition "to be mutually agreed" or the like should normally be resisted.

Note that hidden financial performance tests may be contained in covenants requiring the target to deliver "satisfactory financial statements" or "satisfactory projections." Any requirement for lender satisfaction in such covenants should be limited to "form and scope" rather than "form and substance," particularly where a specific financial performance test has been agreed as a condition.

4. Diligence Out

Lenders will sometimes seek to condition their commitment on the results of their due diligence investigation. In most circumstances, unqualified diligence outs can be resisted on the basis that the lenders have already had an opportunity to conduct their diligence, and that they should therefore "speak now or forever hold their peace." In addition, in an auction context, a diligence out in the commitment papers may simply be a non-starter because it would put the sponsor at a competitive disadvantage compared to other bidders. Moreover, the seller would certainly not permit the sponsor to include a diligence out in the acquisition agreement itself.

However, a narrow diligence out tied to a specific contingent liability that is too difficult or time-consuming to evaluate fully at the time of signing may be appropriate in some circumstances. Indeed, with respect to potential big ticket contingent liabilities, such as environmental exposures, a messy litigation nearing resolution, or an evolving regulatory investigation, a sponsor may welcome the inclusion of a narrowly crafted diligence out because it effectively gives the sponsor indirectly what it could probably not get directly — that is, a basis not to close or, alternatively, to renegotiate, if the liability develops adversely during the period prior to closing.

Care should be taken to plug easily overlooked "mini" due diligence outs that may be contained in information delivery requirements, *e.g.*, for financial statements or environmental reports. Often, such provisions require that the relevant information be "satisfactory to the lender as to form and *substance*." Those formulations may give a lender who finds such information substantively inadequate an out on the basis that the borrower has not properly discharged its covenants. More favorable iterations of information delivery provisions would introduce a standard of reasonableness and require that the information be satisfactory to the lender as to "form and scope."

5. No New Information

Closely related to the diligence out are clauses that condition a lender's commitment on its not becoming aware of new information about the target or the transaction that is *materially* inconsistent with information disclosed to the lender prior to the date of its commitment. Such "new" information clauses are primarily aimed at developments occurring after the execution of the commitment papers but would also capture information that was available but not shared with the lenders *prior* to the date of the commitment.

Provisions of this type are typically preferable to diligence outs for several reasons. First, the sponsor can mitigate the uncertainties associated with this condition by ensuring that the lender had access to all of the information that was available to the sponsor and by keeping careful records of what information was provided to whom and when. Second, unlike a diligence out, which is inherently a subjective determination, this provision can be drafted such that the determination of whether or not any such new information is "materially" inconsistent with the prior information is measured on an objective basis of materiality, rather than a subjective one. And third, unlike a sweeping diligence out, the "no new information" has the appeal of being fundamentally fair — if the lender made its commitment based on information that is subsequently discredited in a material way, it is not unreasonable to allow it to back out of its commitment. As with narrowly crafted diligence

continued on page 27

Reopening the Lockup

The Delaware Supreme Court's controversial 2003 *Omnicare* decision, which held deal protection devices invalid in the absence of a meaningful "fiduciary out" for the target's directors, has created real challenges for private equity firms seeking to negotiate sale transactions for public companies in which they hold controlling interests. Many private equity sponsors would say that the ability to deliver a "done deal" can be an important element of extracting top dollar from an acquirer. Yet *Omnicare* limits the ability of controlling stockholders to lock up agreed deals. Private equity firms that control public companies should be cheered by a recent decision of the Delaware Chancery Court, which interpreted *Omnicare* narrowly to uphold a quite strong voting agreement by a controlling stockholder (*Orman v. Cullman*, C.A. No. 18039 (Del. Ch. Oct. 20, 2004)).

The Cullman family, controlling stockholders of General Cigar, agreed to vote for a transaction in which Swedish Match would acquire half the Cullman family's interest and all of the public shareholders' interest in General Cigar. After the merger, General Cigar would be owned 64% by Swedish Match and 36% by the Cullmans, although two members of the Cullman family would remain in control of General Cigar's operations.

The transaction, which was approved by a special committee of General Cigar's board, was conditioned on approval by a majority of the shares held by the public. The Cullmans, whose high-vote Class B shares gave them voting control over General Cigar, but not a majority economic interest, agreed not to sell their shares and to vote their shares against any alternative proposal, for a specified period after termination of the merger agreement between General Cigar and Swedish Match. The period was originally to be one year, but was increased to 18 months after Swedish Match agreed to improve the deal price by $0.25, to $15.25 per share — a 75% premium over the market price. The public shareholders overwhelmingly approved the transaction.

Chancellor Chandler swiftly rejected arguments that the special committee was ineffectual (the plaintiff failed adequately to allege that the committee lacked independence, the committee retained skilled advisors and did well in negotiating for an extra $0.25 in merger consideration, and in any event the merger was approved by a fully informed majority of the public shareholders) and that the Cullman family members who sat on the General Cigar board breached their fiduciary duties by entering into the voting agreement (they entered into the agreement in their capacity as shareholders, not as directors, and the agreement did not limit their ability to exercise their directorial duties).

Chandler then applied a *Unocal* analysis, as required by *Omnicare*, to determine whether the deal protection mechanisms were adopted in response to a reasonably perceived threat and whether they were "coercive." Chandler noted the plaintiff had not argued that the lockup was "preclusive" under *Unocal* so that only coercion was at issue. He also noted, perhaps a bit wistfully, that the dissents in *Omnicare* would apply the business judgment rule, not the more stringent *Unocal*.

Chandler concluded that the first prong of *Unocal* was easily satisfied: the General Cigar board risked losing the transaction if it did not accede to the lockup, since Swedish Match said it would not proceed without deal protection.

Turning to the second prong, Chandler decided the deal protection measures were not coercive because they did not "cause the vote to turn on factors extrinsic to the merits of the transaction."

Chandler distinguished the deal protection devices in *Omnicare*, which made approval of the Genesis/NCS merger a "*fait accompli*": that merger was required to go to a shareholder vote even if the NCS board withdrew its recommendation, and NCS's controlling shareholders entered into a watertight voting agreement, making the NCS board's ability to change its recommendation meaningless. In contrast, the General Cigar board's ability to change its recommendation was meaningful, since the public shareholders could reject the merger — "even though, permissibly, their vote may have been influenced by the existence of the deal protection measures." He also noted that, unlike in *Omnicare*, "there was no competing bidder for General Cigar."

Chandler acknowledged that the Cullmans' agreement to vote against alternative deals for 18-months meant that "[i]t was this deal or nothing, at least for that period of time," but questioned whether an 18 month delay was "a meaningful 'cost' that could be said realistically to 'coerce' the shareholders' vote." He also questioned whether "it is fair to say that a minority was coerced by a voting and ownership structure that was fully disclosed to the minority before they bought into a corporation whose capital structure was so organized." Ultimately, Chandler concluded that the coercion being complained of results from the fact that the Cullmans own a controlling interest, and declined to hold that "being in a voting minority automatically means that the shareholder is coerced."

Chandler's relatively narrow reading of *Omnicare* suggests that giving stockholders the power to say no — even if they don't have the ability to say yes to an alternative deal in the near term — can protect even a strong lockup from claims that it is coercive.

— William D. Regner
wdregner@debevoise.com

SEC's Proposed Hedge Fund Adviser Registration Rule Sparks Concerns Among Private Equity Advisers

As summer came to an end, the comment period for the SEC's proposed rule on hedge fund adviser registration had just closed. Over the spirited dissent of two SEC Commissioners, the rule was proposed on July 20, leaving the private fund community with little time to respond. Pleas for additional comment time submitted by the Chamber of Commerce, the Managed Funds Association, the National Venture Capital Association (NVCA) and others appear to have gone unheeded.

If adopted as proposed, the rule would require advisers to certain "private funds" (which would include many hedge funds, but not private equity funds) to "look through" these funds and count individual investors as advisory clients rather than count the fund itself as a single client. Because of this look through, most hedge fund sponsors would no longer be able to rely on the exemption from registration under the U.S. Investment Advisers Act for advisers with 14 or fewer advisory clients during the preceding year.

The proposed rule defines a "private fund" as a fund (1) that would be subject to regulation under the Investment Company Act but for the exemptions that generally apply to hedge funds and private equity funds; (2) that permits redemptions within two years of investment; and (3) whose interests are marketed based on the investment advisory skills of the adviser.

The exclusion of funds that do not permit redemptions within two years was designed to exclude private equity (*e.g.*, buyout and venture capital fund) venture advisers from the new registration provision. This approach left some in the private equity community breathing a sigh of relief, but had others, including the NVCA, questioning whether the rule as proposed actually does exclude them. For example, the two year redemption provision would allow a fund to permit redemptions for "extraordinary and unforeseeable" events — *e.g.*, the illegality of an investor's continued participation or a fund's failure to qualify as a venture capital operating company — without being deemed a private fund. Extraordinary events? Yes, but are they really "unforeseeable" when most fund agreements are drafted to address such events? This is probably one of the kinks the SEC will need to work out in any final rule, because the SEC's intention to exclude private equity advisers seems clear in the proposal.

The dissent has enjoyed almost as much notoriety as the proposal itself. According to the dissenting Commissioners, "[i]f valuation problems are motivating the push for hedge fund registration, then we should have the same concerns about private equity and venture capital funds." This remark has some fretting over whether private equity advisers could be next on the SEC's regulatory radar. However, all indications have been that the SEC does not intend to regulate private equity fund advisers.

A private equity fund adviser that is currently exempt should remember though that if it advises even a single hedge fund, it would still need to register in respect of all of its funds if the number of private equity funds that it advises plus the number of investors in that single hedge fund exceeds 14.

Meanwhile, offshore advisers are struggling to understand the exact scope of the proposed rule. An adviser with its principal office outside of the United States would be required to count any U.S. investors in its "private funds," meaning that a non-U.S. adviser to a "private fund" with more than 14 U.S. residents as investors during any 12-month period would be required to register with the SEC.

Non-U.S. advisers would not need to look through an offshore private fund that (1) makes a "public offering" of its interests outside of the United States and (2) that is regulated as a public investment company under non-U.S. laws. Presumably, a hedge fund registered as a mutual fund in the Cayman Islands — as almost any hedge fund organized under Cayman law would be — would satisfy the "non-U.S. public investment company" prong of this exemption. It remains unclear, though, just how the "public offering" prong is met. Often a non-U.S. fund is offered in multiple jurisdictions in reliance on public offering exemptions in some jurisdictions but not in others. To benefit from the exemption, a non-U.S. fund would need to satisfy both of these prongs. To ease its extraterritorial sting, the proposed rule would subject non-U.S. advisers only to the anti-fraud provisions of the Advisers Act. However, non-U.S. advisers would not be required to comply with the SEC's custody rule with respect to its non-U.S. funds.

We look forward to providing you with a more detailed overview of the final rule in the Winter 2005 *Private Equity Report*. ▢

— Jennifer A. Spiegel
jaspiegel@debevoise.com

alert

Private Equity Offerings May Face Prospectus Requirements in Germany

Over the course of the last 18 months, the German legislature has taken numerous steps to modernize its laws concerning the regulation and taxation of funds culminating in the adoption of the German Investment and Investment Taxation Acts this past January. We have discussed the application of these rules to private equity funds in previous editions of the *Private Equity Report*. The legislature is now revising the application of the securities laws, including prospectus delivery requirements, to limited partnerships and limited liability companies.

Recently, the German government introduced a bill to amend the scope of the German Securities Sales Prospectus Act (the "Securities Act") to expressly apply to interests in German and non-German limited partnerships and limited liability companies. As amended, the Securities Act will require that a public offer of interests in private equity funds founded as limited partnerships or limited liability companies be made by way of a prospectus approved by the German Authority for Supervision of Financial Services, popularly known as the BaFin. However, the proposed amendments also provide for specific exemptions from the prospectus requirements of the Securities Act. The exemptions will include offerings which only include 20 equity units or where the purchase price of each unit offered to a single investor amounts to at least €200,000. With proper care, most offerings of private equity funds should be able to qualify for one of these exemptions. The bill is expected to be voted on later this year or the beginning of next year at the latest.

Nevertheless, the new Act does not entirely resolve the uncertainties regarding the regulation of offerings of private equity fund interests, particularly of non-German funds. The German Investment Act, in force since January 2004, establishes separate prospectus requirements for public offers of investment funds and, if applicable, supersedes the provisions of the Securities Act. The Investment Act does not contain exemptions comparable to those of the amended provisions of the Securities Act, but has been interpreted not to apply to offerings made by a sponsor to investors with whom the sponsor has a pre-existing business relationship nor to offerings by most German "investment funds." Given the definition of "investment fund" under the Act, however, most foreign private equity funds still fall within the literal wording of the Act.

There are recent indications that this issue will, at least in part, be resolved soon. The German Ministry of Finance has just issued a draft ruling relating to the Investment Act and Investment Tax Act pursuant to which foreign partnerships (other than hedge funds) as opposed to corporations will not be considered investment funds within the meaning of the Investment Act. This will bring clarity for foreign private equity funds, which are typically structured as limited partnerships. With respect to private equity funds organized as limited liability companies, the situation is less certain. It remains to be seen if the final ruling will also exclude limited liability companies from the scope of the Investment Act. The draft ruling is subject to further changes as it has been submitted to the Federal and States Expert Commission and the relevant industry associations for comments. Until the Ministry of Finance has issued the final ruling (which is expected to be some time in December of this year), prudent sponsors will therefore structure their offerings to avoid application both of the Investment Act and the Securities Act. ▢

— David Hickok
dfhickok@debevoise.com

— Patricia Volhard
pvolhard@debevoise.com

The exemptions will include offerings which only include 20 equity units or where the purchase price of each unit offered to a single investor amounts to at least €200,000. With proper care, most offerings of private equity funds should be able to qualify for one of these exemptions.

Russia: Private Equity Update

Two years ago in the Private Equity Report we profiled the opportunities for private equity investing in Russia after ten years of a nascent market economy and the completion of the government's corporate privatization program in 1994. At that time, the first phase of fund formation and investment was coming to a close with about 20 funds in existence and roughly $3 billion invested. Just as a second wave of funds were in the planning stages, the 1998 financial crisis occurred and fund-raising among the international community for Russian investments came to a halt. Today, after three years of sustained economic growth, the Russian market is once again attractive to foreign investors.

The First Phase

Sponsors of the first, true private equity funds were primarily public organizations such as EBRD (8 venture capital funds; 10 regional funds) and the U.S. government ($440 million U.S.-Russia Investment Fund), but also AIG ($289 million AIG-Brunswick Millenium Fund), PaineWebber ($155 million Russia Partners Fund) and others. Most of the early funds were organized in the Cayman Islands or Bermuda, and the management companies that were created were often joint ventures between foreign sponsors and local investment banking talent (both Russian and non-Russian).

The challenges facing potential private equity investors were significant during this initial phase, and the results from the early funds were mixed. During the 1990s it was difficult to identify and diligence portfolio prospects. Russian companies typically had no business plans, no audited financials and a lack of sophisticated management. Some of the better-managed funds, however, have had IRR's of 30% and been able to return up to three times the money invested.

From 1999 through 2003, the primary activity in private equity investing was domestic. Cash-rich Russian financial groups took advantage of depressed prices and a lack of competition from foreign investors to acquire portfolios of companies in various sectors of the economy. Alfa Group, with an estimated $8 billion in value, bought companies in the banking, oil, telecoms and real estate sectors. Millhouse, with an estimated value of $5 billion, amassed investments in oil, aluminum, air transportation, manufacturing, consumer goods, agriculture, etc. Interros, estimated to have $4 billion in holdings, bought companies in the oil and gas, metals and mining, machine-building and agricultural sectors of the economy. Although the investments in private companies were proprietary, these financial groups have in many cases focused on adding value through active strategic, financial and operational support to reorganize their portfolio companies, many of which are now on the market again.

During this period, only two new funds were raised by foreign sponsors for third-party investment in Russia — the $60 million Fleming Real Estate Fund (1999), and the $205 million [ING] Baring Vostok Private Equity Fund (2002).

Current Trends

Since 2001, the economy has enjoyed sustained growth at an average annual rate of 7%. At the same time, the domestic financial markets and participants in Russia have matured and become familiar with alternative investments, including private equity. New foreign sponsors are entering the market; sponsors and management companies with invested funds are raising new funds; and wealthy Russian companies and individuals are beginning to invest in global funds. Perhaps most interestingly, many of the Russian financial groups with experience and success in proprietary private equity investing are now establishing management companies with plans to sponsor funds to attract third-party investors. The quality of portfolio prospects have evolved as well. Management and corporate governance at small- and medium-sized companies has improved, in some cases, dramatically, over the past ten years.

The Players

Global Sponsors. The most recent entry to the Russian private equity market is Carlyle Group, which has opened a Moscow office and is in the process of forming a buy-out fund for investment in companies in Russia and the CIS region. Baring Vostok Capital Partners is raising a successor fund this year; Delta Capital (manager of the U.S.-Russia Investment Fund) is raising new fund; and AIG has teamed up with Interros on a small fund. Warburg Pincus has made its first investment in Russia, buying a controlling stake in three Russian radio stations.

Domestic Sponsors. Interros is pursuing private equity through a joint fund with AIG. Alfa Group has formed Alfa Private Equity Limited, which is co-managing an industry sector fund and planning to raise a separate regional private equity fund. Other Russian financial groups are

also pursuing the establishment of third-party funds, either in connection with potential international sponsor partners, or on their own.

Russian Investors. Russian corporates and Russian high-net-worth investors are becoming a potential market for sponsors of global funds. There have been a couple of significant investments (in the $50 to $100 million range) in global funds by Russian investors over the past two years. At least one well-known global sponsor of funds was recently in Moscow on a fund-raising road show.

The Legal Landscape

Securities Offerings. Russian securities and investment fund regulation is still developing, and does not yet restrict the marketing of foreign limited partnership interests in Russia. Although there is no clear legislation or judicial practice on the point, most attorneys who have considered the issue believe that a foreign limited partnership interest would not be considered a "security" under Russian law. The Russian Civil Code, in traditional civil law fashion, defines "securities" by reference to a list of instruments that are considered securities (*i.e.*, government bonds, corporate bonds, promissory notes, checks, deposit and savings certificates, bills of lading, corporate shares, privatization securities), together with "all other documents which are specified as securities by other federal laws." One example of such a pronouncement is the Law on Investment Funds' determination that a participation certificate for a domestic mutual fund shall be a security.

Certainly, limited partnership interests in foreign limited partnerships are not specifically stated to be securities under Russian law. By analogy, it is generally considered that even interests in Russian-registered general partnerships, limited partnerships and limited liability companies are not "securities" for purposes of the Russian securities regulation.

Moreover, the Russian Securities Law only restricts the "public" circulation of securities of foreign issuers without registration of a prospectus. Public circulation is an offering to an indefinite group or at least more than 500 persons. Another federal law on securities regulation prohibits the "advertising or offering" of securities to an "unlimited number of persons" without prospectus disclosure. Russian securities law does not restrict the types of materials and statements that can be used in private marketing, and no "legend" practice has developed.

Consequently, marketing to potential Russian investors in one-on-one meetings, or even small, defined groups, is possible, and is beginning to happen more regularly.

Management Activities. The most recent Law on Investment Funds of 2001 only regulates two specific types of investment funds — joint stock company funds and domestic mutual funds known as "unit investment funds." There is not yet a general regulation of third-party management of collective investment vehicles, or licensing requirements for management activities other than the managers of these joint stock company funds or unit investment funds.

Consequently, foreign sponsors who open affiliated management offices in Moscow as a rule establish Russian branch offices or accredited representative offices, which are taxable but are not regulated, not registered as investment managers or advisors, and do not require a license.

Conclusion

Ten years following the end of Russia's voucher privatization, and the beginning of private equity activity in Russia, the foreign private equity community is now raising a second wave of funds for investing in Russian private companies. The new funds will have the advantage of investing in a more mature and normalized market. The domestic Russian business community has discovered private equity as an investment tool. Industrial groups with successful proprietary private equity experience are taking preliminary steps to organize management groups and funds to attract third-party investors. Other cash-rich Russian companies and individuals are beginning to invest in private equity funds inside and outside of Russia. And while the challenges to investment in Russia remain, the abundant capital, management expertise, financial controls and technological advancements that private equity investors can bring to Russian companies should continue to improve profitability and investor returns over the next decade.

— Holly Nielsen
hnielsen@debevoise.com

Since 2001, the economy has enjoyed sustained growth at an average annual rate of 7%. . . . Management and corporate governance at small- and medium-sized companies has improved, in some cases, dramatically, over the past ten years.

French Acquisition Financings — Key Structuring Issues

Notwithstanding an inhospitable legal environment for leveraged acquisition financings, private equity activity in France has boomed in recent years and last year constituted 24% of the private transactions in Europe. The French legal regime creates a lending environment that limits the security and guarantees that can be used to support acquisition financings, but that has not stifled activity.

Legal Framework

Like many other European jurisdictions, French law prohibits financial assistance — thereby prohibiting all arrangements which, directly or indirectly, can be construed as the giving of a loan, a guarantee or the creation of security by a target to facilitate or support the acquisition of its own shares. This is generally thought to include loans or guarantees granted by French subsidiaries even of non-French targets. (Luckily, however, non-French subsidiaries of French targets are not so restricted.) Unlike English law, French law does not provide for a "whitewash" procedure. As a result, security packages granted to lenders are regularly limited to a pledge of the shares of the target company, an assignment to the lenders of the indemnities given by the seller to the purchaser (generally under the share purchase agreement in respect of breach of representation or warranty and/or tax claims) and an assignment to the lenders of the key manager insurance policy (to the extent the key manager is a member of the borrower's management).

Since the scope of the financial assistance rules is limited to acquisition debt, security interests granted to secure debt other than acquisition debt (*e.g.*, working capital or capital expenditures) do not fall foul of the financial assistance rules. This means that lenders may be in a better position when there is minimal acquisition debt and the financing needs of the members of the target group are directly financed by the lenders. Targets with not insignificant outstanding debt are therefore sometimes particularly attractive.

There are other French corporate and tax laws that make structuring acquisition financings seem like running a gauntlet. These include provisions of the French Commercial Code restricting the use of a company's assets contrary to the company's corporate interest either for the personal interest of managers or directors or to assist another company in which they have a direct or indirect interest and provisions restricting the abuse of power by managers or directors. In addition, because French law does not recognize a collective corporate interest shared by members of a group, intergroup loans can be viewed as an abuse of company assets unless there is a clear demonstration of a common economic, labor and financial interest in a defined corporate policy. This is generally not possible.

Other French legal restrictions on acts against the company's corporate "interest," corporate "mismanagement" and transactions outside of the corporate object are additional hurdles. Another factor contributing to the challenging French financing environment is the absence of the concept of a fixed and floating charge (universal business charge): it is not possible under French law to have one single security interest applying to all the assets of a company. Lenders must therefore take security interests over specific assets (*e.g.*, pledge of shares, goodwill, bank account, accounts receivable, machinery and equipment, real estate, etc.). This will require a specific pledge agreement for each asset subject to the pledge. The only security interests that can be granted in France are those recognized by French law, and it is not possible to contractually create other forms of security interest. Although obtaining the security package will generally be more cumbersome and costly in France, banks have adjusted to the available security packages and therefore grant financings on competitive terms.

"Quick mergers" ("*fusion rapide*") effected between acquisition vehicles and targets within a year or two after the acquisition in order to make the cash flow of the target available to service the acquisition debt and to permit the assets of the target company to be granted as security are no longer entered into in France. This is because the French tax authority's position is to deny the tax deductibility of interest expense on the acquisition debt against the operating profits of the merged company. However, "quick mergers" between holding companies may be possible without jeopardizing the deductibility of interest.

Against this backdrop, a number of techniques have developed to structure transactions:

Distribution of Dividends

The distribution of dividends from distributable profits or reserves to the acquisition vehicle from a target is the primary method used to generate funds to service acquisition borrowings. Distribution of dividends does not fall within the scope of the financial assistance rules nor, in principle, contravene the legal provisions relating to abuse of company assets or abuse of powers (since the decision to distribute dividends is generally made by the general meeting of shareholders).

A distribution of dividends may be

financed by new debt at the level of the target company, provided that care is taken to avoid breach of the corporate interest principle referred to above. Interest on this debt is normally tax deductible.

Financings at the Target Company Level

Another method used is to have part of the financing granted through secured financing facilities to the target company and its subsidiaries. However, this option is only available to the extent that there is significant indebtedness at the level of the target company and/or its subsidiaries, such as existing revolving facilities or loans to refinance or a need for a new facility (*e.g.*, a working capital facility and/or capital expenditure facility.)

This structure may allow the lenders to secure the debt (other than the acquisition debt) with additional security interests such as accounts receivable (usually securing working capital facilities) or pledges over the assets acquired with the proceeds of the capital expenditure facility (*e.g.*, pledge over goodwill, shares, trademarks, real estate, etc.). Although these additional security interests will not directly secure the acquisition debt, it will allow the lenders to have "defensive" security and rights over the assets and cash of the operating companies (since bankruptcy would generally occur simultaneously in the holding and the operational companies).

Although not validated by the French courts, another technique is for the acquisition vehicle to on-lend funds to the target (to the extent there is a need for such financing at the target company level). This loan would be secured by the assets of the target company and the secured debt resulting from this loan would be assigned by the acquisition vehicle to the lenders as security for the financing granted to the acquisition vehicle. According to French law provisions relating to assignment of commercial debt by way of security ("*cession de créances commerciales à titre de garantie*" — *Loi Dailly*), a financial institution may become the owner of a debt in order to secure a loan granted to the initial owner of such debt. In this case, any security interest granted to secure the assigned debt (*i.e.*, the loan granted to the target company by the purchaser company) will benefit the assignee (*i.e.*, the lenders).

Tax Consolidation

As noted above, "quick mergers" between acquisition vehicles and targets do not generally occur in France because of tax concerns. Instead, a parent company (assuming it owns 95% of the shares of a target) generally elects to form a consolidated tax group. Once the election is made, interest expense incurred for the acquisition is tax deductible against the operating income of the consolidated entity, including the target and its subsidiaries. In addition, tax consolidation allows the amount of tax otherwise payable by the target and its subsidiaries to be pushed up to the parent company, thus providing additional cash flow to service the acquisition debt.

French tax laws do not impose a debt to equity ratio with respect to third party financings. Thin capitalization rules are expected to be introduced with respect to interest paid to affiliated companies that directly or indirectly own more than 50% of a French borrower. Current proposals provide for a debt to equity ratio of 1.5:1 if the interest paid to affiliated companies exceeds 25% of the operating income before tax and interest paid to such affiliated companies.

Finally, the structuring of the financing must also take into account the provisions of the so-called "*Amendement Charasse*:" if an acquisition company acquires from a shareholder(s) that control(s) directly or indirectly such acquisition company the shares of the target company for cash, then the tax deductibility of the interest expense paid by the members of the tax group will generally be disallowed in proportion to the ratio that the cash acquisition price bears to the overall indebtedness of the group, for a period of up to 15 years after the acquisition. This limits the acquisition of creeping control as well as many recapitalization structures.

Specific Issues Relating to High Yield Bonds and Recapitalization

In the European high yield market, security enhancements have been demanded by high yield bond buyers who are generally structurally subordinated to the senior debt. In some recent high yield bond issues in the UK, the high yield bond holders to acquisition vehicles have benefited from upstream guarantees from the operating companies.

A similar structure is more difficult to achieve under French law because of the financial assistance rules and corporate interest principles described above.

However, to the extent that it can be demonstrated that the proceeds of the high yield bonds are not used to buy the shares of the target and that the target and/or other operating companies benefit from this financing, an upstream guarantee might be envisaged, but only to the extent that the conditions relating to the corporate interest of the company (as described above) are complied with.

This would, of course, require a careful analysis of the benefit (if any) to the subsidiaries of the financing granted to the parent company. The relationship between the subsidiary and its parent company will be particularly material to the analysis; if it can be demonstrated that there is a commercial relationship between the parent and the subsidiary (for example, if the subsidiary benefits from the high yield bond issue through an inter-company loan granted by the issuer) and that the amount of the upstream guarantee does not exceed the financial capacity of the subsidiary, then the corporate interest principle

continued on page 20

French Acquisition Financings — Key Structuring Issues (cont. from page 19)

should be observed.

Recapitalization transactions in France can be particularly tricky. Recapitalization transactions are generally accomplished in France through distribution of dividends or share buy-backs, which are financed by new borrowings.

In order to optimize such a transaction and to maintain a certain leverage ratio, the distribution of dividends or share buy-back will be financed through a new borrowing at the level of the holding company. This structure allows for the deduction of interest paid on the new borrowing from the group profits within the tax consolidation group. Although this structure should not raise any issue with respect to financial assistance rules, the new borrowing will have to be effected with particular care especially where the management is party to the equity investment and benefits from the recapitalization transaction. To avoid any criticism on the ground of the abuse of company assets or abuse of power, there will need to be a demonstration that the new borrowing is not contrary to the corporate interest of the company. The good news is on the tax front: a distribution of dividends or a share buy-back followed by a decrease in the share capital will be 95% tax free (to the extent of the amount that is treated as a distribution in the case of a share buy-back) to a French corporate investor that owns at least 5% of the share capital of the distributing company under the régime mere-fille (participation exemption regime).

The French private equity community and the lenders that serve it have become accustomed to threading the needle to create acquisition financing transactions that do not run foul of French law and provide the best structure and security available under the circumstances.

— Eryl Besse
ebesse@debevoise.com

Recent and Upcoming Speaking Engagements

September 22
Rebecca F. Silberstein
Terms and Conditions In-Depth: Innovative Strategies for Private Equity & Venture Capital Fundraising
Private Equity Analyst Conference
New York, NY

October 7
Andrew N. Berg
Tax Strategies for Financially Troubled Businesses and Other Loss Companies Bankruptcy and Workouts
New York, NY

October 13
Jeff Rosen, Peter Furci
Key Structuring Considerations
IDS Forum
Chicago, IL

October 25
Jeff Rosen
The Current State of IDS Product: Offerings to Date and Market Developments

Peter Furci
The Impact of IDSs on the LBO and M&A Markets

Income Deposit Securities Conference
New York, NY

November 15
Andrew L. Sommer
European Private Equity: A Transatlantic Perspective
Presented by the London Business School and Wharton Club of New York
Sponsored by Debevoise & Plimpton LLP
New York, NY

November 16-17
Marwan Al-Turki
Issues and Practicalities in Establishing a Presence in Europe
The New York European Private Equity Forum 2004
New York, NY

November 18
Kevin Schmidt, John Walker
Cross Border M&A Transaction Issues
Association for Corporate Growth Private Equity Conference
Toronto, Canada

January 26
Sherri G. Caplan
Clawbacks: Key Negotiation Issues for GPs and LPs
2005 Private Equity Fund Formation Seminar
New York, NY

in this instance, the distinction is one of form not substance. Typically in the UK the issue of repetition of warranties is dealt with separately in the section on warranties.

Warranties and Indemnities. Indemnification as a remedy for breach of warranty is absolutely standard in the U.S. However, UK acquisition agreements have historically omitted all reference to indemnification as a remedy for breach of warranty, and the buyer was expected to sue at common law for damages for breach of warranty. Indemnities were reserved for specifically identified liabilities. These days it is not uncommon for the buyer to ask for (and increasingly get) indemnity based damages. What is the difference?

The aim of damages for breach of warranty is to compensate the buyer for loss of bargain. The measure of damages will generally be the difference between the market value of the company at closing with all the warranties being true (usually the purchase price) and the market value given the breach. Thus, common law damages may not be available at all where the breach in question has no impact on the value of the company. On the other hand, liability under indemnification clauses depends on the precise formulation of the clause in question, but usually provides a remedy if there is any negative effect on the underlying assets or liabilities of the business. Thus, an indemnification clause can result in damages being paid to a buyer in respect of a breach of warranty which has little or no effect on the value of the shares. Moreover, because of the way they are calculated, common law damages cannot ordinarily exceed the purchase price, an issue the buyer will be keen to address if paying a small price for a heavily indebted target. The UK common law remedy is subject to numerous additional infirmities. Even if a causal connection can be demonstrated between the breach of warranty and the loss suffered, a buyer is not usually able to recover for a loss which is too remote (*i.e.*, not within the reasonable contemplation of the parties) and the buyer will be under a common law duty to mitigate his losses.

Tax and environmental liabilities are an exception to the UK standard. It is customary in UK share deals (as opposed to asset deals where tax liabilities are usually excluded from the sale) for buyers to receive a tax covenant indemnifying the buyer in respect of pre-closing tax liabilities of the target company, in addition to warranties dealing with tax matters. The tax covenant is typically much longer than a U.S.-style tax indemnity as it generally includes tax specific versions of certain provisions which are contained elsewhere in the acquisition agreement, such as limitations on liability and conduct of claims. Similarly, where there are significant environmental concerns, the buyer may negotiate a separate environmental indemnity with separate limitations on liability.

One function of UK common law damages is that warranties in UK agreements are perceived to be longer than in U.S. agreements. This is because some of the warranties are designed to flush out information in the form of disclosures rather than provide an actual remedy in the event that the warranty turns out to be untrue.

Disclosure. The process of disclosure against individual warranties is not significantly different in the UK, although there is a slight difference in the degree of specificity of the disclosure exercise. In the U.S., the typical formulation of each warranty is "Except as set forth in the Disclosure Schedule …." The effect of this is to put the onus of cross-referencing disclosures against particular warranties on the seller. In the UK, warranties are given in absolute terms with a general statement that all warranties are qualified by matters disclosed in the Disclosure Letter. Sellers will usually make good faith efforts to cross-reference disclosures against the warranties to which they relate but, having made disclosure against one warranty, will not usually accept a contractual obligation to cross-reference the disclosure against each other relevant warranty. As to the level of detail required to defeat a warranty claim, UK buyers often insist that the disclosure be "full and fair" although more often accept the common law standard of "fair disclosure."

In addition to specific disclosures, it is customary in the UK for the seller to

continued on page 22

In addition to specific disclosures, it is customary in the UK for the seller to attempt to make numerous "general" disclosures of matters of which the buyer ought reasonably to be aware. The issue is heavily negotiated in the UK but will come as a greater shock to buyers familiar with the U.S. disclosure process.

attempt to make numerous "general" disclosures of matters of which the buyer ought reasonably to be aware. The issue is heavily negotiated in the UK but will come as a greater shock to buyers familiar with the U.S. disclosure process. The list of general disclosures would include financial statements of the target, the results of public searches against the target at the relevant company, intellectual property or real estate registries, the contents of the corporate books and records of the target, and occasionally even the contents of the data room or the buyer's due diligence report. The initial reaction of the U.S. buyer is often to reject all general disclosures out of hand on the basis that if a warranty is untrue, it is incumbent upon the seller to point out that fact and not expect the buyer to seek out the information. However, it is customary to accept a limited amount of general disclosures. Disclosure of recent financial statements is generally accepted so long as their accuracy is warranted. There is some room for compromise with respect to public searches where the buyer may be prepared to accept disclosure of a limited amount of public information available as of a specific date. The biggest argument is usually reserved for the contents of the data room or the buyer's due diligence findings.

In the UK, the seller may attempt to disclose against all warranties any matter contained (or worse still, any matter referred to) in documents in the data room. The basis for the argument is that the buyer has spent a great deal of time in the data room and may even know more about the business than the seller and should therefore "be on notice" of the contents of the data room. Acceptance of this argument will of course dramatically weaken a buyer's warranty protection as all warranties are automatically qualified by any fact or matter disclosed in the data room. It is not uncommon, however, for the parties to agree to a bundle of disclosure documents comprising documents disclosed in response to specific warranties and certain other data room documents on which the buyer may have focused significant attention.

A UK seller will occasionally try to make a related argument that a buyer should be precluded from bringing a claim if the buyer is aware of the matter giving rise to the breach of warranty as a result of his due diligence. This is strongly resisted by buyers on the grounds that a buyer's due diligence report is a private matter for it alone and that, in any event, a report may disclose potential problems without fully pointing out their significance. That said, the ability of a buyer to recover losses in respect of a matter of which the buyer was already aware is unclear under English law. This is further discussed below.

Limitations on Liability. As in the U.S., it is customary in the UK for the buyer to agree to certain limitations on the liability of the seller under the warranties. The extent of the limitations is hotly debated. If one can generalize on this point, one might say that UK sellers tend to ask for a long list of limitations, more in hope than expectation. An example of a limitation rarely seen in the U.S. is "ring fencing" — a statement that the buyer may not make any claim relating to specific matters, such as environmental liabilities, except for breaches of specific environmental warranties. The effect of this is to deny the buyer the benefit of other more general warranties, to the extent that they might apply to the environment, *e.g.,* no undisclosed liabilities.

The extent of a seller's liability for breach of a warranty of which the buyer had prior knowledge is a burning issue in both U.S. and UK deals. The ability of a buyer to "sandbag" the seller, that is recover losses in respect of a warranty which the buyer knew to be untrue before signing, is unclear under both New York and English law. The message is for the buyer to negotiate an express right to make a claim notwithstanding prior knowledge of the breach. However, the buyer should not expect to be able to rely on such a clause. If the matter is material, the buyer should instead seek a price reduction or a specific indemnity. If a buyer reserves his rights, but accepts a carve-out for his actual knowledge, he should be very careful to define knowledge. In a recent UK case, knowledge of professional advisers carrying out financial due diligence was imputed to the buyer.

Specific Areas of Law

Finance. Unlike the U.S., but in common with many other European jurisdictions, the UK has rules restricting the ability of the target company (or its subsidiaries) to give financial assistance for the acquisition, including by guaranteeing or providing security for the acquisition debt. Breach of these rules is a criminal offense for the directors of the target companies. Historically, this was thought to impair a private equity firm's ability to do U.S.-style leveraged buy-outs. However, unlike other European jurisdictions, the UK has procedures by which "financial assistance" by the target can effectively be "whitewashed." This is a laborious procedure but, provided that the target companies have positive net assets,

financial assistance rules do not usually impair the ability of the target to support the acquisition debt.

Tax. Transfer taxes are additional costs for the buyer of a UK company or business. An acquisition of shares in a UK company will attract stamp duty at a rate of 0.5% of the purchase price. This charge is payable by the buyer and arises irrespective of the location of the buyer and seller. Although the purchase of a business does not in itself attract stamp duty, transfers of real estate attract stamp duty land tax at rates of up to 4% of the consideration allocated to the real estate. In addition, the purchase of assets may attract valued added tax ("VAT") at a rate of 17.5%, although buyers who are registered for VAT in the UK are eligible for an exemption for assets purchased as part of an ongoing business. If purchasing assets, it is therefore important to make clear whether the purchase price is inclusive or exclusive of VAT so that it is clear who bears the risk if the VAT exemption is denied.

UK-based sellers are subject to tax on any chargeable gain arising on a disposal of shares or assets unless a loss is available to shelter the gain or a relief is available. Sellers who accept a buyer's stock or loan notes as part of the consideration may be able to defer their tax liability until sale of the stock or redemption of the loan notes. In addition, provided certain conditions are met, individual sellers may be able to reduce their effective tax rate on eventual sale or redemption. Of course, investing in the buyer's stock carries all the risk of investing in equities. Loan notes, which are typically cash collateralized by the buyer, are a much safer bet and are therefore a popular choice of consideration for UK-based individual sellers. They are recognized by the UK Inland Revenue as a legitimate method of vendor tax planning.

Employees. Asset deals theoretically offer a buyer the opportunity to "cherry pick" the assets of a business, including employees. However, buyers of UK businesses may be surprised to learn that their ability to select employees is very restricted. In common with other European jurisdictions, the UK has rules protecting employees on a sale of a business. As a general rule, employees of target businesses are automatically transferred to the buyer on the same terms and conditions. Any dismissal in connection with the transfer is automatically unfair unless it is for an "economic, technical or organizational reason," a test which is difficult to satisfy. Provisions typically seen in a U.S. asset purchase agreement safeguarding employee rights are, as a result, unnecessary.

Unlike in the U.S., in the UK the target workforce may need to be consulted before consummating the acquisition. At present, the consultation obligation only applies to asset sales. Beginning in 2005, it will also apply to sales of companies with more than 150 employees (reducing to 50 employees in 2008) provided a specified proportion of employees have requested an information and consultation agreement.

Private equity buyers of a UK company or business will typically wish to incentivize UK-based executives. The UK tax rules in this area are complex. Very similar compensation packages can have very different tax consequence. It is worth consulting with a UK tax lawyer as soon as possible so that compensation and incentive arrangements can be structured in the most tax efficient manner. An article appearing in the Summer 2004 edition of the Private Equity Report (*Compensating UK-Based Executives of Private Equity Sponsors*) discuss some of the relevant issues.

Pensions. It may come as a surprise to U.S. buyers that the small matter of pensions can cause so much controversy in a UK deal. However, buyers ignore pensions at their peril. Witness Permira's abortive bid for WHSmith which cratered as a result of pension liabilities or Phillip Green's frustration at being denied access to information about the Marks & Spencer pension fund. Indeed, in our experience, UK pension issues are increasingly becoming some of the more complicated — and difficult to resolve — issues in U.S.-UK cross-border transactions.

Like the U.S., the UK has broadly speaking two categories of pension schemes: defined contribution or money purchase schemes (similar to U.S. 401(k) plans) and defined benefit or final salary schemes which "promise" a specified level of pension payments on retirement, calculated by reference to

continued on page 24

Unlike in the U.S., in the UK the target workforce may need to be consulted before consummating the acquisition. At present, the consultation obligation only applies to asset sales. Beginning in 2005, it will also apply to sales of companies with more than 150 employees . . . . provided a specified proportion of employees have requested an information and consultation agreement.

Caveat U.S. Emptor: Doing Private Deals in the UK? (cont. from page 23)

an employee's salary and length of service. Although, unlike the U.S., the UK has no meaningful state guarantee pension system.

Pension fund deficits in defined benefit schemes will be a risk in any U.S. or UK deal. However, the problem is more acute in the UK as many firms still operate defined benefit schemes (although these plans are increasingly being closed to new members). In addition, underfunded UK pension schemes pose significant issues because the acquisition transaction itself can, under certain circumstances, give rise to an immediate funding obligation (or increased future funding obligations), such as certain situations where a target subsidiary withdraws from a seller group scheme. In the U.S., a transaction will often not trigger immediate full funding obligations.

In the UK, if a pension fund is underfunded, the sponsoring company will be required to make good the deficit within a certain period of time. If the target company is a member of a group of companies participating in a group scheme, it can be required by the pension scheme trustees to pay its "share" of any deficit on withdrawal from the scheme. The government is concerned about companies using financial engineering to avoid paying pension deficits and has proposed controversial new legislation that would have retroactive effect, and could impose personal liability on any company directors, shareholders and associated businesses who have been party to an act preventing the recovery from an employer of a pension deficit on or after June 11, 2003. In addition, where target companies withdraw from group schemes, the "buy-out" basis will be used to calculate the assets and liabilities of the fund, which will likely be much higher than the present minimum funding requirement ("MFR") methodology. These proposals have been heavily criticized by many institutions, including the British Venture Capital Association, who believe that they may adversely affect the private equity sector and discourage foreign investment. Further, a new accounting standard coming into effect in 2005 requires sponsoring companies to bring pension fund liabilities onto the balance sheet. Any buyer of a UK company with a final salary scheme will need to look carefully at the funding levels and, if necessary, seek appropriate price adjustments or indemnities.

Conclusion

It is true that freedom of contract in a common law system means that there are many similarities between a U.S. and UK acquisition agreement. However, there are significant differences between the U.S. and the UK in both market practice and specific areas of law applicable to a private acquisition. Some of these differences may surprise a newcomer to the UK market, although none of these issues is insurmountable for the well-advised client. Consult a UK lawyer early on in the process and reduce the risk of the deal cratering at a late stage in the negotiations.

— Geoffrey P. Burgess
gpburgess@debevoise.com

— John Morgan
jmorgan@debevoise.com

U.S. Congress Approves Sweeping New Rules on Deferred Compensation (cont. from page 6)

law, or at least could be structured to satisfy its conditions if payable only upon the events permitted under the new law (*i.e.*, termination of employment and change of control, if permitted by guidance to be issued by the IRS).

Fee Arrangements. In recent years, many fund sponsors moved away from traditional arrangements whereby the management fee was equal to a percentage of commitments or invested capital and the general partner was allocated 20% of the fund's profits. Under the newer arrangements, the management fee is reduced periodically and the general partner's (or, in some cases, the manager's) share of the profits of the fund is increased by reference to a corresponding amount. While the variety of such arrangements found in the marketplace makes it difficult to generalize, we expect that, in light of the importance of complying with the new rules, certain funds will choose to amend such arrangements in order to ensure compliance.

— Lawrence K. Cagney
lkcagney@debevoise.com
— Jamin R. Koslowe
jrkoslowe@debevoise.com

investors don't have the same ownership rights as they would have if they held the high yield bond directly.

Possible UK Structures

At the end of the third quarter of 2004, there had not been any IDS-type securities issued in the UK. A key driver to the development of the structure in the UK will, in addition to the tax issues, be the regulations of the UK Listing Authority ("UKLA"). The UKLA regulations do not contemplate this type of hybrid security and, in particular, do not allow the "stapling" of the debt and equity in any legal sense, which would be contrary to the UKLA's condition to Listing Rule 3.15 (the requirement of free transferability). We have set forth below three alternative structures for creating an IDS in the UK that we believe are viable and which show the flexibility of the IDS security generally. Inevitably, with a new product there are legal, regulatory and practical hurdles to overcome, some of which will only be ironed out with completion of the first live transaction.

1.The High Yield Share

A Findexa type "high yield share" structure, offering only equity to investors through an issuer incorporated and resident in a tax neutral jurisdiction (such as Jersey). See Table 1.

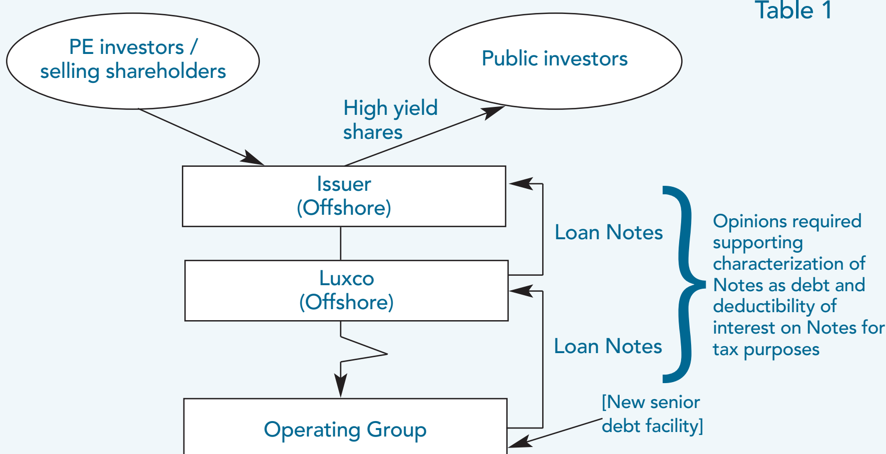
The debt would be issued intra-group, providing interest (to fund dividend payments) to the equity issuer. The upstream guarantees typically supporting the issued debt will require the issuers to be located offshore in order to comply with the strict capital adequacy regime of the UK financial assistance rules. The effect of thin capitalization rules mean that there are likely to be complexities concerning the provision of guarantees by any non-UK operating subsidiaries.

Tax efficiency (to allow interest on the debt to be deducted against profits of the operating group and interest payments to be free from withholding tax) will be dependent on whether the issuer is too "thinly capitalized" (*i.e.*, whether a third party bank would have lent the same amount on the relevant terms). This depends on the amount of debt that the assets and revenues of the issuer can sustain (typically a debt equity ratio approaching 1:1). Placing a proportion of the debt with a third party may also help the issuer demonstrate that the amount of debt is not excessive. In addition, withholding tax issues can be dealt with in other ways, such as by listing the debt on the Luxembourg stock exchange.

A clear advantage of this structure is its structural simplicity. From a regulatory perspective, the IPO is a fairly straightforward offering of shares. Settlement and clearing issues should be routine. One structural shortcoming is that holders will not have a direct interest in the underlying loan notes, impairing their position in a restructuring.

At the end of the third quarter of 2004, there had not been any IDS-type securities issued in the UK. A key driver to the development of the structure in the UK, will, in addition to the tax issues, be the regulations of the UK Listing Authority.

Table 1



2. The Traded Unit

The offering to the public of London Stock Exchange-listed debt and equity issued by separate offshore corporate entities, trading together as a unit. See Table 2.

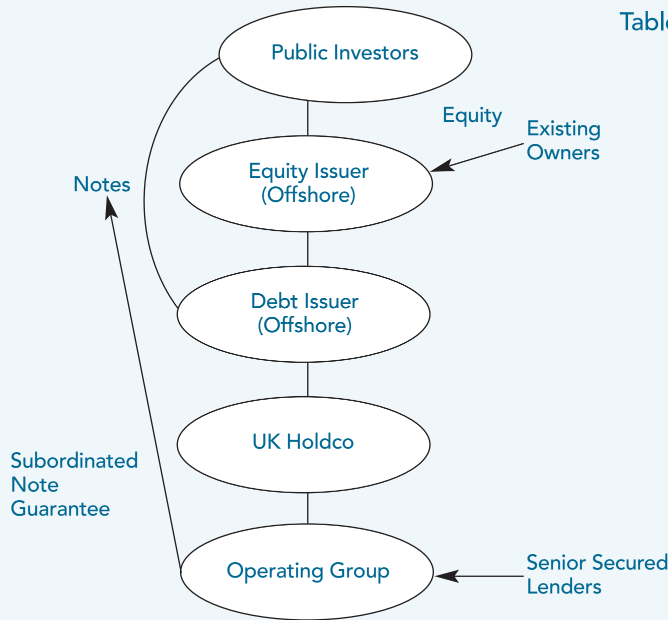
In order to avoid the restrictions on "stapling" described above, the debt and equity would not be "stapled" but would be traded as a "unit" (*e.g.*, one share and one bond) through a mechanism of trading (rather than as a distinct security as a technical matter) on a highly visible trading platform, such as SETS MM. FSA and LSE listing rules would require that the equity and subordinated debt also be listed, but they could be traded separately on lower visibility trading platforms. The use of a higher visibility trading platform for the units would encourage trading in the units rather than in the underlying debt and equity. The unit could be split and freely tradable at will.

Tax efficiency will require that the

continued on page 26

 (cont. from page 25)

Table 2



debt and equity are issued by separate companies, each resident in the UK for tax purposes, and that the interest return on the debt component is a "reasonable commercial return" and not an excessive rate. Placing a proportion of the debt separately from the equity may assist the tax deductability of interest payments. However, as the debt is external, the tax efficiency of the structure does not also depend on whether the amount of the debt is excessive. Moreover, we believe that unlike its U.S. cousin, a "homogenization" feature for the unit would not be required by tax rules in the UK. As above, capital adequacy requirements will dictate that the issuers of the debt and equity be offshore (but as discussed above, UK resident for tax purposes). As a regulatory matter, this structure is more complex than the High Yield Share structure and will be more difficult to list, trade and settle.

3. The Certificate for Underlying Listed Debt and Equity

The listing and issue to the public of a depositary receipt certificate for underlying debt and equity. See Table 3.

There is no such depository receipt or certificate currently in issue and the UKLA Listing Rules do not expressly contemplate this type of security. We believe, however, based on informal discussions with the UKLA, that they would allow this type of certificate to be listed, provided that the underlying debt and equity is also separately listed and freely tradable to ensure that the certificate did not amount to stapling by other means.

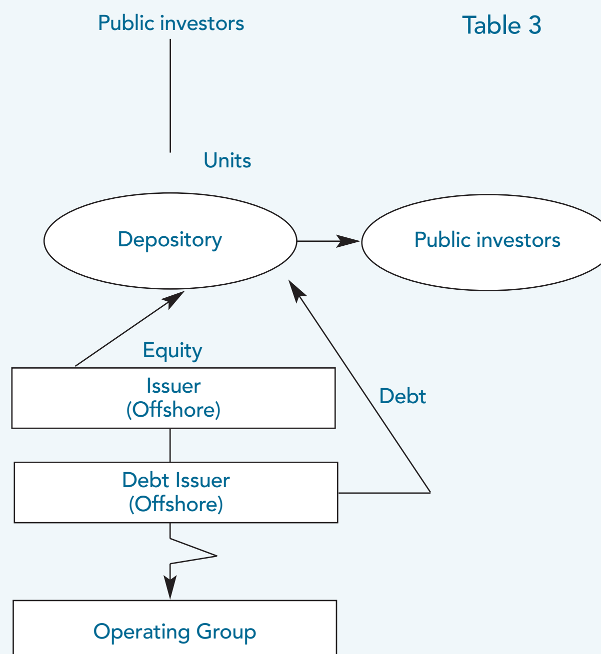
This structure raises the same issues regarding capital adequacy and tax efficiency as in structure (2) above. It may, however, provide an advantage to the unit structure above since the certificate will form a distinct traded security. Nonetheless, it will require the listing of three separate securities, and it is structurally the most complex of the three alternative structures to list, trade and settle. In addition, some depositaries may resist the obligations that come from this structure.

In structures (2) and (3), some practical issues concerning trading and clearing remain to be resolved with the Crest uncertificated trading and settlement system and the London Clearing House. However, our expectation is that these would be ironed out in the course of the first live offering.

— James C. Scoville
jcscoville@debevoise.com

— Arthur Stewart
astewart@debevoise.com

Table 3



Guest Column: Spinning Out of an Institutional Private Equity Manager (cont. from page 10)

such information can be very difficult. Indeed, the Exponent team had to reconstruct detailed information relating to financial returns and performance from publicly available data. This involved analyzing over 6,000 pages of company accounts — a painstaking task to say the least! And we were fortunate that we were able to do this because limited companies in the UK (where most of our investments were made) are required by law to file audited accounts and details of their capital structure at the UK Companies Registry, which is a public registry. Managers in the U.S. and some continental European jurisdictions may find reconstructing their track records more difficult, since such data is generally not publicly available.

So, and I think disappointingly, we remain skeptical about the prospect of an abundance of spinout teams from larger private equity houses coming to market in Europe in the short term. But we remain hopeful for the future, since we believe that the success of our fundraising is evidence of a healthy investor appetite for small, focused teams of experienced private equity managers coming together to offer a value proposition somewhat different to that of the large, institutionalized, mega-buyout firms that have become a feature of the private equity market of late. As in most markets, we expect that supply will eventually find a way to meet demand.

— Hugh Richards
Founder Partner, Exponent Private Equity LLP

Seven Key Issues Under Senior Debt Commitment Letters (cont. from page 12)

outs, it may well be that any information that is material enough to cause a lender to invoke the "no new information" condition is also material enough to cause the sponsor to reevaluate the desirability of the proposed investment.

6. MAC Clauses

Commitment papers typically provide for two types of material adverse effect, or "MAC," clauses: business MACs, providing for an out in the case of adverse developments regarding the target, and market MACs, subjecting the commitment to adverse changes in financial, banking or capital market conditions generally.

While MAC clauses can be subject to fierce negotiation in other M&A contexts, there tends to be little room to eliminate or even significantly water down the clause in the context of a senior debt commitment letter. A sponsor's best bet is to seek to clarify that the adverse change at issue should be evaluated on an objective basis, or, failing that, that any subjective determination made by the lender must be made reasonably. Sponsors also sometimes succeed in removing that little — but expansive — word "prospects" from a business MAC, although this "win" is probably more psychological than substantive given the confluence of all the other conditions in a standard commitment letter.

7. Assignment of Obligations

Another familiar "tug of war" in the negotiation of senior commitment papers is the appropriate scope of the lenders' ability to assign the loans to third parties, either as part of the syndication process or thereafter. Lenders typically argue that in order to provide the most attractive commercial terms at the outset of a loan, they need the liquidity associated with flexible assignment rights. Borrowers, on the other hand, contend that in order to protect the benefit of their bargain, they need assurances that they will continue to deal with the same lenders involved in structuring the initial loan, or at least lenders with a similar commercial orientation. They also argue that unlimited assignment rights create the risk of a highly fragmented syndicate, making administration of the loan logistically cumbersome, and that an unfettered right to assign may result in assignments of the loan (and, perhaps more importantly, the related right to receive information concerning the borrower) to a competitor.

Historically, this issue was typically resolved by providing that — absent a default — a borrower had a consent right on assignments (not to be unreasonably withheld). But given the increasing importance of the secondary market in today's senior bank loan environment, many lenders are now resisting giving borrowers a block on assignments. While some sponsors are still successful in negotiating for the traditional approach, others are being forced to agree to more narrowly crafted safeguards, such as requiring that the agent bank retain a minimum portion of the loan, that any assignment be in excess of a certain threshold amount, or that assignees vote only on matters requiring the consent of all lenders or each affected lender. In all circumstances, sponsors should seek to either restrict assignments to any competitor of the borrower, or, at least, provide that any commercially sensitive information concerning the borrower may be withheld from the competitor in the event it becomes a party to the financing.

— Stephen R. Hertz
srhertz@debevoise.com

— Stefan P. Stauder
spstauder@debevoise.com

Transfers by Investors in Private Equity Funds (cont. from page 5)

fund partnership in cases where the upper-tier partnership and the lower-tier partnership either have a substantial built-in loss at the time of the transfer or have made a 754 election. However, even if the IRS adopts this approach, tiered partnership arrangements generally should not increase the administrative burden so long as the upper-tier partnership (1) does not make a 754 election and (2) elects to be treated as a so-called "electing investment partnership" (discussed below) in the event that there is a transfer of an interest in the upper-tier partnership at a time when it has a substantial built-in loss.

Some Good News: The Exception for Electing Investment Partnerships. Happily, the Act includes an exception for private equity funds that meet certain requirements and file an election with the IRS to be treated as an "electing investment partnership." Specifically, the Act provides that a private equity fund that meets these requirements can file an election pursuant to which it will be deemed not to have a substantial built-in loss (and thus effectively escape the provisions of the Act described above). However, if the private equity fund makes such an election, any transferee of an interest in the fund will not be entitled to claim any losses from the fund except to the extent it is established that such losses exceed the losses recognized by the transferor of the interest (and any prior holder of the interest). The limitation on claiming losses is not expected to be significant for the bulk of the investors in private equity funds, who are either tax-exempt or non-U.S. (and therefore limited in their ability to use losses flowing from the fund in any event). Any such election is irrevocable except with the consent of the IRS. As a result, the ability of a future transferee to claim a loss will generally continue to be limited even if the partnership ceases to have a substantial built-in loss.

One of the requirements for making the election is that the fund must never have been engaged in a trade or business. Although not entirely clear, we believe that an investment by a fund in an operating partnership (*e.g.*, an LLC taxable as a partnership that is engaged in a trade or business) generally should not cause the fund to be engaged in a trade or business for this purpose and therefore ineligible for the election.

The other requirements for a partnership to make the election are: (1) the partnership would be an investment company under section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of section 3(c) of such Act, (2) substantially all of the assets of such partnership are held for investment, (3) at least 95 percent of the assets contributed to the partnership consist of money, (4) no assets contributed to the partnership had an adjusted basis in excess of fair market value at the time of contribution, (5) all partnership interests of the partnership were issued by the partnership pursuant to a private offering before the date which is 24 months after the date of the first capital contribution to the partnership, (6) the partnership agreement of the partnership has substantive restrictions on each partner's ability to cause a redemption of the partner's interest, and (7) in general, the partnership agreement of the partnership provides for a term that is not in excess of 15 years. The IRS is specifically authorized to issue additional regulatory guidance concerning electing investment partnerships, including how the rules applicable to electing investment partners apply in the case of tiered partnerships. ▢

— David H. Schnabel
dhschnabel@debevoise.com

— Rafael Kariyev
rkariyev@debevoise.com

We are pleased to announce that the same Private Equity Team that has been bringing you The *Debevoise & Plimpton Private Equity Report* for 5 years, has published *The Debevoise & Plimpton European Private Equity Handbook.*

Although the European private equity market developed later than its U.S. counterpart, it has been more active since the millennium. Over 60% of global private equity merger and acquisition activity has occurred in Europe since 2000.

The *Debevoise & Plimpton European Private Equity Handbook* is designed as a resource to assist new entrants in the European private equity market in understanding, and to refresh the memories of seasoned private equity professionals about, the business, legal, tax and regulatory issues involved in establishing private equity funds in Europe and in structuring transactions to put those funds to work.

The handbook includes our "top ten" list of differences between private equity funds and transactions in Europe and the U.S. To receive a copy of *The Debevoise & Plimpton European Private Equity Handbook*, please send an email to privateequity@debevoise.com.