Debevoise & Plimpton
Private Equity Report

Volume 5 | Number 2 | Winter 2005

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Vendor Due Diligence Reports — Is It "Put Up or Shut Up" for Buyers?

Vendor due diligence reports, or VDDs, are an increasingly common feature of the auction sale process in Europe, although they have failed to catch on so far in U.S. auctions. So what are VDDs, what factors account for their growing prominence, and what issues does this raise for private equity buyers, especially those not accustomed to this European practice?

Typically, an auction seller taking the VDD approach will engage reputable firms of outside accountants and legal counsel to prepare one or more due diligence reports covering material legal, accounting and tax matters relating to the target business. Separate financial audits are usually reserved only for divestitures of subsidiaries or divisions. Depending on the nature of the business, the seller may also engage other third party consultants to provide VDDs, most commonly environmental reports. However, the seller may provide potential buyers with access to a data room during the auction process, or after a winning bid has been selected, but its expectation will be that a prospective purchaser will do relatively little due diligence work of its own, relying instead on the contents of the VDDs. The seller may also arrange for bidders to have limited access to the authors of the VDDs for the purpose of asking followup questions on the report. The expense of preparing the VDDs and providing any further access to the authors is generally borne by the seller.

The seller arranges for drafts of the VDDs to be provided to bidders on a non-reliance basis during the auction process. Prior to distributing their reports, the VDD providers will require recipients to execute a release letter accepting the terms of the report provider's engagement letter with the seller and releasing the report provider from any liability to the recipient with respect to the contents of the report. At the time definitive sale documentation is signed, the report providers will issue final reports addressed to the ultimate purchaser and its financing sources on the basis of a reliance letter in which the report provider expressly assumes liability toward the addressees.

There are a number of advantages to this approach from the perspective of the seller. Detailed information about the target business can be shared with multiple bidders earlier in the sale process, without the business disruption attendant to independent investigations by multiple buyers. In addition, distributing a VDD prior to the final stage of an auction increases the likelihood that the seller can secure bids that are not subject to further due diligence and avoid nasty surprises after selection of a preferred bidder. As a result, providing a VDD during the auction process may reduce potential buyers' ability to bid high to secure exclusivity and then whittle down the price on the basis of their due diligence investigations. In fact, one of the major accounting firms goes so far as to pitch the use of VDDs in an article on its website as "It's '*put up or shut up*' for the *buyer*." Sellers in auctions may also try

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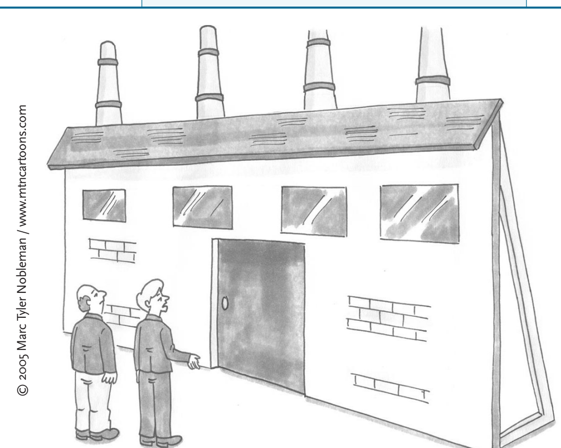

"It looked different in the electronic data room."

letter from the editor

2005 is off to a robust start for the private equity community. Even the traditional business press is awash with articles on private equity's many triumphs, heralding the vitality of the fundraising market, the increasing allocations from many investors, the strength of transactional activity in all segments of the market and the continued vibrancy of the financing markets.

In keeping with our commitment to highlight key differences between U.S. and European practice, we have two sets of articles comparing recent developments in transactional due diligence and increased disclosure risks for private equity funds. Josh Berick outlines the advent of electronic due diligence sites over old-style paper diligence rooms both in the U.S. and in Europe; while Andy Sommer and Wendy Semel discuss the pros and cons of vendor supplied due diligence reports, which are becoming more prevalent in European auctions. Elsewhere, Rebecca Silberstein and Geoff Kittredge separately discuss the effects of recent freedom of information legislation at the state level in the U.S. and in the UK on private equity funds, their relationships with investors and their ability to limit disclosure of potentially sensitive fund information.

In our Guest Column, Tom Franco, CEO of Broadgate Consultants, picks up on the theme of greater scrutiny of private equity funds, with a primer on how funds should handle press inquiries and firm positioning as the business press takes an enhanced interest in the private equity community. Also, we are pleased to note the return of Trendwatch in this issue with an analysis by Geoff Kittredge of the success of first time funds in the current climate in garnering terms that do not vary significantly from their more established brethren.

In this issue we also highlight news on the regulatory front. First, we take a look at a new rule requiring hedge fund advisers, including those based outside the U.S., to register with the SEC and update you on the impact of last Fall's revisions to the U.S. Tax Code on private equity firms structuring of deferred compensation. Andrew Bab warns of the surprisingly broad impact of the Sarbanes-Oxley Act's auditor independence rules for private equity firms and their portfolio companies. And finally from Europe, Antoine Kirry cautions potential investors in French public companies of the risk of inadvertently triggering mandatory tender offer rules.

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.

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Franci J. Blassberg
Editor-in-Chief

Ann Heilman Murphy
Managing Editor

William D. Regner
Cartoon Editor

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

Private Equity Funds
Marwan Al-Turki – London
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Jennifer J. Burleigh
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Sherri G. Caplan
Michael P. Harrell
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M. Ostrognai – Hong Kong
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Rebecca F. Silberstein

Hedge Funds
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Due Diligence in Cyberspace: The Rise of the Electronic Data Room

Electronic data rooms have become a common feature of the M&A due diligence process both in the U.S. and in Europe, particularly in the context of multiple-bidder auctions. As private equity firms increasingly find themselves engaged in auction processes, both as buyers and as sellers, private equity professionals and their advisors should be aware of the relative advantages and disadvantages of electronic data rooms as compared to traditional, "paper" data rooms.

What is an Electronic Data Room?

An electronic data room is the on-line or digital version of a physical data room. Rather than compiling hard copies of due diligence materials in a conference room, the seller assembles the same materials in an electronic format (typically as PDF or TIFF images) that can be accessed by bidders through an Internet site hosted by a third party service provider or an extranet site on the seller's (or one of their advisor's) proprietary network.

Since bidders can enjoy the due diligence review process in the privacy of their own offices, the seller cannot exercise the same level of supervision that it could in a traditional, "paper" data room. Accordingly, a number of measures are typically taken to ensure the security and confidentiality of the due diligence information being provided. Bidders are given passwords, usernames and/or specific log-in instructions in order to permit them to access the data room. Once access has been obtained, data room visitors may be asked to accept confidentiality provisions and other terms of use on a "click-through" screen and may be required to re-enter their passwords and usernames in order to access specific documents. The data room can also be configured so that some or all of the documents are available in a "view only" format to prevent bidders from printing and/or distributing particularly sensitive materials.

Advantages of Electronic Data Rooms

Access. For sellers, an electronic data room has the obvious advantage of allowing multiple bidders to conduct due diligence at the same time. Rather than facing the logistical challenge of shuttling a series of bidders through a physical data room over a period of weeks (or, alternatively, setting up and supervising multiple data rooms at one or more locations), the seller can provide any number of bidders with simultaneous, "around-the-clock" access to its data room materials, which may reduce the overall amount of time required for the submission of bids.

"Real-time" access to an electronic data room also provides bidders — including members of their due diligence teams that may be located in multiple jurisdictions — with the ability to review documents at their own convenience, without being limited by the hours of operation or other time restrictions of a physical data room. By having the time to review and, if necessary, re-visit important documents on-line without having to "beat the clock," the bidder may have a greater opportunity to gain a more comprehensive understanding of the due diligence materials — particularly when compared to reviewing documents in a physical data room in which photocopying is prohibited and the pressure on accurate note-taking is intensified.

Cost Savings. Employing an electronic data room may reduce the seller's overall costs, although the precise amount of savings is difficult to quantify. Pricing models vary among third party service providers, but sellers can expect that the fee for establishing an externally-hosted electronic data room will generally be in the range of $15,000 to $30,000, depending on the volume of data to be stored on the site. Although this hosting fee is likely to exceed the cost of photocopying the same documents for inclusion in a physical data room, the seller would not be required to bear the additional costs associated with maintaining a physical data room (including the fees of junior associates and/or legal assistants that are required to supervise the data room over an extended time period, the expense of responding to duplicating requests from bidders and the cost of conference room dining services).

However, since these additional costs will increase incrementally over time (particularly if the seller is required to host more than one physical data room), the seller's cost savings may increase proportionally with the number of likely bidders in the auction and the anticipated duration of the process. If there are only one or two bidders and a relatively brief due

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diligence process is anticipated, the electronic route may not be justified by cost alone — especially since prudence may dictate that the seller will prepare a hard copy, "back-up" set of due diligence materials in any event.

For bidders, the ability to access the data room contents electronically should eliminate the expenses associated with visiting a physical data room, which can be particularly significant if out-of-town travel is required on one or more occasions. But again, the extent to which bidders can reasonably expect to reduce their overall fees is difficult to predict — being liberated from the time constraints of a physical data room may lead the due diligence team to spend more time reviewing the same number of documents and advisory fees may increase correspondingly.

Functionality. In addition to "real-time" access and potential cost savings, an electronic data room provides both the seller and the bidder with a variety of enhanced features that cannot easily be replicated in paper format. For example, many electronic data rooms allow the seller to monitor usage on a per-document basis, which may underscore the bidders' specific due diligence concerns and better prepare the seller to negotiate definitive documentation. On the buy-side, the ability to search data room indices (and, in some cases, the documents themselves) for key terms can expedite the review process, and, to the extent that documents are not subject to "view-only" restrictions, due diligence materials can be downloaded and/or printed and more efficiently shared among potentially far-flung members of a due diligence team.

Disadvantages of Electronic Data Rooms

Security. The seller's primary risk in establishing electronic data rooms is that unauthorized users may access confidential information posted on the data room site. Third party service providers have established extensive security procedures to protect the confidentiality of due diligence materials included within electronic data rooms, including not only the passwords, usernames, and log-in instructions mentioned above, but also measures such as independent security audits, data encryption and firewall protection. However, information technology specialists generally believe that no site is completely "hack-proof" and there is always the possibility, however remote, that a determined user may be able to compromise these security measures and obtain the seller's confidential materials. This possibility may lead certain sellers to provide paper copies of highly sensitive materials, which may defeat, at least in part, certain of the advantages that the electronic format otherwise provides.

Technical Difficulties. Other than potentially denying future generations of young lawyers the opportunity to rifle through boxes and file folders in cramped conference rooms, the bidder's principal challenges will arise from navigating some of the hurdles that are inherent in the electronic medium. For example, many members of the due diligence team will likely find it easier to read documents in paper format, rather than scrolling through lengthy documents on-line. As a result, bidders often resort to opening and printing each individual file in the electronic data room, which can be a time-consuming and tedious project.

Similarly, it may be easier for seasoned members of the due diligence team to "get the lay of the land" in a physical data room and assess the likely magnitude of the due diligence review that will be required. On the other hand, even if the seller provides a detailed index, it can be difficult to gauge the actual volume of the materials stored in an electronic data room without opening and scanning through the files. And although bidders may share some of the "pros" of electronic data rooms that are enjoyed by sellers, such as potential cost savings, their respective "cons" are at odds with one another — the bidder's "ease of use" issues tend to be compounded by the seller's efforts to address its security and confidentiality concerns, such as by providing documents in "view-only" format, requiring bidders to enter and re-enter their passwords and usernames repeatedly and instituting similar security procedures that can make the electronic data room experience a frustrating one for bidders.

Tracking. For all of the functionality benefits that electronic data rooms provide there is a potential downside for the buyer, the ability of seller to track which documents buyer is looking at and by whom.

Electronic data rooms appear to have become a permanent fixture of the M&A auction landscape and can be expected to become increasingly prevalent as technology is further refined by third party service providers. Private equity firms and their advisors should accordingly be prepared to factor them into their due diligence planning, both in determining whether to set up an electronic data room when running an auction on the sell-side and in efficiently maneuvering through the technical challenges that are likely to be faced on the buy-side.

Joshua J.G. Berick
jjgberick@debevoise.com

guest column

Building and Maintaining LP Confidence in a Transparent World

There is ample evidence that investor sentiment about private equity has improved markedly as a result of large amounts of capital being returned over the past 12 to 18 months. Increasing media coverage of quick flip IPOs and recaps with big pay-outs are feeding LP perceptions that the salad days are back.

Today, scores of reporters cover the private equity sector, often like a football game. There are winners and losers, fumbles and saves. Specialized private equity trade press reporters number 120 alone. If you count general business publications globally, the number is closer to 500 reporters covering the industry. Not surprising then, if you search private equity on *Factiva*, a media search engine, you will turn up on average more than 300 stories per day. The relatively low level of transparency in private equity, once regarded by many as one of its most compelling features, is on its way out.

Private Equity on Center Stage

Much as the first billion dollar private equity fund served as a critical inflection point for the asset class, today the issue of transparency has spurred a spirited debate. And the question of transparency is not simply limited to the debate over whether public funds should disclose return data which the *San Jose Mercury News* and other investigative parts of the media have championed over the past few years. The transparency that I am referring to is much broader than that.

At a conference sponsored by Broadgate, which featured a panel of leading private equity journalists grilled by Debevoise's global private equity practice group co-head, Franci Blassberg, about how they cover the asset class, David Snow of *Private Equity International*, summed up in this way: "Private equity firms are having to differentiate themselves more from their competitors and to stand out in the market because they are essentially competing for dollars from LPs. Talking to the press consistently is the best way to establish a brand. It's a way to say, 'Here's how we do deals differently, and here's how we choose to pursue the market,' and I think that increasingly, private equity firms who, until very recently, couldn't have cared at all about things like a brand are starting to care."

Hard as it may be to swallow, the reality of increased transparency may prove to be a positive development for once shy private equity firms. Potentially it offers the opportunity for sponsors to elevate their reputations, differentiate their capabilities and increase LP confidence, particularly at a time when private equity investment activity and realizations continue to capture the imagination of business reporters. With the surge of fund raising anticipated in 2005 and 2006, developing the right public positioning strategy will play an increasing role in effective fund raising strategies.

Learning How to Perform Under the Media Spotlight

With the secretive nature of the private equity world on the wane, what should a sponsor do? The answer appears to be, at least according to journalists who participated in the Broadgate conference, to learn how to perform on stage.

More and more information about individual firms and their portfolio companies is becoming public knowledge. James Politi of the *Financial Times*, observed that because private equity has become more visible in the global economy, "There has been a realization among the firms that they need to open up to the outside world." One unmistakable outgrowth of this trend in the recent past has been better media access to private equity market participants.

Many industry observers agree that to compete more effectively, firms will need to focus on their firm as a public "brand" that conveys important attributes such as people, investment strategy and profile. And that brand — whether deliberate or accidental — will be marketed not just to LPs, but to potential buyers and sellers of businesses, executives who may be recruited to the firm and portfolio investments.

Private equity firms that take affirmative steps to provide better information will boost the confidence of investors and arguably gain a competitive advantage when seeking to raise additional funds. To engender institutional credibility, three essential imperatives should guide communication policies: projecting a clear and compelling vision; clearly defining distinctive added value; and emphasizing investment process quality.

First, to project a clear and compelling vision, a private equity firm needs to articulate its philosophy, which boils down to responding to the question, "What does the firm stand for?" While the obvious answer may run something along the lines of making as much money as possible for investors, firms should always bear in mind that investors will be more likely to invest money with people

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they trust and who have a reputation for integrity. David Swensen of Yale's endowment, one of the industry's most astute observers, describes these firms as being comprised of "driven, intelligent, ethical individuals operating in a cohesive partnership."

Investors are not alone in wanting to be associated with people of integrity by the way. Lenders, customers, suppliers, management and employees all share the same interest in collaborating with people that are trying to do the right thing, not what is expedient. A firm's vision should always include a statement of values by which the firm's partners conduct themselves. And part of the value system should include a commitment to providing reliable information on a timely basis in understandable language to LPs.

Second is the question of what distinctive value a particular firm brings to the table. Whether you are talking about toothpaste or private equity, the market demands and values differentiated capabilities. In a field crowded with many hundreds of private equity firms, up from a handful only 20 years ago, investors have many choices about where to place their money. Unfortunately, private equity is beginning to resemble the worst aspects of the automotive industry with too much capacity and many of the models indistinguishable. Reflecting on the private equity industry today compared to 20 years ago, David Carey of *The Deal* noted, "It's almost commoditized and the deals coming to market is like watching cattle come to market."

The supply-demand dynamic governing the allocation of dollars to the private equity industry today is savagely competitive. According to David Toll of *Private Equity Analyst*, "There is a select group of venture capital and buyout firms that have figured out how to make money and the rest are way, way behind." And there is overwhelming investor demand for this select group of firms and not enough slots in the funds to accommodate it. "Institutional investors are looking for the managers of the future," says Toll, "Newer groups that could grow into the Kleiner Perkins and KKRs of tomorrow."

To stand out, a private equity firm needs to define clearly the manner in which it delivers added value. The task is a triple one beginning with highlighting previous investments where the firm spearheaded successful efforts to usher in new strategic and operational plans. Next, people always make the difference and so the experience of the firm's human capital, as well as the specialized capabilities of firm affiliates and advisors should be emphasized. Finally, each transaction that a firm undertakes, whether an investment or realization, should provide a powerful platform to reiterate the manner in which it delivers added value.

Third, private equity firms need to communicate effectively the quality and focus of their investment process. Investors who have been burned by investment strategy drift now place as much emphasis on how returns are generated as on actual performance. They want to see that a risk-controlled process exists, that it is consistent, and that there is a reasonable likelihood it can be repeated.

One of the most delicate positioning challenges for private equity firms who have had performance issues is to demonstrate that they have refined their models to address effectively past shortcomings. With lower expectations for funds raised around 1998, sponsors who have weathered the storm have an opportunity to build credibility by owning up to past mistakes, explaining why they were made, and demonstrating the corrective actions taken to improve performance in what promises to be a very strong period for deploying capital in the future.

Keep in mind in the new world of transparency that once the closet door is open, shutting it abruptly when challenges arise is never a viable option. As *Financial Times* reporter James Politi noted: "If you're helpful when times are bad, then it'll be much easier to get your message out when times are good, and the fact is that with LPs, competitors and rivals talking more, it is much more transparent when times are bad, and much more difficult to hide behind the veil."

The positioning imperatives described above are necessary to establish an institutional franchise at a time when investors and other stakeholders are demanding a much higher level of transparency. The most effective public positioning for private equity sponsors raising money, investing or exiting investments is to shine light consistently on the distinctive strategies and capabilities that are being deployed to create long-term value.

Thomas C. Franco
CEO, Broadgate Consultants, which counsels private equity firms on a range of LP relations and fundraising communications issues.

U.S. Public Disclosure Laws Put the Unwanted Spotlight on Private Funds

Amid increased levels of public scrutiny on corporate America over the last few years, private funds have not gone unscathed, facing renewed calls for greater transparency. Private funds have historically been exempt from most forms of government regulation, but their increasing reliance on public money, managed by large public investors such as state pension plans and public universities, the expanding reach of U.S. state disclosure laws (generally patterned on the federal Freedom of Information Act), and the recent rise of disclosure laws overseas has changed the equation significantly. Because public investors are significant players in private funds, their disclosure obligations have impacted the private funds in which they invest.

Ironically, it is worth noting that the disclosure of private fund information has generally been sought not for the benefit of the "public" itself, but rather by journalists and by entrepreneurs looking to commercialize and profit from the information. Public disclosure laws in the U.S. vary from state to state, but generally contain similar guidelines for what must be disclosed and what can remain private. Most notably for private fund sponsors, disclosure laws generally permit proprietary information — information that would benefit competitors or reveal trade secrets — to remain confidential.

Private funds are most sensitive to disclosure related to their underlying portfolio companies. Funds fear the release of the identity and activities of portfolio companies could lead the companies to lose customers, suppliers and sources of credit, adversely impacting their competitive position. The disclosure of portfolio information could also trigger the loss of investment opportunities for the fund, as sellers of businesses could shy away from acquirors likely to expose their confidential and highly sensitive information This of course would have a negative impact on the fund and its returns, and ultimately harm the fund's investors.

Fund sponsors have also expressed concern over protecting the fund's business and legal terms (particularly the fund's economic arrangements). Disclosure of such information could lead competitors to imitate the fund's strategies or leverage its economic arrangements, weakening the fund's competitive advantage.

Given these concerns, funds have agreed to a compromise of sorts on how to comply with disclosure laws. The crux of the compromise is simple: sponsors generally permit the disclosure of fund-level, bottom-line information (*e.g.*, contributions, distributions, management fees) while protecting specific portfolio company information based on the statutory exception for proprietary information available in most states. (Sponsors have largely failed in their effort to keep confidential the valuation information of funds, including internal rates of return. Although fund valuations can be inherently misleading and not indicative of true value because U.S. private fund sponsors do not utilize a consistent valuation methodology, such information has generally been treated as non-proprietary information under state "FOIA" laws.) Legal developments in three states, summarized below, have helped shaped this "compromise."

- *California.* Given the large amount of public money invested in California, it is not surprising that much of the law regarding public disclosure of private fund information has developed there. In 2002, the *San Jose Mercury News* took the California Public Employees' Retirement System (CalPERS) to court to compel disclosure of performance data on its private fund investments. CalPERS argued that certain disclosures could result in its ejection from existing partnerships and exclusion from future opportunities. The judge ruled that the underlying asset information of private funds — not the top-line performance data — qualified for trade secret protection. California State Teachers' Retirement Systems (CalSTRS) also discloses certain information related to its private fund investments, including fund-by-fund IRR information, but keeps portfolio information off-limits. CalPERS recently settled a separate court action brought by a coalition of media organizations by disclosing

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the individual management fees it has paid to private funds.

- *Texas.* 2004 was a watershed year for disclosure of fund information in Texas. Texas Attorney General Greg Abbott departed from the "compromise" and became the first attorney general to publicly support the public disclosure of underlying portfolio company information. In July, Attorney General Abbott ordered the Texas Growth Fund to disclose certain information regarding its portfolio companies. In response the fund filed suit, joined by the state's Teacher Retirement System (TRS Texas), arguing that state law did not mandate disclosure, and that the release of such information would harm its marketplace interests and exclude TRS Texas from lucrative investment opportunities. A few months later in October, Attorney General Abbott reiterated his position in a speech before the Freedom of Information Foundation of Texas. This threat of disclosure sent tremors through the investment community, spurring a large lobbying effort that perhaps led Attorney General Abbott to soften his position and support proposed legislation requiring the disclosure of fund-level information, including information on IRRs and fees, but not portfolio company information.

- *Michigan.* In 2003, the University of Michigan was requested to sell its interest in a private fund after disclosing fund-specific performance data in response to an information request. As a direct result, the Michigan legislature passed a bill limiting disclosure to fund names, aggregate commitment amounts and aggregate performance data.

Several states have followed Michigan's lead and codified the "compromise," in part to avoid court battles on the issue. In April 2004, Colorado enacted a bill preventing the release of portfolio company information but subjecting top-line fund information, including internal rates of return, to disclosure. A number of other states, including Florida and Illinois are considering similar measures.

The Market Force: How Private Funds Have Responded

Despite the general agreement in many states that the "compromise" strikes the right balance between disclosure and confidentiality, significant concerns remain within the fund industry. Many sponsors fear that continued requests to release top-line fund information will soon evolve to requests for information on underlying portfolio companies. And some funds continue to take a strong stand that "private" funds are just that — and consequently should be categorically exempt from any disclosure requirements.

Responding to these concerns, many funds withhold certain information from public limited partners or require that public limited partners inspect such information in the fund's offices and not take copies of information that could be subject to disclosure. Some funds have taken even more draconian steps, ejecting public limited partners due to their possible adverse effect on the fund. In 2003 for example, disclosure concerns resulted in Sequoia Capital moving to oust two public limited partners, the University of Michigan and the University of California, from its existing funds.

Other funds have taken a less aggressive, but more far-reaching approach, by refusing to permit public limited partners to invest in future funds. U.S. Venture Partners closed its ninth fund in November 2004 with plus or minus $600 million in commitments, none from public institutions subject to public disclosure laws. According to *Private Equity Analyst*, CalPERS, Washington State Investment Board and Virginia Retirement Systems were among the past partners that were not invited to invest in the new fund. Other private funds, such as Charles River Ventures have also refused to accept public pension money in their new funds citing disclosure concerns.

International Obligations

Perhaps the most important international development in regard to disclosure has occurred in the United Kingdom. The UK's "Freedom of Information Act 2000" (the UK Act) took effect on January 1, 2005. Applicable to any information held as of that date — even if obtained prior to January 1, 2005 — the UK Act permits individuals and businesses access to any information held by public authorities in the U.K. (*e.g.*, pension funds, governmental departments, public educational institutions). And unlike U.S. public disclosure laws, the UK Act does not mandate that funds receive notice of disclosure, or an opportunity to contest the planned disclosure, before disclosure is made. For further discussion of the UK Act, see *The Impact of the UK Freedom of Information Act on Private Funds*, on page 9 of this issue.

Private Fund Protections

As the law with respect to disclosure continues to develop both abroad and here at home, one thing is clear — private funds would be well advised to take steps to address disclosure concerns proactively rather than rely on policy to be crafted by legislative or judicial means.

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UK Freedom of Information Act Could Spell Trouble for Private Funds

Private funds with UK public authorities as limited partners rang in the New Year to some potentially troubling news. The United Kingdom's Freedom of Information Act 2000 became effective in full on January 1, 2005 (UK FOIA). Unlike the well-documented Freedom of Information Act battles in the United States that are discussed elsewhere in this issue, the private equity community is less familiar with, but perhaps should be more concerned about, UK FOIA. The Myners Report, which was released in 2000 and called for increased participation in private equity by pension plans (including public plans), helped focus the UK public's attention on private equity as an investment asset class. It is precisely this investor group that is likely to become a focus of public attention as it faces requests for the disclosure of information as a consequence of UK FOIA.

UK FOIA applies to public authorities in England, Wales and Northern Ireland, but not Scotland. The legislation is too new and untested for case law precedent to have developed, and as yet there are no detailed guidelines and procedures to provide practitioners with much certainty about how it will be applied or enforced in a private equity context, but the theoretical scope of the statute is wide and its exemptions are potentially narrow. We answer a few threshold questions about UK FOIA below and offer some suggestions on how private equity firms with UK public investors may adapt to the UK's new freedom of access regime.

Who is covered by the new law?

UK FOIA grants a general right of access by allowing any person (including foreign nationals and companies) to request information from a UK "public authority," a term that includes a broad range of state entities such as local government departments, the Bank of England, health authorities, educational institutions, and UK public pension plans. Any person that makes a request to a public authority is entitled (1) to be informed in writing by the public authority as to whether or not the public authority holds the information described in the request and, if it does, (2) to have the information disclosed. (Note that UK FOIA is retrospective: it applies only to information "held" by a public authority at the time a request is received, including information obtained by the public authority before the date that the new law took effect. There is no prospective requirement for the authority to continually update information.)

What information is accessible?

The information subject to a right of access potentially includes fund performance and/or portfolio company data that has been provided to public authorities investing in a fund. There is currently insufficient guidance to determine if the UK public authorities and the supervisory body governing the enforcement of UK FOIA will consider fund-level information (*e.g.*, management fees, IRRs, other performance data) to be a trade secret, and therefore eligible for an exemption from disclosure, or for that matter if portfolio company information will receive any greater protection against public disclosure, as has been the case in the U.S. private equity market concerning requests for information under U.S. FOIA. Certain UK practitioners have even voiced concerns that due diligence information on portfolio companies in a fund manager's track record that is provided to prospective investors during fund-raising may be eligible for disclosure under UK FOIA.

What exemptions are available?

The general right of access to information is subject to a number of exemptions, but the two most relevant to private equity firms are the "confidential information" and the "commercial interests" exemptions.

Confidential Information

There is an exemption for the disclosure of information that would be a legally actionable breach of confidentiality. However, there are several limitations to the exemption: a public authority should only accept confidential information if it is in connection with the exercise of its public functions

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Unlike the well-documented Freedom of Information Act battles in the United States . . . the private equity community is less familiar with, but perhaps should be more concerned about, UK FOIA.

and accepting the confidential information is for good reason that can be justified to an Information Commissioner (an independent official appointed to oversee UK FOIA). Public authorities may not "contract out" of their UK FOIA disclosure obligations by agreeing to broad confidentiality restrictions. It will likely take a few test cases to determine the limits of the availability of the confidentiality exemption.

Commercial Interests

The commercial interests exemption is available if disclosure of the information is likely to prejudice the commercial interests of any person. This exemption also has significant limitations: despite the commercial interests at stake, a public authority may have a duty to release the information under the so-called "public interest" test (*i.e.*, if the public interest in disclosure outweighs the public interest in respecting the exemption). Until there is a consistent set of precedent decisions to rely on, and because the public interest test is not easily or mechanically applied, it is possible that different public authorities will reach different conclusions when applying the test in similar situations.

How does a private equity firm know that a request for disclosure has been submitted to one of its public authority investors? There is no requirement under UK FOIA for a fund manager to receive advance notice when a public authority plans to release information. There is however a code of practice that recommends that public authorities seek consent in certain circumstances, but the code is only a guide to consult on best practices and does not create an enforceable obligation to notify or seek consent. There is a risk that a public authority that is not particularly well versed in the rules and exemptions of UK FOIA (and the code of practice) may agree to release all information requested without any advance notice to, or even consultation with, the fund manager.

Is there an appeal process? A person who is refused a request for information by a public authority may challenge the decision not to disclose by appealing to the Information Commissioner. Following the Commissioner's ruling, the losing party (*i.e.*, either the person requesting the information or the public authority) may seek to overturn the decision of the Commissioner by appealing to the Information Tribunal (an independent supervisory panel). However, third parties that provide information to public authorities (*e.g.*, a private equity fund) and disagree with a decision by either the public authority or the Commissioner to release information do not have the same rights to challenge the public authority's position by going to the Commissioner, nor may they appeal the Commissioner's decision by turning to the Information Tribunal. The third party's only recourse is to pursue legal proceedings through the courts.

What can a private equity firm do in advance? We offer a few suggestions while practitioners await more clarity on how UK FOIA will be applied:

- Review the fund's investor base and identify those investors who may be subject to UK FOIA.
- Require public authority investors to provide the fund manager prompt notice of UK FOIA requests for information about the fund and to cooperate with the fund manager in seeking an exemption from disclosure.
- Consider keeping selective information confidential from public authority investors.
- Include in the fund agreement a provision allowing the fund manager to require a public authority investor to withdraw or transfer its interest in the fund in order to protect the fund or its portfolio investments from harmful disclosures.
- Ensure that all communications between the private equity firm and its investors are marked as confidential and regularly remind investors of the contractual confidentiality obligations contained in the fund's agreements.[1]

We will continue to update you on how to protect yourself against unwanted disclosures pursuant to UK FOIA as the first test cases are handled.

Geoffrey Kittredge
gkittredge@debevoise.com

Saloni Joshi
sjoshi@debevoise.com

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[1] *As mentioned above, the confidentiality provisions in partnership agreements and other governing documents will not serve automatically to protect fund information from disclosure under UK FOIA. The Lord Chancellor has specifically advised that public authorities cannot simply "contract out" of disclosure, without meeting the other components of an exemption.*

Is Your Auditor in a State of Independence?

Insuring the independence of auditors has become a headline item not only for public companies, but for privately-held companies as well. In a world plagued by accounting scandals, with only four major accounting firms left standing and increasingly tangled non-audit relationships between auditors and their audit clients, the importance of auditor independence to investors, regulators, commentators and practitioners cannot be overstated. Although much of the substance of the auditor independence rules has been in place at least since 2001, the amendments flowing from the Sarbanes-Oxley Act, which became fully phased-in as of May, 2004, have forced us all to come to grips with a dizzyingly complex set of rules that has some surprising results for private equity. However, with some forethought and vigilance, sponsors should be able to control and mitigate many of the more unpleasant risks.

The Rules

The basic rule is that an auditor is not independent of its audit client if it cannot — or a reasonable, knowledgeable investor would conclude that it cannot — exercise objective and impartial judgment on all auditing issues. The auditor independence rules go through eight specific, non-exclusive circumstances that would violate the basic rule. These relate to:

- financial relationships between the auditor and audit client;
- employment by the audit client of certain professional employees of the auditor, or certain of their relatives;
- business relationships between the auditor and the audit client;
- the provision by the auditor of certain non-audit services to the audit client ("prohibited non-audit services");
- receipt by the auditor of a contingent fee for services;
- failure by the auditor to rotate audit partners according to specified schedules;
- failure of the audit client's audit committee to pre-approve the provision by the auditor of audit and non-audit services; and
- compensation received by any audit partner based on sales of services or products to the audit client.

Running afoul of any of these rules, even inadvertently or in a relatively minor way, can compromise the ability of a public reporting company to include in its public filings the audit report of the tainted auditor. A company that discovers that its auditor is not independent may be unable to file its public reports on time — which could lead to a parade of horribles, including potential covenant breaches in the company's debt instruments and an inability to access the capital markets.

Private equity sponsors that have public parents or public portfolio companies are very much subject to these rules. Most of them apply not only to relationships between the auditor and the audit client itself, but also to relationships between the auditor and any of the audit client's "affiliates." An affiliate for these purposes includes the classic control, controlled or common control relationships, but also includes relationships in which the audit client has "significant influence" over another entity, unless the entity is not material to the audit client. Fortunately, as a practical matter, the significant influence test, which is presumptively triggered by a 20% interest, is unlikely to be relevant to private equity sponsors, because most portfolio companies will not be material to the private equity group's public parent or any sister portfolio company.

The control aspect of the definition, however, can lead to difficulties. In most cases, a private equity sponsor's portfolio companies will all be under common control, and will therefore be affiliates of one another. Thus, an accountant's improper relationship with, or provision of prohibited non-audit services to, one portfolio company can taint that accountant's independence as the auditor of another portfolio company (see below). And if the private equity firm is itself controlled by a public parent, the independence of the parent's auditor could be compromised if it provides prohibited non-audit services to a portfolio company — even one that is small relative to the parent.

Although many of the potential chinks in an auditor's independence should be controllable, the restrictions on prohibited non-audit services can often create real concern. These services include bookkeeping services, financial information system design and implementation, appraisal, valuation and actuarial services, internal audit services that the client has outsourced, management functions, services relating to decisions regarding the hiring or retaining of employees by the client, broker-dealer, investment advisor or investment banking services, legal services and other expert services relating to the audit. (Note that most tax-related services would not be picked up in this litany, although under rules the Public Company Accounting Oversight Board has recently proposed the provision of certain aggressive tax advice could impair an auditor's independence.) The SEC, in prohibiting these services, expressed concern that, for instance, an auditor that provides its

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audit client with bookkeeping services will be less likely to perform a thorough, unbiased audit, because it will be loathe to second-guess its own decisions as bookkeeper. Similarly, an auditor that helps an audit client select a manager will be less likely to objectively challenge that manager's decisions during the audit.

During the past decade or so, accounting firms have dramatically increased the level of non-audit services they provide to audit as well as non-audit clients. This, together with the ever-dwindling field of prominent accounting firms and the difficulty of quickly switching auditors or providers of non-audit services, makes these restrictions particularly troublesome.

Effects on Private Equity Sponsors

How can these rules haunt a private equity firm in practice?

- *Disposition of Portfolio Company.* A private equity firm ready to dispose of one of its portfolio companies may weigh, among other alternatives, an initial public offering or a sale to a third party. Consider a sale first. If the buyer is public and the portfolio company is large enough, the buyer will need to provide in its public filings up to three years of audited financials of the portfolio company. If the portfolio company's auditor was not independent during any of those periods — because it provided a valuation opinion to the company, for instance — its audit may not be included in the buyer's public filing. The buyer would likely insist on having a different accountant re-audit the portfolio company's financials before the sale was completed. Assuming an independent auditor could be found, the re-audit process would take time and cost money, which could delay if not scuttle the deal.

  The same problems arise when the sponsor contemplates an initial public offering of its portfolio company, because the registration statement must also include audited historical financials. Of course, the private equity firm has some greater control over the timing and can commission the re-audit early on in the process. Keep in mind, however, that the rules kick in as soon as the preliminary registration statement is filed, so you can't use the SEC review period to conduct the re-audit.

  The problem may be exacerbated when the private equity firm turns a portfolio company relatively quickly. Because three years of audited financials are often required upon disposition, if the portfolio company is acquired and then sold in less than three years, it will be important to know whether the prior owners had maintained the independence of the company's auditors. If not, the sponsor may want to have the financials re-audited as soon as the acquisition closes if there is any chance that it might dispose of the company in short order.

- *Capital Raising by a Portfolio Company.* Similar issues can arise when a portfolio company looks to raise capital in the public markets. For instance, a company that offers 144A debt to be followed by an A/B exchange offer to convert the privately placed debt into public, registered debt will need to be able to provide historic financials for the company audited by an auditor that was independent during each of the periods presented.

- *Restatements.* Because an auditor's independence is judged with respect to a particular audit period, an auditor who is currently independent with respect to a portfolio company may not be able to re-audit (for instance, in connection with a restatement) prior year financials if the auditor wasn't independent during the prior period. This suggests that a private equity firm that replaces a portfolio company's current auditor in order to prepare the company for a sale ought to choose the replacement carefully, with an eye not only to the auditor's current, but also its recent past, independence.

- *Cross-Affiliation of Portfolio Companies.* One issue that has plagued private equity firms is whether the independence of the auditor of one portfolio company is tainted by its relationship with another portfolio company. Technically, under the rules, sister portfolio companies, being under common control, are affiliates of one another, and therefore there could be a taint. There is an exception with respect to a number of the more common types of prohibited non-audit services — bookkeeping services, financial information system design and implementation, appraisal, valuation and actuarial services and internal audit services that the client has outsourced ("limited exception services"). Provision of these limited exception services will not taint the independence of an auditor if "it is reasonable to conclude that the results of these services will not be subject to audit procedures." It is hard to see how the provision by an accounting firm

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Hedge Fund Registration Q&A

In our Fall 2004 issue, we reported that the SEC had proposed a new rule under the Investment Advisers Act of 1940 ("Advisers Act") requiring hedge fund advisers, including those based offshore, to register with the SEC. As expected, the SEC adopted the rule in December 2004 substantially as proposed. Onshore and offshore advisers captured by the new rule must register with the SEC by February 1, 2006. Below we explain some key aspects of the new rules in a question and answer (Q&A) format.

Q: What is the main impact of the new rules?

A: An investment adviser to a hedge fund must look through the fund to its investors for purposes of counting the number of clients the adviser has. If an investment adviser has more than 14 U.S. clients in total, then the adviser must register with the SEC. Previously, an adviser counted a hedge fund as only one client and there was no look-through to the investors in the fund for purposes of determining the 14-client limit. Once registered, an investment adviser is subject to substantive regulations under the Advisers Act. Special rules, described below, apply to non-U.S. investment advisers.

Looking Through

Q: What is a hedge fund for purposes of the new look-through requirements?

A: The SEC defines a hedge fund as a "private fund" that (1) is relying on one of two exceptions from the definition of investment company under the Investment Company Act of 1940 (so-called Section 3(c)(1) or Section 3(c)(7) funds); (2) permits redemptions of investments within two years of purchase; and (3) is offered based on the investment advisory skills, ability or experience of the investment adviser.

A right of redemption is the investor's right to put the interest in the fund back to the fund. The two-year redemption test applies to each interest purchased on or after February 1, 2006, but not to those made prior to that date. Thus, most private equity fund sponsors will not be subject to the look-through rule because private equity funds typically do not provide for redemption rights.

Q: How is the two-year period measured?

A: The two-year period is measured from the date on which the interest is purchased or the capital is contributed. For example, if the investment is made in two installments, then two redemption periods would be measured, one from the date of each installment.

Q: Are there any exceptions to the two-year redemption test that apply to existing investors in an adviser's hedge fund?

A: Yes. The two-year redemption test does not apply to: (1) any investments made prior to February 1, 2006; (2) interests acquired through the reinvestment of distributed capital gains or income; or (3) interests redeemed for "extraordinary" reasons. For example, a fund would not be subject to the look-through rule if it permits redemptions upon the death or disability of an investor or if circumstances make the investor's continued participation in the fund illegal or impractical.

Q: Is a private equity or venture capital fund adviser subject to the new rules?

A: No, because such funds typically do not permit redemptions within two years of investment, except for "extraordinary" events.

Q: Who counts as an investor in a hedge fund for client counting purposes?

A: If the fund is organized as a corporation, each shareholder is counted; if it is organized as a partnership, each partner; if it is organized as an LLC, each member; and if it is organized as a trust, each beneficiary. The adviser itself (or a managing partner, member, etc.) does not need to be counted. Investors who are executives, partners or other "knowledgeable employees" also do not count.

Q: How do the look-through rules apply to a fund of hedge funds structure?

A: An adviser to an underlying hedge fund must look through any of

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If an investment adviser has more than 14 U.S. clients in total, then the adviser must register with the SEC . . . . Most private equity fund sponsors will not be subject to the look-through rule because private equity funds typically do not provide for redemption rights.

its investors formed as a fund of hedge funds, whether a public or private fund of hedge funds, and count the investors in the fund of hedge funds. For these purposes, a "fund of funds" is defined as a pooled investment vehicle that invests 10% of more of its total assets in other pooled investment vehicles that are not, and are not advised by, related persons.

Q: How do the look-through rules apply to a master-feeder structure?

A: An adviser to a master fund must look through the master fund as well as any of its feeder funds for purposes of counting clients.

Offshore Advisers

Q: Does the new rule apply to offshore advisers?

A: Yes. An adviser whose principal office and place of business is outside of the United States must register if it has more than 14 clients "resident" in the United States. Unlike advisers with their principal office and place of business in the United States, which must have at least $25 million in assets under management to register with the SEC, there is no minimum amount of assets requirement for offshore advisers.

Q: How is U.S. residence for a client determined?

A: For individuals, their residence. For corporations and other business entities, their principal office and place of business. For personal trusts and estates, follow the rules under Regulation S. For accounts managed by another investment adviser, the jurisdiction of the person for whose benefit the account is held. The place of residence is determined at the time of investment.

Q: Does an offshore adviser to a non-U.S. hedge fund need to look through the non-U.S. hedge fund for client counting purposes?

A: Yes. It must look through a non-U.S.. hedge fund to determine if an investor is a U.S. resident. Each U.S. resident investor counts toward the 14-client limit. As is the case with U.S. advisers to a hedge fund, an offshore adviser to a non-U.S. hedge fund must look through an investor formed as a fund of funds (even if it is an offshore fund of funds) to count U.S. resident investors as clients. Similarly, an offshore adviser to an offshore master fund within a master-feeder structure must look through the master fund and any of its feeder funds organized as private funds sold directly to U.S. investors and count U.S. investors as clients.

Q: Is there an exception for offshore advisers already regulated in their home countries?

A: No. Even offshore advisers to publicly offered hedge funds outside the United States must look through such funds to count U.S. clients. However, an offshore adviser that makes public offerings of non-U.S. funds regulated as other kinds of public investment companies under non-U.S. law (*e.g.*, UCITS funds) need not look through such funds for client counting purposes.

Q: If an offshore adviser to an offshore hedge fund must register with the SEC because there are more than 14 U.S. resident clients in its hedge funds, what substantive regulation applies?

A: Importantly, in this situation, the SEC views the offshore hedge fund itself as the non-U.S. client (rather than the investors). As a result, the substantive provisions of the Advisers Act, other than certain books and records requirements and inspection rights, do not apply to the offshore investment adviser's relationship with the offshore hedge fund. Other substantive regulations under the Advisers Act would not apply to such an offshore adviser if it has no U.S. clients other than for counting purposes. However, if the off-shore manager has any U.S. clients (*e.g.*, a Delaware limited partnership), it must comply with the substantive provisions of the Advisers Act, including compliance, custody and proxy voting rules with respect to those clients.

Offshore advisers subject to the rule, as well as unregistered onshore advisers, are subject to the anti-fraud provisions of the Advisers Act.

Transition Issues

Q: Is a newly registered adviser prohibited from using its pre-registration track record because it does not have the books and records required under the Advisers Act to substantiate the record?

A: No. An adviser required to register by virtue of the new rule is excused from the recordkeeping rule with respect to any of its existing accounts. However, the adviser must retain whatever records already exist to document its pre-registration record.

Q: Must a newly registered adviser kick out from its funds any investors not meeting the performance fee "qualified client" definition?

A: No. Although the Advisers Act prohibits an adviser from charging a performance fee in respect of investors that are not "qualified clients" (generally clients with $750,000 under

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Deferred Compensation Rules Revisited

In the Fall 2004 issue of this publication ("U.S. Congress Approves Sweeping New Rules on Deferred Compensation"), we highlighted some of the new rules established under the American Jobs Creation Act of 2004 pertaining to nonqualified deferred compensation arrangements. In late December, the Treasury Department released its first installment of anticipated guidance with respect to the new rules. The initial guidance from Treasury has helped clarify some of the new deferred compensation rules and provides some transitional relief for 2005, but leaves some important questions unanswered.

Our Fall 2004 article discussed some of the particular effects that the new deferred compensation rules may have on private equity funds, including possible new limitations with respect to (1) stock appreciation right awards and other forms of equity-based compensation, (2) compensation "rollovers" in connection with an acquisition and (3) certain fee arrangements with respect to fund managers. The preliminary guidance from Treasury (Notice 2005-1) has added some color to these issues, while opening the door to new questions regarding the scope of the new rules.

General Background

In the run up to last year's U.S. federal election, Congress radically revised the income tax rules for deferred compensation. The new rules replace fuzzy — but taxpayer-friendly — judicial precedents with mechanical rules imposed at the behest of the IRS to curb real (and imaginary) abuses. The result — Section 409A ("four-oh-nine cap A") of the Internal Revenue Code — the new deferred compensation rules. Although there are exceptions for qualified pension plans and truly short-term deferred payments and some other items, the new law applies to "nonqualified deferred compensation," which is so broadly defined that it can pick up almost any payment for services rendered in one year that is to be paid in a subsequent year.

The details of the new rules are (fortunately) outside the scope of this article, but the basic gist is to impose very mechanical rules requiring deferral elections to be made far in advance and new restrictions on what events can trigger payment of the deferred amounts. These new rules are particularly ill-suited for the kind of flexible and custom-structured arrangements that are a common feature of management arrangements in private equity transactions.

Why It Matters (or, The Cost of Getting It Wrong)

Nonqualified deferred compensation that does not comply with the new and arcane rules of § 409A gets hit with an additional 20% tax (over and above regular income taxes), plus interest, once that non-compliant nonqualified deferred compensation is paid or no longer subject to a substantial risk of forfeiture (whichever is earlier).

During 2005, these arrangements can be cleaned up or paid out without being subject to the new additional tax. Deferrals of pre-2005 compensation are generally grandfathered and will continue to be governed by the old rules. Figuring out what to do with existing arrangements will occupy a lot of time for many companies, executives and tax advisors, but just as importantly, it is worth understanding how the new rules will constrain some management arrangements in private equity transactions going forward.

No More SARs

Stock appreciation rights ("SARs") are quite unusual for private equity portfolio companies, and the new rules will not change this result. A stock appreciation right does not cause a problem under § 409A in and of itself, but it must comply with all of the rigid timing rules for when the award can be paid out if it is to avoid the extra 20% tax. By losing the flexibility of when they could be exercised, stock appreciation rights lose much of their desirability. There will almost invariably be cases where the tax rules would dictate payout at a time that

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How will the new deferred compensation rules affect private equity funds and their portfolio companies?

- No more SARs or discounted stock option grants.
- New limitations on deferred share and restricted unit awards.
- Very difficult to achieve tax efficient compensation "rollovers" in connection with acquisitions.
- New limitations on change in control acceleration payments.
- Need to analyze management fee arrangements to ensure compliance.

does not match up with what people might want from a purely business perspective — perhaps earlier, or perhaps later — and this sort of uncertainty will probably keep stock appreciation rights off the usual menu for private company management incentive programs. (For public companies with regular SAR programs, there is room for continued awards.)

No More Discounted Stock Options

The Notice from Treasury confirms that "at the money" stock option grants will be exempt from the new deferred compensation rules and also exempts certain tax qualified stock options. However, a discounted nonqualified stock option (i.e., an option with an exercise price that is less than the grant date value of the underlying shares) will generally be subject to — and run afoul of — the new deferred compensation rules, thereby subjecting the optionholder to the onerous 20% penalty tax under the legislation. This may put some added pressure on privately held companies to confirm that their methodology for establishing "fair market value" of their stock is a legitimate reflection of true fair market value. In this regard, it is helpful to note that the Notice permits the use of "any reasonable valuation method" for purposes of determining whether the option exercise price is at least equal to the grant date value of the underlying shares.

While the definition of "change in control" now supplied by Treasury under the Notice is fairly liberal . . . the definition under the Notice would not include a change in control with respect to a non-corporate entity. Therefore, portfolio companies organized as LLCs or partnerships may be precluded from cashing out deferred compensation arrangements in connection with a change in control transaction.

Other Equity-Based Awards

Grants of restricted property, such as restricted stock awards, are not considered deferred compensation under the Notice, and therefore are not subject to the new statutory requirements. However, a plan providing employees with a legally binding right to receive cash or shares in a future year (*e.g.*, with "restricted unit" or "deferred share" awards) falls squarely under the new rules. This does not mean "No More Deferred Share Awards;" rather, as is the case with SARs, it means that these tax-deferred share awards will have to comply with the new rigid timing rules of § 409A. Because these rules remove so much of the flexibility that had allowed private companies to match payment (delivery) with liquidity events, deferred share awards will lose some of their luster, but they will continue to have their uses.

Compensation Rollovers

The Notice does not provide any special flexibility to facilitate tax efficient compensation "rollovers" (*e.g.*, the conversion of stock option gains or transaction bonuses into a deferred equity interest) in connection with an acquisition. Therefore, as noted in our Fall 2004 article, it may be impossible in most situations for a fund to structure such a rollover arrangement on a going-forward basis.

Change in Control Payment Triggers

Under § 409A, a deferred compensation plan may permit a change in control triggered distribution only in connection with a "change in control" as defined by Treasury for these purposes. Thus, an accelerated distribution in connection with a portfolio company transaction that does not constitute a "change in control" as defined by Treasury will generally violate the statute and result in the imposition of the 20% penalty tax. While the definition of "change in control" now supplied by Treasury under the Notice is fairly liberal with respect to transactions involving corporations — for instance, permitting the change in control test to be applied at either (1) the employing corporation, (2) the corporation liable for the payment or (3) a direct or indirect majority shareholder of the employer or obligor corporation — the definition under the Notice would not include a change in control with respect to a non-corporate entity. Therefore, portfolio companies organized as LLCs or partnerships may be precluded from cashing out deferred compensation arrangements in connection with a change in control transaction.

Fee Arrangements

In our Fall 2004 article we noted that certain funds might choose to amend their fee arrangements to the extent that the fee arrangements might otherwise be characterized as resulting in a deferral of compensation within the

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Don't Trip over a Tender Offer: Buying Public Companies in France

With interest in European buyout opportunities never higher, private equity funds contemplating an investment in a French public company should be mindful that such an investment could inadvertently trigger a requirement to launch a tender offer to protect the company's remaining shareholders.

Fortunately, in the real world, there have been very few cases in which a party has been unknowingly forced to launch a tender offer because of the mandatory tender offer rules. In most cases, the rules come into play for the purpose of requesting (and, in almost all cases, obtaining) a derogation, but these rules should also be kept in mind when structuring a public company purchase in order to avoid unanticipated surprises.

This article will describe the cases in which a tender offer must be launched, the applicable derogations, the principal features of the offer, and the consequences of not complying with the mandatory tender offer rules.

Is There a "Concerted Action"?

Understanding the notion of "concerted action" is an important prelude to a discussion of the mandatory tender offer requirement since parties acting in concert without intending to do so can trigger the requirement for a tender offer.

Broadly speaking, two or more parties found to be acting in concert with respect to a listed company will be regarded as one for purposes of the securities laws. This means, among other things, that their ownership interests in the company will be aggregated to determine, for example, whether any thresholds have been attained or exceeded. There are several indicators that help in determining where a concerted action is likely to exist.

First, there needs to be a legally enforceable prior agreement among the parties (who need not be shareholders of the company concerned). Second, the purpose of the agreement must be the acquisition, disposition or exercise of voting rights in the company with a view to implementing a common strategy with respect to the company.

Pursuant to this approach, a sale/purchase transaction or option, a right of first refusal or a preemptive right cannot, without additional provisions, be regarded as indicative of the existence of a concerted action, because in these agreements the interests and objectives of the parties are essentially different. In other words, the purpose of these agreements is not to create a future ongoing cooperation between the parties with respect to the company or the parties' interests in the company.

The conclusion would be different where, for example, two or more shareholders agree to consult with each other prior to the election of the members of the board or prior to any major corporate decision to be taken by the shareholders. Lock-ups, tag along, and take along clauses are generally regarded as indicative of a concerted action.

The *Autorité des Marchés Financiers* (AMF) is charged with the determination of the existence of concerted actions subject to review by the Paris Court of Appeals. Recent practice suggests that the AMF is increasingly relying on the parties' own characterization of their agreements (as to whether they act in concert), subject to the validation of this characterization by the courts if there is any dispute.

When Must a Tender Offer Be Launched?

There are two principal cases where a tender offer must be launched: Upon the crossing of a fixed (one-third) threshold of ownership interest in the company, or following the incremental acquisition of shares by shareholders who already hold more than one-third of the shares of the company, but who have not already been required to launch a tender offer because of an applicable exception or derogation ("acquisition speeding").

The One-Third Threshold

Where a shareholder, or a group of shareholders acting in concert, happens to hold more than one-third of the shares or voting rights[1] of a listed company, it or they must immediately launch a tender offer for the shares of such company.

- *Direct Crossing.* A direct crossing of the one-third limit can occur irrespective of whether the shareholders concerned crossed the threshold "passively", *i.e.*, through no action on their part. This could result, for instance, from an acquisition of shares, an acquisition of double voting rights, a cancellation of shares by the issuer, or a loss of double voting rights by other shareholders. Only shares with voting rights are taken into account, such that, if a company has non-voting shares, one may actually cross the one-third threshold with less than one-third of the aggregate share capital.

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[1] *The reference to voting rights relates to the situations where the total number of shares and the total number of voting rights are different (e.g. because of the existence of double voting rights for certain shares, or because of the existence of treasury shares, which are non voting under French law).*

- *Indirect Crossing.* An indirect crossing of the one-third threshold can also occur if a person or entity acquires a controlling interest in a company (the “intermediate company”) that holds more than one-third of the shares or voting rights of a listed company where the interest in the listed company represents an essential portion of the intermediate company’s assets.

  Under one scenario, an indirect crossing can occur where a person acting alone (or a group of persons or entities acting in concert) acquires a controlling interest in the intermediate company. If it is a French company, this means either holding a number of shares that confer a majority of voting rights at the shareholders’ meetings, or holding a majority of voting rights pursuant to a valid shareholders’ agreement, or exercising *de facto* control over the decisions of the shareholders’ meetings through the exercise of voting rights. There is a presumption that a company controls another company where the former holds, directly or indirectly, in excess of 40% of the voting rights of the later and no other shareholder holds, directly or indirectly, a greater percentage of voting rights.

  An indirect crossing can also occur when the intermediate company is merged into another company, or where the shares of the intermediate company are contributed to another company. In this case, the person or entity (acting alone or in concert with others) who is taking the ultimate control of the intermediate company is required to launch a tender offer for the shares of the listed company.

Acquisition Speeding

If a shareholder or a group of shareholders acting in concert holds between one-third and one-half of the shares or voting rights of a listed company but has not been required to launch a tender offer (due to an applicable derogation), the obligation to launch a tender offer may still arise. In short, if such shareholder (or group) increases the number of shares or voting rights it holds by 2% or more of the total shares or voting rights of the company over a period of less than twelve consecutive months, it must immediately launch a tender offer for the shares of such company. This incremental acquisition of shares is often referred to as “acquisition speeding.” For this purpose, only the shares that carry voting rights are to be taken into account.

Derogations

The mandatory tender offer rules are subject to two sets of derogations, which, except for the first one discussed below, apply equally to cases relating to crossing the one-third threshold and to acquisition speeding.

1. The AMF regulations identify two cases where no tender offer is required:

- *Temporary Crossing of Threshold.* A shareholder is not subject to the mandatory tender offer rules, as long as the number of shares and voting rights held in excess of the threshold is less than 3% of the total number of shares and voting rights of the company, and if this situation does not last for more than six months. In addition, the shareholder concerned must not vote the excess shares during this period. This exception may only apply pursuant to a decision of the stock market authorities, which must be obtained prior to the crossing of the threshold.

- *Initiation of Concert without Change of Control.* This refers to situations where there is an existing controlling shareholder (or group of shareholders) that remains in control following the crossing of the one-third threshold or the violation of the acquisition speed limit by another shareholder. In these situations, since there is no change of control of the company, there is no mandatory tender offer.

  There are two sub-cases: one is not subject to the mandatory tender offer rules if the person or entity that crosses the threshold or exceeds the acquisition speed limit is acting in concert with one or more shareholders who already hold at least 50% of the shares or voting rights, and if these shareholders remain “predominant” in the company (which may be through special governance rights, for example). There is also no mandatory tender offer if such person or entity is acting in concert with one or more shareholders who already hold between one-third and one-half of the shares or voting rights, and if these shareholders’ interests in the company remain greater than that of such person or entity, and if none of these shareholders crosses the one-third threshold or exceeds the acquisition speed limit in connection with this concerted action.

2. Seven cases are specifically identified as bases for derogations:

- *Certain Free Transfers.* Where the one-third threshold or the acquisition speed limit is exceeded by an

individual as a result of receiving shares or voting rights without consideration from another individual, *i.e.*, gifts and inheritance or because they are received as part of a spin-off, a distribution of assets to the shareholders or a payment of dividends-in-kind as long as they are made in proportion to the interests held by the shareholders in the entity that is making such transfer.

- *"Rescue" Cash Capital Increase.* Where the one-third threshold or the acquisition speed limit is exceeded because of the acquisition of shares of a company that is objectively in a difficult financial position. This derogation is intended to facilitate the contribution of new capital to the company without placing the "rescuers" in a situation where they must buy out the other shareholders.

- *Merger or Asset Contributions.* Where the one-third threshold or the acquisition speed limit is exceeded because of the acquisition of shares of a listed company as a result of a merger of one or more entities into a listed company, or as a result of a contribution of assets to the listed company. In these cases, the shareholders of the entities that are absorbed by the listed company, and the owners of the assets that are contributed to it, normally receive shares of the listed company. Since, under French law, the merger or contribution requires the approval of the shareholders of the listed company, there is no need to give them an exit if the merger or contribution results in the one-third threshold or the acquisition speed limit being exceeded.

- *Merger or Asset Contributions and Concerted Action.* Where the one-third threshold or the acquisition speed limit is exceeded as a result of the combined effect of (1) the acquisition of shares of a listed company in a merger or contribution of assets and (2) a concerted action, where neither of these facts alone would trigger the obligation to launch a tender offer.

- *Reduction of the Number of Shares or Voting Rights.* Where the one-third threshold or the acquisition speed limit is exceeded "passively" as a result of an action of a third party.

- *Holding a Majority of Voting Rights.* Where the one-third threshold or the acquisition speed limit is exceeded as a result of an acquisition of shares by a shareholder who already holds (individually or in concert with others) a majority of the voting rights, and where holding such majority has not given rise to a mandatory tender offer due to an applicable derogation. In this case, there is no change in control because, by definition, the person or entity who exceeds the threshold or the speed limit already has the control of the company. This also applies if a majority of the voting rights is held by a third party.

- *Intra-Group Transfers.* Where the one-third threshold or the acquisition speed limit is exceeded as a result of an acquisition of shares or voting rights that is or may be regarded as an "intra-group transfer." In this case, analysis centers on whether the transfer of an interest that causes such excess has an impact on the ultimate control of the listed company. The expression "may be regarded" is intended to capture transactions, such as the restructuring of family interests into a holding company, which do not affect the ultimate control but would not fall within the scope of intra-group transfers.

Procedure

A derogation may be obtained by submitting a letter to the AMF before the occurrence of an event that would otherwise trigger the mandatory tender offer (*e.g.*, a shareholders' meeting), which avoids the risk that a party would find itself in a mandatory tender offer situation without the assurance of being granted the requested derogation (which usually takes about a month).

The letter requesting relief should reference the statutory basis for granting the requested derogation and explain the reason for applying such provision.

Principal Features of the Offer

If required, the tender offer must, among other things (1) be for any and all shares and equity-linked securities of the listed company; (2) contain no minimum tender condition; and (3) be at a price that the stock market authorities will find acceptable in light of usual valuation methods and the particular features of the listed company concerned.

Consequences of Not Launching a Mandatory Tender Offer

Failure to launch a required tender offer may result in extreme consequences, such as being deprived of voting rights or becoming subject to a court order requiring the launch of a tender offer. Therefore, acquirors of interests of French public companies should proceed with caution and be ready to apply for derogations to avoid having to launch a tender offer to buy out the minority.

Antoine F. Kirry
akirry@debevoise.com

Vendor Due Diligence Reports — Is It "Put Up or Shut Up" for Buyers? (cont. from page 1)

to have all representations and warranties in the purchase contract limited by whatever is disclosed (or "fairly" disclosed) in the VDD as opposed to specific exceptions to each representation and warranty as is common in the United States.

VDDs offer one final benefit to a seller. In a deal environment in which information is power (and often translates into money) a buyer's extensive due diligence efforts often leave them with vastly superior knowledge about the target than the seller. VDDs level the playing field.

Key Issues Raised by the VDD Trend

The trend toward using VDDs in the auction sale process raises the following issues for buyers:

- *Less opportunity to conduct independent due diligence.* Not surprisingly, sellers will encourage auction bidders to rely on the VDD in place of their own due diligence. Sellers generally accept that a buyer will want to conduct at least a certain amount of confirmatory due diligence after reviewing the report, but typically permit this only relatively late in the auction process. A potential buyer that conditions its bid on further access runs the risk that competing bidders are willing to proceed on the basis of less independent due diligence, or none.
- *Terms of the report provider's engagement.* Buyers and their financing banks will be asked to accept the terms of the VDD

Recent and Upcoming Speaking Engagements

January 13	Franci J. Blassberg, Moderator *Broadgate 59 Minutes: Meet the Press* New York, NY
January 21	Thomas Schürrle *Documentation for Venture Capital Financing* Business School, University of Dresden Germany
January 26	Rebecca F. Silberstein *Structuring Optimal Terms and Conditions in the Current Fundraising Atmosphere* Financial Research Associates' 2005 Private Equity Fund Formation Seminar New York, NY
January 27	Mary S. Boast *Annual Review of Antitrust Developments* New York State Bar Association Antitrust Law Section Annual Meeting New York, NY
February 10	Jennifer A. Burleigh *Private Equity Funds: Structures, Terms and Conditions* Association of the Bar of the City of New York New York, NY
February 21 – March 1	Michael P. Harrell, Conference Co-Chair *New & Innovative Products and Development* Kenneth J. Berman *The 'Nuts and Bolts' of U.S. Investment Adviser Regulation* Geoffrey Kittredge *Mezzanine Funds: Business, Legal and Tax* Sixth Annual International Conference on Private Investment Funds International Bar Association/American Bar Association London, England
March 3-4	Franci J. Blassberg, Program Chair *Special Problems When Acquiring Divisions and Subsidiaries* *Negotiating the Acquisition of a Private Company* 20th Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions San Francisco, CA

provider's original engagement letter with the seller, which may not be as favorable as those a buyer would negotiate for itself in a direct engagement. Engagement letters for accountants and other consultants in Europe commonly contain a liability cap, as well as an indemnity and other protections for the benefit of the report provider. Generally lawyer's engagement letters are fairly bland, but there is evidence that similar practice is developing (particularly in regard to accounting firms' legal affiliates). Sellers tend not to negotiate these provisions, and the liability cap prescribed in a VDD engagement letter may well be the provider's opening offer. Sellers may also be less sensitive than private equity buyers — and their banks — to other terms of the engagement, particularly indemnities.

- *Commoditizing the auction process.* Sellers see providing a VDD as a way of standardizing the information available to competing bidders and thereby commoditizing the auction process and the way in which potential buyers approach the asset. But by effectively limiting the scope of the independent due diligence buyers are permitted to conduct, the VDD approach also limits the extent to which private equity buyers can differentiate themselves by identifying hidden value.

Some Practical Advice

In approaching a sale process in which the seller is providing VDDs, buyers should keep the following points in mind:

- The extent to which a VDD can replace independent due diligence varies from case to case. Although duplicating the work represented by the VDD would rarely be feasible, VDD providers have different incentives in preparing their work than the buyer's own advisors. Not only is the VDD provider's primary relationship with the seller, but it may also be the beneficiary of healthy indemnities or exculpation clauses under its engagement letters.

  If the auction timetable permits, a sensible approach is to assess (together with your own lawyers and accountants) the quality of the advisor and the rigor and scope of the VDDs as a basis on which to determine the degree of independent due diligence necessary. If the seller is willing to provide access to the authors of the report, buyers should use this as an opportunity to delve deeper on issues that concern them, and further evaluate the quality of the work provided.

  Even if the VDDs seem to be thorough and carefully prepared, it is generally preferable for the buyer's own advisors to review very material issues and issues requiring subjective judgments. Auction buyers should assess their comfort level in relying on the VDD against the possibility that other bidders offering comparable price and terms will be willing to do so.

- Improved engagement terms are generally negotiable. Report providers present bidders with standard form release and reliance letters, but the terms are generally negotiable (although the underlying premises that the VDDs are initially provided to bidders on a non-reliance basis is not).

  Buyers can negotiate the terms of these letters to secure more favorable engagement terms — most importantly, with respect to the liability standard and/or cap that will apply — and weed out other terms a private equity client or its banks might be unwilling to accept, such as indemnities running towards the report provider.

  Although report providers may be reluctant to agree to enhanced liability or make other concessions with every bidder during the auction process, it is possible to get some assurance that they are willing to negotiate better terms once they know the identity of the winning bidder. ▢

Andrew L. Sommer
alsommer @debevoise.com

Wendy A. Semel
wasemel@debevoise.com

In a deal environment in which information is power (and often translates into money) a buyer's extensive due diligence efforts often leave them with vastly superior knowledge about the target than the seller. VDDs level the playing field.

of bookkeeping services, for instance, to one portfolio company would be subject to audit procedures by that accounting firm acting as auditor for a sister portfolio company, unless there was a commercial relationship between the two (and even in that case, it seems unlikely). Indeed, in informal conversations with members of the SEC's accounting staff, we were advised that in the absence of a commercial relationship between the companies, it will generally *not* be reasonable to conclude that the results of the services will be subject to audit procedures.

Nevertheless, the SEC has not provided any definitive guidance on this issue. Indeed, in a different context, it has stated that the provision of any prohibited services creates a rebuttable presumption that the services will be subject to audit procedures. Moreover, there is nothing in the rules that would protect the independence of a portfolio company's auditor if that auditor had any of the other types of relationships listed above with a sister company, such as financial, employment or business relationships, for instance. Nor would its independence be protected if it provided management, human resources, broker-dealer, investment banking, legal or expert services to the sister company — all prohibited non-audit services that don't have the "not subject to audit procedures" exception.

- *Acquisition of Portfolio Company.* There is generally no grace period when a sponsor acquires a new company. Any relationships the company has with accounting firms come into play immediately upon the closing of the acquisition, and can just as easily taint the independence of the auditors of public sister companies and parents as relationships between auditors and long-standing portfolio companies. Of course, prohibited non-audit services provided to a target before the closing of the acquisition will not taint the auditor's independence with regard to other portfolio companies or the sponsor's parent as long as those services are terminated before the closing.

- *"Club" Deals.* Deals involving a consortium of two or more private equity firms are subject to an enhanced risk that the portfolio company's auditor may be tainted. Each member of the consortium, depending on the structure and relationships among the members, may arguably "control" the new portfolio company. That means that if the company's auditor had provided prohibited non-audit services to any portfolio company controlled by any of the members, or to a parent company, if any, of one of the members, that auditor may no longer be independent with respect to the new portfolio company. Moreover, it may not be so easy to find an untainted Big Four accounting firm to replace the old auditor. Of course, as described above, an auditor's independence is in less jeopardy if the services provided are limited exception services.

- *Public Parent Company.* Many of the risks noted above are amplified where the sponsor is controlled by a large public parent. In the first place, it could be disastrous for the parent if its auditor lost its independence because it had a prohibited relationship with one of the sponsor's controlled portfolio companies, for instance, a newly acquired portfolio company which failed to terminate the prohibited relationship before the acquisition closed. Secondly, the rules would require the parent's audit committee to pre-approve any audit or non-audit services (whether or not prohibited) that its auditor provides to the parent or any controlled subsidiary (including, presumably, certain of the sponsor's portfolio companies). Failure to comply could taint the auditor's independence. Once again, this rule kicks in immediately after the acquisition of a company, without the benefit of a grace period. It may be difficult in a large institution to have the parent's audit committee convene to pre-approve every audit and non-audit service provided by an accountant to every controlled subsidiary in the group. Although pre-approval policies may be adopted by the audit committee, the SEC is very stingy about the breadth of these policies, and they are unlikely to be particularly helpful in most cases.

What Can Sponsors Do?

We understand that a handful of private equity firms, most of which are arms of larger financial institutions, have petitioned the SEC to relax the rules as they apply to sponsors. While it is too early to predict whether such efforts will be productive, it is likely that any relief would be limited to narrowing the scope of the term "affiliate" as applied to private equity groups and their portfolio companies. While helpful, other rules could still cause problems for sponsors. For instance, the SEC cannot be expected to relax the rules that would require a portfolio company's auditor to be independent of such company if the company wanted to

access the public markets or to sell itself to a public buyer.

What can private equity firms do to mitigate these issues? We suggest a few approaches below.

- *Monitor your portfolio companies' accountants.* Accounting firms normally represent as to their independence before auditing a company. However, it is the portfolio company and the sponsor that suffer if the representation turns out to be wrong. Thus, it is important for the sponsor itself to keep tabs on what services — audit and non-audit — accounting firms are providing to its portfolio companies.

- *Maintain the independence of your portfolio companies' auditors.* Make sure that you have the ability — through board or audit committee action or otherwise — to cause each portfolio company to change auditors and non-audit service providers as needed. As early as possible, make sure that your portfolio companies' auditors are independent, and make sure that nothing taints that independence over time. In club deals, this may be a challenge, because actions by partnering sponsors could affect the independence of the jointly owned company's auditors. Appropriate covenants in shareholder agreements may mitigate this risk for all of the players.

- *Include a review of a target company's accountants in your due diligence process.* Go back a year or so to get comfortable that the current auditor was independent for prior periods. Understand which accounting firms are providing non-audit services to the target or have other tainting relationships with the target to determine whether those services or relationships should be terminated before closing in order to avoid damaging the independence of another portfolio company's auditors. Consider including an appropriate representation in the acquisition agreement. Consider whether it is practicable to change audit service providers prior to closing if necessary to avoid independence issues.

- *Be aware of the relationships between portfolio companies.* Even minor relationships that might otherwise fall under the radar screen could result in some non-audit services being subject to audit procedures.

- *Consider using accounting firms other than the Big Four for certain non-audit services provided to portfolio companies.* One reason the rules are so troublesome is that the Big Four accounting firms are so ubiquitous. Seeking out top-rate second-tier firms could help to mitigate the risks.

Conclusion

At the end of the day, although the auditor independence rules are apt to give private equity firms a headache, many of their unpleasant consequences should be manageable with some vigilance and proactive decision-making. The principle lesson is that failure to act early to establish and to maintain independent auditors at your portfolio companies could have adverse consequences down the road. While the limited number of large national accounting firms exacerbates the problem, looking to local or smaller firms to provide non-audit services may be useful in avoiding independence issues.

Andrew L. Bab
albab@debevoise.com

U.S. Public Disclosure Laws Put the Unwanted Spotlight on Private Funds (cont. from page 8)

Current market approaches include:

- Partnership agreements or other governing documents expressly set forth what a public limited partner may disclose in response to a disclosure request and require the partner immediately notify the sponsor of such request, prior to making any disclosure.

- Partnership agreements or other governing documents contain a protective provision that allows the private fund sponsor to keep any information confidential from partners, if it believes that disclosure would have a material adverse effect on the fund.

- Sponsors provide certain fund information to public limited partners in a prescribed format (*e.g.*, read-only website, onsite review of materials) to minimize risk of disclosure.

- Sponsors communicate clearly to investors the scope of information subject to disclosure.

By being up front at the outset, private funds will increase the likelihood that public limited partners will be prepared for these measures and take appropriate steps to maintain the confidentiality of proprietary information, ensuring that limited partners comply with their disclosure duties while continuing to have access to the best private funds.

Rebecca F. Silberstein
rfsilberstein@debevoise.com

Monica K. Arora
marora@debevoise.com

Hedge Fund Registration Q&A (cont. from page 16)

management or with a net worth of $1.5 million or more), the new rule grandfathers all existing investors in all of the advisers funds.

Q: When do the new requirements take effect?

A: February 10, 2005, with a one year phase-in period for registration of hedge fund advisers. The client counting and residency tests came into effect for all new clients effective February 10, 2005. An adviser subject to registration under the new rule must register with the SEC and be in compliance with other Advisers Act rules applicable to registered advisers, including the rules requiring the adoption of policies and procedures and the designation of a chief compliance officer, by no later than February 1, 2006.

Q: Is there any hope that the new rule will be changed?

Less than a month after publication of the final rule, New York-based hedge fund manager Phillip Goldstein brought suit against the SEC claiming, among other things, that the SEC had exceeded its statutory authority in adopting the rule, thereby "eviscerating" and "re-writing" the statutory exemption for advisers with fewer than 15 clients. The SEC's general counsel has expressed confidence that it acted within its rule-making authority and expects to defend the claims vigorously. Moreover, the Managed Futures Association decided not to challenge the rule. Many hedge fund advisers are preparing to register with the SEC, some because they view it as a good thing to do from a business perspective.

Meanwhile, some are musing over the long-term effects of the rule, including the increased costs to hedge fund advisers (and perhaps hedge funds) as a result of adviser registration and potential trends towards longer lock-up periods in an effort to avoid registration. However, it is still too early for meaningful speculation over the long-term impact of the new rule. One thing is certain though, many advisers required to register will have their hands full in 2005 bringing themselves into compliance with Advisers Act rules.

Kenneth J. Berman
kjberman@debevoise.com

Jennifer A. Spiegel
jaspiegel@debevoise.com

Deferred Compensation Rules Revisited (cont. from page 18)

meaning of the new rules. The Notice provides some helpful guidance regarding the fee arrangement concerns. First, the Notice provides that if both the service provider and the service recipient are accrual method taxpayers, the new deferred compensation rules will not apply. Second, the Notice states that, until further guidance is issued, taxpayers may treat the issuance of a profits interest for services in circumstances where, under the relevant rules, the recipient does not recognize income at the time of issuance as also not resulting in the deferral of compensation for purposes of the new deferred compensation rules. However, some questions remain regarding the possible scope and application of the deferred compensation rules for individuals and other non-accrual method service providers.

Transitional Relief

The Notice gives deferred compensation arrangements subject to the new legislation until December 31, 2005 to be brought into full documentary compliance with the new rules. Additionally, the Notice permits new deferral elections with respect to post-2004 compensation to be made until March 15, 2005 without regard to the normal timing limitations and permits certain additional changes in deferral elections and/or terminations of deferred compensation arrangements until December 31, 2005. As there are still many unanswered questions under the new legislation, exactly what will be required to bring plans into documentary compliance will evolve as the IRS issues more guidance. However, during 2005, all deferred compensation arrangements subject to the new rules must be operated in good faith "operational" compliance with the new rules. This will invariably involve some difficult judgment calls, but it is helpful to note that, because of the effective dates, most pre-existing deferred compensation plans can continue to operate as they have operated in the past without worrying about the new rules, at least with respect to deferrals made in 2004 and earlier — although great care must be taken not to amend, modify or do anything else to any of those arrangements in a manner that could cause them to lose "grandfathering."

Lawrence K. Cagney
lkcagney@debevoise.com

David P. Mason
dpmason@debevoise.com

Jamin R. Koslowe
jkoslowe@debevoise.com