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The Challenges of Convergence

There has been a lot of buzz in the press lately about the "convergence" of private equity and hedge funds. But, what exactly is "convergence?" This article will describe what convergence is and explore the practical ways in which convergence is changing how funds are structured and how deals are done. It will also examine the valuation, liquidity and accounting issues convergence presents, as well as the cultural and market ramifications it introduces, for fund managers investing in unfamiliar territory.

The Traditional Distinction

The table on page 3 compares the terms of "classic" private equity funds and "classic" hedge funds.[1] Traditional private equity investing has sometimes been described as "creating value," in contrast to hedge fund investing, often described as "finding value." A private equity fund creates value for its investors by working with management of a private company over a relatively long term (months or years) to improve the value and eventually dispose of the company through a public or private sale. A typical private equity investment may concentrate as much as 10% of its capital on a single investment. Private equity investments generally consist of privately negotiated control investments in nonpublic companies.

Traditional hedge funds, on the other hand, generally identify pre-existing value inherent in market inefficiencies and pricing anomalies. This value can be realized relatively quickly (minutes, hours or days) through various trading techniques, including taking long and short positions in securities. For example, if two stocks with the same fundamentals in a given industry have diverged in price from their historical relationship, a hedge fund may buy the underpriced stock and sell short the overpriced one with the intention of unwinding the position if historical price relationships are re-established. Traditional hedge funds tend to be "micro" investors that deploy relatively small amounts of their capital. Hedge fund investments generally consist of minority positions in publicly held companies secured through open market purchases.

Hedge Funds Grazing in Private Equity Pastures

More and more, funds are expanding their focus beyond their historical investment strategies. Over the last year, there have been numerous high profile examples of hedge funds taking on the type of long-term control investing previously the domain of private equity funds.

What accounts for this new-found appetite? Some suggest that hedge funds' foray into private equity stems from an overcrowding of the hedge fund marketplace where the influx of new managers means fewer pricing inefficiencies and thus fewer arbitrage opportunities. Others suggest that the tremendous inflow of capital into hedge funds — pushing the industry close to the $1 trillion mark — means capital can be deployed more diversely, including in less liquid investments. Others point to lengthening lock-up

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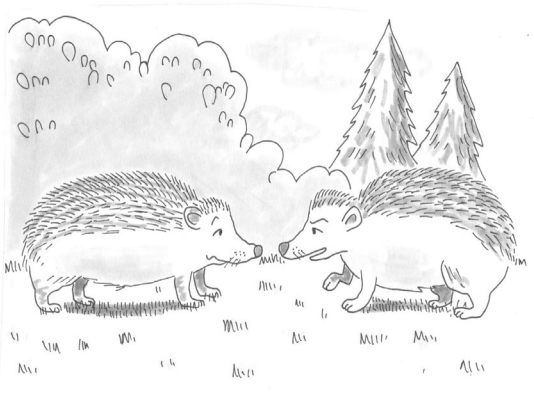
[1] *The descriptions that follow of private equity and hedge funds — which can take many forms and have many different strategies and attributes — are necessarily broad generalizations, but, we hope, will be useful nevertheless in setting the context for the discussion that follows.*

What's Inside



"Now that we have a successful hedge fund, maybe we should expand into private equity."

letter from the editor

Private equity has almost become a household word. As the private equity market has transformed itself from the province of a few long-term investors, the line that once distinguished private equity investors and their investment strategies from public investors in the securities markets are blurring. Not only are private equity and hedge funds dipping into each other's markets, but institutional private equity investors are no longer following a "buy and hold" strategy with their private equity investments. This transformation of the landscape may expose private equity and hedge fund managers to new financial and legal risks. In this issue we explore several ways these once disparate investment approaches are evolving and the issues that evolution can present.

On our cover, Woody Campbell and Jennifer Spiegel describe ways in which hedge funds and private equity funds are "converging" and warn of the challenges that arise as vehicles and firms designed for one type of investing participate in other facets of the market.

In our Guest Column, Brian Mooney and Ari Schottenstein of Cogent Partners discuss how the continued growth in the secondary market for limited partnership interests is changing the old "buy and hold" view of private equity investments and creating a new class of more active LPs who act more like their public company investor colleagues.

For private equity firms used to talking to and locking up key managers and stockholders in a private company acquisition, Peggy Davenport and Stephen Stauder outline the perils of making commitments to target management and significant shareholders when taking a public company private.

We also have two articles focused on deal execution. First, Steve Hertz reminds us of the intricacies of survival of representations and warranties — a crucial component of the allocation of risk in a purchase agreement — and answers the question of what happens when a claim is made just before the end of the survival period. From the financing perspective, Sung Pak discusses how and when seller paper might be a good financing tool, but warns of the unique challenges it presents to value and operating flexibility.

Finally, Richard Ward reports on recent changes to UK tax law which will undoubtedly impact the leverage historically available in UK transactions. The fact that these new rules come at a time when third party financing may be tightening could accelerate the impact on private equity funds' ability to generate the returns they have come to expect in the UK market.

Please let us know if there are topics of interest to you that you would like to see covered in upcoming issues of the Private Equity Report.

Franci J. Blassberg
Editor-in-Chief

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periods — a trend that took root even before the SEC's new rule requiring hedge fund adviser registration. Longer lock-ups enable a hedge fund to make more illiquid investments by easing the pressure to provide liquidity immediately to its redeeming investors. A hedge fund with a two year lock-up can more easily consider an investment that may take up to or over a year to dispose of, while a fund with no lock-up must be able to liquidate up to 10 or 15% of its portfolio within any quarter.

The Challenges of Convergence

Whatever the driving factors for hedge funds' wandering into private equity territory, some see problems ahead. Private equity professionals argue that private equity investing requires an entirely different skill set from hedge fund investing. Private equity managers typically work intimately with the management of a portfolio company over a period of time. Traditional hedge fund managers generally do not develop relationships with company management and instead are primed to make quick decisions within extremely short time frames based on fundamental analysis. For some, this mismatch of skill sets means private companies could fall into the hands of those ill-prepared to manage them, as echoed at last year's Private Equity Analysis Conference by Henry Kravis: "Hedge funds know how to pick stocks. That's not the same as creating value over the long term." Some also fear that hedge fund competition with private equity firms will drive up the purchase price of private companies, thereby reducing eventual returns to investors.

Fund Terms: Classic Private Equity vs. Classic Hedge Fund

Fund Term	Private Equity Fund	Hedge Fund
Capital Contributions	Capital Commitments Draw down over time	100% of capital contributed upon subscription
Liquidity	None; exception made only for extraordinary reasons (ERISA or regulatory reasons)	Monthly, quarterly or annually; sometimes subject to a lock-up of one to two years
Management Fee	Based on Capital Commitments during investment period and actively invested capital thereafter	Based on current net asset values at all times
Performance-based Compensation	Carried interest on realized investments only; subject to a GP "clawback" to preserve an 80-20 deal	Incentive allocation taken annually on realized and unrealized profits; no GP clawback
Reinvestment of Profits	Very limited	Unlimited
Closings	Period for admission of investors limited to 9-12 months from initial closing	Evergreen
Subsequently admitted investors	Must make capital contributions retroactive to initial close plus interest thereon to "true up" participation in investments made to date	All capital contributions on day one; investors participate in all existing investments with no "true up" mechanism
Valuation	Generally stable; investments generally carried at cost until a subsequent round of financing	Potentially volatile; investments marked-to-market at least monthly

Hedge Funds and Illiquid Investments

A hedge fund taking on illiquid investments faces a host of more technical issues as well, including questions of valuation of and accounting for investments and the impact on liquidity for fund investors.

- *Valuation Issues.* Hedge funds depend upon frequently marked to

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market values to determine the amount of the annual performance compensation of the general partner, the profit-sharing percentage of newly admitted investors and the amount of proceeds due to redeeming investors. Striking a monthly or even a weekly net asset value for a hedge fund is relatively straight forward when the fund is invested entirely in publicly traded securities with readily ascertainable values. A hedge fund taking a position in a private company must be able to value that investment just as frequently. Valuing an investment in a private company prior to disposition, however, can be problematic and will inevitably involve some subjectivity.[2]

This subjective element gives rise to an obvious conflict of interest when the person determining the value — the general partner of the hedge fund — is also being compensated based on the value determined. There is a natural incentive to value up. One could defer receipt of any incentive allocation attributable to an illiquid investment until its actual disposition, or rely upon third party valuations to avoid conflicts, but these solutions can increase fund expenses and sponsor uncertainty.

Valuation also is the basis for determining the percentage interest in the fund for a newly admitted investor. Generally, a new investor in a hedge fund shares in all current investments based on the ratio of its capital contribution to the current net asset value of the fund. Thus, any private investments must also be valued. If a private investment is valued conservatively or held at cost, then a newly admitted investor investing the same amount as an existing investor may get a windfall upon the disposition of the private investment. Limiting participation in private investments to investments acquired only after an investor's admission may solve the problem, but also may introduce a new level of complexity in fund accounting. In addition, varying participation in such investments may lead to the creation of a separate class of interests for purposes of ERISA.

Limiting private investment participation to subsequently-acquired investments only means that each private investment will need to be tracked separately. In addition, one must wrestle with how exactly to determine participation in new private investments. Is participation in a new private investment determined according to the net asset value of each investor's interest or the net asset value of only the liquid portion of its interest? Either approach can be problematic. If the net asset value of each investor's interest is used, then private investments that may represent no more than 20% of the current net asset value of the fund on a fund-wide basis could represent far more of any individual investor's interest. This aspect of hedge fund "side pockets" is often overlooked and can be a nasty surprise for a redeeming investor that finds only 40% of its interest is liquid enough to be redeemed. If the latter approach is used — participation in each private investments based only on the liquid portion of an investor's interest — then both the administrative and accounting management with respect to private investments may become unwieldy, especially if one attempts to translate all of this into the structure of a corporate vehicle with multiple series and classes of shares.

Proper valuation is also essential for determining the amount of proceeds due to a redeeming investor. An investor may seek redemption at a time when a portion of its interest is held in an illiquid investment. If the net asset value calculated at the time of redemption later turns out to have been inflated, then the redeeming investor would have received excess redemption proceeds and the general partner excess amounts of incentive allocation, all at the expense of investors that remain invested in the fund. Alternatively, a deflated net asset value could mean underpayment to the redeeming investor. One could limit investors' redemption rights to the liquid portion of the hedge fund's portfolio, which would practically eliminate these risks. For a fund with more than 20% in illiquid investments, however, this may unduly limit the investors' liquidity and may make the investment less attractive. Another option is to provide for full payout upon redemption but implement a modified clawback mechanism to correct for any inaccuracies in valuation and reduce the likelihood of overpayment of incentive amounts to the fund. An investor that has fully redeemed, however, is not likely to accept any obligation to pay back any overpayment of redemption proceeds, and the fund is even less likely to throw

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2 *For discussion of the difficulties inherent in valuation of private equity investments, see "To Standardize or Not to Standardize: Recent Developments in the Private Equity Valuation Debate" in the Spring 2004 issue of the Private Equity Report.*

guest column

Are Private Equity Investors Beginning to Resemble Their Public Equity Brethren?

There is a fundamental and unmistakable shift underway in private equity portfolio management with significant implications for investors and sponsors alike. Bottom line: LPs are becoming more active owners. The driving force behind this trend is the continued growth in the secondary market for limited partnership interests.

This market has rapidly evolved. From its origins as an arcane niche market with a very limited number of dedicated buyers who benefited from distressed and/or uninformed sellers, it has become a well-oiled mechanism for a broad range of sophisticated, long-term investors who access the market from both the buy-side and the sell-side to actively manage and generate excess returns for their private equity portfolios.

Farewell to Buy and Hold

Historically, institutional investors in private equity treated their partnership holdings as static, "buy-and-hold" investments to be passively managed by monitoring the funds' performance over time. No longer.

A growing number of today's sophisticated investors have adopted a substantially more active approach to generating returns. This new approach entails proactively optimizing partnership holdings by continually seeking to increase exposure to certain funds and fund managers, and simultaneously reducing exposure to others. Because such a strategy requires that investors dispose of certain positions and accumulate others, the market for secondary transfers has undergone something of a liquidity boom, with a strong stable of both buyers and sellers.

This increase in market liquidity has largely been driven by the emergence of a new class of buy-side participants — endowments, foundations, pension funds, some financial institutions and even hedge funds — who are collectively referred to as non-traditional secondary buyers and now outnumber dedicated secondary funds approximately ten-to-one. These groups have come to be active on the buy-side of the secondary market in much the same manner as they are now active primary market investors.

As the acceptance of private equity as an institutional asset class exploded during the late 1970s and 1980s, most investors' first foray into private equity was through pooled fund-of-funds vehicles. However, as these investors became more familiar with the asset class and developed the requisite skill set, they began taking a more active role in the asset class such that most now manage their own primary commitment programs and abandoned the use of funds of funds.

Similarly, many of the early investors in the secondary market accessed this segment of the asset class through dedicated secondary funds but, over time, have developed the knowledge base and underwriting skills to acquire secondary positions directly for their own account. Investors in this growing category now compete directly with their old secondary fund-of-funds managers for assets.

In addition to the increased competition from non-traditional buyers, most of the dedicated secondary managers have recently raised very substantial pools of capital of their own and, on top of that, are now employing increasing amounts of leverage in order to remain competitive.

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A growing number of today's sophisticated investors have adopted a substantially more active approach to generating returns. This new approach entails proactively optimizing partnership holdings by continually seeking to increase exposure to certain funds and fund managers, and simultaneously reducing exposure to others . . . [thus] the market for secondary transfers has undergone something of a liquidity boom, with a strong stable of both buyers and sellers.

Are Private Equity Investors Beginning to Resemble Public Equity Brethren? (cont. from page 5)

The Advent of Active Portfolio Management

The excess demand created by this combination of non-traditional buyers entering the market, the massive influx of capital from dedicated secondary funds and the increased use of leverage has resulted in dramatically higher pricing for secondary interests relative to just three to five years ago. As a result, many institutional private equity investors have now recognized the opportunity to participate actively on the sell-side also — not as distressed sellers, but as sophisticated, value-maximizing investors.

Unlike secondary sellers in the past, these institutions are not exiting the asset class; they are utilizing their inherent information advantage to exploit the mis-pricing of partnership interests by the buy-side of the secondary market.

An investor who has been an LP in a fund for several years has an inherent information advantage over many potential secondary buyers, because they've had the opportunity to track the progression of underlying portfolio companies and to develop a view towards ultimate investment performance over a period of several years, while many secondary buyers are required to develop this perspective in less than one month.

We have seen this picture before in public equities, fixed income and other mature asset classes. Many institutional private equity investors are now using the information they have accumulated on specific general partners and specific funds to develop perspectives on future performance. In cases where these projected fund returns do not meet institutional-level targets, or where the buy-side is overvaluing future performance, these original primary investors are using that information to participate on the sell-side at attractive prices and subsequently redeploying the proceeds into more promising opportunities.

One of the strongest indications of this growing trend of active portfolio management is that while 2004 secondary transaction volume (on a dollar basis) was driven by large financial institutions exiting the asset class, the majority of sell-side participants (by number of sellers) were institutions that will remain long-term investors in the asset class, but who sold certain positions for return-maximization and other strategic purposes.

Industry Implications

This industry-wide movement toward value creation through active portfolio management represents a fundamental shift in the conventional impression that private equity capital is "locked." And the new liquidity associated with the asset class has important implications. For GPs, the growth in the secondary market and the increasing participation of non-traditional buyers represents a new opportunity to replace exiting investors, not with a dedicated secondary fund, but with limited partners who are buying the interests for the purpose of establishing a long-term relationship. For LPs, participating on both sides of the secondary market is the only tool available that enables portfolio value creation subsequent to making the original primary commitment decision. ▢

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Cogent Partners is a full-service specialty investment bank dedicated to creating customized solutions for clients in the private equity industry.

This industry-wide movement toward value creation through active portfolio management represents a fundamental shift in the conventional impression that private equity capital is "locked."

Claim Check, Please

A key issue (if not the key issue) in virtually all private company M&A deals is the duration of the survival period of the seller's representations and warranties.

This is true in any deal, since buyers are always eager to obtain as much contractual down-side protection as possible and sellers always want to exit all continuing exposures associated with a disposed business as soon as possible. But it is particularly germane to private equity sellers in deals with an indemnification escrow, since these escrow dollars may not be distributed to the fund's limited partners until the final resolution of any claim made prior to the end of the applicable survival period.

Survival?

In most stock and merger deals a buyer acquires all of the equity interests in the entity which conducts the target business and thus inherits, as a matter of law, all liabilities of every kind and description residing in the target. In asset deals, buyers and sellers generally have the flexibility to establish contractually assumed liabilities, on the one hand, and excluded (or non-assumed) liabilities, on the other hand, but as a practical matter in most asset deals a buyer assumes virtually all of the liabilities of the target business.

A seller's representations and warranties, or the factual statements made by the seller in a purchase agreement about the condition of the target's business, allow the parties to shift some of these liabilities back to a seller. But unlike an "excluded liability" in an asset deal, which effectively imposes the risk of the excluded liability on the seller as a matter of law subject to no limitations, representations and warranties shift risk to the seller only in accordance with the negotiated limitations in the applicable purchase agreement. These limitations derive typically from the scope of the representations themselves, the content of the related disclosure schedules, any applicable deductibles, thresholds or caps and, finally, duration.

Accordingly, "survival," or the period of time within which the parties have a right to make a claim under the negotiated representations and warranties, is a crucial component of the overall risk allocation in any M&A deal and thus is heavily negotiated. This is particularly so in deals where the seller is in a position to stand behind its representations for a sustained period of time, as is often the case, for instance, when a private equity sponsor purchases a business from a corporate seller.

In the current market, most representations and warranties typically survive for one to three years, with a survival period ending on the 30th day after the first full audit cycle under a buyer's watch emerging as an increasingly common outcome.

But Wait...

However, most purchase agreements also contain broad language to the effect that any "claim" made prior to the expiration of the applicable survival period shall *continue to survive* until such claim has been finally decided, settled or adjudicated. This is designed to ensure that incipient claims, or claims which have otherwise not been fully liquidated prior to the end of the survival period, are nonetheless preserved pending their ultimate disposition.

And yet surprisingly, given the level of "lawyering" engineered into your average 80 page purchase agreement, many purchase agreements are quite vague, if not utterly silent, as to what constitutes a valid "claim" for this purpose, or put differently, just how much meat on the bone needs to exist for a buyer to assert a valid indemnification claim. This is crucial because absent some meaningful standard as to what constitutes a valid claim, a buyer could potentially assert insipient or otherwise amorphous claims prior to the end of a survival period, thereby effectively extending its survival period indefinitely, or at least until the disposition of the incipient claims in question.

This is not necessarily inappropriate, of course, since many exposures do have long gestation periods and it is fair game for a buyer to seek indemnification on any claim, no matter how inchoate, which surfaces prior to the expiration of its seller's representations and warranties. Put differently, a buyer can reasonably take the position that an indemnification regime, including its stated survival period, is designed principally to ensure that the parties correctly "priced" the deal at closing; accordingly it is appropriate to allow a

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Claim Check, Please (cont. from page 7)

buyer to preserve any claim, no matter how incipient, which manifests prior to the end of the survival period.

But the degree of elasticity associated with a survival period could nonetheless come as very unwelcome news to a seller who is under the impression that the end of the survival period constitutes a hard stop on the risk shift under a purchase agreement.

Give Me an Example, Please

To illustrate, suppose a buyer delivers written notice to the seller of a claim for breach of the seller's representation prior to the termination of the applicable survival period in each of the following examples:

Direct Claims

- the parties to the sale of a diversified financial services firm include a standard GAAP financial statement representation in the purchase agreement;
- the representation survives for one year;
- shortly before the representation terminates, the buyer discovers probative information which leads it to believe that the target's reserves on its financial statements were seriously understated; and
- in order to confirm (or refute) the possible understatement, the buyer needs to engage a third-party accounting firm to review the target's books and this review is expected to take up to six months to complete, given the complexity of the target's business.

Third-Party Claims

- the parties to the sale of a chemical business negotiate a representation covering virtually all environmental exposures of the target prior to closing;
- the representation survives for two years;
- no environmental problems materialize for 23 months following closing; and
- during the 24th month, the state environmental protection agency notifies target that it has reason to believe that unspecified environmental conditions may exist on the target's property, that it expects to conduct soil sampling at some point during the next six months, and that if its testing confirms its suspicions it intends to seek remedial action by the buyer (one could easily imagine a similar fact pattern for a tax exposure or even a product liability claim).

In both of these cases, the target's potential exposure is purely contingent as of the time the applicable representation terminates; so, to the extent that any liability ultimately materializes, it may be many months or even years down the line and well after the termination of the representations and warranties. Accordingly, neither buyer could make a "claim" in the sense of filing a complaint in court against the seller or initiating an arbitration proceeding — if the purchase agreement has an arbitration clause — since it would lack the facts to do so at this stage. But could either buyer nonetheless make a claim under its purchase agreement and thus preserve the claim pending subsequent development of the facts, no matter how long that process takes?

And the Answer Is...

Under most private company purchase agreements, the answer is yes.

In the case of a direct claim by a buyer against a seller, like the GAAP claim in the above example, most purchase agreements set no standard for what constitutes a claim for this purpose. And absent any such standard, it will be difficult for a seller to successfully take the position that a written notice captioned as a claim along the lines of the above example involving the financial services firm does not constitute a claim under the purchase agreement.

(In this regard, one related practice tip warrants special emphasis — recent case law in New York has made clear that to ensure that a buyer's indemnification protection extends to direct claims *at all* — as opposed to only third-party claims — the purchase agreement should expressly provide that the seller's indemnification obligations include the obligation to "pay and reimburse" the buyer for all losses, "whether or not arising due to third-party claims." Absent language along these lines, at least in New York, our

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The most effective way for a seller to avoid the potential uncertainty associated with a lingering indemnification claim may simply be to define a qualifying "claims notice" under the contract such that a buyer is permitted to assert an indemnification claim only if it can set forth a reasonable degree of specificity about the claim in such claim notice.

Dangerous Liaisons: Teaming Up with Management and Significant Stockholders in Going-Private Transactions

Private equity firms are experts when it comes to wooing management and significant stockholders. In fact, in a typical leveraged private company acquisition, arrangements with management or significant stockholders are commonly made prior to executing definitive agreements with the target. These arrangements may include the terms of employment with the surviving company, post-closing option grants and rollover equity. At the time the purchase agreement is signed with the target, these arrangements may be fully negotiated and documented or may be just in term sheet or letter agreement form.

When a private equity firm acquires a public company, however, teaming up with management or stockholders becomes far more complex. Because of federal securities laws and certain state corporate laws applicable to going-private transactions, there are consequences to the timing and definitiveness of management and stockholder arrangements that need to be carefully considered. This article highlights some of the more recurring of these issues.

Will a Special Committee Be Needed?

Often, a going-private opportunity arises when private equity firms become familiar with senior management and/or significant stockholders of a public company and express an interest in taking a company private. What are the implications of a partnership between a financial sponsor and management or significant stockholders?

One consequence under Delaware law is that the transaction may lose the benefit of the presumption of fair dealing. If a financial sponsor teams up with a "controlling" stockholder to take a public company private, the actions of the target's board become subject to the "entire fairness" test, a standard of review that is more exacting than the traditional business judgment rule. Unfortunately, there is no bright-line test as to when a stockholder or a stockholder group is a "controlling" one. Ownership of fifty percent or more of the voting securities of a target certainly confers control. However, less may suffice. For example, a Delaware court found a forty percent holder who was the target's CEO and Chairman to be "controlling" because of his day-to-day managerial control and the fact that he had a large enough voting block to be the "dominant force" in a control contest. The court based this view, in part, on the facts that the CEO's subordinates and family members, who also held some stock in the target, were likely to vote alongside him, and that, even in a contested vote, a hundred percent turn-out was unlikely.

Normally, when a transaction's fairness is challenged, the target company has to prove that the transaction meets the entire fairness standard. However, the burden of proof often shifts to the plaintiff challenging the fairness of the deal if the target had the transaction approved by a special committee of independent directors. For the shift in procedural burden to occur, a special committee must be properly authorized, pick its own independent advisors, understand its function, and be able to exercise real bargaining power at arm's length, free from the influence of the controlling stockholder.

Even where there is no "controlling" stockholder involved, a target board may opt in favor of installing a special committee to signal to potential challengers of the transaction that the board is striving to run a good process. Consequently, most target boards will at least seriously consider the need for a special committee where a financial sponsor submits an offer in partnership

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When a private equity firm acquires a public company . . . teaming up with management or stockholders becomes far more complex. Because of federal securities laws and certain state corporate laws applicable to going-private transactions, there are consequences to the timing and definitiveness of management and stockholder arrangements that need to be carefully considered.

with one or more members of senior management, especially when senior management has a significant equity stake in the target.

Will Partnering with a Significant Stockholder Trip Take-Over Defenses?

Secondly, pre-signing arrangements with management or significant stockholders may become traps for the unwary because they can trigger a target's take-over defenses.

State statutes typically subject business combinations with significant stockholders to special approval requirements. For example, the Delaware anti-takeover statute (DGCL § 203) provides for a three-year moratorium on certain business combinations with "interested stockholders" unless certain exceptions apply, such as board approval of the deal or the transaction that lead to a stockholder's becoming "interested." The term "interested stockholder" as used in DGCL § 203 extends to persons who, individually or through others, own fifteen percent or more of a target's voting stock. Notably, such ownership need not be outright or beneficial. It suffices if a potential acquiror has entered into "an agreement, arrangement or understanding" with a beneficial owner of target stock "for the purpose of acquiring, holding, voting or disposing of such stock."

Pre-signing arrangements with management or significant stockholders may become traps for the unwary because they can trigger a target's take-over defenses. . . . [They] also pose the risk of mandatory early disclosure of the transaction.

It is critical for financial sponsors to avoid triggering DGCL § 203 by their pre-board approval dealings with significant stockholders. Accordingly, any such dealings need to stay short of "agreements, arrangements or understandings." Although there is no Delaware case law specifically addressing what type of communications overstep the line, some decisions suggest that the "agreement, arrangement or understanding" language may apply even to fairly informal dealings of the parties and that all that is required for the anti-takeover statute to apply may be a meeting of the minds between the parties to the understanding.

Since it is a core objective of DGCL § 203 to encourage prospective acquirors to negotiate with the board of the target, the question arises if a voting or other arrangement with a significant stockholder that is expressly conditioned on subsequent board approval would pass muster under the anti-takeover statute. While conditioning an agreement on board approval would seem to satisfy the policy considerations of DGCL § 203, Delaware courts have not provided definitive guidance on the contingency issue. Until there is a controlling piece of law on this question, financial sponsors should think twice whether the benefits of obtaining a conditional agreement from a significant stockholder outweigh the associated risks.

Considerations analogous to those described above may apply with respect to the often similarly broad triggers of "poison pills."

When Must a Transaction Be Disclosed?

Pre-signing arrangements with management or significant stockholders also pose the risk of mandatory early disclosure of the transaction. For obvious reasons, parties to a going-private transaction will seek to keep their negotiations under wraps. How long they are permitted to do so requires an analysis of the disclosure requirements under Section 13(d) of the Securities Exchange Act.

As a principal matter, a financial sponsor does not have a disclosure obligation under the federal securities laws until it acquires beneficial ownership of five percent or more of a public target. Beneficial ownership is often conferred on the sponsor through the execution of voting agreements with target stockholders that support the transaction — at least where a voting agreement contains an irrevocable proxy. The signing of a voting agreement typically coincides with the execution of the definitive agreement with the target. Since the target must report the latter on Form 8-K, the news of the transaction will have already been broken by the time the sponsor reports its beneficial ownership acquisition. However, the content of a sponsor's transaction disclosure may still attract separate attention. For instance, Schedule 13D includes a line item requirement to disclose the material terms of any acquisition financing.

The analysis is different, however, where a sponsor already has an equity

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Is Seller Paper the Way to Go?

With the relative recent abundance of debt financing options, some sponsors probably need to jog their memories a bit to recall the last deal in which they utilized seller financing. Back in leaner times for the financing markets, it was not uncommon to see seller paper fill in the gap remaining in the capital structure after traditional financing sources had been exhausted. While the day may once again come (we hope not) when seller paper is often used as debt financing of last resort, seller paper has not been absent even during the recent frothiness in the debt markets. Seller paper finds its way into deals for a variety of reasons (lack of other financing options being just one of them), and can take many forms, ranging from a simple, hope-we-get-paid-someday subordinated promissory note to a full high-yield style form, complete with indentures, registration rights agreements and the like. Here's a review course in the ways in which seller paper is utilized, and the forms that it can take.

When and Why Seller Paper Is Used

Seller paper is used for a variety of reasons, driven by the different contexts and reasons for seller financing.

Financing of Last Resort for Buyer. Seller paper is sometimes used to fill in the gap between the targeted purchase price for an acquisition and the amount of financing available from third party financing sources. That gap may exist for a number of reasons. In an environment where financing is scarce, the buyer may need seller paper as a financing source for what would otherwise be the market purchase price for an acquisition. When used in such a context, seller paper tends to take elaborate forms, designed with economic benefits and protections for the seller that either mimic or perhaps even surpass those given to third party financing sources.

Purchase Price of Last Resort for Seller. Conversely, even though financing is available for what would be the market purchase price for an acquisition, the buyer and the seller may wish to 'stretch' the purchase price beyond that mark. Seller paper is often structured in such situations to provide the possibility of achieving that "full" purchase price, while minimizing the risks to the buyer and its third party financing sources.

Cheaper Than You Might Think. Even when financing market conditions are generally reasonable, a bump in the markets or special characteristics of a given company or transaction may produce a situation where seller financing on mutually agreeable terms makes more sense marginally for both parties than full utilization of the most expensive tranche of third party financing.

Some Skin In The Game. In situations where the seller will continue to have a significant continuing role in managing the company, seller paper can be used to ensure that the seller maintains a continuing interest in the performance of the company. Seller paper can also be structured in situations where significant contingencies are built in to the achievement of the full purchase price, or where the buyer has a significant interest in ensuring the realizability of indemnity obligations, to provide a mechanism for returning economics back to the buyer.

More Headache Than You Might Think. While seller financing can be useful, there are also reasons to think carefully about whether seller paper should be utilized. Unlike third party financing, there are often no 'market' terms available to guide the negotiation of terms, and no continuing relationship with the providers of the financing. Negotiations can take unpredictable turns, particularly when thrown into the general mix of the negotiations over the sale of the company. In the longer term, if the relationship with the seller turns sour, or if the seller notes are transferred by the sellers to unfriendly hands, the seller notes may become a device for mischief.

Common Types of Seller Paper

Seller paper takes many different forms (some of them *sui generis*) depending on the specifics of the transaction. For illustrative purposes, it may be useful to consider two examples on the opposite extremes of leverage between the buyer and the seller, as well as an example of a structuring alternative.

- *Deeply Subordinated Promissory Notes.* Common where seller paper is used to stretch the purchase price, this form of seller paper is relatively simple, without significant covenant or other protection for the seller beyond the promise to pay. Commonly, this form of seller paper is deeply subordinated to other financing to reduce the risk to third party financing sources, and comes with significant restrictions of transferability.
  - *Contractual Subordination:* In contexts where leverage has already reached the limits of financeability, third party financing sources will want the seller to agree to a deep form of contractual subordination. In extreme cases, no cash payments of any kind will be permitted during the life of the third party financing. More commonly, cash payments are limited to scheduled payments of interest, with payment blocks imposed during any default under the third party financing. This type of paper typically is not cross-defaulted to the third party financing, and carries

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with it standstills and other blocks on the taking of remedies.
  - *Payment-In-Kind:* This type of seller paper often provides for payment of all or a portion of interest in kind rather than in cash, to reduce the strain on cash flow.

- *"True" Subordinated Financing.* Where seller paper is utilized as financing of last resort for a major portion of the purchaser price, seller paper commonly takes a more elaborate form. Like true third party financing, such paper often includes a full package of restrictive covenants and other protections for the sellers, and is designed to maximize the sellers' liquidity in terms of transferability (no consents over transfers, registration rights, etc.). In many ways functionally similar to bridge financing, the balance of risks and economics favors the seller, while the buyer will be focused on making sure that the paper can easily be refinanced when third party financing on acceptable terms becomes available.
  - *Full Covenants and Defaults*: This type of paper often carries a full set of restrictive covenants, including restrictions on debt, guarantees, dividends, acquisitions, and asset sales, and comes with a full set of events of default, including cross-acceleration or cross-default to the third party financing.
  - *Transferability:* As is the case with third party providers of bridge financing, liquidity is an important concern to the seller in this context, as it is not in the business of holding debt, and wants to convert the investment into cash as soon as possible. Company consent over transfers is rare in this context, and the sellers often obtain liquidity enhancements such as registration rights.
  - *Prepayments/Redemptions:* This type of paper is typically refinanceable at will, with no call premiums or non-call periods.

- *Holding Company Notes.* When seller paper is placed at the holding company rather than the operating company, the seller's claim is structurally, rather than contractually subordinated, to the claims of third party financing sources. While the decision to place the debt at the holding company may occur for a variety of reasons, some principal consequences from a financing perspective include:
  - *Structural Subordination:* The sellers' claims are separated from the claims of the third party financing sources such that the need for negotiations between the sellers and the financing sources is minimized. This can be of particular benefit with an unsophisticated seller whose expectations may clash with third party financing sources' desire for deep contractual subordination.
  - *Access to Operating Company Cash:* Significant limitations on the buyer's ability to access the operating company's cash to pay the seller paper are typically placed under the terms of the third party financing at the operating company level. Both the holding company paper and the third party financing at the operating company level need to be carefully designed to match the cash pay obligations at the holding company with the operating company's ability to pay dividends to service the obligations.
  - *Threat to the Sponsor's Equity:* Because holding company paper is not contractually subordinated to any debt, there are no payment blocks or remedies blocks that can act as a buffer between the claimholder and the sponsor's equity. Granting the sellers significant covenant protection or cash pay rights at the holding company level can result in situations where the sellers can immediately become a direct threat to the sponsor's equity. Covenants, defaults, and cross-default provisions need to be carefully designed to ensure that the sponsor's ability to work with third party financing sources in a downside situation are preserved.

Use As Needed, But Carefully

Seller paper is obviously a useful tool — it can sometimes even save a deal that would otherwise be unworkable from a buyer's or seller's perspective for a variety of reasons. But as with any type of debt financing, the issuance of seller paper is a long-term commitment that can impose significant financial burdens and operating restrictions. Careful thought should be given to whether seller paper is in fact the best financing source in a given situation, and seller paper should be carefully structured to minimize the risk to value and operating flexibility. The time it takes to fully develop seller financing terms early in a proposed transaction can minimize nasty surprises later in the process and once the transaction is completed.

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Goodbye to the Best of Both Worlds: UK Tax Changes Affecting LBO Deals

The supercharged leverage typical of UK private equity transactions has already become history. The UK government sent shivers through the private equity community in March 2005 when it announced a number of legislative changes which would negatively impact the way in which private equity investments in UK companies have traditionally been effected. Leverage on UK transactions has been enhanced by the ability to structure investments with shareholder loans that created tax deductions for the portfolio company but not current income for the private equity fund providing the loan.

This "best of both worlds" approach appears doomed for both future and, in some instances, previously completed transactions. Although the proposed changes have been put on hold pending the outcome of the government elections in May 2005, it is nonetheless anticipated that the changes will be enacted (albeit perhaps in a slightly different form in some cases) with a retroactive effective date, regardless of the outcome of the elections. Here's an outline of what to expect and why these changes are so important to the potential returns on UK transactions.

The Current Regime: Deductibility of Shareholder Loans

The proposed changes severely impact the deductibility of interest and the timing of that deductibility for UK tax purposes. Historically, LBO funds have structured their investment in a UK portfolio company with a significant proportion of the investment (perhaps as much as 99%) being made in the form of shareholder loans which have qualified as debt for UK tax purposes. As a result, the "equity" invested by funds bears financing charges qualifying for tax deductions which can be offset against the profits generated by the portfolio company or group under the UK tax consolidation (or "group relief") rules.

The deductibility of interest on "shareholder loans" is effective because of an understanding of the manner in which UK transfer pricing rules apply to companies that are controlled by one or more private equity funds structured as limited partnerships. Generally, UK transfer pricing rules apply where a company is controlled by one person or by two persons each of which has a 40% or greater interest in the company. Tax relief (or deductibility) for the interest on any shareholder loans made by such persons is potentially at risk unless the loans would have been made on the same terms by a lender dealing with the company at arm's length. Since shareholder loans made under the highly leveraged structures would likely not have been made at all (and therefore tax deductions would be denied if the transfer pricing rules apply), the structures only work if the lenders — the LBO funds — do not control the portfolio company for the purposes of the transfer pricing rules.

Most UK tax practitioners have taken the view that fund partnerships should not be regarded as "persons" for the purposes of the rules. Therefore, so long as a fund with a controlling interest in a portfolio company did not have one or more significant investors on a look-through basis, the portfolio company would not be controlled by one investor alone or by two investors each having a 40% interest and the transfer pricing rules would not apply and deductibility would be preserved.

Proposed Changes Impacting Future and Some Past Transactions

The UK tax authorities brought this well-accepted learning into question in December 2004 when they announced that a partnership itself should be regarded as a "person" for transfer pricing purposes. Although private equity practitioners disagree, the tax authorities announced that this was not a change in approach from their perspective. The UK tax authorities are challenging the deductibility of interest on shareholder loans on this basis in a significant number of UK private equity transactions and tax litigation may be forthcoming with respect to those challenges. The proposed new legislative initiative attempts to bolster the tax authority's position with respect to future transactions and, to some extent,

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UK Tax Changes Affecting LBO Deals (cont. from page 13)

previously completed transactions. The new rules are likely to have "grandfathering" provisions which delay their application to existing transactions until April 2007, with the caveat that any amendment to the terms of existing financing arrangements could potentially accelerate the application of the new rules.

Although the primary target of the new regime is shareholder loans, the deductibility of interest on loans by mezzanine and other lenders may also be jeopardized. If the rules are passed in their current form, any lenders who are considered to be part of a controlling group, (*i.e.*, by being parties to an investment or shareholders agreement to which the controlling shareholders are party) may be subject to the transfer pricing rules as well. In most situations, we would expect that the new rules would not give rise to a denial of tax relief because the borrowing terms should meet the arm's length standard required by the transfer pricing rules unless the mezzanine or other lenders have also acquired equity that impacts the terms of their lending. The rules have similar grandfathering provisions to those relating to the new transfer pricing rules.

Timing of Deductibility

Interest on shareholder loans in the UK has traditionally been deducted on an accrual basis, permitting the portfolio company the benefit of a deduction on interest whose payment was deferred. This, of course, made deep discount bonds attractive for shareholder loans because, although the borrower was able to deduct the interest, the lender had no current income. This was a result of a specific exemption from the general UK rule that interest paid by a closely-controlled company was not deductible currently if the interest was not similarly taxed.

That exemption, however, would be modified under the proposed rules so that interest on shareholder loans will only be deductible after March 2005 when paid, except for limited circumstances where a portfolio company is a specially qualified small business entity ("SME") and the lender is not based in a tax haven.

Special Issues for U.S. Private Equity Players

Private equity funds with significant U.S. investors engaged in UK transactions should be especially wary of certain provisions of the proposed new rules. These provisions would dampen the ability of the portfolio company to deduct financing costs when hybrid entities or instruments are involved. The use of hybrid instruments is common because shareholder debt often needs to be structured as equity for U.S. tax purposes to avoid phantom income issues. In addition it is common, for a variety of U.S. tax reasons, for one or more companies in a transaction structure to be treated as a "check the box" or disregarded entity for U.S. tax purposes. The draft rules on hybrids contain a number of serious flaws and it is expected that they will be subject to considerable amendment prior to being finally implemented. In addition, it is unlikely that the rules will contain any "grandfathering" for existing deals. The hybrid rules may, however, apply in instances not covered by the rules on transfer pricing and the timing of deductibility, creating additional structuring complexity.

Summary

The proposed new rules potentially represent a formidable additional armoury for the UK tax authorities to defeat the availability of tax relief for substantial financing costs after March 2005. The rules ring a death knell for the aggressive financing structures that have been used over the last few years in UK deals, at least in their current form.

Potential investors in funds targeting UK transactions as well as private equity firms may find that their returns will be impacted by these proposed limitations on deductibility of shareholder loans and the limitations relating to the use of hybrids, particularly in view of the tightening of the financing markets. We will be attempting to develop new structures to take their place, the details of which will depend on the precise form of the new rules. Stay tuned.

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alert

New IRS Ruling on "Leveraged Partnership" Structure

The ability of private equity funds or other sellers of businesses to defer tax on exit transactions may be shrinking. In a recently-issued letter ruling, the Internal Revenue Service attacked a transaction commonly known as a "leveraged partnership" structure. The IRS has previously attacked these transactions, and the new ruling makes it clear that the Service remains committed to challenging the structure.

The leveraged partnership structure has been used by taxpayers to attempt to defer taxation of transactions that are economically similar to sales. A private equity fund may often encounter a proposal involving this structure in connection with a purchase of a portfolio company from a seller that stands to recognize a substantial taxable gain. A fund may also consider using the structure upon exit from a portfolio company.

A typical leveraged partnership structure involves the formation of a partnership by Buyer and Seller. Seller contributes an asset that Buyer wishes to acquire, and Buyer contributes other property or cash. The partnership borrows cash and distributes it to Seller, diluting Seller's interest in the partnership to a relatively low level (say, 5%). This leaves the Buyer indirectly owning the lion's share of the partnership's assets.

Why is this not a taxable sale? Under "disguised sale" rules, generally it is. However, exceptions to the disguised sale rules may permit Seller to defer taxation, so long as the debt remains outstanding and is "allocated" to Seller under certain partnership tax rules.

In the transaction examined in the recent ruling, the taxpayer used a variation of the leveraged partnership structure that is generally viewed as an aggressive approach by tax practitioners. The Service stated that the structure was abusive and attacked it using a number of alternative arguments, including that it flunked the technical requirements of the disguised sale rules. Of particular interest, the Service stated that the taxpayer should be subject to penalties. In short, while leveraged partnership structures may still be viable if structured properly, any fund which is contemplating using it on either the buy or sell side should be cognizant of the Service's willingness to attack the structure. ▢

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Reader Interest Survey

We are always interested in feedback from our readers on the usefulness of the *Debevoise & Plimpton Private Equity Report*. We would welcome your responses to the following questions:

1. Which features of the Private Equity Report do you find most interesting/helpful? (Check as many as you feel apply)
   - ▢ a. General articles
   - ▢ b. Guest Column
   - ▢ c. Alerts
   - ▢ d. Trendwatch

2. What do you think of the articles?
   - ▢ a. Too long?
   - ▢ b. Too short?
   - ▢ c. Too lawyerly?
   - ▢ d. Just right?
   - ▢ e. Other comments _____

     _____

3. What topics would you like to see covered in the future?

   _____

   _____

4. Would you like to receive more information from Debevoise & Plimpton about its Private Equity practice?

   ▢ Yes (if so, please provide contact information above)
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To respond to the above, please send information to Dan Madden in the Marketing Department at Debevoise & Plimpton LLP:

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Throwing Out the Bath with the Bathwater

The American Jobs Creation Act, enacted in the Fall of 2004, threw a grenade at a tax shelter generally known as the SILO (sale in lease out). In taking out this transaction, Congress wrote the statute so broadly that it can also apply to certain types of investments commonly made by some private investment fund partnerships, specifically investments in real estate and so-called "operating partnerships." Although there is a lot of uncertainty and complexity surrounding the new rules, there are three important points to bear in mind:

- Because the wide application of the new rules was seemingly inadvertent and not generally understood until shortly before most 2004 tax returns were due, the IRS suspended the application of the new provision to partnerships for the 2004 taxable year.
- Although there is sure to be an effort to limit the application of the new rules going forward, a true solution to the problem is likely to require Congressional action and it is far from certain that will actually occur. Absent a fix by Congress (or perhaps the IRS), the new rules will apply to certain types of investments held in 2005 (or later years). Accordingly, private funds that invest in real estate or operating partnerships would be wise to have some understanding of how the rules operate.
- As currently in effect, the rules could increase the net taxable income generated by certain types of investments while held by a fund, although the increased taxable income would generally reduce the net gain upon exit. The increased tax would be borne by the partners of the fund and, in cases where a fund's investment is made through a partnership or LLC, the other taxable partners or members of the partnership or LLC (*e.g.*, real estate developers). If more than 50% of the partners of the fund are tax-exempt, the new rules can also apply to regular portfolio investments in so-called C corporations if the corporation itself is invested in a partnership. Finally, the new rules may also apply to defer the deductibility of interest on debt incurred by a partnership to fund investments, including investments in stocks and securities.

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What Congress Was Targeting

A SILO transaction generally works like this: A taxpayer buys municipal property (*e.g.*, a subway system) from a tax-exempt municipality (often foreign) and then leases the property back to the municipality. Arrangements are put in place to make it likely that the taxpayer will transfer the property back to the municipality at the end of the lease with modest economic exposure to the taxpayer. During the front end of the lease (which can last a long time), the depreciation deductions taken by the taxpayer on the property, together with the interest deducted by the taxpayer on its financing, substantially exceed the rental income from the property. Although the depreciation deductions are effectively reversed if and when the property is sold back to the municipality, the timing provides a substantial tax benefit to the taxpayer.

New section 470 of the tax code was designed to eliminate the use of SILOs to create this tax benefit. Under section 470, tax deductions (such as depreciation and interest expense) allocable to so-called "tax-exempt use property" for any taxable year generally cannot exceed the income from the property for the year. Any excess deductions are carried forward and treated as deductions (again subject to section 470) for the following taxable year. Any deduction carryforwards are allowable in any event in the year the property is disposed of. Thus, in the SILO described above, section 470 prevents the taxpayer from claiming depreciation and interest deductions from the subway in any taxable year in excess of the rental income from the subway for the year. So far, so good.

Application to Private Investment Funds

Tax-exempt use property is defined to include exactly what one might think — namely, property leased to a "tax-exempt entity" (such as a municipality), unless the lease meets certain detailed requirements. However, in enacting section 470, Congress borrowed the definition of "tax-exempt use property" used in another provision of the Code relating to depreciation. As a result, tax-exempt use property also generally includes a portion of any property owned by a partnership if: (1) the partnership has both "tax-exempt entity" partners and other partners and (2) the allocation to any tax-exempt entity partner is not a "qualified allocation."

The term "tax-exempt entity" includes (among others): (1) the United States, any state or any political subdivision and any instrumentality thereof (*e.g.*, state pension plans), (2) any organization generally exempt from tax (*e.g.*, private pension plans, endowments, and foundations), and (3) any foreign person unless the foreign person is taxed on at least 50% of the income from the underlying property for the year. U.S. individuals and corporations, such as the sponsors and principals of a typical U.S. private investment fund, are not tax-exempt entities. Thus, virtually every U.S. private investment fund will have both tax-exempt entity partners and other partners and therefore meet the first requirement.

The allocation to a tax-exempt entity partner will only be considered a "qualified allocation" if the tax-exempt entity is allocated the same share of each item of income, gain, loss, deduction, credit and basis during the entire period the tax-exempt entity is a partner. It is impossible for a fund with a carried interest arrangement to satisfy this standard since the LPs (including the tax-exempt entity LPs) generally bear 100% of the losses but receive only 80% of the gains.

Thus, unless an exception applies, a portion of each asset owned (directly or indirectly through one or more partnerships) by a private investment fund will be treated as "tax-exempt use property."

Limited Exception for UBTI Property

Property held by a partnership will not be considered "tax-exempt use property" if it is "predominantly used by the partnership" in an activity which, with respect to the tax-exempt entity partner, the gross income is includible in computing unrelated business taxable income (determined without regard to the debt-financed property rules). Since UBTI generally includes income from a trade or business regularly carried on, this exception will help in the case of most operating partnership investments. However, the exception is limited in two important respects.

First, UBTI excludes rent from real property and certain associated personal property and gain from the sale or exchange of property (other than inventory and similar property). As a result, investments in real estate generally will not qualify for the exception and will be subject to section 470. UBTI also excludes dividend and interest income. As a result, deductions associated with this type of income (including interest deductions on debt used to finance the underlying investment) can also be subject to section 470.

Second, state pension plans (as state instrumentalities) are generally not subject to UBTI. As a result, their share of any asset held (directly or indirectly through an operating partnership) by a private investment fund will always be considered "tax-exempt use property." In the case of a buyout or venture capital fund, this will generally only be an issue in the case of operating partnerships.

Simple Example

Suppose that 70% of the partners of a private investment fund are considered tax-exempt entity partners and the fund buys two buildings (the first of which generates $100 of rental income and no deductions and the second of which generates $100 of deductions and no income). Without regard to section 470, the investments generally would give rise to $0 net income. However, under section 470, (1) 70% of each building will be considered "tax-exempt use property" and (2) since the deductions on the second building exceed the income from that building, 70% of those deductions will be suspended until that building generates sufficient income or is sold. As a result, in the first year the investments will generate $70 of net taxable income ($100 of rental income from the first building less $30 of deductions from the second building).

Things Aren't That Simple

Section 470 appears to apply on a property-by-property basis, where a portion of each chair, desk, the goodwill, etc. is treated as a separate item of property. Thus, a portion of the depreciation on each chair is only permitted to the extent that income is allocated to the chair. This raises a variety of problems:

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good money after bad money by seeking to recover from the former investor.

- *Liquidity Issues.* Maintaining an illiquid side pocket, especially one that exceeds 20% of the value of a hedge fund, also introduces cash flow pressures. Because percentage limitations on illiquids are typically measured at the time of investment only, if the value of a hedge fund's liquid holdings declines or the value of its illiquid holdings increases, even a fund with a 20% limit on investments in private or illiquid securities could face times when a much larger portion of the current net asset value of the fund is tied up in illiquid investments. With such a substantial portion of the hedge fund's assets in illiquids with no ability to draw down additional capital to cover expenses, a hedge fund faces the choice of liquidating additional amounts on the liquid side of the portfolio or foregoing management fees on illiquids until their disposition. One could "gross up" the cost of an illiquid such that, upon investment, an amount equal to the cost of the investment *plus* anticipated fees and expenses associated with the investment is transferred from the liquid side of the portfolio to the illiquid side. This can result, however, in some idle cash on the illiquid side, creating an unnecessary drag on returns.

- *Accounting Issues.* A hedge fund with a substantial portion of its assets in illiquids may also face accounting complexities. For example, netting two economic streams — from the liquid portion of the portfolio and the illiquid portion of the portfolio — can be tricky. Some avoid this by separating the two streams. Thus, a loss on the illiquid side would not offset a gain on the liquid side. What results is in effect two separate funds within a single legal entity with a common management fee calculation based on the aggregate value of the two, a result that may not be attractive to all investors. Additional accounting issues may arise if the fund allows for an illiquid investment that has become freely tradable or otherwise fully liquid to be shifted over to the liquid side of the portfolio. The portion shifted over to the liquid side must be given a high watermark that appropriately reflects any losses or gains since capital was originally transferred over to the illiquid side to make a private investment.

A hedge fund taking on illiquid investments faces a host of more technical issues . . . including questions of valuation of and accounting for investments and the impact on liquidity for fund investors.

Housing Private Equity and Hedge Funds Under One Roof

In addition to the trend of hedge funds engaging in long-term control investing, some private equity firms are testing new waters by housing both private equity and hedge funds under the same roof.

Private equity firms' raising hedge funds is likely motivated by weaker private equity returns, difficulty raising capital for new private equity funds and the overwhelming demand from investors for hedge funds. Whatever the motivation, there are tremendous advantages to private equity and hedge fund cohabitation within the same firm. For hedge funds, moving into the private equity market — or vice versa — may enable a manager with an established reputation to leverage its existing client base and possibly circumvent some of the capital raising strains that a first time fund manager faces. Depending on a manager's industry focus, a manager also may be able to leverage its diligence efforts within a particular industry. A hedge fund's extensive research — in an industry for which expertise and research may provide an advantage, such as pharmaceuticals — may unearth valuable private equity opportunities, which typically would be discarded by a manager that houses hedge funds only.

Housing both also might enable a manager to maximize the opportunities in niche areas amenable to both private equity and hedge fund investing, such as distressed debt. Distressed debt can provide investment options to both a private equity fund, which may choose to wait out an investment until control is obtained and the business can be turned around, and a hedge fund, which may choose to flip the investment for a quick profit. And investments by each type of fund can offer different advantages to the firm. For example, hedge funds have the structural advantage of being able to move quickly because they don't need to secure debt for each new transaction, as a private equity fund typically would and, from a profit perspective, hedge funds will earn performance-based fees currently

rather than wait several years until disposition of an investment. In addition to leveraging industry due diligence, a hedge fund manager housing a private equity fund may be able to take full advantage of investment opportunities in illiquids without the pressure of offering periodic liquidity to investors.

Emergence of the "New Hybrid" Funds

A third example of convergence is the emergence of the "new hybrid" funds. These funds have terms that combine classic private equity and hedge fund terms in one investment vehicle to enable long-term investing in illiquid securities while still offering more liquidity to investors than traditional private equity funds. Hybrid funds are able to dampen overall risk while improving returns by deploying capital more diversely. The successes of several recent high profile examples of hedge fund participation in the private equity arena may be due in part to the original or non-traditional structural nature of the funds that pursue these investments, but they also can present marketing, legal and cultural challenges.

Hybrids and the Marketing Challenge

Hybrid funds by their nature fall somewhere in between the traditional hedge fund and the traditional private equity fund. For an institutional investor with clearly defined investment guidelines and allocation limits for investments in "private equity" and "hedge funds," a hybrid fund can be difficult to categorize into one of these buckets.

Marketing hybrids to other investors also can prove challenging. Hedge fund investors may desire liquidity and be concerned about having a portion of assets allocated to private investments. Private equity investors may be unfamiliar with some of the more traditional mechanics of a hedge fund and concerned, for example, by a lack of a GP clawback. For those sponsors marketing their first hybrid, pulling together a track record for a substantially similar strategy may not be possible. Even if it is possible, the sponsor must still choose whether to market any private investments using private equity language — IRR — or using hedge fund language — annual percentage return. If the fund is marketed using an annual percentage return, there is an overwhelming temptation to compare to a benchmark, but determining the appropriate benchmark comparison can be yet another headache.

Insider Trading and Cultural Issues of Combining Funds

Combining both styles of funds in a single house and hybrid funds raise other issues as well. Private investing and public investing must be separated to avoid any potential for insider trading. Unless a sophisticated information barrier is established with an oversight committee of sorts, this separation may limit the manager's ability to leverage its due diligence efforts within a single industry. Also, the compliance burdens and costs associated with investment adviser registration that most hedge fund managers now face can deter an unregistered private equity fund manager from considering housing hedge funds and diminish the ultimate economic benefits of cohabitation.

Having private equity and hedge fund principals share equity in a common enterprise also can raise cultural issues as most hedge fund managers are not accustomed to accepting the long term liability associated with GP clawback obligations. In addition, a private equity firm moving into hedge funds may face serious track record issues. The firm's established track record on the private equity side may not be portable to a hedge fund venture, hampering the firm's marketing ability. Of course a private equity fund can still buy its way into the hedge fund market by acquiring a hedge fund firm with its own existing track record. Acquisition can be a costly and time consuming and diligence-intensive approach, however.

While the convergence of hedge fund and private equity investing is appealing to some firms looking to maximize value and diversify strategies and product offerings in a tightening marketplace, fund managers should be aware that convergence may be a more complex proposition than it may seem at first glance.

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Marketing hybrids to other investors . . . can prove challenging. Hedge fund investors may desire liquidity and be concerned about having a portion of assets allocated to private investments. Private equity investors may be unfamiliar with some of the more traditional mechanics of a hedge fund and concerned, for example, by a lack of a GP clawback.

hypothetical buyer could not assert its GAAP claim at all, even if it were asserted with crystal clarity well before the expiration of any applicable survival period.)

In the case of a third-party claim, like the environmental claim with respect to the chemical company in the above example, most purchase agreements make clear that a buyer can make a valid claim under the purchase agreement with respect to a third-party claim so long as it provides prompt notice of such claim to the seller and specifies in such notice, *to the extent then known*, the basis for the claim, an estimate of the indemnifiable damages associated therewith, and the provision of the purchase agreement under which it is asserting its claim. Like the case of the direct claim, the absence of any standard as to what qualifies as a claim by a third party, coupled with the contractual acknowledgement, through the use of the phrase "*to the extent then known*," that even highly amorphous claims seem to count, will make it difficult for the seller to take the position that a written notice styled as a third-party claim notice along the lines of the above example involving the chemical company does not constitute a claim under the purchase agreement

[A] seller who negotiates for an acceptable survival period without also establishing strict standards governing the preservation of claims made prior to the end of that survival period could well end up feeling like it won the battle but lost the war.

In addition, very few purchase agreements contain any provisions that re-test or otherwise revisit the status of any claim as a continuing claim once it has initially been preserved beyond the applicable survival period, even to the extent the claim languishes or otherwise develops in a way that is much more benign than initially appeared to be the case. This can further complicate a seller's desire to put a temporal fence around the representations and warranties and, as noted above, could be particularly problematic for sellers in escrow deals where a portion of the escrow equal to the amount of any claim made prior to the expiration of the representations and warranties generally remains locked in the escrow pending the final resolution of the claim.

Not a Blank Check

None of this is to suggest that a buyer in a typical purchase agreement has license to unilaterally extend the duration of selected representations and warranties. Like all contracting parties, buyers have an obligation to act in good faith in the course of performing their contractual obligations. In addition, a buyer's ability to make certain kinds of potential third-party claims under a typical purchase agreement *are* subject to some objective standards that can preclude it from asserting an incipient claim prior to the end of a survival period principally so as to preserve it following the end of such period.

For instance, in the case of third-party claims, most purchase agreements do require that a precondition to an assertion of any third-party claim under the contract is *some* objective action by the potential third-party claimant that offers some concrete evidence of the third-party claimant's intention to assert the claim in question. In the case of the chemical business discussed above, that evidence was provided by the actions of the state environmental agency shortly before the environmental representation was set to expire.

But suppose one posits a similar fact pattern involving tax rather than environmental exposures and one also posits that the source of the buyer's concern as the termination of the tax survival period approaches is prompted not by any action of any taxing authority but rather the buyer's own discoveries about the possible under-payment of taxes by the target. In this circumstance, the buyer would be unlikely in most cases to be able to assert a third-party claim for indemnification because it could not produce any objective evidence within the survival period that a taxing authority was asserting, or might assert, a tax claim against the target.

Still, as illustrated above, most contractual survival periods have a degree of elasticity which could come back to haunt an unsuspecting seller. And, for that reason, many sellers, particularly private equity sellers who are always keen to distribute any escrowed sale proceeds to their limited partners as soon as possible, will likely want greater certainty as to the duration of their exposure period on contractual representations and warranties.

Possible Compromises

One potential way to truncate the resolution of indemnification claims is to include a mandatory arbitration clause in the underlying purchase agreement. Compared to the relatively unbounded world of litigation, binding arbitration can ensure that an indemnification

claim, once it is submitted for arbitration, will be resolved in a relatively expeditious manner. But a standard arbitration clause alone doesn't ensure that an incipient claim made shortly before the termination of a survival period will be resolved promptly because the clause applies only *once* the claim is submitted for arbitration; it does not govern the ability of a buyer to assert such a claim and thereby preserve it pending further development. Further, even though binding arbitration can create greater certainty as to the *timing* of a claims resolution, it may create unacceptable risk as to the *outcome* of its resolution because arbitrators in an M&A context do not always take the time to carefully evaluate a claim's underlying merits.

Accordingly, arbitration may or may not be a viable mechanic to expedite the resolution of incipient claims made shortly before the expiration of a survival period.

Instead, the most effective way for a seller to avoid the potential uncertainty associated with a lingering indemnification claim may simply be to define a qualifying "claims notice" under the contract such that a buyer is permitted to assert an indemnification claim *only* if it can set forth a reasonable degree of specificity about the claim in such claim notice. In addition, to the extent practicable, the purchase agreement could provide that if a buyer initially makes such a valid claim, it will nonetheless be deemed to waive that claim if it thereafter fails to process the claim to conclusion in accordance with objective standards set out in the purchase agreement.

Direct Claims

For instance, a purchase agreement could provide that a buyer is eligible to submit an direct indemnification claim against its seller — and therefore potentially elongate the survival period — only if it is in a position to (1) specify the specific provision of the agreement under which its claim is brought, (2) set out in reasonable detail the specific basis for its claim, (3) identify the precise amount of damages it is seeking to recover and (4) make an immediate demand for payment from the seller for such amount. Of course, to work best, these requirements should not be qualified by the words "*to the extent then known*" or words of similar import. In addition, to the extent the agreement contains an arbitration clause, the buyer's ability to continue to assert an indemnification claim, even if it is validly asserted initially, could be made contingent on the buyer's prompt initiation of an arbitration proceeding to collect on its claim and its subsequent compliance with the procedural requirements set out under the agreement with respect to the conduct of any such arbitration, including all time deadlines.

Third-Party Claims

Because third-party claims, by definition, are dependent on actions of third parties, *i.e.*, persons who are not party to, and therefore are not bound by, the contractual regime established between a buyer and a seller under a conventional purchase agreement, third-party indemnification claims can not fairly be made subject to all of the strict requirements described above in relation to direct claims. For instance, to require a buyer to commence an arbitration relating to a possible third-party claim prior to the time when that claim has been definitively resolved by the buyer and the third party in question is to effectively negate the claim, since absent an out of pocket payment to a third party, a buyer is likely to have little success in convincing an arbitrator to grant its indemnification claim under the purchase agreement.

But under these circumstances a seller would be well advised to at least condition a buyer's ability to make a third-party claim on the actual assertion of a claim in writing by the third party in question, as well as on the buyer's ability to (1) specify the specific provision of the agreement under which its third-party claim is brought, (2) set out in reasonable detail the specific basis for such claim, and (3) identify the precise amount of — or at least a range of the — damages it is seeking to recover. Note, for example, that under this standard, our hypothetical buyer of the chemical business described above would be barred from asserting its environmental claim prior to the end of the applicable survival period since, among other reasons, there was not a specific written assertion of a claim by the state environmental protection agency.

As in the case of the direct claims, a seller would also be well advised, to the extent practicable, to condition a buyer's ability to continue to maintain any such claim upon certain empirical standards established under the purchase agreement, such as the actual filing of a law suit by the third-party claimant with respect to its asserted third-party claim prior to some negotiated outside date.

So Sellers Beware

Because of the range of circumstances that potentially apply to inchoate claims, it may well be difficult, if not impossible, for parties to establish standards which appropriately preserve certain incipient claims and filter out others as of the end of contractually established survival periods. This may well explain why most purchase agreements do not address this issue squarely. But a seller who negotiates for an acceptable survival period without also establishing strict standards governing the preservation of claims made prior to the end of that survival period could well end up feeling like it won the battle but lost the war.

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position in the target. In that case, the sponsor's dealings with a significant stockholder may give rise to an earlier disclosure obligation on behalf of a "group" consisting of the sponsor and such stockholder. As a diligence matter, a sponsor should always confirm that there is no such cross-ownership prior to entering into negotiations with a significant stockholder.

The difficult question is whether pre-announcement disclosure is required if the financial sponsor neither holds equity in the target nor enters into a pre-signing voting agreement with a significant stockholder. If the significant stockholder has an existing Schedule 13D on file with the SEC, the Schedule 13D must be amended "promptly" (typically by the next business day) where the significant stockholder forms a plan involving the target that is materially inconsistent with its disclosure on file.

The point in time at which a stockholder is required to amend its existing disclosure depends on a variety of factors, including the nature and scope of the stockholder's discussions with the financial sponsor, the degree of the stockholder's participation in the transaction and the stockholder's existing disclosure regarding intentions and plans in respect of target. Often it will be possible to avoid 13D disclosure until the transaction is otherwise disclosed. However, the extent to which the disclosure of a transaction can be delayed ought to be carefully considered by the significant stockholder, the financial sponsor and their respective counsel. Hopefully, the Schedule 13D will have been drafted broadly enough so as not to require an amendment too early in the process.

How far can a financial sponsor go in locking up a deal through the execution of voting agreements with management or target stockholders? . . . . While — at least in Delaware — absolute lock-ups can backfire, arrangements short of an absolute lock-up may pass muster.

How Much Disclosure Does the SEC Require?

An additional snag of a pre-signing agreement with management is the possible implication of Rule 13e-3 under the Exchange Act. Rule 13e-3 seeks to protect public stockholders of targets that are the subject of affiliate-sponsored going-private transactions by providing them with the information needed to evaluate the transaction's fairness.

Where Rule 13e-3 applies, the parties to a going-private transaction must jump through a number of additional disclosure hoops beyond those imposed by the proxy and tender offer rules. Perhaps most importantly, the parties subject to the rule must file any material financial or strategic advice that they have received from third parties during the going-private process, including board books and similar information prepared by the target's financial advisor. In addition, they are required to discuss, in reasonable detail, whether and why they believe the transaction is fair to the target's stockholders. Rule 13e-3 also calls for the disclosure of any plans or proposals regarding the target, of background information on the control persons (in the case of the sponsor, all the way up the ownership chain to the managing members) and of information regarding the funding of the transaction, including any conditions to the acquisition financing. The SEC is a sharp watchdog when it comes to compliance with these requirements and typically devotes more attention to transactions that are subject to Rule 13e-3 than to ordinary merger or tender offer transactions.

Whether or not a particular going-private transaction falls within the scope of Rule 13e-3 depends on whether the transaction is between a target and its "affiliate." The definition of "affiliate" is generally considered to include a target's senior management and large stockholders. Even where management was merely negotiating the terms of its role in the surviving company (*e.g.*, because a special committee was charged with negotiating the acquisition), the SEC has viewed management as engaging in a Rule 13e-3 transaction in instances where management received a material amount of the surviving company's equity or was represented on the surviving company's board. The SEC has further taken the view that in such situations, *i.e.*, where management is essentially on both sides of the transaction, a financial sponsor may also be deemed an affiliate of the issuer and, thus, become subject to Rule 13e-3. This expansive interpretation of Rule 13e-3 by the SEC leads to the — somewhat counterintuitive — result that a management buy-out by an

otherwise unaffiliated financial sponsor in which management rolls over a large portion of its equity and has and retains key executive positions or board seats may be subject to Rule 13e-3 even where the financial sponsor owns the majority position in the surviving company.

On the other hand, there are instances in which Rule 13e-3 may be avoided even where management is involved in the deal. This may be true, for example, where there are no, or only preliminary or non-binding, arrangements with management at the time of signing such that the parties can argue that no seller affiliate was engaged in the transaction at the relevant time. Arguments against the application of Rule 13e-3 may also be viable, where management was not, or will not be, in a position to exert control on either side of the transaction, for example because the current and retained equity interest is small, management is not represented on the target's board and management will not assume any senior executive or board positions in the surviving company.

Forget the Tender Offer Structure?

Public company acquisitions are commonly structured in one of two ways: as a one-step merger or as a tender offer followed by a back-end merger. While the tender offer structure may provide timing advantages and a more beneficial standard of judicial review, tender offers are rare for a good reason in going-private transactions with management participation.

This is because of the "All Holders/Best Price Rule" (Exchange Act Rule 14d-10), which applies to tender offers, but not one-step mergers. This rule requires the bidder in a tender offer to pay all of the holders of the target's stock the highest price paid to any single holder. Since going-private transactions in which management participates often involve the negotiation, at an early stage, of special arrangements with management (such as new employment agreements, rollover equity or post-closing option grants), the question arises whether these perquisites might run afoul of Rule 14d-10. The law, unfortunately, is uncertain because the courts are split over this issue. This uncertainty and the threat of sizeable damage claims usually makes the one-step merger the structure of choice in going-private transactions with management participation.

How Firmly Can a Deal Be Locked Up?

In these uncertain times for deal certainty, how far can a financial sponsor go in locking up a deal through the execution of voting agreements with management or target stockholders?

The *Omnicare* decision by the Delaware Supreme Court imposed a prohibition on absolute lock-up arrangements with controlling stockholders. In *Omnicare*, a bidder had negotiated for a force-the-vote provision, *i.e.*, a covenant in the merger agreement requiring that the deal be put before the vote of the stockholders even if the target's board withdrew its recommendation. At the same time, the bidder had entered into a watertight voting agreement with the target's controlling stockholders, rendering the target's board's nominal ability to change its recommendation meaningless. This arrangement was held to be preclusive and coercive since it made the approval of the deal a *fait accompli.*

While — at least in Delaware — absolute lock-ups can backfire, arrangements short of an absolute lock-up may pass muster. For example, a recent Delaware decision upheld a controlling stockholder's voting agreement with a prospective acquirer that required the stockholder to vote against competing bids for a period of eighteen months. Other arrangements short of a *fait accompli* may likewise be outside the scope of *Omnicare*. Such arrangements may include a lock on less than fifty percent of the vote or structures that include economic disincentives, but not an absolute restriction, on the significant stockholder's ability to walk from the deal.

The Bottomline

From a legal perspective, partnering with management or significant stockholders in a going-private transaction makes for dangerous liaisons — or at least complicated ones. Because many of the problems posed by management and stockholder arrangements come up during the early stages of a deal, and because the solutions depend in large part on the details and dynamics of a particular transaction, financial sponsors should be sure to consult with their legal advisors as early as possible in the process. ▢

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Throwing Out the Bath with the Bathwater (cont. from page 17)

First, when each chair is viewed as a separate piece of property, the number of properties held by a typical business may well number in the thousands or hundreds of thousands. Few taxpayers have the ability to apply section 470 at such a granular level.

Second, nothing in the statute or the legislative history gives any guidance on how you allocate the income of business among the properties used in the business. How does a business allocate its income among its various assets, such as the real estate it uses, its computer system, each piece of furniture?

Third, there is no hint in the legislative history of section 470 that Congress intended it to apply to regular businesses or real estate held in partnership form. Indeed, the effective date provision states that the rules are "effective for leases entered into after March 12, 2004," but provides no guidance as to when they are effective in the case of tax-exempt use property that does not involve a lease.

What Should Funds Be Doing?

There is very little that private funds can do at the moment in response to the new rules other than understand their potential impact in structuring and negotiating new transactions. For example, in cases where the impact may be substantial, funds may wish to enter into agreements that appropriately allocate the potential incremental tax costs and understand the implications of allowing certain investors to participate. However, in light of the almost universal hope that Congress (or the IRS) is going to fix the problem, we expect that most private funds will (at least for now) maintain their current tempered response to the legislation.

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Recent and Upcoming Speaking Engagements

April 7	Ann G. Baker ***Pan European Fund Raising and Structuring*** EVCA Institute/Tax & Legal Course Brussels, Belgium
May 11	Sherri G. Caplan ***Fiduciary Duties of Persons Controlling Alternative Entities*** Practicing Law Institute New York, NY
May 17	Michael P. Harrell ***Structuring Optimal Private Funds Terms and Conditions*** SuperReturn U.S.A: Private Equity and Venture Capital Summit New York, NY
May 17	Ann G. Baker ***How Not to Lose Your Shirt on Terms and Conditions*** LP Summit Paris, France
May 21	Friedrich Hey ***Structuring Private Equity Investments in Europe*** ABA Conference Tax Section Washington, D.C.
May 23	Thomas M. Britt III ***Asian Buyouts*** Asian Venture Capital Journal Forum Chicago, IL
June 9	Franci J. Blassberg, Moderator ***Current Developments in Leveraged Buy-outs*** 4th Annual Mergers and Acquisitions Conference International Bar Association New York, NY
June 20-22	Adele M. Karig ***Structuring Private Equity Fund Invesments in LLCs*** Private Equity Tax Practice Institute for International Research Boston, MA