Debevoise & Plimpton
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Institutional Fund Sponsors' Consolidation Woes

Financial institutions that control general partners of investment funds are bemoaning recently-approved accounting rules that will generally require them to consolidate their financial results with the results of the funds they manage — unless they share control of the fund with an independent co-general partner or provide kick-out or participating rights to the limited partners. Despite criticism from members of the investment fund community, the Emerging Issues Task Force of the Financial Accounting Standards Board reached a consensus position that will require that virtually every investment fund limited partnership agreement be amended if the general partner (or any entity that controls the general partner) prepares GAAP financial statements and wishes to avoid including all of the fund's assets, liabilities, revenues and expenses in its own consolidated financial statements.

Fund sponsors that prepare GAAP financials have generally avoided consolidation of the general partner (and thus themselves, where they control the general partner) with their investment funds by including in each fund's limited partnership agreement a provision allowing the limited partners to remove the general partner "without cause" upon a super-majority limited partnership vote.[1] Fund sponsors have claimed — and their auditors have generally supported their position — that such a supermajority removal provision is sufficient to overcome the presumption of general partner control of the fund that would otherwise require the general partner to consolidate with the fund for financial accounting purposes.[2] Under the new EITF rules, however, supermajority kick-out rights are not sufficient to block GP control.

New GAAP Rules for Fund General Partners

Due to the nature of a limited partnership (where only the general partners have the power to manage the affairs of the partnership), only the general partners of a limited partnership are treated as having voting equity interests. Thus, the general partners are presumed to control the limited partnership. Under certain circumstances, however, the limited partners may have rights that are sufficient to overcome the presumption of control by the general partners. Until the recent EITF action, which limited partner rights are sufficient and how substantial those rights must be for Fund general partners to avoid control for financial accounting purposes has been unclear.

In June, the EITF reached a final consensus position on Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." The FASB approved the EITF's action on June 29.

Institutional sponsors of investment funds ("Funds") will be the most affected, since those sponsors generally prepare GAAP financial statements, and the general partner is usually a controlled subsidiary of the sponsor and thus included in the sponsor's consolidated financial statements. For Funds sponsored by private equity firms that do not prepare GAAP financials for the general partners of their Funds

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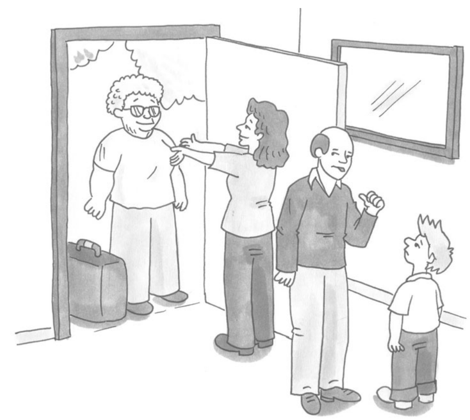

"She's affiliated, but we're not consolidating with her."

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letter from the editor

As all private equity professionals know, tax and accounting issues can make or break fund structures as well as deal structures. In this issue, we discuss several tax and accounting developments of particular import to the private equity world. Our cover article reports troubling news contained in a recent FASB ruling that will require most institutional general partners who issue GAAP financials to consolidate their financials with those of their investment funds and gives some critical steps for GPs to take to avoid consolidation. The last few years have seen numerous spinouts of private equity groups from big institutions into their own boutique firms. One could surmise that the FASB ruling may encourage more financial institutions to divest their private equity funds rather than face the risk of consolidation. Our Trendwatch column analyzes the legal and commercial issues facing all managers contemplating spinning out a private equity group.

Private equity professionals face a myriad of unfamiliar challenges both when taking public companies private and when taking portfolio companies public. In our last issue, we discussed the first scenario; in this issue we report on recent Delaware case law that suggests more protection for controlling shareholders from frivolous lawsuits following the announcement of a going private transaction. Elsewhere, we consider whether deal terms in private equity public to private deals are starting to mirror those of strategic deals in the U.S. On the flip-side, another article reminds us of the issues sponsor firms should bear in mind before taking a portfolio company public.

In our Guest Column, Colin Blaydon and Fred Wainwright, both Professors at the Tuck School of Business at Dartmouth and principals at the Center for Private Equity and Entrepreneurship at Tuck, predict that while GPs seem to be adopting valuation guidelines suggested by PEIGG more broadly in the U.S. than previously thought, recent research indicates that wide-spread adoption of consistent valuation guidelines is unlikely.

Elsewhere in this issue, we remind private equity sponsors of the dangers of blurring the lines between stockholder and director and not being sensitive to the conflicts of interest that inevitably arise when controlling stockholders have Board seats, and we give a ten point primer on second lien financings.

Last year, we reported on the prospect of income deposit securities as a hot new exit strategy for companies without the growth prospects for a traditional IPO. In this issue, we update you on how the IDS strategy has been received to date.

Finally, we review recently proposed rules from the U.S. governing the transfer of partnership interests which if adopted will have significant impact on how private equity firms structure carried interests and other common transfers unless safe harbors are found; and from Germany, we announce that most private equity funds will be exempt from the penalizing tax rules and reporting and publication requirements of last year's Investment Tax Act.

This fall will mark the five year anniversary of the *Private Equity Report*. We hope it has provided useful guidance on issues facing private equity professionals in a rapidly changing deal environment. Keep your eye out for our *Best of the Debevoise & Plimpton Private Equity Report*, which we expect to publish before year-end.

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Proposed Carried Interest Tax Rules: Square Peg, Round Hole

In May 2005, the IRS issued for the first time a comprehensive set of rules governing the transfer of partnership interests in connection with the performance of services. Although not directed at private funds in particular, the proposed rules will (if finalized) apply to a host of transactions commonly undertaken by virtually all private equity firms. These include (1) the receipt by the entity serving as the general partner (the "GP") of the 20% carried interest in the fund, (2) the receipt by the private equity professionals of interests in the GP, and (3) the receipt by the private equity professionals of an interest in the entity serving as the manager (the "Manager").

Overview

- In most circumstances, the proposed rules would generally permit the same favorable tax treatment relating to the carried interest that is available under current practice, such as not including any income upon the receipt of the carried interest and maintaining capital gain flow-through.
- In order to ensure this treatment, both the fund and the GP will need to comply with a new Safe Harbor Election. A variety of detailed requirements must be met in order to qualify for this election, such as including certain language in the partnership agreements for the fund and the GP. The partnership agreement language must be enforceable against all of the partners, including the passive limited partners.
- If an interest in the GP is subject to vesting, the recipient of the interest will generally want to file a so-called 83(b) election with the IRS within 30 days of receiving the interest.
- If a new partner recognizes income upon the receipt of a partnership interest (*e.g.*, where a "capital interest" is issued), the partnership will generally have a current deduction, but the deduction cannot be allocated to the new partner.
- If a partner is allocated income or gain with respect to a partnership interest but forfeits the interest before the income or gain is distributed, the partnership will be required to specially allocate deductions or losses (to the extent available in the forfeiture year) to that partner to reverse the undistributed income or gain. However, if the available deductions or losses are insufficient, no further loss will be permitted.
- The proposed rules apply to both U.S. and non-U.S. funds, if a carried recipient is a U.S. taxpayer. However, it appears that only funds that file U.S. tax returns will be eligible to make the election.
- In addition, the proposed rules include a host of other provisions that could affect how the members of the GP and the Manager are taxed.

Application to Existing Arrangements

As proposed, the rules would only apply to partnership interests transferred after the rules are finalized by the IRS (which is not expected to occur for at least a year, and will probably take much longer). Although the new rules generally should therefore not apply to the GP's receipt of the 20% carried interest in a fund that had already closed or that closes before the proposed rules are finalized, the rules could well apply if such a fund creates a so-called "alternative investment vehicle" to hold a particular investment or a "parallel fund" for particular investors after the effective date. One can expect many sponsors to include language in new fund agreements (and in some cases to amend existing agreements) to ensure that the carried interest in the fund (and any AIVs or parallel funds) are eligible for the safe harbor. Some sponsors have already started to add these provisions to their agreements.

Similarly, the proposed rules generally should not apply to partnership interests in the GP or the Manager issued before finalization of the rules. However, the new rules could well apply where the interests in an existing GP are adjusted after the rules become finalized, such as where the terms of the GP require that each member's share of the carry be adjusted each year or each time a portfolio investment is made. Again, we expect that many sponsors will now include language to provide for general flexibility to ensure compliance with the safe harbor.

Background

Section 83 of the tax law provides that if a person receives property in connection

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with performance of services, the person has income equal to the property's "fair market value" (less any amount actually paid for the property). The income is includible and the property is valued at the time the property is considered "transferred." If the property is subject to vesting, the property is considered "transferred" at the time it vests (rather than at the time it was actually transferred) if a section 83(b) election is not made. If a section 83(b) election is made, the tax treatment follows the form, and the transfer is treated as occurring when the property is actually transferred.

Square Peg in a Round Hole

Although nothing in section 83 carves out partnership interests, the general rules applicable under section 83 simply do not reflect the common understanding of how someone is taxed upon the receipt of a partnership interest. Thus, for example, no one (or virtually no one) who makes partner at a law firm, accounting firm, or other traditional service partnership reports income under section 83 based on the "fair market value" of the partnership interest received. Rather, the understanding is that the new partner will be taxed on his or her share of the partnership's income as it is realized by the partnership.

Similarly, when the GP of a fund receives the 20% carried interest in the fund, it has always been the universal practice (even before the issuance of the IRS revenue procedures discussed below) not to include any amount in income upon the receipt of the interest, even though the "true" fair market value is arguably substantial. Rather, the GP (and the investment professionals who own the GP) report income and gain only as they are realized by the fund and flow through to the partners.

Rules Applicable Until the Proposed Regs Become Finalized

Until the proposed rules are finalized, taxpayers can continue to rely on two IRS "revenue procedures" (which are somewhat like SEC no-action letters). These rulings effectively create a safe harbor pursuant to which (1) the receipt of a "profits interest" in a partnership is generally not treated as a taxable event if it is received in exchange for services "to or for the benefit of the partnership" and (2) such an interest is not treated as property for purposes of section 83 so that the recipient does not need to make a section 83(b) election. A partnership interest is considered a profits interest if the holder would not be entitled to any distributions from the partnership under the partnership agreement if, immediately after the interest was transferred, the partnership sold all of its assets for their fair market value and then liquidated. This safe harbor is not available, however, if the recipient of the profits interest transfers the interest within two years of receipt.

The 20% carried interest in the fund issued to the GP is considered a profits interest under these revenue procedures. An interest in the GP issued to an investment professional is usually structured so that it qualifies as a profits interest.

The Proposed Rules

The proposed rules would repeal the revenue procedures discussed above. Instead, under the proposed rules, section 83 would expressly apply to any transfer of a partnership interest in connection with the performance of services, including the issuance of the 20% carried interest in a fund to the GP and the issuance of interests in the GP and the manager to the investment professionals. As a result, unless the safe harbor discussed below applies, the recipient of such an interest would generally have income equal to the "true" fair market value of the interest (which is generally the amount that would change hands between a willing buyer and a willing seller, each with all available information and under no compulsion to buy or sell, but ignoring any vesting provisions).

Prior to the issuance of the revenue procedures discussed above, there were a number of court cases dealing with how to apply this valuation standard to a profits interest in a partnership. The cases reached conflicting results, with some courts (most notably the court in a case called *Campbell*) concluding that the value of such an interest was sufficiently speculative that it should be valued at zero and others concluding that valuation was possible. It is not clear whether *Campbell* survives the proposed rules.

Valuation Under the Electing Safe Harbor

The proposed rules provide that a partnership can elect for all "Safe Harbor Partnership Interests" in the partnership to be valued based on their "liquidation value" rather than their "true" fair market value. A partnership interest's liquidation value is defined as the amount of distributions that would be made in respect of the interest if, immediately after transfer, the partnership sold all of its assets (including any goodwill or other similar intangibles) for their fair market value and then liquidated. Under this methodology, the 20% carried interest issued to the GP at the fund closing would typically have a zero value and an interest in the GP that corresponds to a portion of the GP's carried interest would typically be structured to have a zero value.

Interests Eligible for the Safe Harbor

Even if all of the requirements for the safe harbor (discussed below) are satisfied, the special valuation rule only applies to so-called "Safe Harbor Partnership Interests" in the partnership. An interest in a partnership can only be considered a "Safe Harbor Partnership Interest" if (among other things) it is

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Navigating Conflicts on Boards of Portfolio Companies

When a private equity firm has a control equity and board position in a company, it's easy for the lines between stockholder and director to blur. The tendency to think of the company as "our company" may be hard to resist. But in light of the current environment of heightened scrutiny of corporate governance and recent Delaware case law addressing directors' fiduciary duties, private equity firms need to be sensitive to and carefully navigate potential conflicts of interest as they consider and evaluate transactions when serving on the boards of their portfolio companies.

There can be more potential for conflicts of interest in serving on the board of a portfolio company than one might think. Conflicts may arise involving different classes of stockholders. Conflicts also could arise involving separate portfolio companies operating in the same industry that are controlled by the same private equity firm. And, if a portfolio company ultimately fails, creditors may scrutinize certain types of material transactions involving stockholders, even if they are taken at a time when the company is not insolvent. On top of all of this, private equity professionals need to be aware that courts will be reviewing their decisions closely because the existence of conflicts of interest in transactions approved by a board of directors will heighten the level of judicial review.

Fiduciary Duties in a Nutshell

As most private equity professionals serving as directors are undoubtedly aware, directors owe fiduciary duties to their portfolio companies, including duties of care and loyalty. Delaware law permits directors to be indemnified for breaches of the duty of care but not the duty of loyalty and not for any actions that are not taken in good faith. The "good faith" exception to indemnification has recently received a great deal of attention in light of Delaware cases that have concluded that directors may be personally liable for breaches of duty of care which are so egregious that they constitute breaches of good faith. In these recent cases, the board's deliberative process and record of review were found by the court to be so woefully inadequate as to constitute a conscious disregard of its duty and therefore, were not taken in good faith. Further, certain types of transactions, such as exit transactions, may impose additional duties that will place additional requirements on the board's deliberation process.

Some situations that are ripe for conflicts of interests and after-the-fact claims against private equity professionals are illustrated below. We will then offer some tips on how you can better protect yourself in addressing these conflicts.

Different Classes of Stockholders

Directors are generally obligated to act in the best interests of the corporation and all of its stockholders. But, if the portfolio company has different classes of stockholders, not all stockholders are going to benefit equally from certain deals. In fact, certain classes of stockholders could potentially be wiped out entirely upon a sale or other exit event. The classes with a lower priority than the private equity firm may well challenge such a deal (after all, they have little to lose) by asking, "Why sell now?" They will claim that the board should bypass this deal and "swing for the fences" in operating the business for the ultimate benefit of all stockholders. Obviously, if the company is insolvent at the time, these claims by lower priority stockholders will clash with those of creditors who will argue that the business needs to be managed for their benefit. (For a detailed discussion of fiduciary duties of directors of insolvent companies, see "Troubling Times for Directors of Portfolio Companies" in the Winter 2002 issue of the *Debevoise & Plimpton Private Equity Report.*)

Fortunately, Delaware case law suggests that courts will respect the decisions of a board that have the effect of benefiting certain classes of stockholders to the exclusion of others if there is a strong record supporting why the approved transaction is the right transaction at the right time. For example, in one case in which the board approved a sale in which the common stockholders would be wiped out, the court rejected the common stockholders' claims even though the board went so far as to take specific action to reduce the voting power of the common stockholders in connection with the transaction. It appears the court reached this conclusion because it was presented with a clear record that the company was struggling and had searched fruitlessly for other sources of capital for two years.

Fighting Over the Same Opportunity.

Private equity professionals may find themselves serving on the boards of directors of multiple portfolio companies that have different minority stockholders but that operate in the same or similar industries. So, if a new opportunity comes up in this industry, should the fund direct it to portfolio company A or portfolio company B? If an opportunity is presented to a private equity firm's director designee by a third party in the context where it is clear that his connection with one of the two firms is leading to the offer, then that firm should be presented with the opportunity. If an opportunity is presented to a private equity professional without clear regard for his affiliation with one of the two companies, the firm should be able to direct it as it sees fit but (as our tips below indicate), the firm should also be sure that the stockholders

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agreement governing each of the companies makes clear that its stockholders have no duties regarding corporate opportunities or other types of competition. Also note that if certain types of recurring conflicts are anticipated, a company can renounce in advance its interest in specific business opportunities or specific classes or categories of business opportunities by adopting an express provision in the company's charter. (Of course, in approving a provision renouncing certain types of opportunities, directors will remain subject to traditional fiduciary duties, including their duty of loyalty, and should make their decision in an informed manner.)

Leveraged Transactions. Private equity professionals on the boards of portfolio companies may be called upon to approve various types of leveraged transactions that will benefit them in their capacity as stockholders, such as a large dividend financed by a leveraged recapitalization or a sale to another private equity firm that intends to leverage up the company immediately after the closing. Approving such a deal when the company is insolvent would be a no-no, but directors should also be aware that there is Delaware case law which states that directors also have a duty of loyalty to the company not to take actions that would leave it with "unreasonably small capital" such that the risk of insolvency is reasonably foreseeable.

In one noted case involving a leveraged buyout, a court sustained a claim (although it was subsequently rejected by a jury) that the board of directors of a selling company breached their fiduciary duties by not informing themselves of all material information reasonably available to them prior to approving the sale which left the company with little to no capital. In that case, the company defaulted under several of its financing covenants within one year of the sale and filed for chapter 11 within the following year. In reviewing the board's decision to approve the sale, the court specifically cited the board's failure to review financial projections prepared by the buyer that would have shown that the projections were not based in reality and left no margin for error. Specifically, the projections assumed immediate savings from an overhaul of the company's distribution system which had been ongoing for years with no proven results.

How to Protect Yourself

So, those are some of the conflicts. Here are a few tips to best protect yourself against subsequent challenge:

1. *Know Your Duties.* Directors' fiduciary duties and the constituencies to whom they are owed may vary based on the jurisdiction of incorporation or the circumstances involved. The board's record should show that it had appropriate counsel explaining their duties — *e.g.*, is a sale transaction triggering the duty to get "the best price reasonably available" or is the company in a state of financial distress such that a duty is owed to creditors — and that consideration of these duties factored into the decision-making process.

2. *Review All Material Information.* As noted above, directors have a duty to inform themselves before taking any actions by availing themselves of all material information reasonably available, such as copies of all significant agreements, financial projections and other relevant financial analyses. Although term sheets and written summaries can be extremely helpful for directors, recent Delaware cases suggest that directors who made decisions on the basis of term sheets or summaries did not act on an informed basis. If a leveraged transaction is being approved, the information to be reviewed should include projections illustrating how the business will be able to sustain the additional leverage, including a sensitivity analysis if the company performs below plan. Sellers in leveraged transactions should have some level of comfort based on its review or its financial advisor's review of buyer's financing commitment papers and any supplemental materials regarding projections for the business (recognizing that a buyer will likely be reluctant to provide its full operational plans).

3. *Create a Good Record.* In addition to exercising applicable fiduciary duties and reviewing appropriate materials, it is equally if not more important to create a record documenting the board's deliberation process. Board members should be actively and consistently involved in the decision-making process. Board meetings should occur on a regular basis and significant decisions taken at a meeting ideally should have some predicate discussed at a prior meeting showing how the decisions are consistent with the plan for the business. Board minutes should be detailed enough to identify the topics discussed and show that alternative transactions were considered. We are not suggesting that individual director questions should be reflected in the minutes (indeed that might be counterproductive) but directors should note that in a recent Delaware case finding that directors breached their duty of care, the court specifically criticized the lack of detailed minutes relating to the approval of a substantial compensation package for the company's president.

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A Tune-Up for Going Privates — Goodbye to Frivolous Lawsuits?

In our last issue, we explored some of the challenges private equity firms face when they take public companies private.[1] Another challenge is dealing with the flurry of lawsuits that seem to be routinely filed when a going private transaction is announced. A recent Delaware case, *In re Cox Communications, Inc. Shareholders Litigation*, explores some of these issues and proposes to overhaul Delaware going private law in a way that might provide better legal protection to controlling shareholders and boards that follow an exemplary process, while reducing the frivolous litigation that dogs these transactions.

The facts of the case are typical of going private transactions. The Cox family, which controlled 77% of the voting stock of Cox Communications, proposed to take the company private at $32 per share, subject to approval by a special committee of independent directors. On the day the proposal was announced, before any deal was agreed, six complaints were filed in Delaware, including the "entirely boilerplate" one before the court.

The special committee negotiated with the Cox family, which eventually agreed to increase its price to $34.75 per share and to condition the transaction on approval by a majority of the publicly held shares. In parallel, the Cox family negotiated to settle the plaintiffs' lawsuit — a process the court describes as "A Tale Of Two Negotiation Paths Leading To The Same Place At the Same Time." In the settlement, the Cox family acknowledged that the efforts of plaintiffs' counsel were "causal factors" that led to the increased price and the minority approval condition. The Cox family later agreed not to oppose an attorneys' fee request of up to $4.95 million.

The court found that the litigation was "unripe and without merit" when filed, since, at that time, the proposal was fully negotiable by the special committee. Nevertheless, the court felt bound to order some fee because the defendants' desire to get rid of the litigation may have had "some useful role" in the price attained. Skeptical that the lawsuit had much of an effect on the ultimate deal price, and finding that plaintiffs' counsel had taken little risk and put in too many hours in bringing the suit, the court awarded fees of $1.275 million — slightly more than a quarter of the requested fee.

But the real problem, according to the court, is that the legal test applicable to Delaware going private mergers tends to breed strike suits. Under Delaware law, all mergers with controlling stockholders are subject to the test of entire fairness — fairness of price and fairness of process — even if the merger is approved by a special committee and is made subject to a minority approval condition. However, if the merger is negotiated and approved by a properly functioning special committee, the burden shifts to the plaintiff to prove that the transaction was not entirely fair. Conditioning the transaction on approval by an adequately informed minority also shifts the burden.

As a result, the court says, controlling stockholders lack adequate incentives to condition their going private transactions on approval by the minority holders, which the court believes to be a "critical" check on the faithfulness and effectiveness of a special committee. Because they receive only the same "modest procedural benefit" — the shifting of the burden of proof — by having a minority approval condition as they would by having a special committee alone, controlling stockholders are less likely to accept the added transactional risk imposed by a minority approval condition. At the same time, requiring a test of entire fairness, regardless of the procedural protections implemented, encourages frivolous litigation. Because the plaintiff will almost always be able to allege that a transaction was not entirely fair, going private litigation is extremely difficult to have dismissed at the pleading stage — which means that it has settlement value.

As a solution, the court proposes a new test: if a controlling shareholder makes a merger proposal that from its inception is subject to (1) negotiation and approval by a special committee of independent directors and (2) minority shareholder approval, then the business judgment rule would presumptively apply, so that any plaintiff would need to plead particularized facts that the independent committee lacked independence or was ineffective because it breached its duties or because of wrongdoing by the controlling stockholder, or that the minority approval was tainted by "misdisclosure, or actual or structural coercion."

It's an interesting proposal, but not one that is legally binding: the Chancery Court remains bound by Delaware Supreme Court precedent requiring "entire fairness" review of all going private mergers. But the court hopes that by holding categorically that "complaints attacking negotiable proposals are non-meritorious and do not give rise to a presumptive claim to a fee," the decision may embolden some future defendant to challenge, rather than settle, a going private strike suit, which could give the Delaware Supreme Court an opportunity to consider these suggested reforms.

Until that happens, however, shareholder litigation is likely to remain a standard — though possibly less lucrative — feature of going private transactions.

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1 *See Dangerous Liaisons: Teaming Up with Management and Significant Stockholders in Going Private Transactions, Debevoise & Plimpton Private Equity Report, Spring 2005.*

Navigating Conflicts on Boards of Portfolio Companies (cont. from page 6)

4. *Exercise Negative Veto Provisions as a Stockholder Rather Than as a Director.* It is customary for stockholders agreements to include "veto" rights that the private equity firm can exercise over certain corporate actions. If potential conflicts could arise, it may be helpful to provide that such rights will be exercised by the private equity firm in its capacity as stockholder rather than by the director who is appointed by the stockholder. As noted above, a director has a duty to all stockholders. An individual stockholder, by contrast, can usually be free to act in its own interest.

5. *Include Protective Provisions in the Company's Charter.* If not already provided, private equity firms should seek to take full advantage of the protective charter provisions permitted by Delaware law, including provisions that limit personal liability of directors for certain breaches of fiduciary duties and provisions that relate to renunciation of corporate opportunities. (Obviously, private equity professionals should also be comfortable with the scope of the portfolio company's D&O policy and also the scope of their rights of indemnification at the fund level in respect of their services as portfolio company directors.)

6. *Limit Stockholder Obligations in the Stockholders Agreement/LLC Operating Agreement.* If the private equity firm as a stockholder wants to be free to pursue corporate opportunities in which the portfolio company may have an interest, a disclaimer in respect of corporate opportunities can be included in the stockholders agreement. Also note that if you are operating in the form of an LLC, the managers (who are often still referred to as a board) have a greater ability to limit fiduciary duties than would exist for a corporate entity.

7. *Consult the Experts.* In evaluating a significant corporate transaction and weighing the relevant alternatives, the board should consider hiring experts, including financial advisors, who can assist in the board's decision-making. Directors of companies who are considering a significant leveraged transaction that may potentially create an unreasonable risk of insolvency are particularly well-advised to obtain financial advisors who can assist them in determining whether the transaction will leave "unreasonably small capital" in the company. Obtaining a solvency opinion from a valuation firm is also helpful. It is important to note that directors must still exercise "reasonable care" on behalf of the corporation in selecting outside experts and may only rely in good faith on such experts.

8. *Require Approval by Independent Directors.* If the portfolio company has independent directors, they could be appointed to a special committee to separately approve the transaction and to recommend it to the full board.

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Proposed Carried Interest Tax Rules: Square Peg, Round Hole (cont. from page 4)

issued to a service provider in connection with the performance of services to that partnership. By contrast, the existing revenue procedures apply to interests in a partnership so long as they are granted in exchange for services provided to or *for the benefit* of that partnership.

In some cases, it is not clear whether an interest in the GP is being granted in exchange for service to the GP (in which case the new safe harbor could apply) or in exchange for services provided to the manager (in which case the new safe harbor might not apply). In many funds substantially all of the activities are undertaken by the manager, with the GP's actions limited to making final buy/sell decisions. Although it seems relatively clear that the individual members of the GP who participate in the buy/sell decisions should be treated as receiving their GP interests in exchange for services to the GP, this may be less clear in the case of the less senior members of the GP who do not have a say in the decision-making process. Similar uncertainties may arise in relation to UK-style fund agreements, where the carried interest recipient typically is a limited partner of the fund, rather than the general partner. In issuing the proposed rules, the IRS specifically asked for comments about how the rules should apply when the services are provided to an affiliated entity.

In addition, an interest in a partnership will not be considered a Safe Harbor Partnership Interest if it is issued "in anticipation of a subsequent disposition" by the recipient. If the GP agreement includes a right to call a member's interest in the GP if the member stops providing services to the GP, the safe harbor will not apply to interests granted in the GP unless it can

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Selected Issues to Consider When Taking a Portfolio Company Public

There has been a lot of buzz in the press recently about IPOs backed by private equity sponsors. Even if the IPO market isn't as frothy as many would like, now is an opportune time to revisit issues sponsor firms should bear in mind before taking a portfolio company public.

Will we still get our management fees?

Private equity sponsors generally receive annual fees for the monitoring or consulting services they provide to their portfolio companies and generally have contractual indemnification rights in connection therewith. Although a private equity firm's relationship with its portfolio company will change following an IPO, the consulting agreement may or may not terminate at that time. Some firms will continue to charge a fee (or a revised fee) for all or a remainder of the term of the agreement. Others charge a fee in connection with the IPO, sometimes based on the present value of the fee payable over the remaining term of the agreement, while yet other firms charge an exit fee in connection with the IPO which is not based on value to the company of "prepaying" the consulting fee for the remaining term. Obviously, such arrangements need to be disclosed and are dependent on there being no restrictions under the fund's Partnership Agreement and may require implementing whatever LP sharing provisions exist. Disclosure may satisfy a private equity firm's lawyers, but any fee that the market views as oversized may impact the success of the offering.

Should we still be on the Board?

Most private equity sponsors generally have contractual rights to designate directors contained in a shareholders agreement or similar agreement. The agreement may or may not provide for the termination or continuation of these rights post-IPO. A private equity sponsor that is taking a portfolio company public should consider whether it is appropriate to adjust or terminate these designation rights. While a sponsor with a majority stake or close to that in the portfolio company post-IPO will generally have the ability to elect a number of its nominees, there may be advantages to having that right as a matter of contract. Contractually mandated nomination rights may be exercised by the sponsor as a matter of right without implicating the fiduciary duties of the independent directors sitting on the nominating committee or otherwise considering the nomination process under the NYSE or Nasdaq rules. The contractual nomination rights will need to be harmonized with the NYSE or Nasdaq mandated procedures for considering nominations and disclosed, but should be respected. Such nomination rights will generally be constructed to bear a reasonable relation between the voting power of the sponsor post-IPO and the number of nominees that may be designated, with that right diminishing and then terminating once the percentage of shares held falls below specified levels.

What anti-takeover provisions should the company adopt?

What are the pros and cons of adopting anti-takeover provisions?

Management and the private equity sponsor may have different views as to the desirability of anti-takeover measures. Management may favor these measures while the sponsor may prefer to have fewer impediments to a transaction in which it might be able to obtain a premium price for its stake. However, certain anti-takeover provisions may benefit the sponsor by making the company more attractive to sophisticated management and providing the Board with more flexibility to resist low-ball takeover approaches and choose the proper time to shop the company for sale. Although institutional investors generally disfavor anti-takeover defenses, it is possible to include some protection for companies going public without alienating institutional investors.

Anti-takeover provisions that might be considered include: a staggered board, a poison pill, restricting shareholder action by written consent, restricting the right to call a special shareholder meeting and creation of blank-check preferred stock. The ability to issue blank-check preferred stock will generally enable the Board to later adopt a poison pill quickly in response to an unwanted takeover approach, in the event that a poison pill is not adopted immediately. Restricting shareholder action by written consent and limiting the right of stockholders to call a special meeting may allow the Board greater control over the timing of stockholder action, while not completely foreclosing the possibility of a successful hostile bid. Provision for a staggered Board increases the Board's ability to resist a hostile takeover combined with a proxy fight, but that utility has to be weighed against investors' attitudes towards such provisions. The anti-takeover provisions adopted should be protected against amendment by a simple shareholder majority vote through required super-majority voting provisions.

Should the company opt out of Section 203 of the Delaware corporation law?

A private equity sponsor of a Delaware corporation should consider whether or not the company should opt out of Section 203 of the Delaware corporation law before taking the company public. Section 203 imposes a three-year moratorium on business combinations with any 15% or greater

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stockholder unless the business combination or the crossing of the 15% threshold receives prior Board approval, the bidder reaches the 85% threshold in the same transaction as it crosses the 15% threshold, or the combination is approved by at least a majority of the Board and by holders of at least two-thirds of the shares not owned by the bidder. A Delaware corporation can opt out of applicability of Section 203 by so providing in its charter. An IPO gives a company a one-shot opportunity to decide whether or not Section 203 will apply, since it is very unusual to opt out once the company is public and any amendment to the charter to opt out made after the IPO will only become effective after a one-year waiting period.

A private equity sponsor that will retain a greater than 15% stake after an IPO may find it desirable to preserve its flexibility to sell a meaningful control block to a potential acquirer who eventually wants to acquire the remainder of the company without Board approval. In reviewing any proposed sale by its large stockholders, the Board will have fiduciary duties to all stockholders, which may limit the ability of the sponsor of a portfolio company that has not opted out of Section 203 to orchestrate a transaction it favors or to obtain a control premium for its shares.

Independence requirements and the controlled company exemption

The role of independent directors on public company boards has been dramatically increased as a result of Sarbanes-Oxley and the new listing requirements recently adopted by the NYSE and Nasdaq. Both the NYSE and Nasdaq require that a majority of directors that serve on the board be independent and the audit committee be comprised exclusively of independent directors. In addition, under the NYSE rules, a nominating/corporate governance committee and a compensation committee must each be comprised exclusively of independent directors. Under the Nasdaq rules, director nominations and CEO compensation are to be approved by committees comprised exclusively of independent directors or approved by a majority of the independent directors. (Unlike the NYSE, Nasdaq does not require the board to have nominating and compensation committees).

Private equity firms that will continue to hold 50% of a company's voting power after an IPO should consider the advisability of the "controlled company" exemption to the director independence rules. When at least 50% of a company's voting power is held by an individual, a group or another entity, then the company may elect to be considered a "controlled company." A controlled company is exempt from the requirements to have a board of directors comprised of a majority of independent directors, and a nominating/corporate governance committee and a compensation committee, each comprised exclusively of independent directors. A controlled company will be exempt from these requirements as long as it discloses in its annual proxy statement that it is a controlled company and the basis for that determination. However, a controlled company still must have an audit committee comprised exclusively of independent directors.

A private equity sponsor that does not own at least 50% of a company's voting power may wish to consider entering into a voting agreement with other investors or with management to reach the 50% threshold that would enable it to fall under the con-trolled company exemption.

The market's receptivity to reliance on the controlled company exemption is not yet clear and a recent market check on whether having fewer independent directors and committees will impact the trading market is advisable.

Who will qualify as an independent director?

Under the NYSE rules, for a director to be independent, the Board must affirmatively determine that the director has no "material relationship" with the listed company. Nasdaq requires the Board to make a similar determination. In examining relationships between a director and the listed company, the Board must consider relationships between the director and any parent or subsidiary in a consolidated group with the listed company. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. As the concern is independence from management, both the NYSE and Nasdaq do not view ownership of even a significant amount of stock, by itself, as a bar to a finding of independence.

The rules provide that certain relationships would automatically cause a director not to be independent. Among other specified disqualifying relationships, a director who is, or has been within the last three years, an employee of the listed company or its parent or subsidiary, is not independent. A director who has received during any twelve-month period within the last three years compensation (other than for Board or committee service) above a specified threshold from the listed company is not independent (the compensation threshold is $100,000 for the NYSE and $60,000 for Nasdaq). A director will not be independent if he or she is a current employee or executive officer of a company that received payments from

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The Challenge of Valuation Guidelines

Introduction

Industry participants are adopting the valuation guidelines developed by the Private Equity Industry Guidelines Group (PEIGG) more broadly in the US than previously thought, according to an online survey of general partners recently conducted by The Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth. Nearly 20% of the 102 respondents indicated they had formally adopted the PEIGG guidelines, while several more indicated that PEIGG had influenced their internal valuation policies.

The Center hosted a by-invitation conference in June to bring together GPs, LPs, accountants, advisors, and representatives of numerous US and international industry associations to discuss the issues surrounding valuation policies. Both the survey data and comments by participants at the conference indicate that there is still a strong discomfort among GPs to Paragraph 30 of PEIGG, which allows non-round write-ups. Respondents and participants also expressed skepticism about global convergence of valuation guidelines.

More importantly, the survey and the comments by conference participants suggest that role and influence of independent auditors is growing. There will continue to be tensions among LPs' desire for consistency, GPs' historical preference for privacy, and auditors' obligation to apply fair value principles that are not formulaic. As the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) further develop their principles-based guidelines, auditors may ultimately be the force that determines the outcome for the application of valuation guidelines in the US and also drives global convergence.

Perspectives on U.S. and International Guidelines

Respondents to the Tuck survey represented a broad cross section of GPs with diversity in investment style, fund size, and number of funds under management. Of the 102 respondents, nearly 70% were VCs and 25% were buyout funds. About 50% of respondents said they relied on well-known industry guidelines for their internal valuation policies, indicating a general acceptance of guidelines as a useful tool to drive internal policies. The 2005 survey followed up on a similar survey by the Center in 2003 and showed that, despite consistent industry attitudes over time about support for valuation guidelines (from about 50% of GPs) as well as opposition (from nearly 20% of GPs), the influence of PEIGG had taken hold.

The PEIGG valuation guidelines, developed 18 months ago (see www.peigg.org), have been endorsed by the Institutional Limited Partners Association (ILPA), which represents over 125 LPs. The Tuck survey and comments made at the conference indicate that comprehensive adoption will take time, if it happens at all. About half of GP survey respondents that specifically had not adopted PEIGG indicated that they preferred write-ups only after a new round of financing. The National Venture Capital Association (NVCA), which represents VCs but not buyout firms, chose not to endorse PEIGG, although it commended the group's efforts. In a 2004 press release the NVCA announced that it "encourages diligence, prudence, and caution when implementing the specific elements of any guideline, such as valuation write-ups of early-stage companies in the absence of market-based financing events."

Despite the situation in the U.S., the rest of the private equity world is

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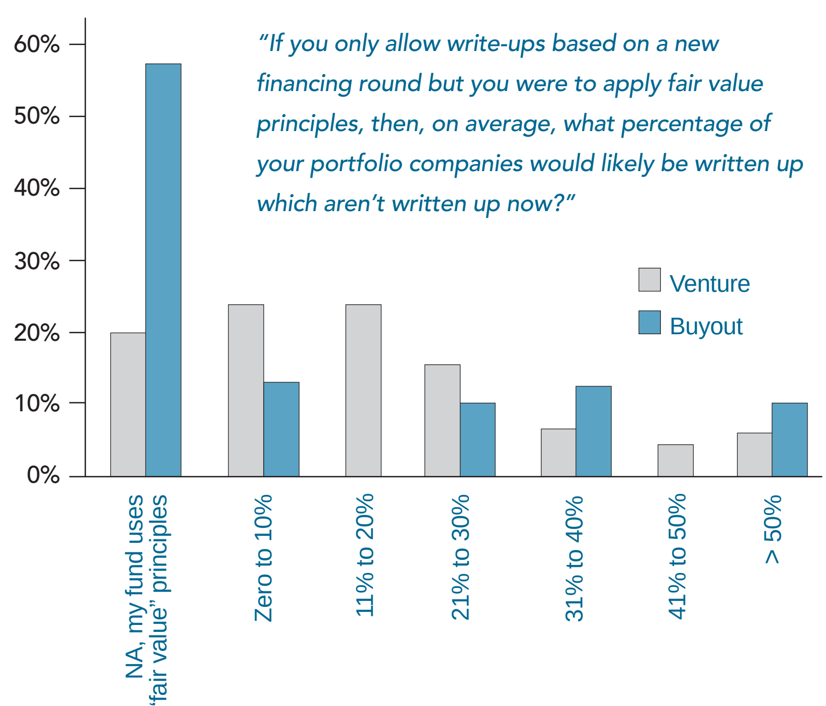
Figure 1: Potential for write-ups



making meaningful progress toward commonly accepted guidelines. Recently, three European industry associations, the Association Française des Investisseurs en Capital (AFIC), the European Venture Capital Association (EVCA), and the British Venture Capital Association (BVCA), issued joint valuation guidelines that were rapidly adopted by over 25 countries and endorsed by ILPA.

The PEIGG board represented a broad cross-section of U.S. industry participants. This broad based effort served to encourage the European associations to work more collaboratively. The international guidelines are based on fair value principles and aim to be consistent with both U.S. generally accepted accounting principles (GAAP), as well as IASB principles. Nevertheless, as the Tuck survey of U.S. GPs indicated, convergence of standards may be difficult to achieve. One quarter of respondents believe convergence of valuation guidelines will occur within 3 to 5 years. Another third of respondents believe convergence will take 5 to 10 years, and nearly 40% say it will never happen.

The Tuck survey also indicated significant reluctance by U.S. GPs to fully apply fair value accounting principles. This was clear in the substantial reported impact on portfolio valuations, if GPs were to mark to market, as shown in Figure 1, page 11. Pressure to aggressively mark to market is not present. LPs are generally seen by GPs as not giving this a high priority, and auditors, while more active, are not insisting on changes (see Figure 2). Conference discussions showed that this situation might be substantially inconsistent with what accounting authorities are intending for fair value principles

Key Issues

Is there a contradiction?

Nearly 80% of survey respondents believe that their current policies adequately reflect fair value. Yet, the survey results showed that many of the same respondents believe the application of fair value could lead to material write-ups. Accountants seem to indicate this means current financial statements of many private equity firms may not be fully GAAP compliant. An overwhelming majority of respondents (75%) said they would change their valuation policy in order to secure an unqualified opinion. However, 60% of GPs report that they believe LPs would be willing to overlook qualified audit opinions as long as fund performance is satisfactory. In addition, 25% of GPs provide their investors with "side schedules" that contain up-to-date valuation estimates that differ from audited financial statements. Ninety eight percent of survey respondents said their auditors did not issue a qualified opinion to them for fiscal year 2004.

Is this only important to VCs?

Interim valuations are more of a challenge for VCs, since buyout funds can rely on operating cash flows as a basis for valuation. While European VCs and buyout funds have broadly agreed on guidelines, this agreement may reflect the relatively small portion of capital that venture capital represents within the entire European private equity industry. Some LPs have expressed concern over "stale" valuations that do not reflect economic reality and cite examples of pre-IPO portfolio companies like Google carried "at cost." Some GPs argue that a conservative philosophy of under-promising and over-delivering is better for all parties. Other GPs say that continually adjusting interim evaluations of early and mid-stage growth companies serves no purpose.

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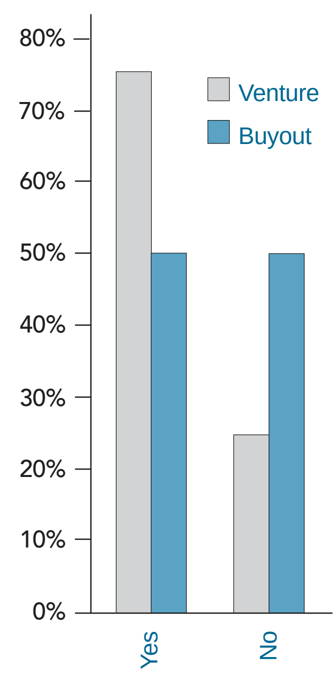
Figure 2: Auditors not insistent on changes

"If your valuation policy does not allow for non-financing round write-ups, does your independent auditor accept this without qualification as GAAP "fair value?"



Times are good for many private equity practitioners so pressure to do something about valuation guidelines is not likely to come from the industry. Instead, it is likely come from the accounting standard setters' and auditors' increasing insistence on fair value.

Are Private Equity and Strategic Deal Terms Converging?

As deal professionals know, U.S. private equity transactions have traditionally differed from strategic deals in a number of ways: these transactions have been highly negotiated, almost uniformly subject to financing conditions, carefully structured to maximize financing efficiencies, focused on cash flows rather than synergies and dependent on a partnership with existing (or sometimes newly hired) management teams. Some have suggested that many of those distinctions are blurring in the current environment, especially in large public transactions. Others have noted that large U.S. public-to-private deals are beginning to resemble their European counterparts more than traditional U.S. private equity transactions. But perhaps recent experience instead suggests that, in the competitive U.S. market, public-to-private "mega" deals are simply different.

Financing Conditions

Financing conditions have been standard practice in U.S. private equity transactions for many years. Corporate sellers have traditionally accepted this increased conditionality when strategic acquirors have not been a viable alternative, comforted in part by the fact that private equity transactions generally involve more limited deal completion risks related to antitrust or regulatory approvals. However, a few recent U.S. going-private transactions have garnered attention not only for their large size but also because they are not subject to customary financing conditions. In most of the deals without traditional financing conditions, the buyer has a quasifinancing condition that is limited very narrowly to the non-occurrence of certain extreme circumstances of the sort that would be conditions to a firm underwriting of securities (such as a banking moratorium or general suspension of trading activities); in another such deal, there is no financing condition at all. These recent deals probably do not signify a well-established trend, however - in fact, our survey of 25 U.S. going-private transactions announced by private equity buyers since January 1, 2004 revealed that the vast majority of such deals featured relatively customary financing conditions. And if lenders struggle to syndicate their loans in deals without traditional financing conditions due to recent instability in the credit markets, this practice may be a short-lived one indeed.

The recent emergence of U.S. private equity transactions without financing conditions may result both from the competitive acquisition environment currently facing acquirors and because many of the private equity players involved in these transactions are veterans of large European public-to-private transactions, which have historically not featured financing conditions and in which definitive financing documentation may well be completed before a bid can be launched.

Other Contract Terms; MAE Clauses

Private equity firms have often focused on contract terms to a degree that strategic buyers in frothy markets have not. The private equity buyer has traditionally demanded more comprehensive representations and warranties from the seller than those typical in strategic deals, consistent with the lower margin of error for post-closing liabilities that may be implicit in the private equity firm's pricing model. In divestiture transactions, the private equity buyer may require more extensive post-closing covenants regarding the separation of the target business from its corporate parent. The private equity buyer has traditionally resisted customary exceptions to the definition of "Material Adverse Effect," including with respect to adverse changes in the seller's industry or related to the announcement of the transaction — neither of which, the private equity buyer might argue, should be borne by a private equity firm to the same degree as by an existing participant in the seller's industry.

Although the absence of financing conditions and the presence of break-up fees have been limited thus far only to a few deals, more widespread changes have been seen in the familiar definition of "Material Adverse Effect." In approximately half of the recent U.S. going-private deals that we surveyed, MAE carve-outs (or exceptions to when a Material Adverse Effect will be deemed to have occurred) were expanded to some extent beyond the customary "laundry list," not only to exclude adverse changes in the target industry that do not disproportionately affect the target business or resulting from the announcement of the

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transaction, but also to exclude effects of actions required to be taken in order to consummate the transaction, the target's failure to meet its earnings forecasts or declines in its share price. While some of these specific exclusions may only be applicable to public company targets, this development suggests that certain private equity buyers are willing to assume a greater degree of deal completion risk — and this risk allocation may potentially translate into privately-negotiated deals more readily than, for example, the disappearance of the financing condition or the emergence of break-up fees, depending on the facts and circumstances of the relevant transaction.

Private equity buyers have also shown increased willingness to assume post-closing risks by agreeing to more limited indemnification protection than was traditionally seen in U.S. private equity deals. Although a private equity buyer may have argued in the past that the seller's indemnification obligations should be "capped" at the purchase price of the transaction, if capped at all, private equity buyers in recent large (but not "mega") deals have occasionally accepted indemnities limited to 20-25% of the purchase price. The fact that private equity buyers may be more willing to accept such risks may again evolve from their experiences in European deals, in which MAE conditions (especially in public-to-private transactions) and indemnification provisions have historically been more narrow than in the U.S. — although, in each case, the willingness to accept such risks will ultimately depend on the parties' relative negotiating leverage, the nature of the target business itself, the extent of the buyer's due diligence inquiry and other relevant facts and circumstances.

Private equity buyers have also shown increased willingness to assume post-closing risks by agreeing to more limited indemnification protection than was traditionally seen in U.S. private equity deals.

Break-up Fees

The few recent transactions in our survey that did not include customary financing conditions also incorporated features rarely, if ever, seen in private equity deals — termination or "break-up" fees (or expense reimbursements) payable by the buyers. In most of these deals, the buyers are obligated to pay break-up fees equal to approximately 2.5-3% of the purchase price to the public company sellers if the transaction is terminated due to a breach of the buyers' representations, warranties or covenants or because the buyers are unable to obtain sufficient debt financing prior to the "drop-dead" date. But again, virtually none of the going-private deals in our survey that included traditional financing conditions also contained break-up fees. This may suggest that the emergence of break-up fees in private equity transactions may be a mini-trend limited to "large cap" going-private deals, which have specific dynamics that involve different considerations than seen in traditional, private company LBOs or other going private transactions - and that by requiring private equity buyers to compete with equally "large cap" corporate acquirors, these deals may require them to assume a greater degree of completion risk than that to which they (and their limited partners) might otherwise be accustomed.

As private equity firms continue to play an increasingly prominent role in high-profile M&A transactions, the U.S. private equity market will no doubt continue to evolve. As this process plays out, commentators may speculate as to whether the terms of private equity and strategic deals are converging, just as M&A practitioners in recent years have discussed the maturation of the European private equity market and the actual extent of perceived differences between European and U.S. practices. In the ever more competitive U.S. acquisition environment, the recent surge in unusually large, public-to-private deals may instead suggest a global bifurcation of the private equity market. The private equity firms doing "mega" deals in the U.S. are familiar with prevailing European deal terms and may be more willing to accept such terms in the U.S. to land bigger targets — but may not necessarily be willing to do so in more "normal" deals. In other words, the most compelling division may not be between the U.S. and Europe, or even between private equity firms and corporate acquirors, but rather simply between mega-deals and the rest of the deal universe.

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Spinouts of Private Equity Funds

In the Winter 2005 issue of this publication we compared the terms and conditions of first-time private equity funds with those of larger, more established successor funds and found that first-time fund managers have generally succeeded in retaining certain standard "market" terms in their fund agreements despite the widespread assumption that as first-time fund managers they are negotiating from positions of relative weakness. One of the factors that explains this unexpected finding is that many new private equity firms are comprised of professionals that are anything but newcomers, having held senior investment and management positions at some of the world's leading private equity and financial institutions. These private equity groups "spinning out" of larger organizations face a variety of legal and commercial issues before, during and after their transition to independence. We consider some of these below.

Although there have recently been a number of significant spinouts announced in the private equity industry, most notably from the large investment banks, spinouts have been part of the private equity landscape for many years (see the accompanying table for a list of notable spinouts). Motivations for a private equity team's departure often include achieving greater investment independence, securing a bigger slice of the carried interest, and realizing long-held entrepreneurial aspirations to build a new firm and culture. Parent institutions also have their reasons for spinning out private equity businesses, which may include minimizing real or perceived conflicts of interest between the in-house private equity teams and the investment banking divisions, reducing balance sheet volatility, managing compliance with anticipated capital adequacy requirements under Basel II, or implementing a broader merger or acquisition initiative. Many of the challenges that confront a team spinning out from its parent relate back to the underlying reasons for leaving and the support, if any, that the parent is ready to provide going forward.

Spinouts tend to fall into one of two basic categories: (1) the parent makes a strategic decision to effect a partial or complete exit from the private equity sector and is transferring responsibility for managing portfolio assets to the outgoing team; or (2) a team decides to make a clean break and departs without the parent's active cooperation or an expectation of continuing to be involved in the parent's private equity business, but with the intention of raising a new private equity fund. In the case of the former, support from the parent may take various forms, such as engaging the team's new firm to advise on the legacy portfolio (or perhaps even to manage the parent's existing funds), committing capital to a new fund that the spinout group is launching, and providing transitional administrative services and facilities.

From the perspective of the spinout team, these negotiated arrangements with the parent essentially put the team "in business on day 1" and help accelerate the process of building the new firm from the ground up. For a team that is spinning out without parental support, there are numerous issues to clarify and resolve before and after deciding to leave. We devote most of the remainder of this article to issues particularly affecting this second category of spinouts.

Restrictive Covenants in Existing Agreements

Private equity professionals considering striking out on their own are likely to find that they are subject to a number of restrictive covenants with the parent, not only in their employment agreements but in the limited partnership and other operating agreements related to the parent's existing carried interest and co-investment programs (*e.g.*, stock options and other employee compensation plans). There are three key obligations that should be reviewed carefully in advance in consultation with counsel:

Non-competition. Most employment agreements in the private equity context prohibit employees from engaging in activity that competes with the employer and provide that the employee may not become affiliated as employee, partner, service provider, investor or otherwise with a competing private equity business. The restriction applies throughout the term of employment and typically extends for a period thereafter, often between three and six months, and sometimes longer in certain jurisdictions (the so-called "gardening leave" period). Depending on how the non-compete clause is drafted, private equity professionals on gardening leave must be cautious about certain start-up activities for their new firm, such as forming management or advisory entities to apply for regulatory clearances, pre-marketing future funds to potential investors, and maintaining "deal flow" contacts.

Non-solicitation. Private equity professionals may be pinned by two prongs of a non-solicitation covenant contained in their existing employment contracts: one prong prohibits soliciting the parent's other employees to leave the parent and join the spinout firm; the other prong restricts an employee's ability to solicit its employer's clients (including fund investors), in effect bolstering the non-competition

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covenant described above.

Like non-competition covenants, both types of non-solicitation restrictions may by their terms continue in effect for a number of months after an employee has resigned or been terminated and can impinge upon a spinout team's plans to move quickly toward marketing and operating a new fund. In the current fundraising environment, we are finding that institutional investors are paying increased attention to mid-level and junior members of a fund management team. The expiration date of covenants restricting a spinout group from "poaching" players away from a former employer can directly impact the timing of a new fund. In addition, if the departing professionals are contractually prohibited (or, as a gesture of good will toward the former employer, wish to refrain voluntarily) from soliciting clients of the former employer, the pool of targeted investors may shrink.

Non-disclosure. Standard employment and other private equity-related operating or partnership agreements proscribe disclosure to another person of *confidential* information obtained during the course of employment or association with the employer/sponsor. This may encompass information about prior funds, investors, fund investments, the investment management company and its affiliates. Reconciling inherent tensions between compliance with this confidentiality clause and the need to present the spinout team's investment track record (including IRRs) when raising a new fund requires careful planning and often involves discussion and negotiation with the former employer/sponsor to obtain waivers and access to data.

In some cases, where the spinout group is unable to secure the cooperation of the former employer and members of the group remain subject to continuing obligations of confidentiality, it is possible to reassemble information on the group's track record through meticulous collection and review of press releases, public information filed with securities regulators (if public debt or equity has been issued), semi-public information available to banks in the context of debt syndications, and commercial services specializing in providing financial information. In addition, portfolio companies may be willing to provide or confirm certain data, although care should be taken not to violate any covenant not to interfere with existing relations of the former employer. In certain jurisdictions, such as the United Kingdom, the mandatory public disclosure of company annual accounts, including for private companies, can be a particularly useful source of information when recreating a track record from public sources.

Complying with an existing agreement not to disclose confidential information (*e.g.*, prior investment performance) is separate from the analysis that any private fund manager must undertake in connection with satisfying the applicable legal and regulatory standards for presenting and properly attributing an investment track record in offering materials. These standards vary according to jurisdiction; however, firms that are registered with the U.S. Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 are subject to certain rules and guidelines, including the maintenance of detailed books and records supporting the presentation of investment performance.

Consequences of breach. The stakes can be high for departing principals if they breach their obligations not to compete, solicit or disclose. These obligations frequently survive beyond the date of their withdrawal or resignation from the firm. The consequences for breach routinely call for a partial or complete loss of undistributed carried interest (even if already vested), including carried interest that has been realized but held back in an escrow or segregated reserve account. There is also the risk that the former employer threatens litigation, which may include seeking an injunction against the new firm's fundraising activities that disrupts the process. Other obligations of the departing principals would ordinarily continue, as they would in a departure that did not involve a contractual breach, such as the obligation to return distributed carried interest in the event of a fund-level clawback or indemnity.

Contrast with legacy assets spinout. When compared to the minefield of restrictions and potential penalties that these spinout teams must steer their way through, the spinout of a private equity team that transitions to independence with the parent's active cooperation and support has a clearer path toward starting a new business and raising a new fund. Although a spinout involving the ongoing management of legacy funds or assets by the new firm will require substantial negotiation with the parent, the issues at the core of the parties' discussions will not be centered around the former employer's ability to constrain the development of the new firm. Instead, spinout negotiations are more likely to focus on structuring a viable alignment of economic interests between the new firm and its former parent and the management of the legacy assets to a profitable end result.

Establishing the New Firm

Following disengagement from the former employer/sponsor and the lapse of gardening leave and any other applicable restrictions, the spinout principals will require a new architecture for the governance,

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For U.S. Companies, Exiting with Canadian IDSs Falls Short of Promise

Last year we reported on the emergence of a new capital markets product, Income Deposit Securities (IDSs), and their use as a potential exit strategy for private equity portfolio companies.[1] IDSs, alert readers may recall, are units consisting of common stock and subordinated debt marketed as a yield-oriented hybrid security. IDSs were viewed as potential exit strategies for companies having stable cash flow and modest capital expenditure requirements that may not have been attractive candidates for traditional IPOs due to their limited growth prospects. There was considerable initial excitement about this product among investment banks and sponsors and by mid-2004, 20 would-be issuers had filed to do IDS offerings.

Ultimately, several IDS transactions by U.S. companies were successfully completed (B&G Foods in October 2004, Coinmach in November 2004 and Otelco in December 2004). However, the realities of pricing and execution fell far short of the promise, and the large majority of prospective IDS issuers abandoned their IDS offerings for other exits (leveraged recaps, high dividend IPOs or M&A transactions). While a variety of factors were at work, the suboptimal execution in the U.S. was most likely due to (1) the lukewarm reception to a hybrid product, containing both equity and debt, by U.S. institutional investors which have traditionally viewed themselves as either equity buyers or debt buyers and (2) the lengthy review of IDS offerings by the SEC which further challenged actually bringing transactions to completion.

Seeking Greener Pastures

Several U.S. companies have found greater success by completing IDS offerings in the Canadian market, the birthplace of the hybrid income security, which has a C$100 billion plus income trust market. (Indeed, IDSs evolved from income trusts). As a result, IDS issuers in Canada found greater market acceptance among buyers and benefited from a more expedited securities regulatory review.

However, there were still challenges to overcome. First and foremost, since U.S. businesses were involved, ensuring that the debt component of the IDSs would be respected as debt (and that the interest on that debt would be deductible) for U.S. tax purposes was a paramount objective. This meant that certain requirements that had been developed in the U.S. IDS offerings (the so-called "Five Commandments") needed to be satisfied, including the sale of "bachelor bonds" (debt identical to the IDS debt but sold separately from equity) and the retention by the sellers of an equity stake in the issuer for a minimum period of two years. The latter requirement of a retained equity stake has proved particularly problematic.

One difficulty that arose in structuring the retained equity portion was the fact that a Canadian holding company issuer was viewed as a necessity for a Canadian IDS offering. Canadian registered retirement accounts (the equivalent of IRAs in the U.S.), which are significant purchasers of income securities, have limitations on the amount of non-Canadian securities they can purchase. As a result, U.S. companies seeking to do a Canadian IDS would create a new Canadian parent to issue the IDSs (sometimes, depending on whether the U.S. com-pany was a corporation or an LLC, with different Canadian issuers for the equity and debt components of the IDSs).

While this accomplished the goal of making the IDSs eligible for purchase by the Canadian retirement accounts, it complicated the structuring of the sellers' retained stake. Most sellers want the right to convert their retained equity into IDSs in the future in order to preserve liquidity upon exit. However, under recently enacted U.S. tax rules designed to prevent so-called "inversion" transactions, having such a right arguably could cause the Canadian issuer to be subject to U.S. taxation or could subject equity-based compensation of management to excise taxes. As a result, in most of the IDS issuances done to date, the sponsors lack the right to convert their retained equity into IDSs, although some liquidity rights do exist.

The Possibility of a Brighter Future

Recent law changes in Canada may provide a path for solving the liquidity issue. Specifically, the limitation on Canadian retirement accounts purchasing non-Canadian securities has been removed in the most recent budgetary amendments, which became law in June. This change would allow U.S. companies to issue IDSs in Canada without the need to create a new Canadian holding company, and, thus, without implicating the inversion rules.

The ability to use a U.S. issuer in Canada raises another interesting possibility-the ability to do a dual offering of IDSs in the U.S. and Canada. A dual offering, likely weighted more heavily to Canada, presents the potential for larger transaction sizes. While the Canadian component would be registered in Canada and listed on the Toronto Stock Exchange, the U.S. component of the offering could be sold as a private placement, avoiding an extended SEC review process, and at

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[1] *See the Winter 2004 and the Spring 2004 issues of the Private Equity Report.*

Exiting with Canadian IDSs (cont. from page 17)

the same time giving U.S. purchasers access to liquidity in the Canadian market. Such a structure would enable would-be issuers to target U.S. investors, such as hedge funds, that are more receptive to hybrid securities than mutual funds.

Although to date only six U.S. companies have completed Canadian IDS offerings, anecdotal evidence indicates a fair amount of interest among sponsors. Only time will tell whether Canadian IDSs for U.S. companies will really catch on or whether they are destined for the relative obscurity of their U.S. counterparts.

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Proposed Carried Interest Tax Rules: Square Peg, Round Hole (cont. from page 8)

be established with clear and convincing evidence that the GP interest was not granted in anticipation of a subsequent disposition.

The Basic Safe Harbor Requirements. We expect that the fund and the GP would each want to make the Safe Harbor Election contemplated by the proposed rules. In order for a partnership to make and maintain a Safe Harbor Election:

1) The partnership must file a document affirmatively electing to apply the safe harbor.

2) The partnership agreement must include provisions legally binding on all partners (including the LPs) stating that (i) the partnership is authorized and directed to elect the safe harbor and (ii) the partnership and each partner agree to comply with all of the requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services. In the case of a transfer, the transferee must agree to assume the transferring partner's obligations. If the partnership agreement does not include the necessary language (or it is not legally enforceable against all partners), the requirement can be satisfied by having each partner sign a separate document that includes the relevant provisions and is legally binding on each partner.

3) The partnership and each partner must report the income tax effects of the Safe Harbor Partnership Interest consistent with various requirements in the new rules.

4) The partnership must issue appropriate information returns with respect to each Safe Harbor Partnership Interest.

Need to File 83(b) Elections. Under the proposed rules, in general, if an interest in the GP is subject to vesting, the recipient will want to file an 83(b) election. If the interest in the GP (or the share of the carried interest) is revised after the initial grant date (as is the case with many GP arrangements), it may be necessary to file a new 83(b) election. This would be a change from current practice. We are hopeful that the final regulations will clarify that multiple 83(b) elections with respect to the same partnership are not necessary.

Non-U.S. funds. The proposed rules apply to both U.S. and non-U.S. funds, if a carried recipient is a U.S. taxpayer. However, it appears that only funds that file U.S. tax returns will be eligible to make the election. U.S. carried interest recipients in non-U.S. funds that do not file U.S. tax returns will likely want to file an 83(b) election, but will need to consider carefully the valuation of the carried interest and the continuing application of *Campbell* to the valuation of the carried interest.

What's Next

The IRS has requested comments concerning the proposed rules and a hearing is scheduled to take place in Fall 2005. A variety of groups are already assembling comments and the application of the proposed regulations to private equity funds is certain to be addressed. It is difficult to predict at this point what exactly the final rules will require in order to maintain the favorable tax results available today. As a result, one can expect sponsors to include language today in fund agreements and GP agreements that will give the sponsor sufficient flexibility to comply with whatever the final regulations will require in the future.

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Most Private Equity Funds Now Exempt from German Penalizing Tax Regime and Reporting and Publication Requirements

There is more good news from Germany for private equity players. In the Summer and Fall 2004 issues of the Private Equity Report we reported on the possible application of new punitive tax rules and onerous reporting and publication requirements for investment funds in Germany. In June, after more than a year of intense discussion and several drafts, the German tax authorities issued a revenue ruling clarifying the new Investment Tax Act (*Investmentsteuergesetz*) which replaced the Foreign Investment Fund Act (*Ausland-Investmentgesetz*) in January 2004, providing some summer relief for most private equity funds.

While the Investment Tax Act is really directed at mutual funds; because of the broad definition of a "fund" there has always been great uncertainty whether foreign private equity funds (including LBO and VC funds) fall within the scope of the Act. If a foreign vehicle qualifies as a "fund" within the meaning of the Act, an investor is subject to a prohibitive tax burden under a penalizing tax regime unless the foreign fund complies with onerous reporting and publication requirements, including the requirement to make public certain information on the internet, more specifically in the German Federal Electronic Gazette (*Elektronischer Bundesanzeiger*).

The new Ruling, which is effective retroactive to January 2004, now provides a clear safe harbor rule according to which foreign vehicles organized as *partnerships* never qualify as a "fund." Rather an investor will be taxed under general principles which prescribe a look-through in respect of partnerships. Thus, based on this look-through principle, if a foreign partnership holds an interest in another vehicle which does qualify as a "fund" within the meaning of the Act (*i.e.* is not itself a partnership), then the mere fact of being owned by a partnership will not cure the investment fund of its fund status under the Act. By contrast, in a typical fund of funds situation since the fund of funds is typically organized in partnership form and holds interest in foreign vehicles which again are organized as partnerships, the new safe harbor for foreign partnerships is applicable to both vehicles. Hedge funds, on the other hand, even if organized in partnership form do not enjoy the safe harbor. It is not always clear what exactly constitutes a "hedge activity;" as a rule of thumb it requires leveraging and taking short/long positions.

On a positive note, the Revenue Ruling also exempts derivative instruments which track the performance of any type of foreign assets or of a fund from the scope of the Act and foreign funds which issue collateralized debt obligations (CDOs, including CLOs) are, subject to meeting certain requirements, also carved out from its scope.

Which vehicles remain potentially subject to the Investment Tax Act and its potentially applicable penalizing tax and onerous reporting regime? All vehicles which are not classified as "partnerships" under German tax law. Without going into detail, it is fair to say that foreign limited partnerships, even if they have a corporation as their general partner, are classified as "partnerships" for German purposes. U.S. limited liability companies (*LLCs*) can, depending on the individual circumstances, be classified either as a partnership or as a corporation. Certainly all incorporated entities (a U.S. "*Inc.*", an English "*Limited*", an Irish/English "*Unlimited Liability Company*", and most notably a Luxembourg "*SICAV*") will <u>not</u> qualify as partnerships and accordingly will continue to be potentially exposed to the Investment Tax Act. Depending on the circumstances, incorporated vehicles may nevertheless be able to escape the ambit of the Act by relying on the guidelines which were used in the past. However, these guidelines are not black and white, and incorporated foreign funds will therefore have to give *side letters* to investors who will want to be insured that certain criteria are fulfilled in order to avoid the penalizing tax regime. Even if these assurances are given in a side letter, a German investor will typically demand that a fund nevertheless comply with the reporting and publication requirements as an additional safeguard to avoid the application of the penalizing tax.

The new safe harbor is effective as of the 2004 enactment of the Investment Tax Act (*i.e.* January 2004), and thus is also applicable with respect to funds which were created before 2004 when the old law was still in effect.

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Which vehicles remain potentially subject to the Investment Tax Act and its potentially applicable penalizing tax and onerous reporting regime? All vehicles which are not classified as "partnerships" under German tax law.

Second Lien Financing: A Ten-Point Primer for the Borrower (and its Sponsor) on Intercreditor Dynamics

The second lien market has exploded from $3.2 billion in 2003 to $12 billion in 2004, as tracked by Standard & Poor's. Some expect that figure to reach $20 billion in 2005. While the lenders' perspective dominates much of the recent second lien financing literature, here are ten intercreditor issues that the borrower should also care about.

Background

In a second lien financing, a borrower grants one or more lenders a junior lien on collateral that is also subject to another lender's first priority lien. The second lien lender believes the value of the collateral will be sufficient to pay its claim after paying the claims of the first lien lenders. For taking the risk that the collateral will not suffice, the second lien lender receives a higher interest rate than the first lien lender (currently around 300 basis points higher). The first lien lender may have a number of reasons to share the collateral; including, the second lien lender's willingness to subordinate its liens and to waive certain rights it would otherwise have as a creditor. But unlike traditional debt subordination (which involves payment blocks), lien subordination runs only to the collateral and the proceeds of the collateral. In other words, the first lien lender is entitled to be paid first only from any proceeds of the collateral.

Banks and large institutional investors generally provide most first lien financing (and they increasingly participate in second lien financing to blend or supercharge their returns). Hedge funds, however, have rapidly become important players in the second lien market, probably as a result of a surplus of available funds and a limited ability under their fund agreements to invest in unsecured debt. The entry of hedge funds and other non-traditional participants into the second lien market is one key reason for its rapid growth.

As this market has grown, borrowers' motives for borrowing second lien financing have changed. At first, distressed borrowers often entered second lien financings to secure liquidity or to buy time to improve leverage and performance in order to access the traditional debt markets. Today, second lien financing is a routine part of a borrower's capital structure, and second lien financings are used for acquisitions as well as partial exit recapitalizations.

There are many reasons why borrowers may prefer second lien financing to unsecured financing such as mezzanine debt or bonds. Because it is secured, a second lien financing should be priced lower than a comparable unsecured financing. There is no equity dilution (which is particularly attractive to sponsors). The documentation involved can be quicker, easier and consequently less expensive than that of mezzanine debt or bonds. Call restrictions and prepayment premiums in second lien financings are generally less burdensome and less costly than those found in high yield debt. Also, obtaining a covenant waiver from a second lien syndicate does not involve a formal consent solicitation process, which may make it less difficult to obtain than a waiver from a large group of bond holders.

On the other hand, second lien financing may disadvantage the borrower in some important ways. It may tie up a borrower's collateral and increase its leverage, making it difficult or impossible to obtain future financing. Second lien covenants, though less restrictive than first lien covenants, are usually more restrictive than the covenants in high yield bonds. Furthermore, when seeking consents or other actions from its lenders, the borrower has two classes of secured creditors whose interests are not necessarily aligned, a circumstance that may add complexity and cost, especially in the event of a bankruptcy. The problem of dueling constituencies may be exacerbated when a large syndicate of lenders holds the second lien debt. The terms of the intercreditor agreement partly determine the extent of this additional complexity and cost.

The Borrower's Perspective on Intercreditor Agreements

The intercreditor agreement specifies the relative rights of the first lien lender and the second lien lender. The borrower signs the intercreditor agreement but is often precluded from exercising any rights under it. Nonetheless, the borrower still has an interest in negotiating the intercreditor agreement, because the relative rights of the first lien lender and second lien lender affect the borrower's relationship with each. The borrower may wish to resist any effort by the lenders —particularly the second lien lenders — to limit the borrower's role in the negotiations.

The borrower's interests in the intercreditor arrangements are largely aligned with those of the first lien lender. The first lien lender wants a "silent" second lien (*i.e.*, exclusive control of the collateral), both before and during a bankruptcy, with extensive waivers of rights by the second lien lender. (Note that, even if an intercreditor agreement says everything the first lien lender wants, all of those rights may not be enforceable. There are only a few, inconsistent cases testing such terms in a bankruptcy context. Notwithstanding some uncertainty, the first lien lender often asks for all of these things- the premise being that, if the first lien lender can't ultimately get everything it wants, it just might find (as the song goes) that it gets what it needs.) The borrower wants to limit the second lien lender's ability to hold up a future waiver, refinancing or reorganization. Because what the first lien lender wants is consistent with what the borrower wants, a borrower may to some extent rely on the first lien lender to lead in negotiating the intercreditor agreement.

Whether the borrower is managing or merely monitoring the intercreditor negotiations, here are ten intercreditor points for the borrower (and its equity sponsor) to review.

1. First Lien Debt Cap

The second lien lender, wanting to know with certainty the amount of first lien debt ahead of it, usually insists that the intercreditor agreement cap the amount of outstanding first lien debt. The existence, scope and size of a cap are key issues for the borrower because the cap will limit its ability to borrow additional funds or refinance the first lien debt without the consent of the second lien lender. The cap is often limited to the principal amount of the first lien debt plus a cushion. The second lien lender may ask that pre-payments and permanent reductions of first lien commitments reduce the cap. The parties may also negotiate whether the cap includes hedging obligations, interest or fees and the consequences of exceeding the cap.

2. Standstill

The intercreditor agreement usually provides for a "standstill" period (often around 180 days) during which the first lien lender has the exclusive right to exercise remedies with respect to the shared collateral following an event of default and, frequently, a demand for acceleration under the second lien financing agreement. The standstill period is often extended if the first lien lender commences enforcement action with respect to all or a substantial part of the collateral. Note that the standstill does not apply to other contractual remedies (unrelated to collateral) the second lien lender may have under its financing documents. This standstill period gives the borrower a window to work out a remedy with the first lien lender and it prevents overlapping or conflicting enforcement actions against the shared collateral.

3. Control Over Shared Collateral

The intercreditor agreement generally grants the first lien lender the exclusive right to enforce rights, remedies and make determinations regarding the release or disposition of the shared collateral, and the second lien lender often waives its right to object to the exercise of these rights by the first lien lender. To facilitate this, the agreement provides for the automatic release of the second lien lender's liens. Together, this ensures that the borrower negotiates primarily with the first lien lender concerning the exercise of remedies. It also means that, subject to other terms of the agreements, the borrower may be able to sell collateral in the course of its business with only the first lien lender's consent.

The second lien lender may negotiate for consent rights with respect to the exercise of remedies or sales of collateral, or it may insist on consent rights following an event of default under the second lien financing agreement. Alternately, it may seek to restrict sales of collateral to those sales permitted under the second lien financing agreement, to retain the right to object to the commercial reasonableness of such sales, to require notice of such sales or to require the proceeds of such sales be used to prepay the first lien debt.

4. Amendments and Waivers

The intercreditor agreement generally permits amendments to the first lien financing agreement without second lien lender consent. But changes to key economic terms — such as the principal amount of first lien debt or any cap, the interest rate margin or the maturity — will often require second lien lender consent. The intercreditor agreement usually places even more limitations on amendments to the second lien financing agreement, including separate restrictions on refinancing of the second lien debt. Such restrictions make refinancing the first lien debt or the second lien debt more difficult for the borrower. The borrower's interest in the outcome of this provision diverges from the first lien lender's interest; each lender has an interest in restricting changes to the other's documents, while the borrower's interest is to eliminate or minimize such restrictions.

5. Buy Out Option

The intercreditor agreement often provides the right of the second lien lender to buy out the first lien debt at par following its acceleration. And in negotiations, the second lien lender will frequently insist on having that right, since it allows for the possibility of taking control of a reorganization and thereby getting a better recovery. The first lien lender will negotiate for the inclusion of unpaid interest or any applicable prepayment fees. The buy out option may not be worth much; in theory, a first lien lender should be willing to sell at par after acceleration, particularly since the first lien debt will often trade below par at the time. In addition, the exercise period is often so short (sometimes just 10 to 20 business days or less) it may be impracticable to arrange new financing. Still, the borrower may welcome the possibility, though remote, of one secured creditor buying out another.

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The borrower's interests in the intercreditor arrangements are largely aligned with those of the first lien lender. The first lien lender wants a "silent" second lien, both before and during a bankruptcy, with extensive waivers of rights by the second lien lender.

6. Use of Cash Collateral in a Bankruptcy

To run its business in bankruptcy, a borrower must normally use cash collateral, which includes not only cash, but securities, deposit accounts and cash equivalents. The second lien lender often waives its right to object to the borrower's use of cash in bankruptcy, if the use is supported by the first lien lender. This is a key point for the borrower; if the first lien lender consents to the use of cash collateral, the second lien lender's waiver in the intercreditor agreement would obviate the need for a second lien lender consent.

7. DIP Financing

To successfully reorganize, the borrower typically needs a debtor-in-possession (or "DIP") financing. The second lien lender usually waives its right as a secured creditor to object to a DIP financing supported by the first lien lender. In connection with the waiver, the second lien lender also typically agrees to subordinate its liens to the liens granted to the lenders providing the DIP financing (which will normally be super-priority liens, senior also to the first lien lender's liens). The second lien lender may negotiate to condition the waiver on the DIP financing not exceeding the first lien debt cap or a separate DIP financing cap that has added cushion. The second lien lender may also ask that any DIP financing be on market terms or that it be given the right to provide the DIP financing itself. The borrower must often secure a DIP financing if it hopes to successfully reorganize, so the absence of a "DIP veto" may be particularly important. Absent the waiver or given an inadequate cap, the second lien lender has considerable leverage to hold up a reorganization or force a liquidation.

8. Asset Sales under Section 363 of the Bankruptcy Code

In a successful reorganization, a borrower will often conduct (under Section 363 of the Bankruptcy Code) a sale of collateral free and clear of liens or other disposition that the first lien lender supports. To simplify the sale process, both the borrower and the first lien lender negotiate in the intercreditor agreement to have the second lien lender waive the right to oppose such sales. The second lien lender often seeks a lien on the sale proceeds or wants the proceeds to be used to pay down the first lien debt.

9. Adequate Protection under the Bankruptcy Code

A borrower — to preserve cash and collateral in a future bankruptcy — will support contractual limits on lender's right to seek adequate protection. (Adequate protection is designed to protect a secured creditor from declines in collateral value and often consists of additional or replacement collateral.) And a first lien lender — to preserve its right to request adequate protection or to raise objections based on lack thereof — will seek to have the second lien lender to waive its right to contest any such request or objection by the first lien lender. The first lien lender also usually seeks to have the second lien lender waive its right to request adequate protection in connection with the use of cash collateral or DIP financing. Requests to have the second lien lender waive its right to request adequate protection under any circumstance can be hotly contested in negotiations. The second lien lender has a natural inclination to try to keep as much as it can of the right to request adequate protection — or at least the right to request a subordinated lien on any additional collateral the first lien lender receives as adequate protection. When a second lien lender does retain the right to request and/or receive adequate protection, the first lien lender typically gets the right to request a senior lien on the additional collateral.

10. Voting on Plan of Reorganization

The borrower might find it nifty to support a first lien lender's request to restrict the second lien lender's right to vote on a plan of reorganization. Such a restriction, if it were enforceable, would ease the burden of obtaining votes for confirmation of a plan of reorganization in a future bankruptcy and serve to deprive the second lien lender of the ability to hold up the reorganization or force a liquidation. (The first lien lender's request may come in one or more of the following forms: a blanket voting restriction; an agreement by the second lien lender not to vote against a plan of reorganization supported by the first lien lender (sometimes qualified by material adverse impact on the second lien lender); or a prohibition against voting for plans that omit certain conditions (like a condition that the first lien lender be paid in full). But such restrictions raise particular concerns when it comes to enforce-ability, and, even if the first lien lender requests them at all, they are all rarely even agreed to in the intercreditor agreement.

Conclusion

These ten intercreditor agreement points have important ramifications for the borrower. Factors such as the liquidity in the market, the relative size of the first lien compared to the second lien, the borrower's credit rating and the type of transaction (syndicated or a private "club" loan) will also determine where a given intercreditor agreement comes out. While changing market conditions and evolving case law will continue to shape these provisions, a borrowers who is aware of the potential issues can best protect its interests.

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Institutional Fund Sponsors' Consolidation Woes (cont. from page 1)

(and where those general partners are not controlled by an entity that itself prepares GAAP financials), the new accounting rules are irrelevant.[3]

Presumption of Control

The EITF consensus on Issue No. 04-5 confirms that the general partners of a limited partnership[4] will be presumed to "control" the partnership. Thus, if there is only one general partner of a Fund (or multiple general partners that are under common control), that general partner, in its own financial statements, must consolidate with the Fund. If there are multiple general partners that are not under common control, then an overall facts and circumstances test must be applied to determine whether one of the general partners actually controls the partnership. If so, that general partner must consolidate with the Fund (and the other general partners account for their interests in the Fund under the equity method). If no single general partner is in control of the Fund, then all of the general partners must account for their interests in the Fund under the equity method.

The presumption of control (and thus consolidation) can be overcome only if the limited partners have either (1) substantive kick-out rights or (2) substantive participating rights (discussed at greater length below). Control must be tested upon the formation of the limited partnership and each time that the general partner prepares GAAP financials (taking into account changes in the limited partnership agreement, changes in the identity or ownership interests of or relationships among and between the general partners and limited partners, and other factors relevant to determining control).

A general partner may control a limited partnership regardless of the GP's economic ownership interest in the assets and earnings of the partnership — in an extreme case, even a de minimis interest (see sidebar).

Even where a general partner has a significant interest (say, 20%) in the Fund's economics, consolidation (as opposed to the equity method of accounting) can have a fairly extreme effect on the general partner's consolidated financial statements — inflating gross assets and gross investment earnings or loss. This is particularly true because Funds must use the investment company method of accounting — they account for the carrying value of their investments at current fair market value, rather than cost, and reflect increases or decreases in carrying value as investment earnings or loss. Thus, general partners forced to consolidate with Funds under the new accounting rules may face significant swings in their net income before deduction for minority interests.

Effective Dates

The EITF consensus on general partner consolidation is effective as follows:

- For new limited partnerships: immediately, if formed after June 29, 2005
- For existing limited partnerships: the sooner of (1) immediately after their partnership agreements are modified, if modification occurs after June 29, 2005, or (2) the beginning of the first reporting period in fiscal years beginning after December 15, 2005

The effect of initially applying these principles, if they result in a change in accounting, should be reported in accordance with new FASB Statement 154 on Accounting Changes.

What Should GP's Do?

The sponsor of every existing and new Fund should consult with its financial accounting and legal advisers concerning the effect of the EITF action if a Fund general partner prepares GAAP

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A GP may control a limited partnership regardless of the GP's economic ownership interest in the assets and earnings of the partnership. For example, a sole GP having a mere 3% interest in a Fund's economics would be required to consolidate with the Fund, if the LP's have neither substantive kick-out rights nor substantive participating rights. The GP's consolidated financial statements would appear very different after consolidating with the Fund, compared to the equity method of accounting.

Example: GP is the 3% sole general partner of a $1 billion Fund that is fully invested. The carrying value of the Fund's investments declines to $900 million.

Consolidation

GP Balance Sheet:	
Assets — Investments	$900,000,000
Minority interest	$873,000,000
Equity	$27,000,000
GP Income Statement:	
Revenues — Investment earnings (loss)	$(100,000,000)
Income (loss) before minority interest	$(100,000,000)
Less: Minority interest	(97,000,000)
Net Income	$ (3,000,000)

Equity Method

GP Balance Sheet:	
Assets — Investments	$27,000,000
Equity	$27,000,000
GP Income Statement:	
Revenues — Investment earnings (loss)	$(3,000,000)
Net Income	$(3,000,000)

financials (or is part of a consolidated group that prepares GAAP financials). If the general partner would be required to consolidate with the Fund under the ruling, and wishes to avoid consolidation, there are three areas for consideration:

- *Share Control:* Add an independent general partner that will block control by a single GP, that is, so that no single GP (or group of GP's under common control) will have the power to make ordinary course decisions concerning the affairs of the partnership.

If two or more general partners share control, no general partner is required to consolidate. Obviously, most GP's will be unwilling to share control of the Fund with a truly independent co-general partner. Parties under the control of the existing GP or its affiliates (such as their employees) and other parties acting on behalf of the existing GP or its affiliates (or that they may remove without cause) are unlikely to be considered independent for these purposes, however.

The EITF's decision that supermajority without-cause kick-out rights will not override the presumption of general partner control is probably the most significant change in accounting practice for the consolidation of a Fund general partner with the Fund.

- *Add LP Participation Rights:* Amend the partnership agreement to provide the LP's the right to approve or block the Fund's making an investment or divesting all or a portion of an investment. The presumption of general partner control can be overcome if the limited partners have "substantive participating rights."

Substantive participating rights are the ability to "effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business." Such rights are contrasted with "protective rights," which do not overcome the presumption of general partner control. The hallmark of participating rights is that they relate to financial and operating decisions of the limited partnership that are made in the ordinary course of business — that is, they allow the limited partners to block (or require them to approve) such ordinary-course business decisions.

The EITF Abstract for Issue No. 04-5 sets out a non-exclusive listing of both participating rights and protective rights. For example, rights to approve or reject transactions with the general partner involving self-dealing or other business conflicts are merely protective rights; rights to establish operating and capital decisions of the partnership are participating rights. Since general partners of Funds make decisions whether and when to make particular investments and to divest the Fund of all or a portion of particular investments in the ordinary course of the Fund's business, allowing the limited partners to block such decisions would probably be treated as participating rights in a Fund.

Limited partners will be concerned that such ordinary-course participating rights will remove the limited partners' limited liability for the obligations of the limited partnership. Delaware law specifically allows limited partners to "act or cause a general partner . . . to take or refrain from taking any action" without losing limited liability, so at least for Delaware limited partnerships, ordinary-course participating rights should not present that problem for LP's. Other states' limited partnership laws are similarly flexible. Fund GP's should consult with their legal advisers on this issue, however, particularly for Funds formed outside the United States.

Of course, Fund GP's will not lightly extend ordinary-course participating rights to LP's, and LP's may see exercising such rights as a task best avoided, even aside from limited liability concerns.

- *Add LP Kick-out Rights:* Amend the partnership agreement to provide the LP's the right to remove the existing GP (without cause) upon the vote of a simple majority of the interests of the LP's other than the GP or parties under common control with or acting on behalf of the GP. The presumption of general partner control can be overcome if the limited partners have "substantive participating rights."

Kick-out rights are the ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners *without cause*. Such rights are treated as substantive if they have *both* of the following characteristics: (1) The rights "can be exercised by a vote of a *simple majority* (or a lower percentage) of the limited partner voting interests held by parties other than the general partners, entities under common control with the general partners or a general partner, and other parties acting on behalf of the general partners or a general partner"; and (2) "there are no significant barriers to the exercise of the rights." The EITF Abstract for Issue No. 04-5 sets out a non-exclusive listing of such barriers, including "[f]inancial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal."

The EITF's decision that *super-majority* without-cause kick-out rights will not override the presumption of general partner control is probably the most significant change in accounting practice for the consolidation of a Fund general partner with the Fund. As noted above, most Fund GP's have relied on supermajority kick-out rights to avoid consolidation under current practice.

Many general partners are wholly unwilling to provide a without-cause kick-out right to limited partners holding a bare majority of their Fund's LP interests. Others may be willing to do so only if limitations are imposed on the right or if there are significant disincentives to the limited partners' exercising the right. Because such limitations and disincentives may make the kick-out right non-substantive — and thus not overcome the presumption of GP control — Fund general partners will need to work closely with their accounting and legal advisers on the establishment or amendment of kick-out rights.

In the final analysis, it may be easiest simply to provide a bare majority kick-out right without significant limitations — and then for the Fund sponsor to make even greater efforts to maintain the goodwill of its limited partner investors.

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[1] The supermajority has generally been a 66-2/3% majority in interest of the limited partners. 75% and even 80% supermajority GP removal provisions have also been seen in practice.

[2] U.S. GAAP requires an entity that "controls" another entity to include all of the controlled entity's assets, liabilities, revenues and expenses in the controlling entity's own consolidated financial statements. For consideration purposes, "control" is generally defined as ownership of a majority (more than 50%) of the outstanding voting equity interests of an entity.

If the controlling entity does not own all of the equity interests in the controlled entity, the carrying value of the interests owned by other equityholders (known as minority interests) is accounted for separately between the liability and equity sections of the consolidated group's balance sheet; and the minority interests in the net income of the controlled entity are reflected as a deduction from consolidated net income.

In contrast, equity investments in entities over which an investor can exert significant influence (but not control) and virtually all noncontrolling interests in limited partnerships and similar entities are accounted for under the "equity method of accounting" (sometimes known as a one-line consolidation).

[3] Most non-institutional sponsors prepare GAAP financials for their Funds, but not for themselves, since the sponsors and Fund general partners are generally privately held by firms or individuals that do not themselves require GAAP financials.

[4] Including other types of entities having governance provisions that are similar to those of limited partnerships, such as limited liability companies where only the managing members have the power to manage the affairs of the LLC.

The Challenge of Valuation Guidelines (cont. from page 12)

Do LPs want judgment calls or do they want consistency?

If interim valuations depend heavily on VC judgment and the application of multiple methodologies, it can be expected that different VCs will produce different valuation figures. Will LPs continue to be comfortable with this? The proposed 1989 NVCA guidelines, commonly used by the industry in previous years, had always been clear about requiring write-downs. However, LPs' anxiety over the lack of discipline by GPs in the timing and amount of post-bubble write-downs are exactly what led to pressure for developing new guidelines. Yet non-round write-ups, as allowed by PEIGG, may result in inconsistencies of valuation and timing in an era of economic growth.

Conclusion

Times are good for many private equity practitioners so pressure to do something about valuation guidelines is not likely to come from the industry. Instead, it is likely come from the accounting standard setters' and auditors' increasing insistence on fair value. "Conservatism" is a dirty word to accountants - it refers to a willful and artificially low valuation of an asset. The result of the accounting industry's drive for fair value will be a tension between judgment and consistency in valuing portfolio companies. Industry guidelines or even new accounting regulations are unlikely to eliminate this tension, because they deal with statements of principle. Valuation guidelines cannot be formulaic and at the same time be effective because such prescriptive guidelines will invariably fail to include all situations or become too complicated to be useful. The judgment / consistency issue in private equity can only be resolved in the U.S. and internationally through years of application and incremental learning. In the interim there will continue to be grappling and discomfort before broad agreement on best practices emerges.

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employment policies and economic sharing arrangements that apply to the new firm and related entities and will need to act on a number of organizational and administrative tasks. One of the challenges to the spinout principals is striking the right balance between perpetuating the former sponsor's practices (which are the practices that the principals are probably most familiar with) and renouncing those practices on the grounds that they are rooted in long-established institutional precedents and policies that are not well suited to the new firm's more closely held structure.

Year	Parent	Spinouts*
2005	Marsh & McLennan	Stone Point Capital
2004	3i	Exponent
2004	CSFB	Diamond Castle
2004	Morgan Stanley	Metalmark
2003	Deutsche Bank	MidOcean
2003	HSBC	Montagu
2002	BNP Paribas	PAI Management
2002	Nomura International	Terra Firma
2001	DLJ	Phoenix Equity Partners
2001	Foreign & Colonial	Graphite Capital/F&C Ventures
2000	Mercury Asset Management	HgCapital
2000	NatWest	Bridgepoint Capital
1999	Dresdner Kleinwort Benson	Indigo Capital
1998	Hambros Bank	Duke Street Capital
1995	British Coal Pension Schemes	Cinven
1993	First Chicago Corporation	Madison Dearborn Partners
1989	Enskilda	Industri Kapitalà → Altor (2003)
1989	Schroders	Permira
1988	Barings Bank	BC Partners
1985	Lehman Brothers	Blackstone Group → Evercore Partners (1995) → Heartland Industrial Partners (1999) → Silverlake Partners (1999) → → Elevation Partners (2004)
1978	BancBoston	Thomas H Lee → Berkshire Partners (1986) → JW Childs (1995)
1976	Bear Steams	KKR → Forstmann Little (1978) → → New Mountain Capital (2000) → → Jupiter Partners LLC (1994) → Kohlberg & Co (1987) → Fox Paine (1997)

** "→" indicates a private equity spinout from the prior spinout.*

Governance, carried interest, employment, etc. To some extent, spinout principals must re-orient their perspectives from their previous roles as employees of a large institutional sponsor when the time comes to propose a fresh set of governance, economic and employment arrangements for the new firm. In this new context, the spinout will require its own set of restrictive covenants against competition, solicitation of colleagues and clients, and disclosure of confidential information, along with a complete set of good-leaver/bad-leaver provisions and penalties (*i.e.*, termination with and without "cause"), carried interest allocation and vesting schedules, bonus plans, anti-dilution clauses, investment and other decision-making procedures and dispute resolution mechanisms. Furthermore, institutional investors in a new private equity fund expect to be informed of the basic carried interest allocation and vesting arrangements to ensure there are appropriate incentives throughout the firm.

Carried interest and other economic terms frequently involve intricate tax and estate-planning analysis, sometimes in multiple jurisdictions. All of these are complicated arrangements for any private equity firm, particularly when terms vary across different levels within the organization from junior employees to founding principals, although in a legacy spinout there is a preference for avoiding unnecessary changes to the existing carried interest structure on the legacy assets.

Practical Necessities. There are a myriad of practical things to do as the spinout firm comes "on line":

- Depending on the jurisdiction, regulatory licenses may need to be applied for and obtained (*e.g.*, see Chapter Three of the *Debevoise & Plimpton European Private Equity*

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the listed company in any of the last three fiscal years in excess of specified amounts. Certain additional independence requirements, discussed below, apply to directors serving on the audit committee.

Private equity sponsors will usually have designees sitting on the boards of portfolio companies when they go public. It will thus be up to the portfolio company's Board to determine whether the private equity sponsor nominees have any material relationships with the portfolio company such as would bar a finding of independence. Given the typical structure of private equity sponsors, the nominees may not fall within any of the expressly proscribed non-independent relationships (depending on the fees paid to the sponsor by the portfolio company and who employs the nominees). The Board will need to consider whether the relationships are nonetheless close enough to the proscribed categories that the private equity sponsor nominees should not be determined by the Board to be independent. Apart from complying with the NYSE or Nasdaq listing rules, there are other good reasons to have at least some independent directors not affiliated with either the company or the private equity sponsor because such unaffiliated independent directors could deal with issues that may arise where the private equity sponsor and the portfolio company have differing interests.

What are the major specific rules applicable to the audit committee?

The NYSE and Nasdaq rules require that a listed company, including a controlled company, have at least three members on its audit committee who are all independent directors, subject to the IPO grace period discussed below.

In addition to the other independence requirements, a member of the audit committee is not allowed to: (1) accept any consulting, advisory or other compensatory fee from the company or any subsidiary of the company (other than fees for service on the board of directors or any board committees); or (2) be an affiliated person of the company or any subsidiary of the company (except as a result of board or committee membership). The rules prohibit indirect payments of compensatory fees, which include payments accepted by an entity in which an audit committee member is a partner, a member or an officer (except limited partners or non-managing members who have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the company or any subsidiary of the company.

In addition, a company must disclose in its annual report on Form 10-K whether its board of directors has determined that the company has at least one independent audit committee financial expert and, if it has made such determination, identify such financial expert. A company disclosing that it does not have an independent audit committee financial expert must explain why not. An audit committee financial expert must have an understanding of GAAP, financial statements, internal control over financial reporting and audit committee functions. A private equity sponsor should make sure, prior to taking a company public, that the company has an audit committee financial expert at the time of the IPO because disclosure that the company does not have such expert may raise red flags with investors.

The audit committee must also pre-approve all audit services and all permissible non-audit services to be provided by the independent auditors. This pre-approval requirement will apply for services rendered in the year the portfolio company goes public, so care must be taken early on to ensure compliance.

Grace period for independent directors

Under the NYSE and Nasdaq listing rules, companies engaging in an IPO are allowed a grace period in which to comply with the requirement to have a majority of the board and all of the audit, nominating and compensation committees comprised of independent directors. Companies listing in conjunction with an IPO would need to have one independent director on each of the audit, nominating and compensation committees at the time of listing, a majority of independent directors on such committees within 90 days and fully independent committees and a majority of independent board members within one year.

When should the independent directors join the Board?

The requirement that companies engaging in an IPO have a majority of independent directors on the audit, nominating and compensation committees within 90 days can be a stringent one, because it may be difficult to recruit suitable members that meet the independence requirements. A private equity sponsor should, if possible, identify the independent directors well in advance of a listing. It is preferable to have the independent directors in place early on so that they can participate in the review of the IPO registration statement and get comfortable with the corporate governance provisions before they are adopted. If the independent directors are only identified later in the process, they may not have the time to due diligence effectively the registration statement and may be reluctant to be named as directors at the time of the IPO, because all directors will have Section 11 liability on the registration statement. In that

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Selected Issues to Consider When Taking a Portfolio Company Public (cont. from page 27)

case, independent directors could be appointed immediately after the closing of the IPO, thus avoiding liability for the registration statement and yet satisfying the phase-in requirement that there be at least one independent director at the time of listing.

Do we have the right management team in place?

In light of the more extensive regulation of public companies under the Sarbanes-Oxley Act and related listing requirements, a private equity sponsor needs to be diligent about whether the management team of its portfolio company has the right skill set and experience to lead a public company. In particular, senior management will have to contend with certification as to financial statements and disclosure controls, assessment and documentation of internal controls, interaction with the investment community in compliance with Regulation FD, and new, more demanding SEC reporting requirements, including the more current reporting obligations required under Form 8-K and with respect to Form 4s.

Even if a private equity sponsor believes that management is up to the task, it would be wise to make sure that the company's independent auditors and independent Board members agree. If the auditors are dubious about the capabilities of the CFO, for example, the auditing and attestation process could be a rocky road. It may be difficult to retain or recruit the required complement of independent directors if there are issues about the management team. Moreover, weaknesses in the accounting or disclosure functions could lead to missteps that can be troublesome in the public arena.

Do we need to restructure existing loans to management?

The Sarbanes-Oxley Act prohibits a company from extending or maintaining credit or arranging for the extension of credit in the form of a personal loan to any director or executive officer. Loans outstanding on July 30, 2002 are not affected, provided there are no material modifications to any term of the loan or any renewal of the loan in the future. A private equity sponsor should examine whether any existing loans to management will have to be restructured prior to the IPO in light of this prohibition.

Should we have registration rights?

Private equity sponsors generally obtain extensive registration rights at the time they make their initial investment in a portfolio company. These should be reviewed in advance of an IPO to make sure that they provide the sponsor all the registration rights it may need in order to effectuate possible future exits through public offerings post-IPO. Making any changes to the registration rights agreement pre-IPO is preferable, because any adjustment will likely be disclosed in the prospectus and be part of the baseline that public investors evaluate. The scrutiny accorded to any adjustment made after the IPO would also be greater and directors may be less willing to grant rights to the sponsor different from those contained in the registration rights agreement at the time of the IPO.

* * *

Planning for an IPO far in advance can help a private equity sponsor ease the transition into the public arena and avoid unpleasant surprises.

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Trendwatch: Spinouts of Private Equity Funds (cont. from page 26)

Handbook on establishing a London office).

- The new firm will need a name that does not violate any other firm's rights or otherwise create confusion in the marketplace (appropriate trademarks may need to be registered).
- The spinout firm will need to register a domain name and create a website that complies with various regulatory requirements, including U.S. securities laws.
- Office space must be found and fitted, administrative support and accounting staff must be hired, auditors appointed, insurance purchased, and public relations managed.

As is the case with other aspects of disengaging from a former employer, spinouts that are managing legacy assets may purchase or receive the benefits of transitional services and support from the former parent sponsor.

* * *

Time is probably the scarcest commodity of private equity professionals planning the commercial terms of a spinout, but attention in advance to pre- and post-departure obligations under existing agreements can prevent unwelcome delays.

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