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KKR Takes the "Private" Out of Private Equity

The successful offering of KKR Private Equity Investors (the "KKR Listed Fund"), a private equity fund listed on the Euronext (Amsterdam) stock exchange, has dazzled the private equity community. In case you have not heard a presentation from one or more of the investment bankers that are visiting their clients to discuss this topic or have found the 300-page offering memorandum a bit daunting, we've summarized the offering and put it in context of the overall private equity marketplace.

What Is the KKR Listed Fund?

The KKR Listed Fund is the ultimate hybrid fund — a real mélange. It combines at least five interesting ideas, none of which by itself is novel, and each of which could be used by private equity sponsors separately or in a variety of combinations.

(1) The KKR Listed Fund is a captive primary fund of funds, investing in other KKR funds. The KKR Listed Fund will commit roughly $2 billion to KKR's 2006 Fund (a traditional private equity fund that is currently being marketed by KKR), and it has purchased from KKR principals an interest representing $100 million in commitments to KKR European Fund II. A captive public fund of funds format has a number of potential advantages to KKR, as well as to investors in the KKR Listed Fund:

- The KKR Listed Fund expands KKR's universe of investors beyond its traditional institutional investor base. The underwriters are referring to this as the "fourth largest IPO in U.S. history." This is only partially true: over three-quarters of the offering was sold to institutions, mostly in the U.S. According to *The Deal*, only 15% of the buyers were high net worth individuals: 30% were hedge funds and the balance (55%) were institutions drawn from KRR's traditional institutional base.
- The KKR Listed Fund is an evergreen source of funding for KKR. Not just evergreen, but growing. Investment gains are reinvested (it will make tax distributions only) and 25% of future after-tax carried interests owned by KKR principals and attributed to the KKR Listed Fund will be reinvested in new KKR Listed Fund shares, priced at net asset value.
- The KKR Listed Fund's $5 billion in capital will permit it to commit substantially more than $5 billion to KKR funds. It will follow an "over-commitment" approach, taking into account future distributions from existing fund investments in determining capital availability for new fund investments. In theory this approach could provide an incentive to rush dispositions in the 2006 Fund if the KKR Listed Fund finds itself in a liquidity bind.
- The terms of the KKR Listed Fund are more favorable to KKR than typical private institutional fund terms because of the absence of key man provisions, absence of a general partner clawback and retention by KKR of 100% of transaction and other fees attributed to the KKR Listed Fund's investments. Management fees are based on total (and potentially increasing) assets, rather than declining assets during a run-off period.
- The terms of the KKR Listed Fund are more advantageous to investors when compared to a typical high net worth retail fund of funds, reflecting the institutional nature of subscribers. For example, there is no layering of fees

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"I'm looking for a hedge against my hedge funds."

letter from the editor

The private equity market continues to dazzle, with records of all sorts (fund-raising, deal size, investment vehicle design) being broken time and time again. On our cover, Woody Campbell describes the ultimate hybrid vehicle, KKR Private Equity Investors, a private equity fund recently listed on the Euronext stock exchange. Although you have probably read a lot about this offering, we think that you'll find that this article brings a refreshing perspective. Our article puts this new vehicle in the context of the overall private equity marketplace and notes that it may raise a number of challenges relating to investors' arbitrage activity , sponsor perception and the adoption of uniform valuation standards.

Our London colleagues warn about how the new UK pension regulatory powers are changing the UK deal environment and making some acquisitions and recapitalizations both more expensive and more time consuming, and in some cases, impossible. Our European colleagues remind us that "*ce n'est pas la même chose*" when designing management incentives in various European jurisdictions.

In our continuing effort to provide you with practical guidance, we provide tips on how to get the best deal when negotiating with electronic data room providers. We also provide a primer on issues raised by investing in the insurance sector.

We report on the status of the New York legislature's action that reportedly had been threatened to put at risk the limited liability of investors in private equity vehicles which fail to publish. Luckily, at press time, these issues appear to be far less serious than originally anticipated.

In our Guest Column, Mark Wiseman of the Canadian Pension Plan Investment Board and Chairman of the Institutional Limited Partners Association, brings the investor perspective into focus and shares ILPA's viewpoint on best private equity practices.

Look out for the *Best of the Private Equity Report* being published this summer in celebration of almost six years of the *Debevoise & Plimpton Private Equity Report* and the firm's 75th anniversary. To keep your summer reading list to a minimum, the *Private Equity Report* itself will go on vacation this summer, but we look forward to seeing you again this fall.

Franci J. Blassberg
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Watch Out: The UK Pensions Watchdog Has Teeth and Is Changing the UK Deal Environment

It is tempting to believe that the latest changes to UK pensions law have received an undeserved rap for stymieing private equity deals that in reality should never have taken place. However, a closer look at the new pensions regime shows that not only has it already prejudiced a number of otherwise viable acquisitions and recapitalizations but that it will be a major factor in many UK deals for the foreseeable future.

The UK pensions landscape has been fundamentally altered through the establishment in 2005 of a new statutory watchdog, the Pensions Regulator (the "Regulator"), a body with wide-ranging powers to protect the interests of members of UK private sector final salary pension schemes (the UK equivalent of U.S. defined benefit pension plans).

It is clear that the Regulator has already had a significant effect on general M&A activity in the UK, and its impact has been particularly important on private equity transactions. This is because the Regulator pays particular attention to three types of transactions: changes in control (which covers the purchase and the sale), returns of capital (which includes distributions and recapitalizations) and changes in priority of debt (which includes debt "push downs").

This, coupled with the fact that many UK final salary schemes are in deficit, means that pension considerations have become a priority issue for many UK private equity transactions and, in a small number of high profile cases, have stopped them dead in their tracks. While in the majority of cases the new pensions regime *per se* should not preclude an investment for any private equity fund interested in a target with a UK final salary pension deficit, how to deal with that deficit is likely to be a key consideration, and may have a material effect on, acquisition price, post-acquisition refinancing plans, and even exit strategies.

A Regulator With Teeth

The Regulator has two key powers: the ability to issue "contribution notices" ("CNs") and "financial support directions" ("FSDs") to a wide range of parties. Either can involve the acquisition vehicle or a holding company, even though not directly liable for the pension deficit, having to make what could be a very sizeable payment into the relevant final salary pension scheme.

Contribution Notices (CNs)

In order to issue a CN there must be a pension scheme deficit, as determined typically on an "FRS17" basis (the UK accounting/actuarial valuation basis used in calculating deficits for the purposes of company accounts), and the Regulator must establish an act or omission the main purpose (or one of the main purposes) of which was to avoid or reduce (or otherwise than in good faith prevent coming due) the employer's statutory pension liabilities. We assume that most private equity funds will rarely take any action or omission which would fall within this provision.

Financial Support Directions (FSDs)

As with CNs, an FSD can be issued only if there is a pension scheme deficit, but unlike CNs, an FSD may be issued by the Regulator without there having been any "wrongdoing." Consequently, it is FSDs which are more typically issued.

In order to issue an FSD, the Regulator has to be of the opinion that the company operating the pension plan is either "insufficiently resourced" (*i.e.,* where the value of its resources is less than 50% of the estimated "buy out" debt of the pension deficit) or a "service company" (*i.e.,* where the company's turnover is principally or solely derived from amounts charged for the provision of the services of employees to other members of the same group), and in either case there are persons within the group (whether subsidiaries, sister companies or direct or indirect holding companies) which can meet part or all of that company's pension liability, even if they are not directly liable for the pension plan deficit.

The FSD will require the recipient to establish and retain financial support for the relevant pension scheme. A recipient will be the employer in relation to the scheme, or a person connected with , or

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an associate of, the employer (including group companies, controlling shareholders, directors and trustees). As with CNs, private equity funds may be potential recipients, although in practice the acquisition vehicle or a holding company, even though not directly liable for the deficit, is more likely to be issued with an FSD.

A is for Acquiror Angst: "Type A Events"

Particular emphasis is placed by the Regulator on so-called "Type A events," as it is in respect of these that it expects to be consulted by the relevant parties and for its clearance to be obtained. There are three broad types of transactions which may constitute a "Type A event" (changes of control; dividends or other returns of capital; and changes in priority of debt). Different tests apply for each type of transaction in order to establish whether or not it is a "Type A event," but for private equity funds, the acquisition, as well as the financing and any recapitalization, will frequently constitute a "Type A event" (or otherwise fall foul of the Regulator).

The increased bargaining power of pension trustees since the establishment of the Regulator means that private equity buyers will often have to factor into their valuation models the effect of either one-time deficit reduction payments at the time of the acquisition or accelerated pension contributions to reduce the deficit over time, or both.

Change of Control on an Acquisition

The acquisition by a private equity fund of a group or company with a pension deficit will often constitute a "Type A event" as the leverage on the acquisition vehicle (or an acquisition group holding company) is often viewed by the Regulator, because of the resulting increase in group debt, as negatively affecting the credit capacity of the company providing the pension. This is the case even though the acquisition vehicle (or the holding company) is not directly liable for the pension deficit.

Potential acquirors are advised to meet with the trustees of the target's pension scheme at as early a stage as possible to try to arrive at an agreement with them as to reduction of the deficit over time. Trustees often have considerable influence in these circumstances for two reasons. First, the Regulator is far more likely to approve a transaction which has their blessing. Second, if the trustees are unhappy with a proposed transaction they can contact the Regulator, which in turn can issue a CN or FSD. Ideally, the seller or target will have consulted with the trustees prior to the sale process in order to ascertain the trustees' likely attitude to the sale, though in practice this often may not happen or not be feasible.

Recent M&A activity in the UK suggests a growing trend for trustees to extract value for the benefit of the pension plan from both sellers and buyers. In many cases trustees are now demanding increased funding from employers (and thereby from buyers) as the *quid pro quo* for helping obtain the Regulator's approval of the acquisition. This may take the form of a lump sum payment to the pension fund, or a combination of a one-off contribution, with increased contributions going forward. The increased bargaining power of pension trustees since the establishment of the Regulator means that private equity buyers will often have to factor into their valuation models the effect of either one-time deficit reduction payments at the time of the acquisition or accelerated pension contributions to reduce the deficit over time, or both.

Potentially as important to a private equity buyer as one-time and other contributions will be the investment policy of the pension fund to be adopted in the future. This policy can have a fundamental bearing on the likelihood of deficits going forward. The pension trustees have increasing influence on the investment policy, which will be determined in part by their view of both the creditworthiness of the buyer and the size of any up-front payment. An up-front payment which substantially reduces the deficit at the time of acquisition may be of significantly less use to the private equity buyer if the trustees then adopt an investment policy so risk averse that increased contributions are likely to be required in subsequent years.

In light of this it is important for all buyers (but in particular private equity buyers) at an early stage in the acquisition process to assess and try to agree with the trustees on several items — up-front payments, contribution rates and investment policies — as part of an overall arrangement. Trustees are subject to fiduciary duties so it is difficult to ensure such proposals will be binding on them in all circumstances, but in practice an arrangement acceptable to all parties can often be found.

If agreement with the trustees cannot

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LPs and the Role of ILPA

Mark Wiseman is Chairman of the Institutional Limited Partners Association and Vice President — Private Investments at the Canadian Pension Plan Investment Board. Recently, he answered some questions about the status of limited partners and the role of the Institutional Limited Partners Association (ILPA) and other representative bodies in addressing limited partners' needs in the ever-changing world of private equity.

What is the history of ILPA and how has the organization evolved?

The ILPA really started as an informal networking club in the early 1990s, where limited partners representing some of the leading institutional investors in private equity would get together to discuss the state of the market, trends in the industry and due diligence matters. Today, the organization is not all that different in terms of its basic operation; however, the ILPA is now much more formalized. With over 160 member organizations from around the world, it is the leading industry association for the limited partner community. In fact, it has been estimated that the ILPA's members represent the source for more than 80% of all private equity and venture capital funding.

What is the purpose of ILPA and how does its mission differ from that of other organizations representing LPs?

In fact, there is really no other organization that solely represents the interests and serves the needs of the limited partner community. While there are many well-established industry associations and other groups serving the needs of the private equity and venture capital community, the ILPA is the only organization that focuses on limited partners. And this fact is important, since the interests of limited partners often differ from other industry participants. Having said this, it is also important to note that the ILPA is not a lobbying organization. While we will weigh in on important issues facing our industry, such as valuation and reporting standards, our mission is to facilitate value-added communication amongst our members, to enhance education for investors in the asset class and to promote research and standards within the private equity industry.

Who are your members? And, what are the criteria for membership?

When the ILPA first started the membership was dominated by North American public pension plans. Today, our members are much more global and less than a majority (35%) are public pension plans. Our membership also includes foundations, endowments, corporate pension plans, family offices and insurance companies. The unique feature of the ILPA is that, in order to qualify for membership, the organization must predominantly be managing its own capital. Therefore, for example, funds-of-funds do not qualify for membership, even though they are limited partners.

Wouldn't LPs be better served in combining their strength into one lobbying body?

There are two reasons why lobbying is inconsistent with the ILPA's mission. First, we have a very diverse set of members, which come from many different jurisdictions and which have interests that are not necessarily aligned. For instance, some of our members are taxable institutions, while others are non-taxable; some are subject to FOIA legislation, while others are not; some have investment motivation beyond simply maximizing economic returns; while other are driven only by profit motive. Given these facts, it makes more sense for us to focus on our core mission. Second, there are several excellent national and transnational organizations that provide advice to governments and regulators — the NVCA, EVCA, BVCA, CVCA, etc. And, many of our members are also members of one or more of these organizations.

There have been several news reports that the GP community is forming a trade organization. How would that development affect LPs and ILPA?

The ILPA would welcome the formation of such an organization, particularly in the U.S. At present, the

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While [ILPA] will weigh in on important issues facing our industry, such as valuation and reporting standards, our mission is to facilitate value-added communication amongst our members, to enhance education for investors in the asset class and to promote research and standards within the private equity industry.

LPs and the Role of ILPA (cont. from page 5)

NVCA does an excellent job representing the venture capital community in the U.S.; however, unlike some of the other national and transnational industry associations, it does not also have a focus on the buy-out side of the business. I believe that our industry would be well served by a buy-out trade organization in the U.S. and the ILPA would be very interested in working with such an organization in championing common causes and strengthening the private equity industry in general.

What are the key issues/concerns facing LPs in today's investment environment? What services/support can ILPA provide its members in analyzing and handling these issues?

In addition to the obvious concerns about market conditions, there are many issues facing the limited partner community today. Clearly, valuation standards are high on our agenda, as are issues related to best practices in reporting, and ensuring alignment of interest in fund terms and conditions. As well, issues surrounding benchmarking are key to the limited partner community. Many of the benchmarks used by institutions for private equity and venture capital are inappropriate or are subject to calculation based on insufficient data or inaccurate assumptions. Given the illiquid nature of the asset class, benchmarking will always be difficult, but we could do much better. In order to further our understanding and treatment of all of these issues, the ILPA has recently announced that it will be adding to its full-time staff with the hiring of a Director – Education and a Director – Research. We hope that this new complement of staff will be able to assist our members in analyzing and handling these tricky issues.

Are the opportunities for mega-deals changing the way that funds are structured and does that increase the need for networking organizations such as ILPA?

It seems that there are big changes taking place in our industry. Funds are getting larger, new publicly traded investment vehicles are being formed, deal sizes are ballooning, emerging markets are becoming more sophisticated and well developed, and deal and fund structures are evolving at a breakneck pace. This environment is one that is very difficult for the institutional investor to navigate, especially those that do not have sufficient internal resources to dedicate to understanding all of these issues. In my view, these facts make the ILPA even more important. We provide a confidential forum where institutional investors can share views, market intelligence and best practices with one another. This activity is even more essential as more and more institutions, many of whom lack experience, enter the private equity asset class. As new entrants come into the market, many of whom are from outside of North America and Western Europe or are from smaller organizations that had previously eschewed private equity, it is that much more important that the ILPA provides an educational platform for the institutional investor. At the end of the day, the long term health of our industry depends on well-informed, sophisticated limited partners making investments in and being aligned in interest with funds managed by the most highly qualified general partners.

[ILPA] provide[s] a confidential forum where institutional investors can share views, market intelligence and best practices with one another. This activity is even more essential as more and more institutions, many of whom lack experience, enter the private equity asset class.

How to Be a Savvy Electronic Data Room Consumer

Electronic data rooms have become a standard tool when private equity firms sell portfolio companies in multiple-bidder auctions Here's how to get the best deal when you hire an electronic data room service provider.

Today's electronic data room product. First, here's what to expect in a state of the art electronic data room. An electronic data room is a secure, on-line version of a physical paper data room that the seller invites the bidders and their advisors to enter. The data room documents are presented as PDF or TIFF images and are accessed by clicking on a hyper-linked index. Electronic data rooms also provide Q&A, search and reporting functionalities. Most of the providers charge on a per page basis for their services, although we are aware of at least one provider that has moved to per document pricing. (Please see "Due Diligence in Cyberspace: The Rise of the Electronic Data Room" in the Winter 2005 issue of *The Debevoise & Plimpton Private Equity Report* for a full description of electronic data rooms and their advantages and disadvantages.) IntraLinks and Merrill dominate the general M&A market today, but other providers, including BMC, Bowne and LegalTools, have recently entered the market. Other companies offer solutions for specific industries or services, such as DocClarity's SmartCabinet for commercial real estate development or Petroleum Place's The Oil and Gas Asset Clearinghouse for divestitures of oil and gas properties.

Decide what you need in an electronic data room product. Sellers should seek system compatibility, simplicity of set-up and administration, ease of use, speed of access, security and customer service. Some of these features can be evaluated in a demonstration of an electronic data room product that is presented by the vendor in person or in an online meeting.

Use your lawyers and bankers as information resources. Since the technology behind electronic data rooms and the service providers are developing rapidly, check with your deal lawyers and investment bankers for recommendations and recent experiences. Law firms and investment banks with active M&A practices will have recent experience with electronic data room providers and be able to offer anecdotal information on the customer service capabilities of the providers and ease of use of the products, among other things. These are important to the success of an electronic data room and cannot be evaluated from demos or written proposals. If trying a new provider, ask for references.

Solicit proposals from the providers for your transaction and let them know that you know they operate in a competitive market. In order to solicit a proposal, estimate the number of pages that will be hosted by the provider. A general rule of thumb is that one banker's box of documents contains 2,500 pages. A vendor should be able to respond to your request for a proposal in one business day. To get the best price, be sure to let the providers know that you know that they have competitors and that you are talking to them.

Make sure that the provider's pricing structure is optimal for the size of your transaction and carefully scrutinize scanning charges. Typically, electronic data rooms are priced on a per page basis. The price per page ranges from \$.70 to \$1.45 depending on the total number of pages in the data room. Each provider uses a different pricing structure, with volume discounts coming into effect at different page counts. We are aware of at least one provider that is pricing its data room on a per document basis, which may result in a lower overall cost if your data room primarily contains long agreements or other voluminous materials. Scanning charges are never included in the standard pricing and are typically quoted from \$.23 to \$.25 a page, with the exception of one provider that offers scanning prices reflecting a volume discount. The "full retail" price can be higher than those you or your law firm or banker obtain from scanning

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Decide what you need in an electronic data room product. Sellers should seek system compatibility, simplicity of set-up and administration, ease of use, speed of access, security and customer service.

service providers with whom you or they regularly do business, so consider whether convenience outweighs cost.

Obtain an independent security audit from a new provider. Your provider should have an independent security audit as to the effectiveness of the security precautions on its website. The auditor will attempt to access private information that is stored on the target site by using known hacker methods. An unsuccessful security audit indicates that private information stored on the site may be vulnerable and accessible to intruders. You will need some technology expertise to be able to evaluate the audit.

Learn what features come with the electronic data room and consider using them. Generally, the basic price per page includes general project management, data upload of electronic documents, index and website creation, web hosting for six months to one year, up to 500 users or unlimited users, reports, around-the-clock customer service, training, a Q&A feature and one DVD of the data room. The search feature may be used to locate a document in the data room without having to look through the entire index. Regular use of the Q&A feature to communicate frequently asked questions and your responses to all bidders can eliminate duplicate work for portfolio company personnel and advisors. It is also possible to link questions and specific provisions in the data room documents with the Q&A feature, which could help speed up the M&A due diligence process. Be sure to obtain the DVD of the data room, which gives the seller a clear and unambiguous record of the documents that were provided to the buyer and an audit trail as to how, when and by whom the site was accessed, and may prove to be indispensable in resolving or even preventing a post-closing dispute.

The seller's electronic data room serves multiple functions for the buyer. A well-organized and indexed electronic data room is a central and easily-accessible repository of a company's contracts and other key documents. The care and presentation of the data room will reflect on the company, and a well-organized data room may become a sales and marketing tool supporting a higher purchase price and help expedite the sales process. The data room (including index and structure) can be copied onto a DVD and can serve an important role in the buyer's post-closing operations as a resource for addressing integration issues, starting a contract management system or for use in a "self due diligence" process to prepare the company for an IPO or eventual resale.

* * *

If selected and used properly, an electronic data room can add value for a private equity firm in a multiple-bidder auction sale of its portfolio company by reducing deal costs, saving time and, potentially, making the process more efficient and (best of all) increasing the purchase price.

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How Much Control Is Too Much for the Department of Justice?

A recent Department of Justice settlement alleging "gun-jumping" violations of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act") offers lessons for both private equity and strategic buyers, but also helps illustrate some competitive advantages available to private equity buyers in transactions where they have developed good working relationships with management. The DOJ's action, one of only a few "gun-jumping" challenges in several years, resulted in a $1.8 million civil penalty against merger partners QUALCOMM and Flarion Technologies.

Enforcement agency concerns about "gun-jumping" under the HSR Act are usually prompted by restraints imposed by strategic acquirers on competitive targets pending closing, and the QUALCOMM/Flarion case is no exception. A private equity buyer, unless it owns competing properties, typically has little reason to worry about this issue. But the DOJ's complaint also focused in part on the *de facto* control exercised by QUALCOMM over Flarion prior to expiration of the HSR waiting period, an exposure potentially faced by strategic and private equity buyers alike.

QUALCOMM and Flarion entered into a merger agreement on July 25, 2005, and filed the requisite HSR Act premerger notification forms shortly thereafter. The waiting period normally would have expired no more than 30 days after the filing, but in this case, the DOJ issued a "second request" for information to enable it to examine possible anti-competitive effects of the transaction and did not terminate the waiting period for several months.

Merger agreements governing transactions that require HSR Act filings typically contain "conduct of business" covenants intended to ensure that the target operates its business in the ordinary course and does not take actions that could seriously impair the value of the acquirer's proposed investment. The antitrust authorities recognize the valid business purposes behind these provisions.

The DOJ's complaint addressed covenants in the merger agreement that required Flarion to obtain QUALCOMM'S written consent before engaging in a variety of business activities between signing and closing of the transaction. The DOJ contended that application of these provisions gave QUALCOMM "beneficial ownership" of Flarion before the waiting period expired, in violation of the HSR Act. The DOJ objected to four (out of twenty-one) restrictions on Flarion's business, including provisions prohibiting Flarion from:

- presenting business proposals to any customer or prospective customer;
- entering into any agreement to license intellectual property (the core of Flarion's business) to a third party;
- entering into certain contracts involving the obligation to pay $75,000 or more per year or $200,000 or more in the aggregate; or
- hiring any employee other than in the ordinary course of business in accordance with past practice.

Some of these restrictions, taken alone, are not unusual, although the prohibition on presenting business proposals absent QUALCOMM's consent was out of the ordinary and no doubt highly suspect to the DOJ.

Unless confidentiality concerns dictate otherwise, the private equity buyer typically requests early termination of the 30-day HSR Act waiting period, which typically is granted in less than 15 days. Once HSR Act clearance is received, the private equity buyer, unlike the strategic buyer, is free to exercise any degree of control the target will tolerate prior to closing. Because the private equity buyer may already be working closely with management, it may have an informal understanding about operational

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A recent Department of Justice settlement alleging "gun-jumping" violations of the [HSR Act] offers lessons for both private equity and strategic buyers, but also helps illustrate some competitive advantages available to private equity buyers in transactions where they have developed good working relationships with management.

direction that a strategic acquirer would not have. Indeed, according to the DOJ's complaint, QUALCOMM had insisted on the allegedly offensive provisions in its merger agreement with Flarion because it was concerned that Flarion might enter into agreements that were inconsistent with QUALCOMM's future plans for the business. But according to the DOJ, QUALCOMM, as a strategic buyer, was not legally entitled to exercise the latitude the merger agreement afforded prior to closing.

A private equity buyer that already owns a business competing with that of the target is not necessarily free to shrug off "gun-jumping" concerns until after HSR Act clearance is received. In the eyes of the antitrust agencies, the HSR Act's waiting period requirements aim to preserve the target firm as an independent competitor during the period of HSR Act review in case the proposed transaction is not consummated.

The QUALCOMM settlement likely does not presage heightened scrutiny by the DOJ of standard conduct of business covenants . . . . The agreement's restriction on presenting business proposals was unusual and went to the heart of the target's ability to compete and grow its business, as did QUALCOMM's actual exercise of operational control over Flarion.

In QUALCOMM, the DOJ was concerned about the parties' actual pre-clearance conduct. The complaint alleged that QUALCOMM used its approval authority over Flarion's business proposals to customers "to further [its] own business interests and its post-merger business plans for the Flarion assets" by requiring Flarion to obtain QUALCOMM's consent before marketing products and services to customers, and by discouraging Flarion from business opportunities it might otherwise have pursued. Although QUALCOMM's conduct raised obvious competitive concerns, even more subtle efforts to give direction to the competitive aspects of the target's business should be avoided by a private equity buyer that already engages in a competing business.

Penalties

Violators of the HSR Act can be penalized up to $11,000 for each day of violation, to say nothing of the credibility loss and business and legal costs accompanying any government enforcement proceeding. The QUALCOMM settlement penalized each party $900,000 but gave them credit for the period after they amended the offensive provisions of the merger agreement.

Conclusion

The QUALCOMM settlement likely does not presage heightened scrutiny by the DOJ of standard conduct of business covenants. "Beneficial ownership" is a fact specific determination. The QUALCOMM/Flarion agreement's restriction on presenting business proposals was unusual and went to the heart of the target's ability to compete and grow its business, as did QUALCOMM's actual exercise of operational control over Flarion.

The QUALCOMM/Flarion action nonetheless reminds parties and their lawyers to look closely at covenants that go beyond the standard ordinary course provisions. Control should not be exercised by any buyer prior to HSR Act clearance, and private equity buyers owning competing properties, whether as majority or minority owners, should ensure that the parties' actual conduct through the closing does not allow the buyer to exert undue influence over the target's ongoing business.

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Assuring Yourself a Slice of the Insurance Sector

Introduction

The insurance sector continues to be a source of great interest and potential for private equity firms. Yet, investing in insurance and insurance-related companies is very different in many respects from investing in the average widget factory. Apart from a whole host of arcane terms and concepts, the prospective private equity buyer also needs to be aware of the unique regulatory aspects, risk allocation issues, the potential for a state investigation and the tax implications of buying an insurance company.

Private equity investments in the insurance sector have grown steadily since the early 1990s. While many of the deals have been concentrated in a handful of specialty boutiques, such as Stone Point Capital's Trident funds, and funds managed by Capital Z Partners, private equity participation in the industry is much broader, with significant investments by Hellman & Friedman, JP Morgan Partners, Diamond Castle Holdings, Thomas H. Lee, and other firms.

Private equity firms have taken stakes not only in established insurance operations, but have also played major roles in the start-up of a number of billion dollar insurance companies. These include the so-called "Class of 2001" Bermuda specialty lines insurance and reinsurance operations that were launched following the terrorist attacks of September 11, 2001 and transactions, such as the capitalization of Harbor Point Limited with approximately $1.3 billion from investors including Stone Point Capital, Trident III, JP Morgan Partners, and Diamond Castle Holdings and the related acquisition of the assumed reinsurance business of Chubb Re, which were driven in part by the dislocation, and related opportunities and risks, created by Katrina, Rita and the other disasters of 2005. Other private equity firms are now making similar investments in so-called "side car" deals, in which one or more private equity funds form and capitalize a new Bermuda reinsurer for the sole purpose of enabling it to act as a retrocessionaire (see below) for insurers and reinsurers like Harbor Point.

In addition to investments in insurance companies, private equity firms have also actively invested in a myriad of insurance services providers. For example, in the last several years KKR, Hicks, Muse, Tate & Furst, Vulcan Capital, Stone Point Capital and Hellman & Friedman, among many others, have acquired brokers, software providers and other service providers to the insurance industry.

The Players

Broadly speaking, insurance companies can be divided into life and health insurance companies, on the one hand, and property and casualty companies, on the other. These broad categories, of course, include many different lines of business and niche markets. Private equity firms have tended to invest primarily on the property and casualty side of this divide, in both primary insurance companies and in reinsurance companies.

Insurance companies distribute their products to customers through insurance agents and brokers. An insurance agent or agency is generally an agent of an insurance company that sells, solicits or negotiates insurance policies on behalf of the insurance company with potential customers. An insurance broker, on the other hand, is generally understood to be a person or entity that solicits or negotiates insurance on behalf of a purchaser of insurance, even though a broker is generally compensated by a commission paid by the insurer. However, as the Elliot Spitzer investigation of the Marsh & McLennan Companies illustrates, the line between agents and brokers is often blurred. In fact, recent trends in licensing and regulation of insurance agents and brokers tend to use one label, "producer," for any person that sells, solicits or negotiates insurance.

Beyond these general categories, there are a number of specific types of agents and brokers as well as other types of insurance-related entities that can and have been acquisition targets of private equity firms. These include managing general agents, or MGAs, and surplus line brokers. Other key insurance services businesses include third-party administrators, or TPAs, which collect premiums, adjust and settle claims and provide a variety of other services in connection with life, annuity or health insurance policies underwritten by unaffiliated insurers, and software companies specializing in products for the financial services and insurance industries.

The Jargon

Before a private equity buyer gets into the insurance business there are a few terms and concepts it needs to know. It is widely understood that the "reserves" established to pay claims and other losses under insurance policies written by an insurer is the most crucial liability line item for an insurer. But the term "reserves" actually encompasses many separate types of exposures, including loss reserves and reserves for loss adjustment expenses. The term "loss reserves" itself is composed of reserves for known claims that are due but not yet paid, known claims that are not yet due, and also reserves for losses that are incurred but not yet reported, or "IBNR."

Another esoteric element of the insurance industry is the accounting standards utilized by all insurance companies in the preparation of their financial statements. Insurance companies in the U.S. are required to prepare their annual statements filed with regulators in their states in accordance with what is known as statutory accounting practices or "SAP," rather than GAAP. SAP, which varies from state to state, is designed principally to reflect an insurance company's ability to pay the claims of its policyholders rather than the broader "financial condition" measured by a GAAP balance sheet. While insurers that are publicly traded or that have publicly-traded securities prepare financial statements on both a SAP and a GAAP basis, non-public insurers may

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Assuring Yourself a Slice of the Insurance Sector (cont. from page 11)

or may not do so.

Reinsurance is another important concept. Insurers purchase reinsurance in order to reduce their exposure to risks on the policies they write, and to increase capacity. Reinsurance is obviously crucial as a matter of risk diversification, much like the syndication of a bank loan. But it is also a practical reality of growth, since due to the booking under SAP of expenses associated with the placement of insurance, the more business underwritten by an insurer during a given accounting period, the lower an insurer's surplus position will be as of the end of that period. This anomaly, known as "surplus strain," can stunt growth because an insurer's ability to place new business is subject to minimum capital requirements; hence the imperative to protect surplus. Reinsurance can ameliorate surplus strain if it meets the standards set by applicable law because an insurer can book the receivables from such reinsurers as an asset on its balance sheet.

Reinsurers face most of the same commercial and regulatory imperatives as insurance companies and hence often look to "cede" (or transfer) a portion of their exposure under an inward reinsurance contract to other third-party reinsurers, in a process known as retrocession. Hence the tongue twisters "retrocedent" and "retrocessionaire."

Leverage?

The LBO model has traditionally sought to generate private equity returns (25-35%) on the basis of a leverage target of 3-4:1 and repayment of debt from target cash flow over a four to seven year period. But the traditional capital structure of a private equity deal is difficult to apply in an acquisition of a U.S.-based insurance company due to significant regulatory impediments to leverage, including:

- Restrictions on debt placed directly on the insurance company target, unless the loan proceeds are utilized by the insurer in its operations.
- Restrictions on pledges of the assets of the operating insurance company.
- Legal restrictions on the dividends by a target insurer to its holding company parent that are much more onerous to the equity than the Delaware and other state corporate law tests that all private equity professionals know quite well.
- Significant restrictions on all affiliate transactions involving the target insurer, including prior approval requirements of tax-sharing and service agreements between an insurer and its affiliates and an effective bar to arrangements like deal fees and monitoring fees.

Note, though, that an acquirer can in some senses "mimic" leverage at a target insurance company level through the use of reinsurance or securitization of policy obligations. By reinsuring a portion of a target insurer's portfolio or setting up a special purpose vehicle to issue securities backed by the portfolio, an acquirer can use less of its own capital to finance an acquisition without incurring debt on the target insurer's balance sheet, thereby replicating some of the benefits associated with leverage.

In addition, although LBO-like leverage is a non-starter in the acquisition of an insurance company, it is important to note that the same restrictions generally do not apply in the less heavily regulated or unregulated portions of the insurance services sector, including acquisitions of agents, brokers, TPAs, software providers and other insurance service providers.

Regulatory Approval Requirements

One of the unique features of the U. S. insurance industry in the U.S. is the fact that it is primarily regulated at the state level. While the state in which an insurance company is organized usually takes the role of primary regulator, insurance companies, agents and brokers, and other insurance services providers are regulated by, and generally are required to be licensed in, each state in which they do business. But the extent of regulation is generally much greater with respect to insurance companies than it is with respect to insurance services companies.

The acquisition of control of an insurer in the U.S. requires the prior approval of the insurer's domestic state insurance regulator and of the insurance regulator in any state in which the insurer is deemed to be "commercially domiciled." An acquirer is required to file an application with the insurance regulator, usually called a "Form A," that requires disclosure of the acquirer and all of its controlling persons, details on the financing for the transaction, financial statements of the buyer and its controlling persons and a description of the buyer's plans for the acquired insurer, including financial projections.

Of particular note for private equity firms, potential control persons, including individuals, are typically required to provide financial statements in connection with an acquirer's acquisition of an insurance company target. This can put partners in private equity firms in the sticky position of having to publicly disclose their personal balance sheets. Some regulators, however, have accepted "net worth" affidavits as to an individual's having adequate net worth in lieu of detailed balance sheets.

State insurance regulators review proposed acquisitions of insurers and apply statutory standards in deciding whether to approve an acquisition. These include whether the financial condition of the acquirer is such as might jeopardize the financial stability of the insurer or prejudice its policyholders, and whether any plans the acquirer may have to liquidate the insurer or sell its assets or make any material change in its corporate structure or management may be unfair or unreasonable to policyholders or not in the public interest.

Political considerations inform a lot of insurance regulation and they can certainly be a factor in a regulator's decision

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Ce n'est pas la même chose: Designing Management Incentives in Europe

U.S. private equity firms have learned that they just can't replicate U.S. practice when they invest in Europe. Nowhere is this more true than in incentivizing management. In fact, devising private equity incentives to management in different European jurisdictions also requires more than copycat techniques. In this article, we focus on the substantial differences in market practices between the U.S. and Europe and in the UK, France and Germany.

In U.S. leveraged buyouts, a customary management equity program covers 5% to 15% of the equity. Typically, options are granted to senior manage-ment who take advantage of stock purchase opportunities, with one to three options granted for each share purchased. Options may also be granted to mid-level management employees who do not purchase stock. Options may vest based on service, performance (such as meeting EBITDA or other targets) or the financial sponsor's exit IRR or some combination thereof.

In Europe, management equity programs take different forms, in part because the grant of options is often less favorable from a tax perspective than in the U.S. Gain upon the exercise of options or the subsequent sale of shares is generally treated as ordinary income from employment, taxable at progressive rates or subject to social security charges. As a result, complex share investment plans, often with attached warrants or "ratchet" arrangements, have become increasingly common.

The basic irony, however, is that potential after-tax returns may often be richer than those in U.S., particularly in France. Private equity firms may be well advised to analyze programs in different jurisdictions on an after-tax basis under such arrangements to fully understand their economic impact.

Management Equity in the UK

One management equity program commonly used in the UK, and to a far lesser extent in France, is the purchase of shares which are subject to so-called "ratchet" arrangements. Rather than receiving options, management employees purchase shares in the acquisition vehicle (or a holding company) and, by separate agreement or provisions in the articles of the association, the economic value of the equity held by the management employees is calibrated by reference to the extent to which specified targets (often various levels of sponsor IRR upon exit) are met. This calibration can be effected in different ways, for example, a conversion of sponsor shares into so-called "deferred shares" (which have no real economic value) or redemption of management shares with an increasing redemption price.

If structured properly, any gain on a sale of the shares by a management shareholder will be subject to capital gains tax rather than income tax and will avoid national insurance contributions. Although income is generally taxed at a 40% rate, plus national insurance contributions of 13.8% in aggregate, the effective rate of tax on capital gains will vary between 10% and 40%, depending upon a number of factors. In addition, if the shares acquired are in a non-UK company, non-UK domiciled management shareholders may be able to avoid UK tax on the gains altogether.

Under rules introduced in 2003 (generally referred to as the "Schedule 22 rules") most UK based employees (those who are both "ordinarily resident" and "resident" in the UK) and the employer may make a joint election within 14 days of the issue of management shares for the manager to be taxed only at capital gains rates on sale of the shares. These elections are somewhat akin to the well-known Section 83 elections in the U.S. If the election is made, income tax and national insurance contributions will be payable at the time of issue of the shares on the difference between the value of the shares at the time of issue (computed without regard to any vesting or other restrictions) and the price paid by the management shareholder. This value must be determined by the management shareholder and his or her advisers. Any

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In Europe, management equity programs take different forms, in part because the grant of options is often less favorable from a tax perspective than in the U.S. . . . The basic irony, however, is that potential after-tax returns may often be richer than those in U.S., particularly in France. Private equity firms may be well advised to analyze programs in different jurisdictions on an after-tax basis under such arrangements to fully understand their economic impact.

subsequent gain will be subject to capital gains tax, but "taper relief" may reduce the gain depending on the holding period prior to sale.

If the election is not made, income tax and national insurance contributions will be payable, first, at the time of issue on the difference (if any) between the value of the shares (taking into account any vesting and other restrictions) and the price paid by the management shareholder and, in addition, when the shares vest or other restrictions lapse or the ratchet arrangements take effect.

In a significant concession to the general Schedule 22 rules, the UK tax authority published a Memorandum of Understanding in 2003 that provides a safe harbor that limits the application of the rules to certain management incentive shares in companies that are financed by a venture capital or private equity fund. Under the safe harbor, even if no election is made, the operation of the ratchet arrangements and subsequent disposals of shares will not be subject to tax under the Schedule 22 rules. Gain on subsequent sale of the shares will be subject to capital gains taxation, but the effective rate may be reduced to 10% under the taper relief regime. The ratchet must satisfy a number of detailed requirements. These include provisions relating to the timing and pricing of the acquisition of shares by the management shareholders, the leverage provided by the sponsor and a requirement that the management shareholders be fully remunerated via salary and bonuses through a separate employment contract.

[T]he UK tax authority published a Memorandum of Understanding in 2003 that provides [the] safe harbor that limits the application of [certain tax] rules to . . . management incentive shares . . . . [However] the UK tax authority regards the safe harbor in its current form as being generous to management and its scope is under review.

Because of the complexity of the detailed requirements of the Memorandum of Understanding, management shareholders generally make a "protective" joint election under the Schedule 22 rules even where it is thought that the terms of the shares are within the scope of the safe harbor. It should be noted that the UK tax authority regards the safe harbor in its current form as being generous to management and its scope is under review.

Management Equity in France

Although neither the grant nor exercise of options in France pursuant to a qualified plan will give rise to recognition of taxable income, upon the sale of shares acquired upon exercise of qualified options the employee will pay substantially more tax than a U.S. employee would pay. First, the excess of fair market value at the time of exercise over exercise value is subject to income tax and related "social" contributions at varying effective rates, up to as much as 51%, depending on the amount of such excess and time of sale (before four years after grant, before six years or thereafter). In addition, if the shares are sold before the end of a four-year period, such excess will be subject to substantial social security charges. Second, in any case, any increase in the fair market value of the shares after the exercise of options is treated as a capital gain upon sale subject to aggregate income tax and social contributions of 27% if it exceeds €15,000 in any calendar year (the general regime applicable to equity investments).

Because the taxation of qualified options is not as favorable as the general regime applicable to equity investments, management and sponsors have increasingly structured senior management equity programs using shares with attached warrants (*Bons de Souscription d'Actions*). The warrants are convertible into a number of shares which increases as the sponsor's IRR (or in the case of an IPO, assumed IRR based upon the market price achieved at the time of the IPO) increases. Often the formula is based upon specified multiples of management's initial investment for specified levels of IRR in a given year. One advantage of such warrants is flexibility — the conversion ratio can be made variable depending not only upon IRR achieved but also upon time of exit to take into account the different absolute value, for example, of an IRR of 40% achieved in six months or achieved over six years.

These plans require extremely careful tax planning because there is risk that the plans will be recharacterized as non-qualified stock option programs having even more unfavourable consequences than qualified plans. To limit the risk, managers must make an initial investment at market value and must be exposed to some genuine risk. Warrants are therefore acquired at market value (often determined with the support of a professional valuation report), management investment multiples are set at less than one at low levels of IRR, so that there is a real risk of loss of

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When You Are Not the "First Call" — Finding the Right Finder

In the early days of the private equity industry, before investment bankers recognized the potential role of private equity in the M&A and financing landscape, finders or business brokers played a significant role in many buyout transactions. In today's environment, that role may have been ceded to institutional players in most areas of the market, but certainly not in all market niches. In fact, broker or finders are still very active in the sales of mid-sized family businesses and in smaller transactions. According to Thomson Financial, in 2004 there were more than 5,000 private equity firms in the U.S. and another 4,000 in the rest of the world. Needless to say, not all of them are investment bankers' "first call."

This article focuses on finders in the context of private equity M&A transactions. The role of finders, and their place in the current regulatory scheme, is a high profile issue. The SEC, the NASD, the ABA and others have in recent years expressed concerns regarding finders, their operations and their status in the current regulatory regime. The discussion that follows highlights key issues for a private equity fund to consider when engaging a finder and addresses the regulatory status of finders.

What is a Finder

Finders who want to avoid the cumbersome and costly process of broker-dealer registration must severely limit their activities. Simply put, the role of a finder is to make introductions and nothing more. In making the introduction, the finder, unlike a registered broker dealer, may *not* actively engage in negotiating or consummating the transaction. In fact, the finder is prohibited by securities laws from effecting any transaction involving securities, and finders' activities have been subject to recent heightened scrutiny by the SEC and state securities regulators.

Given the limited scope of a finder's duties, and the growing presence of investment banks in private equity, one might ask: why do finders still exist, let alone play an important role in private equity transactions? The short answer is because investment banks and other regulated entities will never capture all of the market's opportunities. In light of the legal costs and risks involved and the more limited payoffs offered by smaller deals, investment banks often prefer to focus on their "sweet spot" of deals valued at $25MM and higher, leaving finders free to dominate the smaller deal market.

The Fee and Who Bears it?

For private equity funds and their underlying investors, the most important component of the finder arrangement is the fee. The amount of the fee can vary greatly. Historically, the standard fee was based on the "Lehman formula:" 5% on the first $1 million of total consideration; 4% on the second $1 million; 3% on the third $1 million; 2% on the fourth $1 million and 1% on anything above $4 million. Many finders follow a variation of the Lehman formula, depending on the characteristics and size of the deal; and larger intervals in the formulation are now typical. The "new" Lehman formula has also become more common: 5% of the first $5 million of total consideration; 2 ½% on the next $10 million; and 1% on anything above $15 million. There can be flat fees and retainers in addition to, or in lieu of, these formulations.

The fee may be incorporated into the purchase price and paid at closing by the target with the proceeds of the deal, or the fee may be deemed a fund expense and directly paid by the fund to the finder. In certain circumstances, depending in large part on the relationship between the finder and the private equity fund, the fee may be paid by the fund's manager to the finder.

Most private equity funds are structured so that the fund's manager provides portfolio management and administrative services to the fund, for which it receives an annual management fee (typically based on a percentage that is 1-3% of the size of the fund) from the investors. Outside of the management fee, the costs related to the manager's operations are borne by the manager, not the fund. The costs related to the operation and activities of the fund itself (*e.g.*, costs related to the acquisition and disposition of portfolio investments), however, are borne by the fund and its underlying investors. In short, determining whether the finder's fee is appropriately borne by the manager or the fund depends on the distinction between a manager expense and a fund expense, a fact-specific analysis based on the services provided by the finder.

The issue can quickly become complicated, however, when the finder has been regularly engaged by the manager or if the finder is affiliated with the manager. These issues arise often when a private equity firm wants to explore a new industry or a new geographic territory. It becomes less clear then that the fee should be allocated to the fund in connection with a portfolio investment, rather than to the manager as an ongoing operation cost.

The Terms

The terms on which a finder is engaged, including the calculation of a fee, should be carefully determined prior to any engagement. Litigation involving finder arrangements occurs regularly. (There is the old story about more than one finder showing up at closing to collect a fee and being legally entitled to it.) Private equity sponsors should tread carefully and understand exactly what they are bound to, and for how long, under a documented finder's agreement. Several key terms to be discussed when entering into a finder's agreement include:

- *Exclusivity:* Will the finder be engaged exclusively? Typically, a private equity fund requires the flexibility to work with a number of financial intermediaries. Will

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the finder be permitted to work for others? If not, will his engagement properly be a "fund expense?"

- *Fees and Expense:* What is the formulation for the fee? Is a retainer paid? Is there a minimum fee? Does the finder have to make an introduction to receive the fee? Does the transaction need to close for the finder to receive the fee?
- *Exceptions:* Will there be exceptions to the payment of a fee? Will a fee be earned with respect to a public company? A company with which the private equity fund has an existing relationship? A company that is part of an investment bank auction?
- *Who is covered?* Who will be the covered targets? If a finder introduces you to company X, would a fee be earned with respect to a transaction involving company X or any of its subsidiaries and any of its affiliates. Watch the definition here. It can be costly to use a standard affiliate definition.
- *Tail Periods:* Will there be a tail period after the termination of the finder's agreement during which the finder will be owed a fee if a transaction is consummated? If so, for how long?

A finder's agreement should be in writing to be enforceable in the event of a breach of contract claim and to aid in resolving any possible disputes. In addition, the documentation of the finder's fee and proposed conduct is an important component of disclosure, always an issue of top concern to regulators.

The Regulatory Landscape for Finders

Persons acting as finders (and those hiring them) need to be careful to limit the finder's activities so as to not run afoul of the SEC and NASD's broker-dealer registration requirements. A broker is defined in the 1934 Act as any person, other than a bank, that is "engaged in the business of effecting transactions in securities for the account of others." Based on this definition, the staff of the SEC through a series of no-action letters has developed a two-part analysis to determine whether a finder must register as a broker.

Has the finder effected transactions in securities? Finders must be careful not to take steps toward the consummation of the underlying transaction and beyond the limited act of introduction. Such prohibited steps include involvement in negotiations, discussions regarding securities and discussions regarding the provision of add-on services.

Has the finder "engaged in the business?" In addition to the existence of a prior history of securities transactions, the staff of the SEC has found that the receipt of transaction-based compensation is one of the most important factors in determining whether a finder is operating as an unregistered broker. Registration would ensure that the person receiving such compensation operates in a manner consistent with consumer protection standards. This concern is further exacerbated if a person has an adverse regulatory history (*e.g.*, they were previously barred or suspended from broker-dealer registration), where such persons may be attempting to "backdoor" themselves into the brokerage world and remain on the SEC's radar.

The SEC issued a position in a 1986 no-action letter which is still the most useful guide in determining whether broker registration is required in the M&A context. The letter involved a finder that sold assets of businesses that were going concerns, and in exchange received a commission based on the sales price (all sales were treated as asset sales). The SEC granted no-action relief based specifically on the following facts: (1) the finder had a limited role in negotiations between the purchaser and seller; (2) the businesses sold were going concerns and not shell corporations; (3) only the assets of the company were being offered; (4) if transactions involved the sale of securities, the finder would not provide any assistance; (5) the finder did not advise the parties whether to issue securities or assess the value of any securities sold; (6) the finder's compensation did not vary depending on the form of conveyance (*e.g.*, securities rather than assets); and (7) the finder had limited involvement in assisting purchasers to obtain financing.

In May 2005, the Task Force on Private Placement Broker-Dealers, ABA Section of the Business Law issued a Report and Recommendations suggesting that the SEC consider promulgating a rule adopting this analysis (and consider broadening its scope to permit equity transactions) to provide greater comfort and certainty to *bona fide* finders.

The Woes of Registration

The finder exception is crucial because it would be impossible for most finders to subject themselves to the current broker-dealer registration. The registration process is expensive, cumbersome, and impractical for someone not engaged in the business. Unlike registration for investment advisers, there is no bright line *de minimis* exception for broker-dealer registration on the federal level (*e.g.*, an investment adviser is excepted from registration if it has fewer than 15 clients). Under the current "one size fits all" regime, an "occasional finder" that receives transaction-based compensation would be regulated in the same manner as a multinational investment bank that effects securities transactions on a daily basis. The current state of regulation does not encourage compliance with broker-dealer registration requirements and in fact incentivizes finders to believe (rightly or wrongly) that its activities fall within the narrow finder exception (even if they do not) under the

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Close Call in New York: The State Legislature Appears to Have Backed Away From Imposing Unlimited Liability on the Owners of Limited Partnerships and Limited Liability Companies for Failure to Publish

A new law, scheduled to take effect on June 1st, will modify New York State's limited liability entity publication requirement, and private equity and hedge fund sponsors with ties to New York — as well as their investors — have been following the matter closely.

By way of background, as a condition to formation or qualification to do business in New York, limited partnerships and limited liability companies, including many private equity and hedge funds, have long been required to publish notices of formation or qualification (the latter if an entity formed outside of New York elects to qualify to do business in New York) in various local newspapers for a number of weeks. Historically, the penalty for failure to comply with the publication requirement has been limited — a non-complying entity has not been permitted to bring suit in New York until it has fulfilled the requirement, which it may do retroactively. As a result, many entities, including entities formed outside of New York that are not clearly "doing business" (a legal concept for which there is no bright-line test, and which is expected to remain unchanged in the new law) in New York, have elected not to qualify and publish.

The new law will upset the status quo, but it remains unclear how, and to what extent, it will do so. An earlier proposal would have stripped the owners of non-compliant entities of their limited liability. In the private equity and hedge fund context, that would have resulted in the limited partners of a non-complying fund becoming personally liable on a joint and several basis for all of the fund's debts and other obligations — an obvious departure from the deal that investors expect to receive when they make passive fund investments. Given those stakes, the law became the subject of intense lobbying by legal and other trade and business groups and, in part as a result of these efforts, the final version of the law, which could be enacted before this edition of the *Private Equity Report* becomes public, is not expected to make any sweeping changes to the state's existing publication regime, or to pose any explicit threat to limited liability.

In all, the new law is expected to make a handful of technical changes to the publication requirement and provide that a non-complying entity will have its authority to do business in New York "suspended." As currently drafted, the law provides that a suspension of authority can be "annulled" by bringing the entity into compliance with the publication requirement. The law does not, however, specify the ramifications of a suspension (although it does say that a suspended entity's contracts will not be voided) or enumerate the differences between a suspension and the current penalty for non-compliance (inability to bring suit in New York). In the absence of definitive guidance from Albany, there is still some concern that limited liability could be at risk during a suspension, but existing provisions of the state's limited partnership and limited liability company laws establish that the failure of a foreign entity doing business in New York to file for a certificate of authority (and, it follows, to satisfy the state's publication requirement) does not impair the limited liability of the entity's members or partners.

Still, an increase in the penalty for non-compliance with the publication requirement may induce many entities, including many private equity funds and their general partners to qualify and publish.

The law is expected to provide a grace period, until June 1, 2007, to bring existing entities into compliance.

We will continue to follow the matter and provide an analysis of the final law in a future edition of the *Report*.

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The new law will upset the status quo . . . but it is not expected to make any sweeping changes to the state's existing publication regime, or to pose any explicit threat to limited liability.

because the KKR Listed Fund's fees are reduced dollar-for-dollar by fees paid at the portfolio fund level. The typical securities firm-sponsored high net worth fund of funds has management fees on the order of 150 basis points on committed capital and might involve an additional carried interest layer of five percentage points. KKR has agreed to waive management fees and carried interest (at the KKR Listed Fund level) until the KKR Listed Fund has earned back the placement commission and fees, and offering expenses.

- Of course an investor in a typical fund of funds would benefit from diversification among managers, which is not the case here: all of the private and public equity assets will be managed by KKR. Fund sponsors such as Blackstone and Carlyle who have a large number of funds pursuing diverse strategies could offer diversification among strategies with this structure.
- The KKR Listed Fund limits investment in any one KKR fund to 40% of the Listed Fund's assets. This restriction was adopted in light of certain U.S. securities law issues. For sponsors with multiple funds pursuing diverse strategies this limitation should present no challenge.

(2) The KKR Listed Fund is a secondary fund of funds. It is expected to acquire substantial secondary interests in KKR's current domestic LBO fund (KKR Millennium Fund) and current European fund.

- The structure contemplates that the KKR Listed Fund will make an offer later in 2006 to purchase secondary interests in existing KKR funds in amounts and on terms to be determined.
- If the KKR Listed Fund acquires an interest in a KKR fund (for example the Millennium Fund) at less than net asset value, then at the time the KKR fund is wound up, the KKR Listed Fund will treat a portion of the gain as a trading gain in the hedge fund side pocket (see below), potentially generating a 20% incentive distribution. If an interest is purchased for more than NAV, the hedge fund side pocket would recognize an equivalent loss. This obviously gives KKR an incentive to calibrate its offers to existing fund investors on the low side of reasonable, which aligns KKR's interests with the KKR Listed Fund investors, but creates a conflict of interest with the Millennium Fund investors (for example), who are by hypothesis sophisticated institutions, who are not forced to sell and who can take care of themselves.
- KKR Listed Fund transactions in downstream KKR funds is an untested area of conflicts of interest given the disparity of information on KKR fund valuation between KKR and the sellers. Doing the purchases of secondary fund interests as a formal offering provides a structural context to minimize these issues, and ameliorates the risk that the KKR funds could suffer adverse U.S. tax consequences of being deemed "publicly traded partnerships."

(3) The KKR Listed Fund is a co-investment fund. Investors in the KKR Listed Fund get access to the co-investments on institutional LBO fund terms. The KKR Listed Fund will initially co-invest in Capmark Financial Group, Inc. which is currently being warehoused by the KKR Millennium Fund, and will co-invest in future transactions. KKR earns a management fee (at an average rate of roughly 1.15% given the KKR Listed Fund's current size) and a 20% carried interest on co-investments. From KKR's standpoint these terms are better than the typical institutional co-investment terms, where the amounts (if any) of management fee and carried interest are highly negotiable.

(4) The KKR Listed Fund has a public securities "side pocket." This flips the hedge fund side pocket structure on its head.[1] It can invest up to 25% of its assets in friendly investments in public market securities. The public side pocket is a long-only hedge fund, in effect a non-registered mutual fund. The size of this pool is in KKR's discretion (subject to the 25% cap).

- Public side pocket's carried interest is calculated on a mark-to-market basis with a high watermark, as would be expected in a hedge fund. The high watermark and the calculation of gains and losses are adjusted to account for flows into and out of the side pocket.
- One way of viewing the side pocket is as a temporary investment pool pending the creation of the next KKR private equity fund, or the next offering for secondary interests in existing KKR funds. The feature provides KKR with tremendous flexibility.
- KKR states that the purpose of the public side pocket is to permit public market investments in companies that KKR has researched in its private equity business. Of course, if KKR's interest in a company reaches the point where it has inside information about the company, securities laws will preclude the KKR Listed Fund from engaging in market transactions in the company's securities.

(5) By necessity, the KKR Listed Fund has a significant money market fund aspect. Private equity funds typically call

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1 *Many hedge funds today provide for a "side pocket" portfolio of illiquid securities — the investment rationale for this is that side pockets provide a means for the hedge fund manager to exploit private equity investment opportunities, to sponsor public to private deals, to invest in PIPEs and to otherwise exploit opportunities for illiquid assets that would otherwise be difficult for a hedge fund because of redemption and valuation features.*

capital on an as needed basis. This is not feasible for a listed vehicle where all of the investors' cash has to be put in up-front. Almost all of the proceeds of the offering will be invested in money market instruments, government securities, asset backed securities, and other investment grade debt.[2] These investments are expected to be dilutive of the KKR Listed Fund's private equity returns, depending on KKR's investment pace in underlying transactions.

Why Did This Offering Succeed?

The key to the success of this offering was first and foremost the star power associated with KKR's name. There are other firms that have the capacity to do this, but not many.

It's important that the terms of the offering were broadly fair to investors. In this respect the KKR transaction is distinctive from the business development company deals that were offered in the U.S. a few years back that were widely criticized as overreaching.

Finally, there is the appeal of liquidity. The KKR Listed Fund is valued daily by market forces. Early trading volume (about a million shares per day) suggests a real market may develop for these interests. Liquidity is not a unique feature. There are already a significant number of private equity funds listed in Europe.[3]

Whether future offerings of this structure succeed depends in an important measure on how the KKR Listed Fund trades. The fact that Apollo's BDC quickly traded to a fairly deep discount effectively killed the dozen or so similar deals that were in the pipeline. The KKR Listed Fund closed on May 22, 2006 at $23.75 (on 625,000 shares), a 5% discount from the offering price (The underwriters' discount was 5.6%.). Current market prices need to be approached with caution since stabilization continues through early June.

Issues and Concerns

There are a number of expected and some unexpected issues raised by this unique offering:

- *Hedge fund ownership.* The word on the street is that hedge funds subscribed for almost a third of the KKR Listed Fund's capital. This has a couple of implications. The market price of the KKR Listed Fund may be driven by arbitrage activity (buy the portfolio companies and sell the KKR Listed Fund — or vice versa — or sell portfolio debt and buy the KKR Listed Fund, or any of the other myriad of possibilities). That has little to do with the merits of the KKR Listed Fund as an investment. Moreover, if the KKR Listed Fund performs poorly in the market (for whatever reason) KKR may find itself responding to relatively aggressive actions taken by hedge fund investors, such as proxy solicitations, public relations campaigns and so on.

- *Sponsor Perception.* The market success and trading volatility of the KKR Listed Fund may impact public perception of KKR and investor perception of the KKR 2006 Fund and other KKR funds. There is serious confusion in the public mind as to what shares of listed private equity funds represent. In some cases it is the private equity firm. In others it is a fund (Apollo and Ripplewood) or a fund of funds (KKR) managed by the sponsor. In the public mind these distinctions are blurred.[4] This confusion is anathema to private equity fund sponsors: if the publicly-traded fund trades down it could impair the sponsor's standing in the deal community and impair the firm's ability to compete for transactions.

- *Pressure on Valuation Standards.* The KKR Listed Fund will create serious pressure on KKR to provide financial reports for all of its funds on an EVCA basis, which contemplates real mark-to-market accounting, as opposed to the "cost until valuation event" approach followed by most U.S. LBO firms. If KKR makes this change, it may encourage the rest of the private equity community to do the same.

Other Consequences

Other potential consequences of the success of the KKR Listed Fund offering and subsequent performance in the aftermarket include:

- Revival of interest in the U.S. business development company structure. The KKR Listed Fund was not offered directly into the U.S., where the U.S. Investment Company Act of 1940 radically constrains the structure of a U.S. listed private equity fund offering, effectively making a fund of funds like the KKR Listed Fund impossible. Primary private equity funds (as opposed to funds of funds) can be and have been offered in the U.S. (albeit with some difficulty) as BDCs, typically with a mezzanine tilt.

- The success of the KKR Listed Fund offering does not portend a wholesale migration of private equity fundraising from the private to the public markets. Because at least half of the global demand for private equity investments is in the U.S., where private partnership structures will continue to dominate, this suggests a serious public policy issue for U.S. regulators. The 65-year old scheme regulating investment funds in the U.S. makes listed private equity offerings of this type impossible and renders the U.S. markets increasingly less competitive.

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2 *We assume KKR will use third-party managers for this asset class, as is permitted under the terms of the offering. KKR's management fees are reduced by the cost of third-party managers.*

3 *For example: Candover, 3i, Apax, Permira, Ripplewood, SGV, although each of these is quite different from the KKR Listed Fund.*

4 *"Other private equity players such as Apollo are publicly traded too." Business Week Online, May 3, 2006. "The well known US venture capital concern Kohlberg Kravis Roberts (KKR) was listed on the Euronext Exchange in Amsterdam . . . ." Deutsche Presse-Agentur, May 3, 2006.*

whether to approve a private equity buyer's acquisition of an insurer. Regulators have shown some discomfort with private equity firms as buyers, as opposed to strategic buyers, in part since most regulators believe that a strategic parent would likely bail out a troubled insurer if necessary, even if there is no legal obligation to do so, so as to avoid any collateral commercial damage to its brand. Insurance regulators assume that private equity parents would not share similar incentives.

These regulatory requirements may deter many would-be investors from acquiring or starting up an insurance company, at least in the U.S. However, these type of regulatory approval requirements are less onerous with respect to the formation and operation of Bermuda-based insurers and generally do not apply at all to the acquisition or operation of insurance services providers.

Risk Allocation

Historically, the convention in an insurance company M&A deal was for a seller to disclaim from all of its representations, warranties and indemnities any post-closing liability arising out of or relating to the adequacy or sufficiency of its reserves or the collectibility of third-party reinsurance. As compared to a conventional M&A deal where practically all of the post-closing exposures of the target business are up for grabs in any negotiation, this is a sweepingly seller-friendly convention, since it insulates sellers from just about all post-closing risk associated with any aspect of the target's assets and liabilities as of the closing. In recent years, some deals have been done without this provision, creating a fairer fight as to this issue in today's market, but private equity buyers should still have their eyes open to this backdrop at the outset of any potential acquisition of an insurance company.

Spitzer Risk

As everyone knows, in recent years the financial services industry, and the insurance industry in particular, has become the focus of a number of investigations begun by New York's Attorney General Elliot Spitzer, other state attorneys general, the SEC and other regulators and has led to hundreds of millions of dollars in fines and litigation. These investigations have included the mutual fund market timing and late trading scandals, the investigations into finite reinsurance arrangements involving AIG and other prominent insurance companies, and the investigation of the contingent commission practices through which insurance companies have shared profits with insurance brokers that place business with them, of which Marsh was a primary focus.

Unfortunately, many practitioners and other observers find it very difficult to find a logical theme to these investigations, making it very difficult for potential buyers and their advisors to assess with certainty the "Spitzer Risk" associated with the acquisition of any particular participant in the financial services sector.

Not surprisingly, this uncertainty complicates a buyer's ability to value potential targets with confidence and inevitably leads to a tough negotiation in each insurance industry M&A deal as to whether the buyer or the seller should bear the risk of a "Spitzer"- like regulatory investigation relating to the target. This risk allocation is further complicated by the fact that the damages resulting from a "Spitzer"-type investigation are likely to consist more of lost profits, damaged reputations and other consequential damages rather than the more conventional out-of-pocket damages covered by many indemnities. Accordingly, private equity buyers in the insurance industry should expect to spend a lot of time analyzing and anguishing about these issues in the case of any deal involving the acquisition of any insurance or insurance services company.

A Word about Tax

An investment in an insurance company organized outside the U.S. raises special tax considerations for a private equity fund. First, there is a risk that such a company could be a "controlled foreign corporation," or "CFC," for U.S. tax purposes. CFC status may result in (1) taxable phantom income for some or all U.S. investors in the fund (including many U.S. tax-exempt investors with respect to phantom insurance income) during the period that the fund holds shares in the CFC and (2) gain on the fund's sale of stock in the CFC being taxed at ordinary income (rather than capital gain) rates. A foreign company generally is a CFC if more than 50% of its stock, measured by either voting power or value, is owned by certain "U.S. shareholders." However, for purposes of including certain phantom insurance income, this threshold is lowered to 25%.

One easy structural "fix," which usually reduces the risk of CFC status, is to form the investing fund in a non-U.S. jurisdiction such as the Cayman Islands. This avoids making the entire fund a "U.S. shareholder" for purposes of the threshold ownership test, and results in the U.S. ownership test being done at the partner level. In the case of a fund that is organized in the U.S., it may be possible to make the investment through an alternative investment vehicle that is formed outside the U.S. and owned by the fund's partners. In order to ensure that the offshore sister vehicle is respected as an entity separate from the main U.S. fund, the economic results of the offshore vehicle are frequently not aggregated with the results of the main fund in computing the GP's carried interest and clawback. Although this non-aggregation reduces the tax risk, it can be a sticking point in negotiations with the limited partners.

Second, even if CFC status is avoided (or only affects some but not all U.S. investors), there is always a risk that the foreign insurance company (or one of its subsidiaries) is or will end up becoming a "passive foreign investment company," or "PFIC." Investing through an offshore fund would not reduce PFIC risk. There is no minimum U.S. ownership requirement in order for a company to be a PFIC; instead, PFIC status depends on the percentage of the company's passive income or passive assets. Although the PFIC rules provide an exception for passive income derived in the active conduct of an insurance business by a company which is "predominantly engaged in an insurance business," the PFIC determination can become a tough call in the case of an insurance company (or one of its subsidiaries) that accumulates excessive reserves of cash and securities, or earns substantial income from investments, while conducting relatively little insurance business. PFIC status affects all U.S. taxable investors in the fund, regardless of their level of ownership, and could result in distributions from the PFIC and gains on exit from the PFIC being subject to an interest charge. As is the case with CFCs, another potential detrimental result of PFIC status is taxation of capital gains on exit at ordinary income rates. Although there are some ways to mitigate these potential consequences of PFIC status, they generally require phantom income inclusions and significant compliance burdens for the insurance company and its U.S. shareholders.

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While investing in insurance and insurance services companies creates some unique challenges for private equity firms, it also affords important opportunities, especially given the enduring nature of the insurance business, its inevitable growth over time, its relatively stable cash flows and a cyclical nature which often parallels the 5-7 year investment horizon of a private equity firm.

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When You Are Not the "First Call" — Finding the Right Finder (cont. from page 16)

theory that the current regulatory regime is not only expensive and a hassle, but irrelevant to the finder's activities.

Unfortunately, the penalties for operating as an unregistered broker are harsh. The SEC can levy financial penalties, restrict such persons from registering as a broker-dealer in the future, argue for a civil injunction, refer the case to the Department of Justice for criminal action, and in certain circumstances issue rescission rights with respect to the transaction that involved the finder. There are varying penalties under state law as well.

Know Your Finder

To be honest, the risks for a private equity fund that engages an unregistered broker as a finder are more problematic in the context of raising capital than in an M&A transaction. A private equity fund that engages an unregistered broker in connection with the offering of its limited partner interests could suffer rescission rights for any interests purchased in connection with such offering. This is consistent with the SEC's sensitivity to illegal sales practices.

The practical risks in the M&A context are significantly lower. It is theoretically possible that an acquisition could be voided if the finder were found to be an unregistered broker. The SEC has not taken such steps in the past, particularly absent any fraud or misrepresentation, and such draconian measures in the future are unlikely. Given the large number of operating unregistered business brokers, the SEC is generally concerned with identifying egregious behavior (typically penalizing the unregistered broker and requiring disgorgement of its fee). At the same time, should a private equity fund involve itself in an M&A transaction where fraud or misrepresentation occurred — and in which an unregistered broker was engaged as a finder — the fund would at a minimum risk bad press, and perhaps more importantly, risk leaving a negative impression on the SEC.

A New Regime for Finders?

Given the increased attention to the finder exception, and the impracticality of registration of such persons under the current regulatory regime, many groups are proposing the adoption of a simplified system for registration of finders that would create a workable solution for compliance.[1] The finder exception has dominated the SEC and ABA small business initiatives over the last few years.[2]

A simplified registration system would (1) bring regulation closer in line with a finder's level of activities; (2) make possible and encourage licensing by currently unregistered brokers; (3) reduce the number of unlawful brokers to levels that make enforcement of "bad actors" feasible; and (4) provide consumers the ability to evaluate whether a finder is suitable based on their registration status.

What to Take Away

If you are engaging a finder, be sure to ensure that the finder's activities are narrow enough to fall within the finder exception; document and negotiate the terms of the finder agreement carefully and most importantly, know your finder's history!

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1 *Michigan is the only state that currently has a registration system for finders. Similar regulation is pending in Texas.*

2 *The Final Report of the 22nd Annual SEC Government-Business Forum on Small Business Capital Formation (December 2003) included the following recommendations to clarify and enunciate the regulatory status of finders: (i) create an exemption for certain finders and (ii) issue a new regulation to register finders under a simplified regime. In May 2005, the Task Force on Private Placement Broker-Dealers, ABA Section of the Business Law issued a Report and Recommendations with a similar proposal that would (i) expand the SEC staff's no-action positions with respect to M&A transactions, and promulgate a rule based on such findings or (ii) create a simplified registration system, reducing the current regulatory scope to an appropriate level.*

be reached, potential buyers should consider seeking a deal with the Regulator. Recent indications suggest, however, that the Regulator is likely to exact a high price. While the Regulator has issued guidelines that companies should aim to remove pension deficits over ten years, in many cases it has approved acquisitions only on the basis that the deficit be removed in four or five. This is often coupled with a requirement for an up-front payment into the pension scheme of 25%-40% of the FRS17 deficit amount. We understand, for example, that in connection with the successful 2006 bid for BOC plc by Linde, a very large and creditworthy German company, Linde has agreed to clear BOC's £500m deficit within three years (including a multi-million pound up-front payment into the pension plan).

If agreement with the trustees cannot be reached, potential buyers should consider seeking a deal with the Regulator. Recent indications suggest, however, that the Regulator is likely to exact a high price. While the Regulator has issued guidelines that companies should aim to remove pension deficits over ten years, in many cases it has approved acquisitions only on the basis that the deficit be removed in four or five.

The result of all of this is that in some high-profile cases the price of a pensions deal has been too high for private equity bidders. In 2005, Permira walked away from an acquisition of high-street retailer WH Smith because of the demands of the pension plan trustees and pension concerns are widely perceived to have been a factor in the billionaire Philip Green's withdrawal of his bid for Marks & Spencer.

Dividends, Other Returns of Capital and Post-Acquisition Disposals

Any proposed return of capital from a target group (for example by way of dividend payments, repayment of shareholder debt, share buybacks or distributions in specie) should be considered in light of the new pensions regime. If a return of capital is large or unusual (*i.e.*, more than two times the average of the last three years' return of capital or one which reduces dividend cover to less than 1.25 times), is made to an entity outside the group or the EU (such as an off-shore private equity acquisition vehicle or private equity fund) and the company operating the pension plan will have negative distributable reserves after the distribution, then the return of capital will constitute a "Type A event."

Moreover, the Regulator has already shown itself to be very concerned about proposals by private equity investors to extract cash from highly leveraged targets. Even those proposals which do not strictly constitute "Type A events" (because the company operating the pension plan does have substantial distributable reserves) may raise issues. For example, a dividend recapitalization structure, whereby an indirect parent company in the group borrows money (and thus increases group debt) to fund a dividend outside the group, even though the company operating the pension plan has not guaranteed or given security for the new debt, may well lead the Regulator to require that a portion of the new borrowing be used to make a lump sum contribution to the pension deficit. As the money to make the contribution will be funded out of an unsecured, subordinated and relatively expensive loan, this may often be viewed as a price not worth paying.

Private equity funds should also be aware that the pension plan deficits can affect any post-acquisition plans involving the disposal of assets or companies in the target group to a third party or parties. The sale in 2005 of almost all the assets of the Marconi group to Ericsson was permitted only after a contribution was made to the Marconi pension scheme materially in excess of the FRS17 deficit amount. Likewise, Pernod Ricard, following its successful bid for Allied Domecq, was only permitted to dispose of a significant part of the latter's business following a substantial payment to the Allied Domecq pension scheme.

Indebtedness: Change in Priority and "Debt Push Downs"

A final salary pension deficit is an unsecured liability of the employer company and any grant of security over assets of that company or its subsidiaries or any increase in the level of debt of the employer company and its subsidiaries which has a materially detrimental affect on that unsecured liability will attract the interest of the Regulator. For example, if the grant of a charge materially affects more than 25% of the total assets of the employer company and its subsidiaries or more than 20% of the total assets of the employer company, it would constitute a "Type A event."

Private equity investors proposing to grant security over a target's assets (whether as part of a refinancing or otherwise) or to replace junior with senior debt will need to consider the relevant pension trustees' and Regulator's likely response, and if necessary consult with them in advance. As with proposed returns of capital, a contribution to the pension scheme deficit may be required.

The acquisition of a target with companies in many different jurisdictions will often involve a post-acquisition debt "push down," whereby debt initially owed to third parties by non-UK companies is repaid from the proceeds of a third-party loan to (or by an intra-group loan from) one or more UK subsidiaries, thus allowing the non-UK companies to return funds to the investment vehicle. Such transactions, if material, are likely to attract the scrutiny of the Regulator and, as with acquisitions and returns of capital, investors should consult with the relevant pension trustees and, if need be, the Regulator at an early stage.

The Payment Protection Fund

As part of the new pension regime UK companies with final salary pension schemes are now required to pay an annual levy into a statutory fund, the Payment Protection Fund. Part of the levy is risk-based so that the greater the risk of the sponsoring employer's insolvency the higher the contribution. The amount of the levy can be sizeable so private equity buyers will need to factor the estimated post-acquisition cost of this into their valuation analysis.

Conclusion

The Regulator has already had a significant impact on UK transactions and will continue to do so, particularly for private equity funds. There is evidence that pension trustees and the Regulator are particularly concerned about private equity transactions because of their highly leveraged nature.

While the number of deals in the UK to date which have been stymied by pension issues is relatively small, investors are well advised to consider carefully the full ramifications of a substantial pension plan deficit on a bid and any proposed post-acquisition refinancing or return of capital. Consultation with the relevant pension trustees at an early stage is recommended and clearance from the Regulator in some circumstances may also be advisable.

What is certain is that while pension deficits are common (and there is much evidence to suggest that they are going to continue to be in the near future), pension issues and how to tackle them should be near the top of any UK private equity issues list.

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investment, and repurchases of shares or warrants in most cases are made at not more than market value rather than at a guaranteed minimum price.

Management Equity Programs in Germany

In Germany, the tax treatment of stock options has become clearer following several recent decisions of the German Supreme Tax Court. It is now settled law that a management option holder is not taxed at the time of issuance of options, nor at the time of vesting, but only upon exercise. The excess of the fair market value of the shares at the time of exercise over the exercise price is then subject to tax. The income will be treated as ordinary income from employment, taxable at ordinary rates (including solidarity surcharge but without German church tax, if any, the maximum rate is approximately 45 %). In practice, social security taxes will not be due because the ceilings on income subject to social security taxes will already have been exceeded by senior management's cash remuneration.

A historical approach to minimizing taxes by issuing convertible debt to senior management has recently become unavailable. The tax position was that conversion would not be a taxable event under the principles applicable to convertible debt. However, in a series of decisions in 2005 the German Supreme Tax Court ruled that the principles applicable to options also applied to convertible debt issued to management as a management equity program. Consequently, management is taxed upon the exercise of the conversion right and any resulting gain is treated as ordinary employment income.

Private equity firms investing in Europe, as well as in various jurisdictions within Europe, would be well advised to know how best and most efficiently to incentivize management so that the after-tax impact of that incentivization meets their expectations and those of the relevant management teams.

Currently, the favored approach is for management to purchase restricted shares or shares subject to forfeiture restrictions and vesting provisions. To the extent management pays less than fair market value for the restricted shares, the difference is employment income, taxable at ordinary rates. Therefore, valuation of restricted stock has become an important exercise, in particular because the employer is liable for any under-withholding.

The good news is that the tax treatment of restricted shares is quite favorable. If the shares are held for more than one year and the management shareholder holds less than 1% of the registered share capital (and has not held 1% or more in the preceding five years), there will be no tax at all on the gain. If the management shareholder holds 1% or more or sells before one year has elapsed, the gain is subject to capital gains taxation, but 50% of the gain is excluded, resulting in an overall tax burden of approximately 22.5%. For planning purposes it should be kept in mind though that there is ongoing discussion in the German legislature about how to overhaul the system governing taxation of capital gains. The result of the legislative discussions could well be that Germany will tax capital gains regardless of any ownership threshold (presently at 1%). Whether the legislature would also seek to tax a portion greater than the present 50% remains to be seen; Germany does not have favourable tax rates for capital gains which would give relief in addition to the exclusion of a portion (presently 50%) of the gain. The maximum ordinary rate currently stands at around 45%.

A current technique is for a manager's purchase to be of shares coupled with (partial) financing via a non-recourse loan. Whether non-recourse loans would withstand a governmental challenge is not free from doubt. To date there is no authority on point. However, good arguments can be made that a non-recourse loan should not give rise to immediate income, if properly structured and not overly aggressive.

From a corporate law perspective, two very recent decisions from the German Supreme Civil Court affirmed that "bad-leaver" provisions requiring management to surrender shares on unfavorable terms are permissible. This enforceability of bad-leaver provisions had become questionable in light of German corporate law rules which make it difficult to force out a shareholder against his will.

* * *

Private equity firms investing in Europe, as well as in various jurisdictions within Europe, would be well advised to know how best and most efficiently to incentivize management so that the after-tax impact of that incentivization meets their expectations and those of the relevant management teams.

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