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Shop Till You Drop:

A Closer Look at Go-Shop Provisions in Going-Private Transactions

Over the last two decades, private equity transactions have made a number of contributions to the jargon of deal making. This may happen once again as "go-shops" join "no-shops" as part of the going-private deal lexicon. The traditional no-shop provision, a clause prohibiting a target from soliciting better offers after signing, has been supplemented in a number of recent going-private transactions — among them such prominent examples as the consortia acquisitions of Kerzner, HCA and Freescale — by the go-shop provision, which allows a target actively to solicit offers from other bidders for an agreed period after the signing of the acquisition agreement.

The business press perceives go-shop provisions as another example of how the competitive M&A market is changing acquisition agreements in favor of targets. Boards, the theory goes, have become increasingly wary of shareholder lawsuits and, in the current climate, can insist on go-shops to alleviate their jitters.

But do the recent go-shop deals really indicate that it's a seller's market? This article will take a closer look at go-shop provisions, initially examining the terms of go-shop clauses in recent going-private transactions. In the second part, we consider how private equity firms might think about the go-shop phenomenon.

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"Look at this. Pet Products of America is trying to use the Holiday Catalogue to satisfy their go-shop!"

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Letter from the Editor

It is hard to pick up the newspaper, listen to the news or go to a cocktail party without hearing about the record-breaking impact of private equity fundraising or deal making. Whether popular media attention benefits or harms private equity managers and investors is a debate we are not prepared to take on. So, we offer you an alternative: a concise and clear analysis of the legal and practical issues facing players in the ever-evolving private equity marketplace. We bring to that effort a commitment to help you understand the varying degrees of myth, popular perception and reality that have attached themselves to private equity.

We hope that you have enjoyed our recently published book, *The Private Equity Primer: The Best of the Debevoise & Plimpton Private Equity Report.* If you have not received your copy and/or would like another one for one of your colleagues, please let us know.

On this issue's cover, we take a look at the recent use of go-shop provisions in going-private transactions. What do they tell us about the market in which we all participate? We examine the terms of a number of recent go-shops and consider the pros and cons of including a go-shop provision in the merger agreement.

In our Guest Column, Professor Josh Lerner of the Harvard Business School responds to the popular perception that reverse leveraged buyouts have historically provided no real value for public investors. The results of his study on the long-run performance of RLBOs deliver good news — not only for private equity investors but also for public investors in RLBOs.

We have two articles of particular interest to hedge fund investors and managers. First, for investors wondering about their redemption rights in light of recent losses at some notable funds, we remind them of the "gating" procedures contained in many fund documents and the broad discretion of fund managers with respect to mass redemptions. Also, we update hedge fund advisers on the long saga of registration requirements.

Second-lien financing has emerged as a surprising financing of choice in many deals. For those of you not yet familiar with this type of debt, we provide a primer on concerns that arise when issuers of second-lien notes face workouts or bankruptcy.

Elsewhere in this issue, we continue a discussion begun in our last issue on the viability of the insurance sector for private equity investment. Here, we provide a more in-depth discussion of the rise of an innovative special use vehicle — the reinsurance sidecar — for hedge funds and, more recently private equity funds, wishing to invest in a short-term pure insurance play without the usual infrastructure associated with investing in an insurance company. We also explore the opportunities for private equity investment in the German insurance market following recent regulatory changes in the EU and the growing demand within the German insurance sector for new sources of equity.

Finally, for those fund managers contemplating raising capital from Middle Eastern investors, we provide some advice about how to cope with the need to comply with Islamic law and its impact on fund structures and investment policies.

Franci J. Blassberg
Editor-in-Chief

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What Borrowers (and Sponsors) Should Know About Second-Lien Financings in Bankruptcy

Second-lien debt is now appearing in prime time. Once reserved for companies in need of rescue financing, second-lien debt has become an increasingly significant component of major acquisition financings and exit recapitalizations. The amount of second-lien debt issued on an annual basis will undoubtedly surprise many investors, with newly-issued second-lien loans topping $16 billion in 2005 and more than $16 billion through August 2006 alone. Assuming that second-lien debt pricing remains advantageous compared to unsecured debt, the market for second-lien debt is here to stay and all private equity sponsors should be aware of its unique issues.

If a company with second-lien debt is contemplating a restructuring, the company and its equity sponsors should be mindful of the potential impact of having second-lien lenders at the table.

The recent experience of Chapter 11 cases involving second-lien debt suggests that valuation issues may surface earlier in these cases than in bankruptcies of companies with only one layer of secured debt. Moreover, disputes between first- and second-lien lenders differ to some extent from traditional intercreditor disputes because second-lien lenders usually have more power than unsecured creditors.

Second-Lien Financing in a Nutshell

In exchange for getting a bite at the collateral after the first-lien lenders, second-lien lenders agree to receive a lower interest rate than unsecured creditors and to give up some of their creditor rights in favor of the first-lien lenders. Whether that bargain proves to be wise in hindsight will depend of the facts of each case.

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The leverage and ultimate recovery of second-lien lenders in a restructuring will be driven largely by how much collateral value there is above the first-lien debt. In other words, are the second-lien lenders really secured? If so, they will benefit from rights of secured creditors under the Bankruptcy Code, including the right to adequate protection, the right to post-petition interest, the right to object to sales of collateral unless they are paid in full from the proceeds, and the right to be treated as a separate class for plan voting purposes.

Regardless of whether second-lien lenders are secured, however, they typically waive certain secured and unsecured creditors' rights pursuant to an intercreditor agreement with the first-lien lenders.[1] The negotiation of the intercreditor agreement reflects a tension between two often irreconcilable objectives. On the one hand, first-lien lenders want to maintain maximum control over key decisions relating to the collateral, including exercise of remedies, sales of collateral (both in and out of bankruptcy), and conditions to the borrower's incurrence of debtor-in-possession (DIP) financing or use of cash collateral. On the other hand, second-lien lenders do not want to waive rights if the waivers would make them worse off than unsecured creditors. The outcome of this negotiation will determine how "silent" second-lien lenders are supposed to be in a restructuring.

Intercreditor terms are not yet

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[1] *For more information on intercreditor agreements in second-lien financings, please see "Second Lien Financing: A Ten-Point Primer for the Borrower (and its Sponsor) on Intercreditor Dynamics," published in The Debevoise & Plimpton Private Equity Report, Volume 5, Summer 2005.*

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Second-Lien Financings (cont. from page 3)

standardized, particularly in middle-market deals where they tend to be more negotiated than in large syndicated deals. Common waivers by second-lien lenders include waivers of their right to object to a DIP financing or sale of collateral approved by the first-lien lenders. These waivers are usually, but not always, subject to conditions. For example, second-lien lenders' advance consent to a DIP financing is often subject to a cap on the amount of debt that can be incurred under the DIP financing. If the borrower needs DIP financing in excess of the cap, second-lien lenders can effectively block the DIP financing unless the borrower agrees to meet their adequate protection demands. Second-lien lenders may request that the borrower make interest payments or pay their professional fees during the bankruptcy or, as happened in one case, refinance the second-lien debt as part of the DIP financing. Similarly, the consent of second-lien lenders to a sale of collateral may be conditioned on the sale being permitted by the second-lien loan agreement or the proceeds being used to repay the first-lien debt. If these conditions are not met, the borrower or the first-lien lenders may be forced to "tip" the second-lien lenders to obtain their consent.

Borrower's Perspective

A company may decide to incur second-lien debt instead of unsecured debt. However, in many cases, companies layer first- and second-lien debt on top of high-yield bonds or other forms of unsecured debt. In those cases, second-lien lenders will be a party with a voice in the restructuring process in addition to unsecured creditors. Disputes between secured or senior creditors and unsecured or subordinated creditors are common features of restructurings, but disputes between first- and second-lien lenders are different to some extent because second-lien lenders, who are (at least nominally) secured creditors, usually have more power than unsecured creditors in a bankruptcy.

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For this reason, borrowers, like first-lien lenders, prefer silent — or at least not very vocal — second-lien lenders. From a practical standpoint, it is easier to negotiate with one rather than two groups of secured creditors. Additionally, if second-lien lenders have consent rights over critical events in the restructuring, they may be able to extract significant concessions from either the first-lien lenders or the borrower in exchange for their cooperation.

Complex intercreditor agreements may create additional opportunities for intercreditor fights. Although the borrower is more a spectator than a participant, these fights can translate into real costs for the borrower by increasing both delays and expenses associated with protracted negotiations and the risk of litigation that will derail its restructuring. In a spectacular though not necessarily representative Chapter 11 case, a fight between first- and second-lien lenders over the proper interpretation of the intercreditor agreement resulted in the conversion of the case to a Chapter 7 liquidation when the first-lien lenders withdrew their proposed DIP financing. Interestingly, notwithstanding the potential impact of the intercreditor agreement on the borrower, the borrower is not always a party and, except for limits on its ability to incur more first- or second-lien debt, often does not have the ability to negotiate its terms.

A number of case-specific facts can further complicate already complex intercreditor dynamics. One of these facts is the extent to which holders of first-lien debt hold second-lien debt and vice versa. A particularly tricky situation, which has already arisen in several Chapter 11 cases, is where one group controls one class but only a majority of the other class and where another group holds a blocking position in that other class. By contrast, if significant cross-holdings exist, the terms of the intercreditor agreement may be less relevant because decisions affecting the collateral are more likely to be negotiated between the two groups.

Valuation Issues

Valuation issues are at the heart of most bankruptcies and particularly those involving multiple classes of secured debt.

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GUEST COLUMN

Reverse LBOs Create Wealth for Equity Holders in the Long Run

Over the past several years there has been increased public scrutiny into the success of reverse leveraged buyouts (RLBOs) or initial public offerings (IPOs) of companies that had previously been purchased by private equity funds. Many business journalists have argued that buyout groups have rushed overleveraged companies into the market to reap quick returns for the private equity investors leaving the public owners holding the bag later on. Even Warren Buffet has warned that whenever he sees savvy private equity investors selling their interests in a business there must be cause for concern, and public investors should be wary.

These discussions and the lack of significant empirical date with which to analyze the veracity of such claims led Josh Lerner of the Harvard Business School and Jerry Cao of Boston College to conduct a study into the long-run performance of RLBOs. Recently, Franci Blassberg sat down with Josh Lerner to discuss what the data says about the success of RLBOs.

FJB: How was the study designed?

JL: The study was designed to answer a question that had generated a lot of interest and discussion: how did offerings that were reverse LBOs, or IPOs of companies that had been originally backed by private equity firms, perform going forward? This question was interesting not just from the academic perspective but also from a popular perspective in the sense that everyone from Warren Buffett to *BusinessWeek* was opining about it. But when we asked, "what's been done in terms of earlier work on this question?," it turned out that amazingly little had been done.

In the academic literature, there were a few studies done in the early 1990s using data from the 1980s which used the very small sample of such offerings during that decade. When it came to the more popular articles, it seemed that the vast majority of them either relied on anecdotes, or on very small samples over a very short period of time, without any of the controls that are second nature in systematic academic research. So, studying reverse LBOs was a nice opportunity to provide academic discipline to a question that had practical application.

In the study, we collected nearly 500 RLBOs between 1980 and 2002 that satisfied two criteria: (1) the financing was undertaken by a buyout group and (2) the investment was characterized by the use of leverage. To answer the question of RLBO performance, we looked at how the performance of RLBOs after the offering varied with their characteristics at the time of or shortly after the offering, including the following: equity market capitalization, book-to-market ratio, assets, the ratio of operating income to assets, the ratio of net income to assets, the debt to assets ratio, the capital expenditures to assets ratio and the underwriters' reputation.

FJB: What were the major conclusions?

JL: First, on average, RLBOs are much larger in size, have more leverage and higher book-to-market ratios, are more profitable and are backed by more reputable underwriters than other IPOs. Unlike other IPOs, reverse LBOs, by and large, create wealth for equity holders in the long run. Value-weighted portfolios of RLBOs strongly outperformed the market relative to other IPOs and relative to other market benchmarks of comparable companies and the market as a whole. The outperformance is especially strong in the first year, fourth and fifth years after the IPOs. The superior performance is not confined to a single time period, but has been seen in the 1980s, 1990s and 2000s. Larger RLBOs appear to perform better, but this seems driven by their sponsorship by larger buyout groups. Finally, greater leverage after the IPO does not lead to poorer performance.

FJB: Were there any surprises?

JL: The outperformance of RLBOs was not a total surprise. But, generally when I read something that Warren Buffett says, I tend to believe there must be a germ of truth there. There was so much consensus in the popular literature that we were surprised that we didn't see any underperformance in the data, except among the quick flips. When you look at the subset of

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offerings where the buyout groups hold them for less than a year, one does seem to have substantial underperformance.

Another thing that struck me was that we didn't see a deterioration with size. The myth is that the small buyout groups somehow had more time and energy to really work with companies in their portfolio given that they are less overextended and have the time and attention to groom the portfolio. But for at least that subset which did succeed in going public, there is no evidence that having been sponsored or nurtured by a large buyout group leads to any kind of deterioration in terms of performance.

To a certain extent, I was also surprised that we didn't see a more dramatic time trend. I still thought that we would see superior performance in the 1980s and early 1990s and then some deterioration, but looking at least in terms of performance relative to market, it is hard to see of any of that sort of thing going on.

FJB: What questions about the private equity industry still intrigue you for further study?

JL: We are organizing a conference through the National Bureau of Economic Research on the private equity industry and the changes in the industry in the last five to ten years. There are several areas related to private equity which are really ripe for exploration, including understanding more of the contact sport of adding value to portfolio companies. Over the years, various private equity groups have approached me and said, "Let's decompose our portfolio and really try to figure out where we have created value," but often it seems like a very tricky exercise to really definitively answer that question, especially since in so many cases, it is the result of a combination of different things that private equity groups did, like making follow-on acquisitions.

FJB: Do you think that is a topic that lends itself to statistical economic research?

JL: I don't think we can definitively answer the question; but like many other topics, some combination of having practitioner perspectives analyzed through detailed case study evidence, large sample studies, and an ongoing discussion around these issues can collectively lead to some real insights.

The question of fees and compensation is another area that's gotten a fair amount of attention recently — which we have looked at in the venture area but not really in the buyout area. In many ways, the buyout industry is operating under the same fee structure that was in place in the early 1980s, so it is reasonable to ask whether compensation that may have made a lot of sense when people were organizing $50 million funds still makes sense when you're in an era of $10 billion funds.

I don't think there has been really any careful academic analysis looking at whether cost structure has kept pace with increase in value-creation potential, particularly evaluating deal fees size relative to management fees and the interaction between them. Even less has been done on the tougher question of what's right, and whether fees have gotten too large etc. These are very important questions that really deserve more research.

The limited partner investment decision making process is an area where Antoinette Schoar of MIT and I have a very large research project going on right now. We have noticed a large disparity between the performance of university endowments and other limited partners during the course of the 1990s. We have shown that there was huge dispersion in returns, with the endowments doing far better than anyone else. That really begs the question of what investment criteria are being used by the endowments and to what extent the insights and approaches that endowments have developed can be carried over to other limited partners, as well as to investors in other alternative asset classes.

The rise of syndication in the private equity arena is also a

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Sidecars: New Vehicles for Private Equity and Hedge Fund Investment in the Insurance Market

In the Spring 2006 issue of the *Debevoise & Plimpton Private Equity Report*, Steve Hertz and Tom McGuiness discussed the opportunities and challenges for private equity investment in the U.S. insurance industry. In this issue, we continue the discussion of the insurance sector with two articles. First, a more in-depth discussion of the rise of the reinsurance sidecar as a vehicle for private equity investment and from our Frankfurt office, an analysis of the opportunity for insurance investment in Germany.

Private equity and hedge funds were a significant source of capital as the property and casualty reinsurance industry replenished its coffers following 2005's record hurricane losses.

Typically, a significant loss event and the resulting spike in premium rates attract institutional capital to new insurers whose clean balance sheets offer a marketing advantage over legacy insurers. In keeping with this pattern, Hurricanes Katrina, Rita and Wilma spawned a large "class of 2005" Bermuda-based start-ups, including Harbor Point Limited, Flagstone Reinsurance Holdings Ltd., Lancashire Inc. Co. Ltd., Validus Reinsurance Ltd. and Ariel Reinsurance Ltd., which reportedly raised approximately $7.5 billion in initial capital on a combined basis, largely from private equity and hedge funds. This compares to the approximately $8.6 billion in capital raised by the "class of 2001" start-ups, in the last big wave of new Bermuda-based insurers, in response to market dislocations resulting from the events of September 11, 2001.

But the run-up to the 2006 hurricane season also saw growing use of an innovative vehicle for financing reinsurance for hurricane and other risks — the reinsurance sidecar. Although sidecars' short duration, relative liquidity and potential for attractive returns that are not correlated with the interest rate environment are tailor made for hedge funds, several private equity funds have found the expected returns of these vehicles sufficiently attractive to invest in them as well. Indeed, in several sidecars, private equity funds have played the role of "anchor" investor, taking the lead in negotiating the terms of the transaction with the insurance company sponsor and doing the due diligence on which other investors informally rely.

A sidecar is a special purpose insurer of limited duration formed to reinsure specific risks underwritten by a single reinsurer. The sidecar has none of the infrastructure normally associated with an insurance company (including employees), and instead relies on its reinsurance partner for marketing, underwriting and claims management and on a third-party management company (or its reinsurance partner) for other aspects of its operations.

From an investor standpoint, a sidecar offers a pure insurance play, typically limited to specific categories of underwriting risk (*e.g.,* wind risk in a particular geographic location). Investors commit their capital, generally for a one to two year period (sometimes with the possibility of extending their investment for an additional one to two years), on the expectation that their returns will be dependent entirely on the underwriting (and, to a significantly lesser extent, investment) performance of the sidecar. This contrasts with an investment in a traditional insurance startup, where underwriting performance is an important element in determining investment return, but the price/earnings multiple on an initial public offering or sale of the company is the most significant driver of investment performance.

There are a number of factors that have contributed to the development of the sidecar market.

- The scarcity of management teams that are both strong and unengaged creates an inherent limitation on the number of attractive insurance start-up opportunities. Sidecars provide a vehicle for new investment in reliance on a management team at an established insurer, without exposing investors to the historic business of the insurance company and, in particular, the still developing losses associated with the last two hurricane seasons, which were both unusually severe.
- The record hurricane losses have caused an industry-wide reassessment of catastrophe risk models, including by rating agencies, the most important of which in the insurance industry is A.M. Best Company. In order to maintain A- or better financial strength ratings, many insurance companies have had to limit wind and other high severity exposures on their books. A properly structured sidecar allows its insurance company sponsor to underwrite a higher volume of volatile business in the sidecar without an adverse ratings impact, while sharing in positive underwriting results in the sidecar through the payment of a performance-based

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underwriting fee or an equity stake in the sidecar held by the insurer. A sidecar thus provides the insurance partner with an opportunity to diversify its revenue streams while reducing balance sheet volatility.

- The post-2005 contraction in capacity has made reinsureds receptive to alternative sources of coverage which they might view less favorably in a softer market environment. While there is reason to wonder whether the new private equity and hedge fund capital infusing sidecars will dry up if the current round of investment does not perform well, more stable sources of capital are simply not available in the current market.
- These same market factors have led to a steep increase in insurance rates, notwithstanding the moderating influence of newly-formed reinsurers, including sidecars. Rates on line — the relationship between premiums and policy limits — are reportedly as high as 25% - 40% in certain risk classes, even at relatively high attachment points (*i.e.*, the amount of losses at which coverage "attaches"). The search for yield has caused a number of private equity and hedge funds that have not traditionally invested in the insurance sector to view sidecars, which offer high rates of return (on a no loss scenario) and relative liquidity, as attractive investments.
- Sidecars can be formed in response to dislocations in the insurance marketplace and their capital put to work in very short order. They do not need to recruit a management team, find office space in the very difficult Bermuda real estate market, put in place information technology systems or do any of the myriad other tasks that face a start-up insurer. By the same token, a sidecar's business can be wound down quickly and is by its nature of limited duration. It is therefore a vehicle that is well adapted to the needs of the highly cyclical reinsurance market.

Structuring a Sidecar

There are variations in the structure of the sidecars that have come to market in the last year, and their flexibility and adaptability to the needs of both insurers and investors is part of their attraction. Nevertheless, there are common structuring issues for all sidecars.

Corporate Form. The sidecar insurer is typically organized as a wholly-owned subsidiary of a Bermuda or Cayman company, which issues securities to investors. This permits borrowings in the holding company which can be downstreamed as equity capital to the insurer, increasing its underwriting capacity.

The formation of a Bermuda sidecar insurer requires submission of an application, including a business plan, to the Bermuda financial services regulator. Conditional approval, subject, among other things, to capitalization of the sidecar in accordance with the business plan, can be obtained in as little as a week.

Market Facing or Not? As indicated above, market facing sidecars write reinsurance coverage for third party insurers directly on their own paper, while others write retrocessional coverage (reinsurance of reinsurance) for policies written on the paper of their insurance partner. Some sidecars do both. This is principally driven by commercial rather than legal considerations. Where the sidecar is a direct writer of reinsurance, it will enter into an underwriting agreement with its insurance partner, which will have the authority to bind the sidecar to any policy that meets prescribed underwriting guidelines.

A market facing sidecar may need to obtain a financial strength rating in order to compete for many types of business. If the sidecar simply stands behind reinsurance policies written on the paper of its insurance partner, it will enter into a quota share reinsurance policy pursuant to which it will share a percentage of the premiums and risks on each policy written by its insurance partner that conforms to the underwriting guidelines set forth in the quota share agreement. In either event, the sidecar is ultimately reliant on the underwriting prowess and claims settling capabilities of its insurance partner.

Alignment of Interests; Adverse Selection. The economic interests of the sidecar and its reinsurance partner must

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Is the German Insurance Market Worth a Look?

In the United States, private equity firms have been significant investors both in established insurance operations and start-ups. In addition, private equity firms are now making investments in so-called "side car" transactions in which one or more private equity funds form and capitalize a Bermuda law partnership to act as retrocessionaire for insurers and reinsurers. For more sidecar transactions see "Sidecars: New Vehicles for Private Equity and Hedge Fund Investment in the Insurance Market" elsewhere in this issue.

The German insurance market has so far seen little private equity activity. The only private equity insurance transactions to date have been the acquisition of Württembergische und Badische Versicherungs AG by JC Flowers, and the unsuccessful offer for Gerling Group by Cerberus (Gerling was eventually taken over by Talanx, one of the biggest German insurance groups.). There are, however, signs that the interest of private equity investors in German companies is increasing and that such transactions are getting easier to accomplish. With the increasing internationalization of the German insurance industry, and the growing demand within the German insurance sector for new sources of equity, private equity investors will surely find the German insurance market more hospitable.

For decades, the German insurance market was like a fortress, controlled by German insurance groups and closely-knit mutual insurance companies and protected by a regulatory system that warded off takeovers and even friendly transactions. New European regulations, not only those specific to the insurance industry but also those stemming from the European Takeover Directive, should help to open the German insurance industry to outside investment.

At the same time, the German insurance market is likely to require new sources of financing for a variety of reasons. Many large German insurers, facing increasing price competition from international insurers, declining customer satisfaction and rising administrative costs, will need to restructure. Increased equity levels will be imposed by the upcoming Solvency II capital requirements of the new European Insurance Solvency Rules by the year 2007. While German mutual insurers have thus far, contrary to expectation, resisted restructuring, continuing international competition, particularly in the areas of property and casualty and automobile insurance is likely to put considerable pressure on mutual insurers to attract private capital.

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THE PRIVATE EQUITY PRIMER

The Best of the Debevoise & Plimpton Private Equity Report

From the authors of the *Debevoise & Plimpton Private Equity Report* and *The Debevoise & Plimpton European Private Equity Handbook* comes the definitive overview of the private equity industry today — *The Private Equity Primer: The Best of the Debevoise & Plimpton Private Equity Report*.

This compendium, based on articles previously published in the *Debevoise & Plimpton Private Equity Report*, updated to reflect the current marketplace, is a must-read for new entrants into the private equity market and will serve as a valuable resource for seasoned professionals.

To request your complimentary copy of *The Private Equity Primer*, send an email to privateequity@debevoise.com.

Is the German Insurance Market Worth a Look? (cont. from page 9)

The Challenge for Private Equity

A private equity investor in a German insurance company faces a number of challenges under German insurance laws. However, these obstacles are not insurmountable.

One of the positive features of the German insurance industry regulation is that, unlike its U.S. counterpart, it is regulated only at a federal level by one authority, the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) — commonly known as the BaFin). Any intention to acquire 10% or more of the voting rights or capital in an insurance undertaking (primary or reinsurer) and any intention to increase that participation to thresholds of 20%, 33% or 50%, must be notified by the insurance company to the BaFin. The reporting requirements permit the BaFin to prohibit an intended acquisition if the acquiror does not meet certain discretionary requirements, including those of sound and prudent insurance management and sufficient financial capacity to ensure the continued development of the target's insurance operations. In particular, the BaFin can prohibit or limit the acquisition of an insurance business by a non-German if the insurance supervisory authorities of the acquiror's home country are not satisfactorily cooperating with the BaFin.

A private equity acquiror will need to prove to BaFin that it is financially able to control the insurance business of the insurance company target. Since insurance company regulation in the United States is controlled by individual states, not the Federal government, any acquiror which is a U.S. portfolio insurance company will have to show that its home state control is similar to the requirements in Europe or, in the alternative, accept limitations from the BaFin on its freedom to run the German target's insurance business.

The BaFin's review of an acquisition will concentrate on the financial and managerial suitability of the acquiror as a controlling shareholder of an insurance enterprise. A private equity purchaser is required to provide the identity of its controlling persons, including individuals, as well as their financial statements. This could require individual partners in a private equity fund to disclose their personal finances but, contrary to the U.S., the proceedings with the BaFin are not public and personal data and information as well as business secrets are kept strictly confidential.

Also complicating leveraged transactions is the fact that insurance regulations in Germany prohibit borrowings by insurers except in exceptional circumstances and not to finance acquisitions of insurance companies. These rules do not preclude quasi-equity financings, such as subordinated loans coupled with an equity conversion right, convertible subordinated bonds, or subordinated surplus notes with an extended minimum maturity. But the regulations would generally preclude leveraged investments where the acquisition vehicle is ultimately merged with the target company to facilitate debt service.

German insurers operating in the form of a stock corporation often have restricted registered "name" shares which can only be transferred with the consent of the company in order to more easily comply with the BaFin reporting requirements. (Most publicly traded stock corporations do not use this possibility under the German Stock Corporation Act because it restricts the liquidity of their stock.) Therefore, non-friendly takeovers of German insurance companies are not practical.

It had been anticipated that Article 11, the new EU Takeover Directive regulation would limit the potential takeover defenses available to a publicly traded EU company, such as the ability to use restricted registered "name" shares. However, disputes among the member states eventually led to a compromise allowing the EU member states to opt out of the EU restrictions on takeover defenses. In implementing the EU Takeover Directive, the German legislature (as well as the French and UK legislatures) opted out of these restrictions. Germany, like France and the UK, allows individual companies to opt in by shareholder approval but this is not expected to happen except under very limited circumstances. Therefore, the acquirors of public companies, including public insurance companies, will continue to face significant hurdles in unfriendly transactions.

While opportunities for private equity investment in German insurance companies have not historically been as significant, recent changes in EU law have opened the playing field making German insurance companies worth more of a look for private equity funds. ■

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ALERT

Benefits Covenants Can Be Ties That Bind

Acquisition agreements often contain covenants by the buyer to maintain employee benefits for some period post-closing. While such covenants are clearly designed to benefit target employees, are they actually enforceable by benefit plan participants? Or, as many practitioners have planned, does the typical “no third party beneficiary” clause prevent such a claim?

In *Halliburton Co. Benefits Comm. v. Graves et al.* decided this past August, participants in a target company retiree medical plan were able to enforce the buyer’s commitment to continue the pre-merger level of their benefits even though the purchase agreement had a specific clause providing for no third party beneficiaries reliance or enforcement.

The court’s decision was based on the conclusion that, by the terms of the merger agreement, the buyer had effectively amended the underlying retiree medical plan to limit its ability to reduce benefits in the future. Accordingly, the participants were entitled to enforce the terms of the amended plan. The no third party beneficiary clause was irrelevant because the participants were not seeking to enforce the merger agreement, but rather the underlying benefit plan as amended by the merger agreement.

In this case, the buyer had not placed a time limit on its commitment not to amend the retiree medical plan, but had done so with regard to the plans for active employees. The merger agreement had also specifically referred to the benefits to be provided under the retiree medical plan.

One way for acquirors to limit the adverse consequences of this decision would be to provide expressly that any commitment to provide benefits (or not to reduce benefits) be limited to a specified period of time — in which case the “amendment” to the plan would have a built-in sunset provision.

It may also be advantageous to provide that nothing in the merger agreement is to be construed to amend any plan or to limit any rights that any parties may have under any applicable plan to amend, modify or terminate that plan. This kind of clause may be useful when the commitment is to provide substantially comparable benefits in the aggregate (so that no single benefit is guaranteed at any specific level), or to provide benefits substantially comparable to those the buyer generally makes available to its own employees. It may also be useful where there is a commitment to continue the target’s existing plans. However, inserting this kind of clause may be difficult in a deal where a specific level of benefits under a specific plan was part of the specific deal negotiated.

In any event, buyers should be aware that they can be held to the commitments they make in purchase agreements not only by parties to the agreement by also by plan participants, regardless of the “no third party beneficiaries” clause — and they should therefore be careful about the scope of such covenants. ■

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Investors at the Gate: What to Do if Your Hedge Fund Is on Uncertain Ground

As high profile hedge funds imploded after natural gas trades went bad, some investors flocked to their lawyers to figure out what their rights might be with respect to the fund's remaining assets. What rights does an investor have in that unsettling phase after a fund announces dramatic losses but before complex bankruptcy rules kick in? Once investors brush the dust off of their fund documents — some of which may not have been negotiated, much less reviewed — investors may be slightly surprised by the broad discretionary powers given fund sponsors facing steep losses and mass redemptions. An investor in a hedge fund faces entirely different options than an investor in a private equity fund would following fund losses.

Before the Collapse — Certain Gating Items

Hedge funds that ultimately collapse sometimes first go through a phase of instability (which may vary in length depending on the magnitude of initial losses experienced). As the sponsor assesses the future prospects of its portfolio and the continued viability of its strategy, its fund investors deliberate over whether to redeem or stick with the manager. Unlike private equity fund investors, hedge fund investors do not benefit from the comfort of a general partner clawback when a fund goes through a rough patch and suffers losses. Instead, their only recourse is to limit their exposure to future losses by exercising the redemption rights the fund provides. However, these redemption rights may be somewhat limited in certain circumstances. For example, if the fund has received sizeable enough redemption requests, it may consider triggering the fund's "gate."

Opening and Closing the Gate. A "gate" is a standard hedge fund device. It enables a fund to satisfy only that amount of redemption requests that is within its "gate," defined as a percentage of the current net asset value of the fund. Without a gate, a fund might be forced to liquidate assets at inopportune times to satisfy redemptions, which could undermine the sponsor's efforts to preserve or enhance value. Thus, the gate helps ease the pressure on a fund manager created by redemption rights — rights that create a critical distinction between hedge funds and private equity funds. Gates typically range between 10% and 25% of a fund's NAV with 15% common for a fund with no side pocket and 10% more common for funds holding some illiquid assets. Thus, if a fund receives redemption requests that in the aggregate exceed 15% of the NAV of the fund, the fund may satisfy only a portion of each request such that only 15% of the NAV of the fund is redeemed. Redemption requests that are not satisfied in full because of the gate are typically deferred until the next redemption date and receive priority over redemption requests subsequently submitted.

A "gate" is a standard hedge fund device. It enables a fund to satisfy only that amount of redemption requests that is within its "gate," defined as a percentage of the current net asset value of the fund.

The size of a gate is usually stated quite specifically in a fund's documentation. What is rarely spelled out, however, is the precise timing of the implementation of a gate. For example, assume a fund requires 60 days notice for quarterly redemptions and assume redemption payouts (or a substantial portion thereof) are typically paid out within 30 days of quarter-end. Theoretically, the fund sponsor would have almost 90 days (the period from when the redemption requests are due up until the deadline for the payout of redemption proceeds) to determine whether to implement the gate. Although the fund may face operational pressures to make that determination sooner, it has every interest in waiting until it has as complete a set of facts as possible about the portfolio and investment conditions before determining whether to close the gate on redemptions above 15%.

For various reasons, a fund may require a longer redemption notice period and payout period. This may have the effect of delaying the news of the gate and preventing additional redemptions. For example, assume a hedge fund requires 75 days notice for quarterly redemptions and pays out 90% of proceeds within 45 days. If the sponsor waits until April 30 to impose the gate with respect to redemption notices received by February 14 for redemption effective as of March 31, investors that have not submitted redemption notices may not know about the gate in time before the redemption notice deadline (April 15) for June 30 redemptions. This may ultimately benefit the fund by precluding additional

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What to Do if Your Hedge Fund Is on Uncertain Ground (cont. from page 13)

redemptions, giving it enough breathing room to stay afloat and recoup losses. This may also infuriate investors that learn of the gate too late. This slight shift in timing, which precludes an investor from submitting a redemption notice for the subsequent quarter, could mean the difference between a higher or lower position in the creditor pecking order if the fund subsequently slides into bankruptcy.

Although gates are designed to prevent a sudden exodus of capital from a hedge fund and prevent fire sales of assets, the imposition of gates can often be exactly what incites that exodus. A hedge fund imposing its gate sounds an alarm bell to its investors, especially to those who have not yet submitted redemption notices. News of the imposition of a gate may very well make an existing investor wonder why it's not running for the door as well.

Although gates are designed to prevent a sudden exodus of capital from a hedge fund and prevent fire sales of assets, the imposition of gates can often be exactly what incites that exodus.

Should I Stay or Should I Go? Investors may wonder whether there is any advantage to sticking it out once a fund has announced dramatic losses. On the one hand, the implementation of a gate is not necessarily the death knell for a hedge fund. There are funds that have implemented gates and then later generated profits. Also, in some instances, a third-party purchase of the fund's undesirable holdings can breathe new life into a fund.

On the other hand, investors do not necessarily reap any economic benefits by sticking with a manager during a crisis. Nor do a fund's portfolio managers and traders. An investor's money and a portfolio manager's time might each be spent more productively elsewhere. Following steep losses, it could be years — if ever — before a fund surpasses its previous highwater mark and yields profits once again. Faced with a potential 24-month wait before being entitled to any share of the incentive allocation, a portfolio manager has little incentive to stay around. Even a strict non-compete may not change this. A manager may understandably prefer to change industries completely rather than stick around and watch the fund's situation, and the manager's reputation go from bad to worse. Thus, the differing economic model of a hedge fund may very well make manager talent more transient than in the private equity world, where a clawback obligation will follow a manager even if he chooses to leave for greener pastures.

Suspensions—Prelude to Liquidation?

Basics of Suspension Provisions. Implementing a gate may be the first step in a downward spiral. If a fund is not able to recover its losses and stabilize its portfolio, it may take the more dramatic step of suspending redemptions and NAV calculations altogether, which often signals the imminent liquidation of the fund. Under most fund documents, a sponsor is entitled to suspend redemptions and NAV calculations in various extreme circumstances, such as closure of the exchange on which the fund's assets are traded, the illegality of satisfying a redemption, or when satisfying a redemption might cause the fund to become "plan assets" for ERISA purposes. However, fund documents also provide catch-all discretionary power that allows fund sponsors to suspend redemptions if the fund determines in its sole discretion that satisfying redemptions would not be in the best interests of the fund. Once investors have submitted redemptions *en masse*, it's difficult to imagine that allowing a complete run on the fund is in the best interests of the fund; thus, the fund would be entitled to suspend redemptions.

Once a fund suspends redemptions, an investor may face uncertainty over the amount of redemption proceeds it may ultimately receive once the suspension is lifted or a liquidation is announced. This uncertainty can make managing any investor's portfolio difficult, but some classes of investors—such as funds of funds—encounter more difficulties than others when faced with unpredictable liquidity.

Impact of Suspensions on Fund of Funds Investors. Funds of funds are significant sources of capital for hedge funds, but a fund of funds wrestles with unique challenges when an underlying hedge fund in which it is invested suspends its redemptions and NAV calculations. The fund of funds must still value its interest in that underlying fund for purposes of valuing its own portfolio. The fund of funds may wrestle with a dearth of information when making this valuation. Even if the available information warrants a dramatic write-down, the fund of funds manager may be

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Hedge Fund Investment Advisers: To Be or Not to Be (Registered)?

Over the summer, the regulatory rules of the game changed — yet again — for hedge fund advisers when a controversial new rule (the "Rule") requiring hedge fund adviser registration with the SEC was struck down. Hedge fund advisers that had already registered are now asking, "Should I remain registered or deregister, and how do I decide?" Now that the SEC has decided not to appeal the decision, advisers must wrestle with a number of legal and business decisions.

The Hedge Fund Adviser Registration Rule

The Investment Advisers Act of 1940 (the "Advisers Act") governs the conduct of both registered and, to a lesser degree, unregistered advisers. Prior to the effective date of the Rule on February 1, 2006, most hedge fund advisers relied on an exemption from registration for an adviser that has had no more than 14 "clients" during the preceding 12 months and has not held itself out to the public as an investment adviser.

For client-counting purposes, advisers to private pooled investment vehicles relied on an SEC rule providing that a private fund (including a hedge fund) rather than its investors was the firm's client. The Rule effectively rescinded the application of the "single fund as client" rule to require that hedge fund advisers "look through" a "private fund" and count each investor as a "client."

As a result, if a hedge fund had more than 14 investors, the hedge fund adviser was required to register with the SEC under the Advisers Act. The term "private fund" included a fund that permitted its owners to redeem any portion of their ownership interests within two years of purchase. This two-year redemption provision was designed to differentiate hedge funds, which generally permit periodic redemptions, from venture capital and private equity funds, which do not. At the time the Rule was adopted in 2004, the SEC believed that the typical "lock-up" period during which an investor in a hedge fund could not redeem its interests was typically less than two years. The SEC observed that it had not encountered significant enforcement problems with respect to managers of private equity and venture funds and did not want to require these managers to register. Thus, private equity fund sponsors could continue to count each fund as a single client for these purposes. Predictably, hedge fund managers that were in a position to do so began to extend their lock-up periods beyond two years in order to avoid registration. Others registered with the SEC.

Shortly after the Rule's adoption, Phillip Goldstein of Opportunity Partners (a hedge fund) sued the SEC challenging its authority to adopt the Rule. Fewer than six months later, the United States Court of Appeals for the District of Columbia Circuit struck down the Rule in *Goldstein v SEC*.[1]

The decision raised at least two interesting questions. First, could investment advisers that had registered because of the Rule and in reliance on some SEC transitional relief be faced with a regulatory regime far more burdensome than that envisioned by the SEC in adopting the Rule?

Second, according to the Court of Appeals, only the fund receives advice directly from a fund adviser and an individual investor in a fund typically does not. This raised a significant question whether an investment manager to a hedge fund had any duties — fiduciary or otherwise — to the investors in the fund as opposed to the fund itself.

The SEC's Answer

In the wake of the *Goldstein* decision, those that thought the SEC would retreat from its effort to regulate hedge fund advisers, or defer to Congress to fill the regulatory void, may have been surprised by Chairman Cox's testimony at a U.S. Senate Committee hearing on hedge funds held in July.[2]

After emphasizing that the SEC retains enforcement authority over hedge funds and their advisers under the antifraud and other provisions of the federal securities laws, Chairman Cox announced the following SEC initiatives:

- Emergency action to restore the transitional and exemptive relief provided in the Rule for hedge fund advisers who registered with the SEC.
- A new antifraud rule under the Advisers Act that would have the effect of "looking through" a hedge fund to its investors to clarify the fiduciary duties of hedge fund advisers to their investors and enable the SEC to protect investors against fraud.
- To address possible concerns about the "retailization" of hedge funds, analysis of the possibility of amending the current definition of "accredited investors" (as defined in Regulation D of the Securities Act of 1933) as applied to retail investment in hedge funds.

Barely two weeks after this testimony, the SEC staff delivered emergency relief through a no-action letter and effectively reinstated much of the interpretive and regulatory relief

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1 *See Goldstein v SEC, 451 F.3d 873 (D.C. Cir. 2006).*

2 *See http://www.sec.gov/news/testimony/2006/ts072506cc.htm.*

provided in the Adopting Release.[3] The other two initiatives are still being considered.

To Be or Not to Be (Registered)?

Any decision of an adviser whether to remain registered depends on the adviser's unique circumstances, taking into consideration its marketing sensitivities, investment activities, client base and financial and operational resources.

Basis for Withdrawal. Can an adviser that registered as a result of the Rule (a "New Adviser") withdraw from registration if, during the period it was registered, it took on more than 14 clients or held itself out to the public? The recent no action letter confirmed that a New Adviser may withdraw its registration if it has fewer than 15 clients at the time of withdrawal, even if it had additional clients or held itself out to the public as an investment adviser while registered. In order to benefit from this, the New Adviser must deregister by February 1, 2007.

Investor and Client Perceptions. An adviser choosing to deregister will no doubt need to consider how withdrawal might affect the firm's marketing efforts. Although registration was never intended to represent a seal of approval by the SEC, the fact that an adviser is registered may affect how investors or potential investors perceive the adviser. In addition, depending on the original reasons it articulated for registering, an adviser choosing to deregister may feel pressured to articulate a cogent rationale for withdrawing to prevent investors or potential investors and their advisers from drawing any negative inferences.

Target Investor Base. Determining whether to deregister may also be driven by an adviser's desire to maintain an existing investor base or expand and develop a new one. Withdrawing registration may mean losing access to pension plan investors subject to ERISA, an increasingly significant source of capital in hedge funds. Even if an adviser has no present intention to operate a fund as "plan assets" subject to ERISA, some ERISA investors may use registration as a gating criterion when assessing advisers.

Managing Resources. Deregistering will probably reduce the burden on an adviser's financial resources and personnel. Maintaining required books and records, designating and perhaps providing additional compensation to a chief compliance officer, complying with the custody rule and exposing a firm to the potential business disruption associated with SEC inspection all carry costs. In some cases, a New Adviser may have realized significant managerial and risk reduction benefits from compliance with the Rule.

Deregistration need not necessarily mean that these benefits will be lost. However, the "stick" of an SEC examination can be useful to coax unwilling employees to accept a compliance culture. Maintaining a compliance environment may comport with what many institutional investors may have come to expect. Personnel issues, may also arise, such as determining whether to retain and redeploy an individual previously engaged to act as a chief compliance officer (required for registered advisers). In addition, the need to meet investor/client expectations may suggest that the cost savings of deregistration will not be significant. Prospective investors may expect a hedge fund manager to have a compliance program even if the manager is not registered.

There can also be compelling legal reasons to maintain this compliance environment. The SEC has the authority under the Advisers Act to bring enforcement proceedings and sanction an adviser or an associated person of an adviser (whether or not registered) for failure to supervise, with a view to preventing violations of the federal securities laws, a person committing a violation of the federal securities laws. A "failure to supervise" action is not a hypothetical threat and the SEC has pursued such actions against unregistered as well as registered investment advisers. A robust compliance system may serve as defense against a failure to supervise allegation. Thus, maintaining the core elements of a compliance program, even if an adviser chooses to deregister, may be beneficial for a variety of reasons.

In connection with any decision to deregister with the SEC, an adviser should also consider whether it will be subject to other regulation, including possible state registration and other requirements.

Looking Ahead: Is There a Specter of Additional Regulations?

Is there a credible prospect of legislation designed to fill the "regulatory void" created by the *Goldstein* decision? Not at the moment. In his July testimony, Chairman Cox tactfully avoided stating whether legislation was necessary and instead acknowledged Congress' and other regulators' concerns that any regulation not interfere with the investment strategies or operations of hedge funds. Nevertheless, there is a bill pending in Congress that would provide the SEC with the authority that the Court of Appeals determined the SEC lacked.[4] In light of Chairman Cox's

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3 *See ABA Subcommittee on Private Investment Entities (Aug. 10, 2006), available at http://www.sec.gov/divisions/investment/noaction/aba081006.pdf.*

4 *Securities and Exchange Commission Authority Restoration Act of 2006, H.R. 5712 (109th Congress, June 29, 2006).*

Shari'ah Compliant Private Equity Funds:

What Private Equity Managers Need to Know

The forging of new relationships with Middle Eastern investors (beyond those with the region's merchant families and investment houses which have, for some time, been investors in the private equity asset class) has brought with it new and complex issues of culture, commerce and religion. In light of the compelling size of the pool of available Islamic capital estimated at between $300-500 billion, private equity funds and their general partners (GPs) may be well advised to learn about accommodating the concerns of Islamic investors.

The use of interest-bearing debt at both the portfolio company level and at the level of any special purpose financing vehicle in the acquisition structure is of particular concern to Islamic investors, given the *Shari'ah* prohibition on *riba*.

Private equity managers accustomed to fundraising in Asia, will probably not be surprised to find that it generally takes longer to secure firm commitments from Middle Eastern investors than from their European or U.S. counterparts. This is due, in part, to the greater emphasis that investors in the region place on personal contact and establishing trust in business dealings, as well as the need to educate certain investors to whom private equity is a relatively unfamiliar asset class.

Private equity managers commonly encounter the most difficult issues when seeking to admit Islamic investors into their funds. These investors conduct their commercial activities (as well as all other aspects of their lives) in accordance with the body of Islamic jurisprudence known as *Shari'ah* law. The *Shari'ah* prohibits, *inter alia*, the charging or paying of interest (*riba*), investment in certain forbidden (*haram*) industries (such as conventional financial services, armaments, cable-tv operators, gaming, alcohol (including hotels and restaurants that serve alcohol, unless such income is "purified"), contractual uncertainty (*gharar*) and the guarantee of a fixed return on investment.

Not all Islamic investors require the same degree of compliance with *Shari'ah* law, and the extent of the modifications which a private equity manager will have to make to its fund documentation will depend on the degree of compliance necessitated by any given investor. However, in general, where a GP wishes to admit an Islamic investor into its fund, it will have to adopt a *Shari'ah* compliant investment policy, which will include some, if not all, of the following restrictions being incorporated into the fund documentation:

To the extent that a fund or a portfolio company conducts *Shari'ah* compliant activities, most Islamic investors will tolerate interest income provided that such income does not exceed 5% of the total income of the fund or portfolio company.

- no investment in *haram* industries;
- no investment in interest-bearing instruments such as convertible debt securities (although these may be restructured in a *Shari'ah* compliant manner);
- no participation in bridge financings;
- no investment in financial products such as options or futures (*i.e.*, no hedging), although recent developments in the Islamic finance market have suggested that certain types of derivative contracts may be permissible; and
- no investment in companies which do not meet specific financial parameters in relation to debt to equity ratios, interest income and accounts receivable.

The use of interest-bearing debt at both the portfolio company level and at the level of any special purpose financing vehicle in the acquisition structure is of particular concern to Islamic investors, given the *Shari'ah* prohibition on *riba*.

At the portfolio company level, most Islamic investors take the view that they can only invest in a portfolio company if the interest-bearing debt to equity ratio of such portfolio company is no more than 33%, where equity, for these purposes, is deemed to be the enterprise value of the portfolio company. It is also worth pointing out that some *Shari'ah* scholars take the strict view that if an Islamic investor gains control of a

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Shari'ah Compliant Private Equity Funds (cont. from page 15)

portfolio company, it must undertake to repay all of such portfolio company's debt within three years of the acquisition. Portfolio company debt may, however, be restructured in a *Shari'ah* compliant manner and new debt may be incurred by relying on traditional Islamic financial products, although this may be more expensive and is only really feasible if Islamic investors control the company.

Investment in LBO funds is obviously problematic for Islamic investors, given the use of acquisition indebtedness in most typical buyout structures. It is, however, possible to structure around these difficulties and create "Islamic debt" (by utilising, among other techniques, a lease financing arrangement (*ijara wa iktina*) in respect of the assets of the portfolio company). Islamic debt has become more widely available over the last 5 years and more western banks are now familiar with these types of transactions. As a consequence, transactions are not as difficult or costly as they once were; however, there are still complex legal, tax and accounting issues that need to be grappled with on a jurisdiction-by-jurisdiction basis and this often leads to a somewhat lengthier transaction process.

Certain GPs have attempted to reconcile the inherent tension of having Islamic investors and their western counterparts as partners in the same fund by establishing a Shari'ah compliant parallel vehicle which invests in parallel with the main fund.

Fund documentation may also require modification to prevent the manager from charging interest on monies due but unpaid in relation to investors' drawdown obligations and in relation to investing surplus cash in interest-bearing temporary investments. To the extent that a fund or a portfolio company conducts *Shari'ah* compliant activities, most Islamic investors will tolerate interest income provided that such income does not exceed 5% of the total income of the fund or portfolio company. In practice, such investors will "purify" this income by donating it to a charity.

In addition, for certain Islamic investors, there will also be a need to address issues in relation to the exercise by the fund of redemption rights and liquidation preferences attaching to preference shares, which may not be acceptable in a form familiar to western investors.

Significantly, certain investors may insist also on the establishment of a *Shari'ah* Committee in relation to the fund, which would consist of Islamic scholars appointed by such investors and which would advise the GP in relation to *Shari'ah* compliance. Compliance is an ongoing obligation and the *Shari'ah* Committee will be responsible for conducting annual *Shari'ah* audits to ensure that the fund and portfolio companies continue to be operated in accordance with the *Shari'ah*. Where this is found not to be the case, purification of non-complying investments will be required.

A thorny issue in the negotiation process with certain Islamic investors is whether the *Shari'ah* Committee should have the power to prevent the GP from making investments that are not *Shari'ah* compliant. This raises fundamental issues for the GP as it relates to its control of the investment process and also may not be acceptable to other non-Islamic investors in the fund since such a restriction may lead the GP to forego making what would otherwise have been a profitable, albeit non-*Shari'ah* compliant, investment. One solution that we have used as a compromise in such circumstances is to allow Islamic investors to opt out of investments which the *Shari'ah* Committee regards as being non-compliant.

Certain GPs have attempted to reconcile the inherent tension of having Islamic investors and their western counterparts as partners in the same fund by establishing a *Shari'ah* compliant parallel vehicle which invests in parallel with the main fund. This may work for certain investors and in certain circumstances but the more sophisticated Islamic investor is increasingly worried that the GP will devote its time and effort to the main fund, where the bulk of the capital usually is, rather than making the effort to find and execute investments that both the main fund and the Shari'ah compliant parallel vehicle may make together.

In summary, not all Islamic investors will have the same requirements and not all GPs will want to make concessions, particularly where Islamic investors do not represent a significant investor group. Yet, given the wealth and potential for growth in the region, many GPs are likely to be willing to comply with the special concerns of Islamic investors in order to differentiate themselves and be able to avail themselves of Islamic capital. ■

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Impact of the New Tax Shelter Rules on Tax-Exempt Entities Investing in Private Equity Funds

Congress recently enacted additional legislation in its continuing effort to crack down on abusive tax shelter transactions. Although the new rules are designed to target tax-exempt entities serving as "accommodation parties" in tax shelter transactions, the rules have a potentially much greater scope and could be read to apply to fairly standard investments. The rules impose stiff penalty taxes on most types of tax-exempt entities that participate (whether knowingly or unknowingly) in what are referred to as "prohibited tax shelter transactions." In addition, the new rules impose an excise tax (of $20,000) on "entity managers" (broadly defined) of tax-exempt entities who approve the entity as a party or otherwise cause the entity to be a party to a transaction that the manager knows or has reason to know is a prohibited tax shelter transaction.

How do the new rules work?

What is a "prohibited tax shelter transaction?" — Prohibited tax shelter transactions ("PTSTs") consist of what are known as "listed transactions" — transactions that are, or are substantially similar to, transactions the IRS has specifically identified as tax avoidance transactions and are listed on the IRS website — as well as two other categories of transactions that are already subject to reporting requirements, "confidential transactions" and "transactions with contractual protection." Although listed transactions are generally aggressive tax shelter transactions, questions may arise as to whether a legitimate transaction could be found to be substantially similar to a listed transaction (for a time, there was a concern that certain swap transactions could be found to be substantially similar to a listed transaction involving notional principal contracts). A confidential transaction is a transaction offered under conditions of confidentiality and for which a taxpayer has paid an advisor a minimum fee. A transaction with contractual protection is a transaction for which a taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or for which fees are contingent on the taxpayer's realization of tax benefits.

Who does the tax apply to? — All tax-exempt entities, other than qualified pension plans, IRAs, and similar tax-favored savings arrangements ("Pension Plans"), are potentially subject to the basic tax, including public charities, churches, hospitals and schools, private foundations, and government entities such as state retirement plans and Indian tribal governments. In addition, "entity managers" of tax-exempt entities, including entity managers of Pension Plans, are potentially subject to the $20,000 excise tax.

When is a tax-exempt entity a "party to the transaction?" — The tax may be imposed on a tax-exempt entity, or the entity manager, only if the entity becomes a "party" to a PTST. Neither the statute itself nor a subsequently-issued IRS Notice addresses when indirect involvement in a PTST (such as through another entity) will result in the entity being a party to the transaction (although as discussed below, the legislative history provides a helpful discussion).

Who is an entity manager? — In the case of entities other than Pension Plans, the term "entity manager" means the person with authority or responsibility similar to that exercised by an officer, director or trustee and having the authority or responsibility over the act in question. In the case of Pension Plans, the term means the person who approves or otherwise causes the Pension Plan to be a party to the PTST. (An individual beneficiary or owner can only be liable as an entity manager if it has broad investment authority under the arrangement.) This clearly covers in-house managers, and has been read as covering external managers and advisors as well.

How is the tax computed? — A tax-exempt entity that is a party to a PTST will have to pay a tax equal to 35% of the greater of (1) 100% of its net income attributable to the transaction and (2) 75% of the proceeds received by the entity that are attributable to the transaction, for the year in which the entity becomes a party to the PTST and each subsequent year. (The term "proceeds" is not defined, and could even be read as including every dollar received in a transaction, even those representing a return of capital.) However, if the tax-exempt entity knew or had reason to know that the transaction constituted a PTST at the time it entered into the transaction, the excise tax will equal 100% of the greater of (1) 100% of its net income attributable to the transaction and (2) 75% of the proceeds received by the entity that are attributable to the transaction. In addition, a tax of $20,000 can be imposed on each entity manager of a tax-exempt entity who approved the entity's becoming a party to the transaction and knew, or had reason to know, that the transaction was a PTST.

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Impact of the New Tax Shelter Rules (cont. from page 19)

Additional reporting requirements — A tax-exempt entity must report to the IRS its participation in a PTST and the identity of any other parties known by the tax-exempt entity to be participating in each such transaction. A taxable party to a PTST must report to each tax-exempt entity which is a party to the transaction that the transaction is a PTST.

How does all of this apply to private equity funds?

Could an investment by a tax-exempt entity in a private equity fund itself be a PTST? Some tax lawyers have expressed concern that the confidential nature of a private equity fund's documents could cause the fund itself to be a confidential transaction. We do not believe this should be the case. A number of funds have chosen to foreclose any concern by adding "tax exception" language (which gives investors the right to disclose the tax treatment and tax aspects of the fund) to the confidentiality provisions in the fund's private placement memo and partnership agreement. (Many funds had already included this language when confidential transactions were merely subject to disclosure.) The influential New York State Bar Association Tax Section report (the "NYSBA Report") calls such "magic language" unnecessary, and many funds refuse to include it.

Could a private equity fund be a transaction with contractual protection? The American Bar Association's comments to the legislation when it was in proposed form note that customary agreements by investment managers not to expose exempt organizations to the tax on unrelated business taxable income could be construed to involve contractual protection. (The NYSBA Report believes such treatment is not appropriate and recommends that guidance be issued to that effect.) This raises the question, what about a private equity fund that agrees to use commercially reasonable efforts to avoid certain transactions that may generate unrelated business taxable income? We think it would be a stretch to view such a covenant as constituting contractual protection.

What if a private equity fund invests in a PTST? The conference report to the new rules states that certain indirect involvement in a PTST would not result in an entity being considered to be a party. Giving as an example an investment in a mutual fund that in turn invests in a PTST, the report says that the tax-exempt entity would not be a party to the PTST "absent facts or circumstances that indicate that the purpose of the tax-exempt entity's investment in the mutual fund was specifically to participate in such a transaction." The report goes on to say that the determination will be informed by whether the entity or entity manager "knew or had reason to know" that investment of the entity would be used in a PTST. In the case of a typical private equity fund, the limited partners are investors in a blind pool whose offering documents give no indication that the fund will invest in a PTST. It is hard to see how the fund's tax-exempt investors would be found to be parties to any investment in a PTST to be made by the fund under this reasoning. We note that listed transactions in particular seem to be unlikely investments for typical private equity funds, which have a variety of investors with widely varying tax profiles. Nonetheless, the NYSBA Report notes that well-advised tax exempts already routinely are asking for side letter agreements with funds in which the fund represents that the tax-exempt investor will not be a party to a PTST by reason of an investment in the fund.

Could the fund's general partner or manager be viewed as an "entity manager" of a limited partner that is a tax-exempt entity? Although the language of the statute seems broad enough to cover this, because the limited partner would have to be viewed as a party to the transaction undertaken by the fund in order for the entity manager to be subject to tax, we think it is generally unlikely that a fund general partner or manager would have any liability as an "entity manager" under these rules.

Status of the New Rules

The new rules are fully effective. On July 11, 2006, the IRS issued a Notice explaining the new rules to tax-exempt entities and requesting public comments on the new provisions in anticipation of additional guidance. Over 90 comment letters were received. On September 19, Treasury announced that they are reviewing the comments and expect that they will provide guidance "soon." Many commentators have criticized the law as overbroad. For the meantime, until further clarification is forthcoming, tax-exempt investors and fund managers should consult their tax advisors as to the applicability of these rules to their specific investments and funds. ■

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Duration and Scope

Despite the recent attention they have received, go-shop deals remain rare. We identified a total of 17 going-private transactions since 2004, 15 of them sponsored by private equity firms. More recently, of the more than 100 going-privates announced during the first nine months of 2006, ten included a go-shop provision; private equity firms sponsored 65 of these recent transactions, including nine with a go-shop feature.

The go-shop periods in these precedents ranged between 15-55 days, with two outliers permitting the solicitation of better offers until the date of the stockholder approval. The majority of the other 15 transactions provided for solicitation periods of 20-30 days. Notably, recent and particularly large transactions such as the Kerzner, HCA and Freescale going-privates represented the upper end of the spectrum, with go-shop periods of 45, 50 and 50 days, respectively.

The vast majority of these precedents permitted the post-signing solicitation of bids from an unlimited number of both strategic and financial buyers. Only two precedents regulated the universe of potential bidders the target could contact: one by imposing a numerical cap, the other by restricting the pool to strategic buyers.

Information and Matching Rights; Proxy Filing Obligations

Virtually all of the agreements we reviewed provided for a right of the buyer to be kept up to date as to alternative bids solicited during the go-shop period. Only about half of the precedents included an express obligation on the part of the target to negotiate with the initial purchaser to allow it to match or top any alternative proposal (though several of the large going-privates of 2006 included such a provision). Arguably, however, a matching right may be implicit even where it is not expressly addressed.

A large majority of the precedents required the merger proxy to be prepared and filed with the Securities and Exchange Commission as *promptly as practicable* after the execution of the merger agreement, suggesting that buyers are generally successful in avoiding the transformation of a go-shop period into a full-blown "time out" on the way to closing. Only one of the agreements we reviewed deviated from this approach, suspending proxy preparation and filing obligations until the end of the go-shop period, which, at 20 days, was on the short end.

From Go-Shop to No-Shop

We further found that all but three of the precedents permitted a target that has received a potentially superior offer during the go-shop period to continue discussions with the new bidder even after the end of the go-shop period, so long as the new proposal could reasonably be expected to result in a better deal. By contrast, the three exceptions required the target to cease all discussions that resulted from the post-signing shopping. Of course, the target remained entitled, in all circumstances, to receive *unsolicited* offers after the expiration of the go-shop period. In other words, the go-shop deals reverted into ordinary no-shop deals after the shopping window closed.

Breakup Fees

Breakup fees, requiring a public target to pay a fee to the buyer if it invokes its fiduciary out, have long been a staple in no-shop deals and have been blessed by the Delaware courts so long as they are not excessive; fees of around 2-3% of equity value have become the norm. With one exception, all of the go-shop transactions we identified likewise provided for a termination fee. A majority of the agreements we reviewed reflected a "one-size-fits-all" approach, applying the same fee regardless of whether the fiduciary out is exercised for a bid solicited during the go-shop period or a later unsolicited offer. On the other hand, six of the precedents provided for a bifurcated regime, with a discounted fee if the transaction was abandoned in favor of a bid obtained during the go-shop phase. Some of these precedents applied the discount only if the original agreement was *terminated* prior to the expiration of the go-shop period (or, in some cases, a portion of the go-shop period); others allowed the discount as long as the target terminated in order to pursue an alternative transaction for which a potentially superior offer had been *made* prior to the end of the go-shop period. The discounted fee typically ranged between one-third and two-thirds of the full termination fee. All six of these transactions were entered into in 2006, suggesting that the bifurcated approach may be becoming more prevalent.

What to Make of Go-Shop Provisions?

There are numerous ways to take a public target private, ranging from announcing that the company is "on the block" or has received a buyout proposal, followed by a full-blown, pre-signing auction, to signing up a transaction agreement without prior announcement or auction and relying on a post-signing market check. The best approach for targets and potential buyers is, of course,

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entirely dependent on the circumstances. A go-shop provision is by no means legally required and is but one of several approaches available to the target. Other options, including the classical fiduciary-out structure, have been blessed by the courts and continue to remain popular — as is reflected by the fact that the vast majority of going-private deals announced in 2006 do not include a go-shop feature.

If a go-shop is on the table, what should a private equity sponsor make of it? The answer depends on what the alternatives are. Obviously, agreeing to a go-shop is undesirable for a sponsor able to convince the target to sign up a merger agreement and rely on a traditional post-signing market check. But if the choice is between a pre-signing auction and a go-shop, the latter may provide benefits to both sides of a going-private transaction.

Faster Process Thanks to Go-Shops

While a pre-closing auction will, for its duration, bring the process to a halt, a go-shop provision allows the parties to sign up a merger agreement without first testing the market — indeed, all of the 2006 go-shop deals were entered into without a pre-signing announcement or market check. Once the agreement is executed, the parties can move on parallel tracks: the target runs the auction while at the same time working with the initial buyer to satisfy the closing conditions. Only if go-shop agreements were to suspend proxy preparation or filing obligations during the shopping window — an approach not taken by most of the precedents — would the timing advantage of a post-signing auction evaporate. It may be, however, that management distraction during the shopping process will result in a longer timeline to closing than would be the case in a traditional fiduciary-out structure.

The Termination Fee: Consolation Prize or Deterrent?

A lost pre-signing auction leaves a prospective buyer empty-handed. Losing a transaction as a result of a post-signing auction, on the other hand, leaves the initial purchaser with a consolation prize — the breakup fee. While no private equity firm would trade an attractive investment opportunity for a modest one-time payment, the fee does serve to deter a competing bidder willing to pay only a marginally higher price. The recent trend towards discounting the breakup fee if the transaction is abandoned in favor of a bid solicited during the go-shop period may well illustrate how buyers and sellers are splitting the difference: while the buyer ends up with some payback, there is less disincentive for a competing bidder to throw its hat into the ring than would be the case under an ordinary no-shop/fiduciary-out regime.

Tactical Considerations

During many pre-signing auctions, all bidders are on equal footing. This is not necessarily so in a post-signing auction, where, depending on the circumstances, the initial buyer may have a number of advantages.

For one, the announcement of the transaction with the initial buyer creates an expectation, on the part of the target stockholders and management, that a liquidity event will occur in the near term, and that expectation may diminish a target's motivation to reset the clock by starting over with an alternative bidder. For another, the go-shop window, particularly if in the customary range of 20 to 30 days, requires that a competing bidder be quite determined in order to get up to speed in terms of due diligence, building a relationship with management and identifying financing sources.

This last point is reflected in the public filings for the Kerzner transaction, which reveal that an alternative bidder who emerged during the go-shop period felt that the investor consortium had an edge over other bidders as a result of its pre-existing knowledge of the company. Consequently, the new bidder requested that Kerzner provide it with an "incentive package," consisting of expense reimbursement, triggered upon the submission of a proposal above a certain price threshold, and a fee, payable if the alternative bidder's proposal was the best offer but Kerzner failed to enter into a definitive agreement with the new bidder

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A go-shop provision is by no means legally required and is but one of several approaches available to the target. Other options, including the classical fiduciary-out structure, have been blessed by the courts and continue to remain popular — as is reflected by the fact that the vast majority of going-private deals announced in 2006 do not include a go-shop feature.

within a specified period of time. Although no such incentive package was agreed to in Kerzner, similar requests may become more common in the future.

Comparable tactical advantages may result from agreements between the initial purchaser and significant stockholders or senior management. Accordingly, special committees may demand that target stockholders who have entered into voting agreements with the initial purchaser switch their allegiance and vote in favor of an alternative transaction if one is supported by the board. Similarly, special committees may seek to ensure that, if an emerging bidder so requests, management sever its ties with the initial buyer and agree to work with the new bidder. However, since management is not likely to agree to a worse deal than the one promised by the initial buyer, management, in turn, may seek to condition any such commitment on the new bidder's matching or topping the management package proposed by the initial buyer.

Do Go-Shop Provisions Really Result in Richer Deals?

Targets have made ample use of their rights under go-shop provisions — Maytag, for example, canvassed over 100 potential other bidders. Thus, a go-shop is clearly not a risk-free proposition from a financial sponsor's perspective. Yet, beyond putting a buyer's nerves to the test, do go-shop provisions actually yield results? While it is too early to pass definitive judgment on this question, here is an interim report:

Only four deals in our sample resulted in target shareholders receiving a higher price than the initial deal price, and, in three of them, the go-shop provision may not have had an impact on the outcome. The first, Chalone, involved an attempted going-private transaction by the founder who controlled almost half of the vote and could thus have blocked the ultimately prevailing bid. In the second, Maytag, Whirlpool's offer was an unsolicited one, presented by Whirlpool *after* the expiration of the go-shop period. In the third, Kerzner, the initial purchaser consortium agreed to a higher price, but the impetus for the increase was not so much the emergence of competition during the go-shop period but rather a Schedule 13D filed by one of Kerzner's significant stockholders stating that it would not support the transaction unless the deal was sweetened. Only in the fourth, Hollywood Entertainment, did the go-shop provision play a critical role. However, Hollywood Entertainment is unique among the sampled precedents in two respects: it did not include a breakup fee and the go-shop provision was agreed to in connection with a significant reduction in price prompted by the target's poor performance, arguably making it easier for an alternative bidder to put forward an attractive competing proposal.

Do Go-Shop Provisions Really Help Avoid Litigation?

One litmus test for go-shop provisions may be whether they in fact deliver protection from shareholder lawsuits. So far, it does not appear that activist shareholders are buying into the analysis that go-shops are products of a particularly meticulous going-private process. In fact, many of the recent go-shop deals, including Kerzner, HCA and Freescale, have been attacked by the plaintiffs' bar and activist shareholders on the same grounds as their no-shop counterparts. Notably, some of the complaints specifically address go-shop provisions, pointing to the initial buyer's advantage as to due diligence and the deterrent effect of matching rights and breakup fee.

One litmus test for go-shop provisions may be whether they in fact deliver protection from shareholder lawsuits. So far, it does not appear that activist shareholders are buying into the analysis that go-shops are products of a particularly meticulous going-private process.

Can a Buyer Live with a Go-Shop?

So should a private equity sponsor be prepared to live with a go-shop? The answer depends on a number of factors, among them the sponsor's negotiating position, the other facts and circumstances of the transaction and on how market terms for merger agreements may evolve. The recent spate of go-shop deals suggests that, at least in some going-private transactions, both sides may benefit from endorsing the maxim "shop till you drop." ■

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Second-Lien Financings (cont. from page 4)

If the first- and second-lien lenders are fully secured, their interests should generally coincide, which will minimize the risk of intercreditor disputes. If there is not enough collateral value to cover the first-lien debt, the fight will be between first- and second-lien lenders, with unsecured creditors trying to extract some value in the process. In that case, first- and second-lien lenders are likely to have very different views about the value of the collateral, if, when and at what price it should be sold and, if it is not sold, how that value should be divided between them as part of a plan of reorganization. Since second-lien lenders' leverage will depend on the extent to which they are in fact secured, valuation disputes may surface earlier than they usually would in bankruptcies that do not involve multiple classes of secured creditors.

The Chapter 11 case of *Nellson Nutraceutical* pending in the District of Delaware is a recent case on point. In an unusual step, the debtors filed a motion asking the bankruptcy court to determine the amount of the secured claims of their first- and second-lien lenders. Although valuation litigation is a common feature of the plan confirmation process, Nellson filed the motion only a few months into bankruptcy and before proposing a plan of reorganization. Citing extreme divergence in opinion as to the debtors' enterprise value and therefore the reorganized debtors' capital structure, Nellson argued that its approach was necessary to avoid a litigation free-for-all and to pave the way for a consensual plan of reorganization. The financial advisors of each creditor constituency arrived at valuation estimates within a reasonable range of one another, while Nellson's estimate was considerably higher and would result in some recovery to existing equity. Nellson's creditors accused the debtors' private equity sponsor of guiding the hand of Nellson's valuation experts. To make matters worse, the United States Trustee filed a motion seeking the appointment of a trustee based on the dishonest and incompetent conduct of the debtors' management, allegations of improper influence of the debtors' private equity sponsor and the high level of acrimony at the valuation trial. It remains to be seen if other debtors will follow Nellson's strategy. (The trial is still underway at the time of writing this article.)

A few words of caution for equity sponsors: Based on the small sampling of recent bankruptcy cases involving second-lien debt, chances of maintaining a stake in the reorganized company are slim. In fact, with one exception, recoveries of second-lien lenders in recent Chapter 11 cases have been closer to those of unsecured creditors than those of first-lien lenders. According to Standard & Poor's, 64% of all of their rated second-lien loans would receive virtually no recovery in a default situation.[2] But there may be more bad news. Sophisticated hedge funds, which have a big appetite for second-lien paper, are taking note of companies funding generous dividends with second-lien debt. If these companies head for bankruptcy within a year after the distributions, these hedge funds will no doubt attempt to recapture that value by attacking them as fraudulent conveyances.

2 *"Second-Lien Pricing May Not Fully Recognize Risk of Loss Given Default," Standard & Poor's, August 7, 2006, www.ratingsdirect.com.*

Conclusion

While there have been relatively few bankruptcies of companies with second-lien debt, there are already some important lessons to be learned. We expect that, as illustrated by the *Nellson Nutraceutical* case, valuation disputes will come up earlier in these bankruptcies than in restructurings of companies with only one layer of secured debt. More generally, because second-lien lenders will usually have more power than secured creditors in bankruptcy, disputes between first- and second-lien lenders will differ to some extent from traditional disputes among unsecured creditors or between secured and unsecured creditors. In order to avoid these complications, a significant number of recent cases involving second-lien debt were pre-arranged or pre-packaged bankruptcies. However, second-lien lenders' cooperation will come at a price in a restructuring (even if they are in fact significantly undersecured), and the price of a consensual plan is likely to be paid by the first-lien lenders, who might be required to give up some of their recovery. ■

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Guest Column: Reverse LBOs Create Wealth for Equity Holders (cont. from page 6)

development ripe for focused study. There has been a lot of work done in terms of syndication of venture capital transactions — almost none on syndication of buyout transactions. How has the rise in club deals affected the valuations being paid in various transactions, for example? What can we say intelligently about the governance of companies which are owned by multiple buyout groups? Do we end up seeing differences in terms of how they operate, how decisions get made etc.?

That's our intellectual agenda. The good news is that the industry is going through a really interesting transition. Hopefully, there will be some real synergies between some of the academic work being done and the issues that people are worrying about in real life.

FJB: What do you conclude from the move of private equity towards a more liquid market, not just the public offerings of private equity products but also the increasing liquidity of private equity investments held in various forms, whether through fund of funds or secondary sales of portfolios and the like?

JL: That is an area that Antoinette Schoar and I did a paper on a couple years ago called "The Liquidity Puzzle." We basically made the argument that in a lot of respects it may well be that illiquidity is particularly well-suited for private equity. There is a whole broad range of benefits from illiquidity that are not to be understated in the private equity setting. I remain somewhat skeptical that liquidity is really going to be beneficial, as one can see from looking over the track record and history of liquid private equity funds. It seems they have a cycle where they do great when everything is in a frenzy and then wither away when market enthusiasm drops.

FJB: Was there anything behind the data in your recent paper that you found of interest?

JL: As in many things, it highlights the difference between the popular consensus view and reality. What the data show is that for all of the cynicism that has been directed at buyout groups when they speak about adding value, there is some tangible evidence that the buyout firms do create companies that perform better, not just in the three months, or two or three-quarters leading up to the IPO. These are sustainable superior organizations in the years after going public, for at least five years after the offerings. That to me is again saying that there is quite substantial evidence of value creation. If you think about three, four and five years out, given that the buyout groups are likely to have liquidated their stakes by a sale or distribution by then, I think it's saying something about these groups' ability to profoundly shape the companies in which they invest. We didn't check when the buyout groups unwound their positions, but it would be worth doing to see if you find something interesting around those times.

FJB: Is the impact of the overhang a myth? As an academic, how do you analyze that? Every underwriter that I talk to is worried about the overhang.

JL: There's been some evidence that suggests around the time the lockup expires there is some downward pressure in terms of stock prices, but most of the data suggests a decline of a few percent, rather than some dramatic collapse of the stock price.

FJB: Is there any thought about how long that downward pressure lasts?

JL: I think it's sort of a short hit of about a couple percent, but basically that's it; there's no discernable movement after that.

FJB: Is there a risk that such studies eventually disprove their conclusions, *i.e.* by changing market performance in reaction to the study?

JL: That's an interesting question. I assume that, in theory, if everyone read this study and started buying into reverse LBOs, the outperformance would eventually go away over time. There has been some evidence for that proposition. My colleague Paul Gompers and I did some earlier work, maybe a decade ago, about stock performance when venture capitalists distributed stock. After the study was released, we got a lot of requests from hedge funds for a copy of the paper. Someone else later did a paper on what happened after that study became available, and it did seem that behavior had changed. It's certainly the case that the markets are full of smart people and they adjust over time. Nevertheless, the basic answer seems to be that if you followed a strategy of basically going long on reverse LBOs and going short on the stock market, you would have made money over the last 20 years.

FJB: But can you promise that you'd do it for the next 20 years?

JL: No. Which is why I'm an academic rather than a hedge fund manager. ■

be aligned with respect to the policies written by the sidecar. Without such an alignment, the sidecar could be used by the insurance partner as a vehicle for placing less profitable business or for granting an accommodation to an existing client in order to garner more favorable terms on business that will not be ceded to the sidecar. This alignment of interests is generally accomplished in several ways.

First, the insurance partner may be required to share (generally a minority interest) in each risk written by the sidecar. The insurer may also or instead make an equity investment in the sidecar itself. Second, in the event that the sidecar is writing insurance directly, the insurance partner/underwriter should be barred from competing with the sidecar with respect to business that meets the sidecar's underwriting guidelines. Similarly, the quota share reinsurance agreement should provide that any business that meets its underwriting guidelines that is written by the insurance partner is automatically subject to sharing under the quota share, so that the insurance partner does not have the discretion to retain a disproportionate share of the most profitable business. In either event, the sidecar must receive its share of any business that meets the underwriting guidelines. Finally, the insurance partner's commissions under the underwriting agreement or quota share agreement largely will be based on the profitability of the sidecar in each policy year, and may be subject to clawback or loss carryforward provisions.

Collateralization and Ratings

Sidecars typically write business on a fully or highly collateralized basis. Equity capital provided by investors and premiums paid by reinsureds are deposited into a trust account which may be used to collateralize each policy written by the sidecar up to the full limits of the policy or on a probable maximum loss basis. Alternatively, the sidecar may be permitted to fund the collateral trust with a letter of credit or financial guaranty by a creditworthy institution.

Collateral determinations will generally be driven by commercial considerations, principally the desire of the reinsured (either the sidecar sponsor or another insurer in the case of a market-facing sidecar) to avoid any funding risk if payment is required under its reinsurance policy. In addition, collateralization to limits will avoid an otherwise potentially steep capital charge for rating agency purposes that would to some extent mitigate the benefit of obtaining reinsurance through the sidecar.

Exit and Distributions

Because sidecars are often very dependent on hedge fund capital, they need to provide liquidity opportunities, since hedge funds are subject to investor withdrawals. Generally, insurance companies require capital to back their reserves against potential losses and are therefore unable to provide investors with much short term liquidity. In contrast, the nature of sidecars makes them particularly good vehicles among insurance sector investments to provide investors with short term liquidity. This is true for a number of reasons. First, they are short duration investments since they are typically one to three year deals. Second, the business assumed by the sidecar generally involves low frequency "short tail" catastrophic risks, such as hurricane risk. This means there is a probability of no losses during the life of the sidecar and that if a loss event occurs, the insurer knows of it immediately and quickly receives claims, permitting a reasonably informed determination of the approximate size of the loss (and the need to reserve capital) shortly after the conclusion of a policy year.

Sidecars are, however, still insurance companies, and so the ability to return capital is still limited by the need for adequate reserves, including possible regulatory and ratings constraints. This is especially acute where the sidecar is required by the deal terms to be highly collateralized. As a result, the interplay between reserving and collateralization requirements, including the timing and methodology for establishing reserves and releasing capital on the one hand, and the availability of capital to be returned to shareholders on the other, is one of the most highly negotiated aspects of most sidecar transactions.

In addition to regular dividends to investors whenever capital is available for release, many sidecars allow for early exit opportunities in the form of redemptions. Deals may provide for voluntary redemptions periodically or upon certain trigger events that would cause investors to want to cease partnership with the insurer, such as loss of license, insolvency, material breach of the transaction documents or change of control. Investors also typically have book value redemption rights at the end of the term of the reinsurance arrangements. This may be coupled with the right to force a commutation of the reinsurance agreement (a termination of the agreement along with settlement of any outstanding losses) to provide for liquidity to enable the redemption. A critical mass of investors may have the right to extend the reinsurance agreement for an additional term with non-participating investors given redemption rights.

Tax Considerations

A tax adviser for a fund investing in a sidecar should consider whether the sidecar may be treated as engaged in a trade or business outside of the tax haven where the sidecar is organized. This is generally a fact-specific inquiry with no clear guidelines, but

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New Vehicles for Private Equity and Hedge Fund Investment (cont. from page 8)

significant economic effect. For example, the determination that a sidecar is engaged in a U.S. trade or business may result in U.S. taxation of the income that is effectively connected with such trade or business and additional taxation under the branch profits rules. U.S. tax advisers for sidecars generally impose strict limitations on the type of activities that the sidecar may conduct in the U.S., restricting directors and shareholders from meeting in the U.S. (and individual directors/shareholders from participating in meetings telephonically from the U.S.), and prohibiting execution of any "substantive" documents in the U.S. Because sidecars generally engage in fewer activities than a traditional insurance company, any activity may be significant for these purposes. Note that it is also possible for the sidecar to be treated as engaged in a U.S. trade or business as a result of the investment activities in the trust account for the benefit of the insurance partner, although some comfort may be derived from safe harbors that allow foreigners to trade in stocks, securities and commodities without such trading being treated as a U.S. trade or business.

Because sidecars are corporations for U.S. tax purposes, they may be treated as "controlled foreign corporations" (CFCs) or "passive foreign investment companies" (PFICs) with respect to their U.S. investors. Some U.S. investors subject to the CFC rules may (1) recognize income generated by the sidecar before receiving distributions of such income and (2) have some of their disposition gain characterized as ordinary income, rather than capital gain. Similarly, a U.S. investor in a PFIC recognizes income on a "pass-through" basis assuming such investor makes certain U.S. tax elections with respect to its interest in the PFIC. While U.S. tax advisers to sidecars often impose limits on investment in the sidecar to avoid CFC status, because sidecars often distribute their income on an annual basis and because they are typically one to three year deals, phantom taxation described above may not be especially significant in this context.

* * *

Sidecars are an innovative response to dislocations in the insurance markets caused by Hurricanes Katrina, Rita and Wilma and other significant loss events. The financial performance of the current generation of sidecars and, in the short run, the continuation of the current hard market cycle, is likely to determine whether sidecars continue to attract funding from private equity and hedge fund investors. ■

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Hedge Fund Investment Advisers (cont. from page 16)

testimony and the SEC initiatives already underway, many are skeptical that any such bill will gain support.

The SEC staff is still considering additional rulemaking, including, as noted above, a new anti-fraud rule under the Investment Advisers Act that would have the effect of "looking through" a hedge fund to its investors. The SEC staff is currently analyzing what the contours of such a rule might be. Managers that extended lock-ups to avoid registration may wait until this rule is issued before determining whether to shorten lock-ups. Thus, it is premature to conclude whether shorter lock-ups will return as result of the Rule's invalidation or whether the Rule was around long enough to have modified industry standards to make longer lock-ups easier to market.

Although its tenure was brief, the Rule will undoubtedly have lasting effects. For some, the Rule may have been nothing but an unwanted business intrusion – either forcing them to lengthen lock-ups or register with the SEC and comply with rules which had few, if any, perceived benefits. For these advisers, the demise of the Rule was welcome. For others, the Rule may have helped reinforce or even stimulate a compliance culture with unanticipated benefits for both the firm and investors alike. In view of the various issues to be considered, each hedge fund adviser that registered — and even those that did not — can now take the time to make an individual assessment without the pressure created by the now invalidated Rule. ■

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What to Do if Your Hedge Fund is on Uncertain Ground (cont. from page 14)

tempted to reflect a more modest mark down if the underlying fund represents a significant portion of its portfolio.

The underlying fund's suspension of redemptions may also affect the liquidity that a fund of funds can provide its own investors. A fund of funds is typically entitled to suspend its own redemptions if one of the underlying funds in which it is invested has suspended redemptions. However, this is a drastic remedy where the underlying fund represents 5% or less of the fund of funds portfolio and may send the wrong message to investors. Nevertheless, the fund of funds will not be able to satisfy properly a redemption request from one of its investors if it does not have a reasonable valuation on which to base the value of the interest to be redeemed (a portion of which will be allocable to the underlying fund) or the ability to liquidate the holding in the underlying fund.

A fund of funds marketing itself to new investors may also want to assure potential new investors that any new investor will not participate in an underlying fund that is threatening bankruptcy or liquidation. Side pocket mechanisms can be used to segregate bad investments and permit new investors to participate in the rest of the portfolio minus the bad apple. However, the segregated investment may still tarnish an otherwise clean track record for the fund of funds' foreseeable future. Also, not all fund of funds are authorized under their documentation to implement side pockets.

Divvying Up the Leftovers

New hedge fund investors might ask whether a hedge fund that liquidates after severe losses is obligated to give back performance fees earned during profitable years to ensure investors see a return of capital. Not a chance. The so-called "GP clawback" is a creature comfort of private equity funds but generally unheard of in hedge funds. This is a fundamental aspect of the hedge fund bargain. A hedge fund investor generally controls the timing of its entry and exit from a fund. An investor may enter the fund at a time when the fund is below its high watermark (and thus not entitled to any incentive fee). The investor can then redeem once the fund has returned to a more profitable phase before any future losses might occur, thus enabling the investor to pocket the short term profits. But the converse is also true: investors that enter a fund during a profitable period and redeem during a down phase are not entitled to claw back the profits previously made by the fund sponsor.

The Side Letter Twist

The prevalence of side letters between hedge fund investors and fund sponsors can exacerbate problems that arise when a fund opts to liquidate following steep losses. Investors sometimes succeed in negotiating side letter provisions that entitle them to more frequent liquidity, a shorter redemption notice period, enhanced transparency or all of the foregoing. This could mean that some investors are able to redeem shortly after learning of bad news while others are obligated to sit and wait as fund assets dissipate.

The press highlighted such scenarios in the Lipper and Bayou collapses in 2005. High-profile investors escaped near disaster through early exits while other investors were left holding the bag, or whatever was left in it. Many of these investors claimed that those who had exited early had in fact run off with proceeds that should rightfully be shared with other investors.

Although the extension of preferential liquidity when coupled with enhanced transparency may raise serious fiduciary concerns for a fund sponsor, it does not necessarily entitle one fund investor to the assets of another. In the absence of a contractual term to the contrary, under Delaware law, a fund investor is obligated to return distribution proceeds only if it knew that the fund had made a distribution that, together with fund liabilities, exceeded the fair value of the fund's assets. Although fund sponsors typically do implement a contractual term to the contrary in their fund documents — to ensure that the fund can "claw back" distributions from an investor regardless of whether an investor knew a distribution was improper — this is exactly the contractual term that some side letter arrangements may override.

These side letter practices underline the fact that hedge funds are no longer simply sold — they are negotiated. Although typically investors do not negotiate hedge fund documents as thoroughly as private equity fund documents, hedge fund investors routinely negotiate side letters covering anything from key man redemption rights to strategy restrictions. There is little reason then that investors could not negotiate different contractual protections affecting their treatment during a fund crisis. However, investors should be careful what they — and more importantly, what other investors — negotiate. The provisions an investor may seek to alter are the very same ones that may prevent a run on the fund and enable a fund sponsor to preserve remaining value in a portfolio. ■

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