DEBEVOISE & PLIMPTON
PRIVATE EQUITY REPORT

Winter/Spring 2007 | Volume 7 | Numbers 2 & 3

The Tender Offer Returns: What Does It Mean for Private Equity Buyers?

Introduction

Because of a recent clarification by the SEC of its "best price" rule relating to tender offers, private equity firms are likely to need to add tender offers to their play book in order to compete with strategic buyers for public company targets.

In recent years, tender offers have become virtually extinct in private equity and many other transactions because of conflicting judicial decisions about the scope of Rule 14d-10, otherwise known among deal professionals as the "best price" rule. On its face this rule seemed relatively straight forward: it required that with respect to any tender offer all security holders be paid the highest price paid to any security holder in the tender offer. Yet, in the early 1990's some influential courts held that certain compensatory arrangements with officers and other employees of a tender offer target who tender shares into a pending tender offer could constitute consideration paid to those holders with respect to such tendered shares. This led to the virtual demise of the tender offer as an acquisition structure in transactions in which the acquiror sought new employment or similar arrangements with target management.

CONTINUED ON PAGE 23

© 2007 Marc Tyler Nobleman / www.mtncartoons.com

"I'd like to make you a tender offer."

WHAT'S INSIDE

3 Taking Private Managers Public: Structuring Issues
5 Private Equity Firms Discover the Spin-off
6 Trendwatch: Selected Terms of Recent Megafunds
9 Fund Formation in Emerging Markets
11 Private Equity Activity in Korea and India
13 Alert: ERISA and the 25% Exception
15 The Impact of the U.S. Foreign Corrupt Practices Act on Private Equity Deals
17 Alert: SEC Proposal May Limit Ability of Natural Persons to Invest in Certain Private Funds
19 A Sellers' Deal Market: The View From Europe
21 Alert: SEC Proposes Antifraud Rule Targeting Private Equity and Hedge Fund Advisers
22 Alert: The Shopping Spree Continues

Letter from the Editor

For those of you similarly immersed in the Private Equity scene, it will come as no surprise that we are uncharacteristically late with our Winter Issue. The Private Equity world has never been more consuming. Amidst unprecedented deals of record-breaking size rushing to close while the financing markets remain robust comes enhanced government scrutiny of private equity activities and an increasingly skeptical public perception of the asset class' contribution to the global economy. While private equity managers structure public offerings of both themselves and their portfolio companies, at least one Delaware court has suggested that private equity buyers, once shunned by management teams, are now actually preferred over strategic acquirers. Meanwhile, the industry is organizing itself to counteract popular criticism about the benefits of private equity. We expect you can see why we combined the Winter/Spring issues of the Private Equity Report to cover a broad range of topics and to allow for more in-depth analysis of current issues facing fund managers and investors.

First, on our cover, Andy Sommer and Greg Woods discuss how the recent clarification by the SEC of the "best price rule" may signal the return of the tender offer as a useful tool for private equity buyers. Separately, one of the hottest topics in the private equity world is the public offering of private equity fund managers — the ultimate convergence of private equity and the public markets. Our multi-disciplinary team analyzes structuring considerations relating to taking private equity mangers public.

As its proponents are delighted to point out in response to recent critics, private equity has been one of the most successful asset classes of the last 20 years, outperforming traditional M&A deals and stock indices alike. One of the key drivers of this success has been the ability of private equity fund managers to find and create value in underperforming assets. Today, private equity has turned its attention beyond the United States and Europe to the less developed markets of Asia and South America. We examine the challenges of investing in the emerging markets from several perspectives, with Michael Gillespie and Jennifer Burleigh exploring the challenges of fund formation and related issues and Thomas Britt and Mark Lee of our Hong Kong office focusing on a host of important considerations applicable to M&A activity in Korea and India.

In our Trendwatch column, Michael Harrell and Andrew Ahern outline common terms found in recent megafunds in both the United States and Europe. Elsewhere in this issue, Geoff Burgess and David Hickok review the contractual state of play in European auctions.

As the private equity scene continues to evolve, so too does our approach to publishing this report. I am pleased to announce that Steve Hertz and Andy Sommer, two of my favorite colleagues, will act as Associate Editors, and will join Ann Murphy and me as members of our Editorial Board. Steve and Andy are both seasoned private equity transactional lawyers, and I know that you will look forward to their participation in bringing you our firm's perspective and analysis of the latest private equity developments.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of

Debevoise & Plimpton LLP

919 Third Avenue
New York, New York 10022
1 212 909 6000

www.debevoise.com

Washington, D.C.
1 202 383 8000

London
44 20 7786 9000

Paris
33 1 40 73 12 12

Frankfurt
49 69 2097 5000

Moscow
7 495 956 3858

Hong Kong
852 2160 9800

Shanghai
86 21 5047 1800

Please address inquiries regarding topics covered in this publication to the authors or the members of the Practice Group.

All contents © 2007 Debevoise & Plimpton LLP. All rights reserved.

Franci J. Blassberg
Editor-in-Chief

Stephen R. Hertz
Andrew L. Sommer
Associate Editors

Ann Heilman Murphy
Managing Editor

The Private Equity Practice Group

All lawyers based in New York, except where noted.

Private Equity Funds
Marwan Al-Turki – London
Ann G. Baker – Paris
Kenneth J. Berman – Washington, D.C.
Jennifer J. Burleigh
Woodrow W. Campbell, Jr.
Sherri G. Caplan
Jane Engelhardt
Michael P. Harrell
Saloni Joshi – London
Geoffrey Kittredge – London
Marcia L. MacHarg – Frankfurt
Andrew M. Ostrognai – Hong Kong
David J. Schwartz
Rebecca F. Silberstein
William L. Sturman

Hedge Funds
Byungkwon Lim
Jennifer A. Spiegel

Mergers & Acquisitions
Andrew L. Bab
E. Raman Bet-Mansour – Paris
Paul S. Bird
Franci J. Blassberg
Richard D. Bohm
Thomas M. Britt III – Hong Kong
Geoffrey P. Burgess – London
Marc Castagnède – Paris
Margaret A. Davenport
Gregory V. Gooding
Stephen R. Hertz
David F. Hickok – Frankfurt
James A. Kiernan, III – London
Antoine F. Kirry – Paris
Marc A. Kushner
Li Li – Shanghai
Christopher Mullen – London
Dmitri V. Nikiforov – Moscow
Robert F. Quaintance, Jr.
William D. Regner
Jeffrey J. Rosen
Kevin M. Schmidt
Thomas Schürrle – Frankfurt
Wendy A. Semel – London
Andrew L. Sommer
James C. Swank – Paris
John M. Vasily
Philipp von Holst – Frankfurt

Leveraged Finance
Katherine Ashton – London
William B. Beekman
David A. Brittenham
Paul D. Brusiloff

Taking Private Managers Public: Structuring Issues

Over the past several years, a number of alternative investment firms have considered taking themselves public in the United States, but none had done so until Fortress pulled the trigger in February of this year. Now it appears Fortress and soon Blackstone may be the trailblazers for several such IPOs. As we go to press, other high profile firms are rumored to be seriously considering the merits of a public offering.

Given the initial success of the Fortress IPO and the anticipation that the Blackstone IPO may be even more successful than the Fortress IPO, we believe this a good time to review some of the key issues to be considered in taking an alternative investment manager public, and to examine the structuring issues that will be on the minds of private fund managers — and their investors — in connection with any determination to go public.

Valuation

The threshold question of viability for an IPO of an alternative investment manager, as with any IPO, is valuation: Is the public willing to pay what the principals think their business is worth?

A private equity firm, hedge fund manager or other alternative asset manager (a "Manager") and its affiliates and principals earn income from management fees and carried interest (or, in the case of a hedge fund, incentive allocation or incentive fees) paid or distributed by the investment vehicles (*e.g.*, private equity and hedge funds and managed accounts) that are sponsored or advised by the Manager. As such, the real value of a Manager is based to a great extent on the value of these current management fee and carried interest revenue streams, as well as the goodwill of the business and its expected ability to raise future funds, make future (hopefully profitable) portfolio investments and generate future management fees and carried interest.

Valuing even the current management fee and carried interest is highly challenging and requires making a large number of assumptions; valuing future fees from future funds is even more speculative and difficult. The value of management fees expected to be received on current portfolios alone depends on many factors, including the management fee percentage, the amount of assets under management and (because fees often vary as investments are disposed of or as net asset value fluctuates) the timing of dispositions or the value of the portfolio. Similarly, valuing the carried interest expected to be received from current portfolios requires consideration of numerous factors and the making of many assumptions, particularly as to the anticipated sale prices of portfolio holdings, many or most of which may be highly illiquid. The current value of a private equity portfolio, for example, could suggest that a substantial amount of carried interest may eventually be paid out. However, whatever their carrying value, those current investments may or may not in fact yield significant profits when monetized and indeed may generate significant losses, depending on factors outside the control of the Manager.

The threshold question of viability for an IPO of an alternative investment manager, as with any IPO, is valuation: Is the public willing to pay what the principals think their business is worth?

Some Managers may derive substantial income from advisory and other businesses, such as Blackstone does, as well as from management fees and carried interest, making it somewhat less speculative to assign value to these components of the expected revenue stream, particularly those tied to future fees.

The market's assessment of these questions will of course dictate a crucial element of any Manager IPO: How much of a Manager's performance-based income will need to be given to the public in order to make the upside sufficiently attractive to investors?

Assuming the economics can be made to make sense, the following issues would need to be addressed in any IPO of a Manager:

General Business Concerns

To Consolidate or Not to Consolidate. To fine tune their assessment of the Manager's value, public shareholders will want to assess the financial statements and operations of the

CONTINUED ON PAGE 4

Pierre Clermontel – Paris
Alan J. Davies – London
Peter Hockless – London
Alan V. Kartashkin – Moscow
Gregory H. Woods III

Tax
Andrew N. Berg
Pierre-Pascal Bruneau – Paris
Gary M. Friedman
Peter A. Furci
Friedrich Hey – Frankfurt
Adele M. Karig
David H. Schnabel
Peter F. G. Schuur – London
Marcus Strock
Richard Ward – London

Employee Compensation & Benefits
Lawrence K. Cagney
David P. Mason
Alicia C. McCarthy
Elizabeth Pagel Serebransky

Trust & Estate Planning
Jonathan J. Rikoon
Cristine M. Sapers

The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. Federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

Manager as distinct from those of the funds and other investment vehicles under the Manager's direct or indirect management. Otherwise, the revenue streams generated by those investment vehicles may become mixed in with, and obscured by, the underlying investments of the funds and associated income. In addition, the principals of the issuer may want to protect the confidentiality of certain competitively sensitive information, which would appear in financial statements of the funds, from the issuer's public investors, such as details concerning individual fund investments.

Separation of fund performance from Manager performance may be complicated by the fact that U.S. GAAP typically requires consolidation of a fund's financials with those of its general partner (or managing member or investment manager) depending on the structure, unless the fund agreement provides for removal of the general partner, for example, without cause by a vote of a majority in interest of the fund investors. Apart from such a no-fault removal provision being unattractive to most Managers from a business perspective, this type of general partner removal provision may have regulatory implications. For example, a no-fault general partner removal provision is inconsistent with the type of general partner removal that the FCC allows to be included in fund partnership agreements in order that ownership of FCC-licensed portfolio companies not be attributed to fund investors (such attribution can cause problems for the investors and the FCC-licensed portfolio companies if, for example, it results in a violation of the FCC's multiple and cross-ownership rules).

Retaining Control over Investment Discretion. Following the offering, the entity brought public, which may be an affiliate or parent of the Manager, will by definition share a portion of its profits with its public shareholders. But what about the governance rights typically associated with the ownership of shares? Principals of a Manager in the private equity and hedge fund businesses will not want — nor will its fund investors want — to share their investment management and discretion with respect to the funds under its management. For the continued success of the business of the Manager, it is critical that investment discretion and the investment advisory function clearly be vested with the principals of the Manager, and not with public investors in the Manager, who will not have the expertise, much less the desire, to manage alternative investment funds.

For the continued success of the business of the Manager, it is critical that investment discretion and the investment advisory function clearly be vested with the principals of the Manager, and not with public investors in the Manager, who will not have the expertise, much less the desire, to manage alternative investment funds.

Happily, by using a dual class structure — with one class having economic but no voting rights and the other having voting rights — one can sever the economics associated with the Manager and its affiliates from certain related voting rights and help ensure that the investment discretion of the Manager remains entirely in-house. One can also limit the overall amount of voting shares sold to the public to ensure that voting control remains concentrated in the hands of the principals, as was the case in the Fortress IPO. Alternatively, one could use a master limited partnership in which the voting power and discretion remain concentrated in a general partner that continues to be owned and operated by the founding principals, as Blackstone contemplates doing.

Keeping the Principals at the Helm. Since a Manager's most precious assets leave every night in the elevator, a viable IPO will require reasonable assurances to the investing public that after a richly valued deal, key employees of the Manager do not leave in their Bentleys one night never to return. While this type of risk exists for any public financial services company, it is particularly true for private equity and hedge fund firms given the relatively small number of individuals often making up the core investment team for the Manager.

Because flight risk and its impact on shareholder value are obvious risks, a number of provisions will need to be negotiated to make a principal think twice before leaving. Fittingly, many of the same tools — such as employment contracts, carried interest vesting provisions, and non-compete and non-solicit provisions — that are used to discourage management of portfolio companies from leaving can be just as useful here. Economic forfeiture provisions can also work. In the Fortress IPO, for example, an agreement among the Fortress principals (to which the issuer itself was not party) required a principal who left within five years of the IPO to forfeit a portion of his equity in the intermediate companies owned by the issuer, cutting the principal off from sharing in a significant

CONTINUED ON PAGE 29

Private Equity Firms Discover the Spin-off

Private equity firms have a new acquisition tool: the tax-free spin-off. The tax-free spin-off rules allow a corporation to distribute a line of business to its shareholders without incurring tax at the corporate or shareholder level.

However, two obstacles have historically prevented PE firms from effecting an acquisition in the context of a tax-free spin-off. First, PE firms almost always use cash to make their investments and there are significant limitations on the use of cash to effect an acquisition in connection with a tax-free spin-off. Second, PE firms generally look to acquire a controlling interest in their investments, and under the so-called "anti-Morris Trust rules," the acquisition of 50% or more of the stock of the distributing company or the spun-off company (by vote or value) can cause the spin-off to be taxable at the corporate level.

PE firms have recently found ways to overcome these obstacles, as illustrated by the transactions described below.

Background about Spin-offs

If a U.S. corporation sells a line of business, the corporation is fully taxable on any resulting gain. Similarly, if a corporation distributes a business (or other asset) to its shareholders, the corporation is generally taxed on the gain as if it had sold the business (or other asset) for cash. However, under a set of complex rules that require numerous conditions to be satisfied, a corporation may distribute (or "spin-off") one line of business to its shareholders without triggering tax at the corporate level (or the shareholder level).

The tax-free spin-off rules are generally designed to accommodate two basic transaction structures — neither of which involves a PE firm. In the first, the distributing company distributes one business to its shareholders, usually in the form of a stock dividend, and there is no further corporate combination or other transaction (a "straight spin-off"). Following a straight spin-off, the distributing company and the distributed companies are operated separately, as was the case when Viacom recently completed a straight spin-off of CBS.

> Against this challenging backdrop, PE firms have acquired companies in the context of a tax-free spin-off using a variety of forms over the last year.

Under the second structure, the same distribution takes place but either the distributing company (a "Morris Trust transaction") or the spun-off company (a "Reverse Morris Trust transaction") is immediately combined with another company (the "merger partner") in an all stock merger deal. ("Morris Trust" refers to the tax case which first approved the use this structure). However, the so called "anti-Morris Trust rules" enacted in 1997 have further curtailed the ability to use this second type of structure in a tax-free spin-off. Under these rules, a spin-off will be taxable at the corporate level (but potentially not at the shareholder level) if the distribution is part of a plan (or series of related transactions) pursuant to which one or more persons acquire 50% or more of the stock of either the distributing company or the spun-off company.

As a result, while it is still possible to effect a Morris Trust transaction or Reverse Morris Trust transaction, the shareholders of the merger partner must receive less than 50% of the stock of the combined company (meaning that the merger partner must be smaller than the company with which it combines).

What Works. Against this challenging backdrop, PE firms have acquired companies in the context of a tax-free spin-off using a variety of forms over the last year.

Spin-Off with Cash Distribution. Take a public company ("pubco") with two divisions ("A" and "B"), where division A is ripe for an LBO. If pubco sells division A for cash, pubco will realize only the after-tax proceeds arising from the sale (which may be as little as 60% of the total purchase price).

As an alternative, pubco can avoid the corporate level tax entirely if it (1) borrows against division A, (2) receives a substantial cash investment from a PE firm for a significant stake in pubco's equity and (3) distributes division B, together with the cash received from the borrowing against division A and the proceeds of the PE investment, to its shareholders.

The PE firm ends up owning up to 49% of pubco, which in turn holds all of division A, the LBO candidate. Plus, the acquisition is effected with leverage, thereby generating more cash to make the overall deal attractive to pubco's stockholders and enhancing the potential return on the PE firm's contributed equity. The transaction is attractive to pubco's stockholders because in the process they can receive a substantial cash distribution and still retain ownership of 51% of division A and 100% of division B. Moreover, the transaction benefits all of the parties because it avoids any corporate tax on the sale.

While the 49% ownership cap is not ideal, it is possible to give the PE firm effective control over the board of pubco. Indeed, from the PE firm's perspective, the transaction is in some respects similar to a club deal in which the PE firm leading the transaction receives less than 50% of the equity and the club members are public

CONTINUED ON PAGE 8

TRENDWATCH

Selected Terms of Recent Megafunds

In the past two years, a number of leading U.S. and European private equity fund sponsors have raised so-called "megafunds" with capital commitments in each case that are at least two or three times higher than those of the predecessor fund. We reviewed some of the most significant business terms of megafunds raised by 16 of the industry's best known U.S. and European firms. Highlights of our findings are as follows:

Fund Size

- *U.S. Funds.* Generally between $8 billion and $10 billion, with some larger than $15 billion.
- *European Funds.* Generally between €4 billion and €5 billion, with some larger than €10 billion.
- ***Trend.*** Fund sizes have increased dramatically.

Management Fees

- *U.S. Funds.*
  - *During Investment Period.* Blended rates are common, typically 1.5% per annum on commitments up to an amount between $5 and $7.5 billion, and 1.0% on the excess. Only one fund that we included in our sample had a base rate higher than 1.5% of commitments.
  - *After Investment Period.* Generally 0.75% of invested capital. Three funds charge 1.0% (or more) of invested capital.
- *European Funds.*
  - *During Investment Period.* Generally 1.5% of commitments, blended rates are less common.
  - *After Investment Period.* Generally 1.25% to 1.5% of invested capital.
- ***Trend.*** The point at which the fee "breaks" (*i.e.*, the number above which a lower fee percentage applies) is higher. For example, a common blended rate for predecessor funds was 1.5% on commitments up to $3 billion and 1.0% on the excess. As noted, European megafunds tend not to have blended management fee rates.

Transaction Fee Sharing

The transaction fee sharing provisions vary more than the other key economic terms that we examined.

- Transaction fee offsets against management fees in the 65% to 80% range are most common. Three funds applied only 50% of deal fee income to reduce the management deal fee, while four funds shared 100% of fee income.
  - *Broken Deal Expenses.* If the fund pays broken deal expenses, six funds offset 100% of deal fee income up to the amount of such expenses.
  - *Other Thresholds.* A few funds offset a higher percentage of deal fee income once certain thresholds are reached: total enterprise value, fee income as a percentage of deal size, or total fee income received.
  - *Director's Fees.* Director's fees typically are treated differently than transaction fees. Eight funds in our sample reduce the management fee by an amount equal to 100% of such fees.
- ***Trend.*** No clear trend, though certainly this is a term that is "in play." Some fund sponsors have recently increased the percentage of transaction fees shared with the fund, while others have decreased this percentage as compared to their predecessor funds.

Profit Sharing

- *Preferred Return:* Generally 8%. Sometimes as low as 7% (three funds) or as high as 10% (two funds). Two funds in our sample did not have a preferred return.
- *Catch-up.* Generally either 80% (six funds) or 100% (seven funds) of profits are paid to the general partner once the preferred return has been paid to investors until the general partner and the investors share in profits 80/20. One fund had a 60% catch-up provision.
- *Carried Interest.* 20%, with one exception (30%).
- ***Trend.*** These terms have stayed relatively stable.

Participation by Fund Sponsor

U.S. funds generally require a higher capital commitment or participation by the fund sponsors than European funds. The European megafunds in our sample do not allow the general partner to fund its commitment through an offset against the management fee, while for U.S. funds this is quite common.

- *U.S. Funds.* Participation by fund sponsors is generally 2.0% to 2.5% of fund size.
- *European Funds.* Participation by the fund sponsors is generally 1.0% to 2.0% of fund size.

CONTINUED ON PAGE 7

Trendwatch: Selected Terms of Recent Megafunds (cont. from page 6)

- ***Trend.*** The participation by fund sponsors in predecessor funds (generally 2.5% to 3.5% of fund size) was generally higher on a percentage basis than in the megafunds raised most recently.

Investment Restrictions

- *Diversification.* Diversification caps generally range between 15% to 25% of total commitments (and 20% to 30% when bridge investments are included).
- *Foreign Investments.*
  - *U.S. Funds.* Generally the fund can invest 25% to 50% of total commitments outside of the United States. In some cases, the foreign investment cap applies only to investments outside of the U.S. and Europe.
  - *European Funds.* More restrictive than U.S. Funds. Generally 10% to 25% of total commitments may be invested outside of Europe. Some funds in our sample are not permitted to make any investments outside of Europe. ■

Michael P. Harrell
mpharrell@debevoise.com

Andrew M. Ahern
amahern@debevoise.com

Recent and Upcoming Speaking Engagements

January 10, 2007
Gregory V. Gooding
Drafting Corporate Agreements 2007
Practicing Law Institute
New York, NY

January 24, 2007
William D. Regner
Update on Corporate Governance and Its Effect on the Board of Directors in M&A Transactions; Ethical Considerations and Overview of the 2006 Proxy Season; Communications Issues
Contests for Corporate Control 2007
New York, NY

February 3, 2007
Kevin M. Schmidt
Large Cap Private Equity
Thirteenth Annual Venture Capital & Private Equity Conference, 2007
Student Clubs of Harvard Business School
Harvard Business School Campus

February 14, 2007
Thomas M. Britt III, Mark J. Lee
Current Issues in Private Equity Transactions in Asia
Debevoise & Plimpton LLP
New York, NY

February 27-28, 2007
Katherine Ashton
Are Private Equity Companies and Hedge Funds Driving the Distressed Debt Market?
Fifth Annual European Corporate Restructuring Summit
London, England

February 28, 2007
Andrew L. Bab
Tender Offers are Back! Do You Know (or Remember) What To Do?
Regulation 14D and Tender Offer Mechanics
Association of the Bar of the City of New York
New York, NY

February 26 – March 1, 2007
Li Li
Broadening the Asian Investment Opportunity: New Ways of Putting Money to Work – and Getting Out
SuperReturn 2007
Frankfurt, Germany

March 1-2, 2007
Paul S. Bird, Program Co-Chair
Special Problems When Acquiring Divisions and Subsidiaries and Negotiating the Acquisition of the Private Company
Twenty-second Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions
San Francisco, CA

March 8, 2007
James C. Scoville
The Eleventh Annual Conference: SEC Regulation Outside the United States
Corporate Governance, Continuing Obligations and M&A
London, England

March 11-13, 2007
Sherri G. Caplan
Infrastruture Funds
Eigth Annual International Conference on Private Investment Funds
London, England

March 28, 2007
Rebecca F. Silberstein
Doing Deals 2007: Understanding the Nuts & Bolts of Transactional Practice
Practicing Law Institute
New York, NY

March 29, 2007
Paul R. Berger, John M. Vasily, Bruce E. Yannett
FCPA Update: Complying with the Foreign Corrupt Practices Act
Debevoise & Plimpton LLP
New York, NY

April 18-19
Andrew M. Ostrognai
Strategies for Managing Deal Cost Expenses and Workshop: Key Fund Terms in Asia Limited Partnership Agreements
2007 Asian Private Equity Partners Forum
Hong Kong

Private Equity Firms Discover the Spin-off (cont. from page 5)

stockholders. An example of a spin-off with a cash distribution is Clayton, Dubilier & Rice's 2006 acquisition of a 47.5% interest in Sally Beauty, the beauty supplies distribution business formerly held by Alberto-Culver.

Portfolio Company as Acquiror of Spun-Off Business. Many more possible structures are available if a PE firm's portfolio company (rather than the PE firm itself) is in a position to be the acquiror in a sponsored spin-off. For example, a public company can spin-off a business to the public and the spun-off company can immediately combine with a PE firm's portfolio company, so long as the PE firm ends up with less than 50% of the resulting company. Moreover, if the spun-off company is very large relative to the portfolio company (which would cause the PE firm to own an unacceptably small percentage of the combined company, from a commercial perspective), it is possible to reduce the size of the spun-off company by recapitalizing its outstanding stock into stock and long-term debt immediately prior to the distribution. The distributing company can (and indeed must) use the long-term debt to repay existing creditors of the distributing company. While this may seem like a tall order, distributing companies may find it quite attractive because it is economically the same as receiving cash consideration in exchange for a portion of the spun-off company. Recent examples include the Verizon/Fairpoint and the Alltel/Valor Communications deals.

Sit, Spin & Pounce. As another alternative, the public company may distribute the LBO-ready business to its public shareholders with no agreement or arrangement in place for its subsequent acquisition. A PE firm that eyes such a target generally may (immediately after the distribution) commence negotiations to acquire 100% of the stock of the spun-off company, so long as there were no (or very limited) discussions between the PE firm and the distributing company (or the spun-off company) during the two-year period prior to the distribution. See Apollo Management's acquisition of Realogy, which was distributed by Cendant.

Cross-Border Deals. Morris Trust and Reverse Morris Trust transactions are possible in the international context as well. For example, a PE firm with a foreign portfolio company could combine the portfolio company with a domestic distributing or spun-off company. For a variety of tax reasons, the foreign company would likely have to end up as a subsidiary of the domestic company. In such a transaction, pursuant to a prearranged plan, a public domestic distributing company would spin off a domestic subsidiary. Immediately thereafter, the domestic distributing or spun-off company would acquire the PE firm's foreign portfolio company for stock. The PE firm could end up with up to 49% of the post-combination domestic company. An example of a recent cross-border Reverse Morris Trust transaction (although not involving private equity) is the Domtar-Weyerhaeuser deal. ■

Gary M. Friedman
gmfriedman@debevoise.com

David H. Schnabel
dhschnabel@debevoise.com

Looking for a past article?

A complete article index, along with all past issues of the *Debevoise & Plimpton Private Equity Report*, are available in the "publications" section of the firm's website, www.debevoise.com.

Fund Formation in Emerging Markets

As markets across Asia, Latin America and Eastern Europe have surged, private equity investments in those markets have increased considerably, and sophisticated investors now routinely make investments in emerging market PE funds as part of their portfolio of alternative assets. As anyone who invests in emerging markets knows, however, not all private funds are alike, nor are all emerging markets. The number of new funds being formed, and the range of countries in which they are investing, makes it important to be sensitive to significant legal, tax and other political and economic issues that are peculiar to funds focusing on emerging markets.

In organizing and operating an emerging markets fund, private equity sponsors will typically consider, in addition to the unique characteristics and risk profile of potential downstream investments in the fund's target market, the particular legal, tax and other issues that may affect the structure and operation of the fund itself. Similarly, investors in emerging markets-focused funds will wish to deepen their understanding of these issues as they evaluate the structure and documentation of a fund in which they plan to invest.

Where to Organize

Like other funds focused on investing outside the United States, most emerging markets funds marketed to U.S. investors are formed as non-U.S. entities. However, the "right" jurisdiction for any particular fund will depend on a host of factors, including the investor base, relevant tax treaties and internal tax policies of the countries where the fund will invest. The fund's returns can be dramatically affected by the tax treatment resulting from the chosen jurisdiction, so this initial choice can be critical to a fund's ultimate success.

For investments in certain countries, the decision regarding a fund's jurisdiction (at least as the law currently stands) is quite clear-cut. For example, as discussed in more detail in our separate article on page 11 in this issue on private equity transactions in Asia, funds targeting India normally make use of a Mauritius legal entity because of the uniquely favorable tax treaty between India and Mauritius. Applicable tax treaties change with relative frequency, however, so a jurisdiction and structure that were effective even a year ago may no longer achieve the desired results. For instance, also as discussed in our article on private equity transactions in Asia, Labuan holding companies were once viewed as desirable vehicles to make investments in Korea, but are now in disrepute for that purpose as a place to organize.

> Using local structures and advisors can be a challenge for sophisticated investors, who want to know with certainty that certain basic protections critical to all PE investment — e.g., limited liability of investors, no exposure to additional tax in the jurisdiction, default rules relating to fiduciary duties — are present in the local market.

In other countries, there are jurisdictions a fund clearly wants to avoid as a place to organize. Certain Latin American countries such as Mexico, for example, impose a tax on investments made by any entity organized in certain "blacklisted" countries — essentially tax haven jurisdictions such as the Cayman Islands. Funds organized in a blacklisted country must either invest through an intermediate vehicle (or create more elaborate structures) to avoid having to pay this incremental tax. Some countries may impose lower taxes on vehicles organized in, or majority-owned by investors resident in, that country.

Several countries (Brazil, for example) have recently changed their laws in an effort to encourage capital formation within the country, using local structures and service providers. However, using local structures and advisors can be a challenge for sophisticated investors, who want to know with certainty that certain basic protections critical to all PE investment — *e.g.*, limited liability of investors, no exposure to additional tax in the jurisdiction, default rules relating to fiduciary duties — are present in the local market. Unfortunately, that certainty is difficult to come by in the context of new laws that have largely not yet been tested by the relevant judicial and regulatory decision makers. Still, regardless of the legal jurisdiction of the fund entity itself, fund mangers will typically have access to experienced deal teams and advisors available in the country of investment in order to make full use of on-the-ground experience in evaluating targets, as well as structuring investments in them.

Structuring Investment Vehicles

In addition to the jurisdiction of a fund's formation, private equity sponsors should also consider the tax implications of the fund's structure and ownership because some countries will tax an investment differently depending on the structure and ownership of the investing entity. For example, Brazil has recently introduced a new entity, known in English as a private equity investment fund (*Fundos de Investimento em Participaçes*) or "FIP," that permits foreign investors to

CONTINUED ON PAGE 10

benefit from a lower tax rate so long as they own less than 40% of the FIP's equity. Similarly, under Mexico's network of tax treaties, a foreign investor's capital gain is generally exempt from Mexican tax so long as the investor owns less than 25% of the Mexican company. Some funds deal with this by setting up multiple "alternative investment vehicles," or "AIVs," and dividing fund limited partners among them to bring each AIV's ownership below the applicable percentage. Others have organized a series of parallel funds from the outset, an approach which can be problematic in the event of the default by (or excuse of), investors in one of the parallel funds, as the resulting reallocations can no longer be done within a single vehicle but instead require selling securities between the funds, a potential taxation event.

In addition to the particular concerns relating to investments in emerging markets, a sponsor must be cognizant of the more traditional structuring concerns of its investor base. For example, if the fund plans to make an investment that could generate "unrelated business taxable income" for U.S. tax-exempt investors (for example, by causing the fund to borrow to make the investment), some of those investors may prefer that the fund interpose a tax-paying "blocker" entity between the fund and the target, or that the fund make all or a portion of the investment using an AIV that employs such a blocker. A fund's partnership agreement must provide sufficient flexibility in structuring investments to meet the tax requirements not only of the countries where it invests but also of its own limited partners.

Managing Risk

Of course, the risk profile for investments in emerging markets is generally higher than that in more developed markets. Emerging market investors regularly take on these risks, however, and take steps to try to protect against them in order to find the kind of outsized returns that these markets can sometimes offer. Investors should understand the range of economic, foreign currency, political, legal and financial risks that may exist with respect to any particular country or region, and what steps a fund sponsor is taking to address or mitigate them. Just a few of these risks are discussed below.

While…many key emerging markets have enjoyed remarkable economic, financial and political stability over the past few years, recent events in Venezuela highlight the fact that the political systems of emerging market countries, more than more established democracies, are susceptible to abrupt changes…which could adversely affect private investors.

Political and Economic Risks

Political and macro-economic risk remains an element keen in the mind of every emerging markets fund manager and investor. While it is true that many key emerging markets have enjoyed remarkable economic, financial and political stability over the past few years, recent events in Venezuela highlight the fact that the political systems of emerging market countries, more than more established democracies, are susceptible to abrupt changes in political and economic power, as well as critical shifts in government institutions and policies, any of which could adversely affect private investors. These changes need not be as dramatic as nationalizing industries or a *coup d'etat* — changes in tax treatment of foreign investment or laws governing the national exchanges or banking institutions can have an impact on the value of investments held by a fund. Changes of this sort can also constrict or eliminate avenues to liquidity, at least for periods of time.

Fund managers seek to cover these risks through a variety of measures at the fund level itself and, of course, within and among the fund portfolio investments. Some of the steps fund managers can take include: partnering with local strategic investors (whose knowledge of and contacts in industry and government can be useful), looking for club investments as a means of maximizing diversity among fund investments, structuring investments at the outset with multiple alternative avenues to liquidity and overseeing investments with an eye towards making optimal use of sometimes narrow liquidity windows.

As further protection against adverse local stock market shifts, funds often give themselves the ability to engage in various hedging transactions (*e.g.*, buying put and call options on stocks, writing covered call options on stocks and entering into stock index futures contracts). While these hedges are not guaranteed to smooth the bumps completely, they can be valuable tools in a choppy economy, assuming the stock market in the particular country is developed enough for them to work as intended.

CONTINUED ON PAGE 33

Private Equity Activity in Korea and India

Asia has captivated the imagination of numerous private equity firms and their limited partners. In 2006, private equity funds investing in Asia raised an all-time high of approximately US$32 billion, compared to US$23.6 billion raised in 2005 and the relatively paltry sum of US$6.5 billion raised 4 years ago, in 2002.

Capital is not only being raised in significant amounts; it is being deployed as well. In Asia in 2006, approximately US$39.9 billion was invested by private equity firms, compared to approximately US$12.4 billion during the preceding year. The trend has been towards larger transactions, with twelve private equity transactions in Asia in 2006 that were greater than US$1 billion in size. Unlike in the United States and Europe, control deals still represent a minority of all transactions, but this too is changing with over 50 control transactions reported in 2006. The geographic focus for many private equity funds has been North Asia, particularly Japan, Korea and China, and, increasingly, India.

Against this backdrop and the ever-increasing levels of interest in Asia within the private equity community, we examine below M&A and PE transactions in two of Asia's most important and occasionally controversial markets — Korea and India. In particular, we will discuss the relevant foreign investment restrictions, securities, anti-trust, financing and tax considerations applicable to M&A transactions generally in these jurisdictions, as well as the local private equity landscape.

Korea

Introduction

Korea is the third largest economy in Asia after China and Japan. Over 1,700 companies are listed on either the Korea Exchange or KOSDAQ, with an aggregate market capitalization of approximately $817.7 billion.

As for private equity activity, Korea is also the third largest market in Asia, with approximately $3.0 billion of capital raised in 2006, an increase of 18% compared to 2005, and $5.4 billion invested in 2006, up from a mere $1.7 billion invested in 2005. The key target sectors for private equity investments are varied and include financial services, industrial, telecom/media and consumer/retail, among others.

[I]n part as a result of [the Asian financial crisis in 1997], the Korean government and the private sector opened its doors to foreign capital and actively encouraged foreign investors, including foreign PE firms, to invest in Korea, which led to a wave of foreign investment in Korea.

Prior to the Asian financial crisis in 1997, there was little significant cross-border M&A of any kind, let alone PE activity, involving Korean companies. But in part as a result of this liquidity crisis, the Korean government and the private sector opened its doors to foreign capital and actively encouraged foreign investors, including foreign PE firms, to invest in Korea, which led to a wave of foreign investment in Korea.

Since 1997, there has been a continuing flow of significant cross-border M&A activity in Korea, with a significant amount of investments by foreign financial and strategic investors in financial institutions, including banks, securities companies and investment management companies and certain industrial companies. During this period, there have also been some significant exits from Korea by PE firms, with certain large investments receiving significant media attention for the multiples earned on invested capital.

Foreign Investment Restrictions

Korea maintains a "negative list" of industries in which foreign investment is limited or restricted. Prohibited or restricted industries include: (1) media, including broadcast, print and cable; (2) power — electricity or nuclear; (3) defense; and (4) telecommunications. Acquisitions exceeding 10% of banks and certain other financial institutions require the prior approval of the Financial Supervisory Commission (FSC). Any investor whose main business is not "financial" cannot acquire more than 4% of the voting shares of a bank or bank holding company without the prior approval of the FSC. It is unclear whether PE firms that have portfolio companies engaged in, for example, the banking or securities industry would be considered to be in the "financial" business such that it could acquire more than 4% of a bank/security firm without FSC approval.

Foreign Exchange

Any foreigner making an equity investment (including convertible bonds and other securities) in an "unrestricted" Korean

CONTINUED ON PAGE 12

corporation or a company controlled by a Korean national must file an advance notice with any branch of a designated foreign exchange bank. Once a report has been accepted, the foreign investor is clear to make the investment from a governmental approval/notice perspective. This filing is an administrative process and, in most cases, is readily approved and takes only a few weeks.

Monopoly Regulation and Fair Trade Act

The acquisition of "all or a major portion" of a business, assets or shares (newly issued or existing) of a Korean company, if the target company or acquiror exceeds certain asset or revenue targets, requires the approval of the Korean Fair Trade Commission (KFTC). The KFTC will not approve and will stop (or require divestiture if the investment is already made) any investment if it is considered to have the effect of substantially restraining competition in the relevant market. Although there have not been any major transactions which were reported to be terminated or cancelled due to KFTC issues, there have been limited cases where the KFTC required divestiture or sale of certain assets in order for the application to be approved, primarily on anti-competitive grounds. Also, there is a sense, as recent cases against Microsoft and HP in Korea have shown, that the KFTC is exercising more of its administrative powers in looking at activities that it considers impact competition.

Securities Laws

Korea's large and sophisticated capital markets provide an obvious and potentially attractive exit alternative for private equity investors. But important considerations in this regard for PE investors include the following: in order to qualify for a domestic IPO, the largest shareholder in the newly public company must be the same person or entity that was the largest shareholder of the company 12 months prior to the proposed IPO, meaning that if a PE fund were to make an investment in a company and as a result become its largest shareholder, the portfolio company would have to wait one year in order to qualify for an IPO in Korea. In addition, subsequent to such IPO, such largest shareholder and any other shareholder receiving new shares from the issuer or purchasing shares from the largest shareholder during the 12 months prior to the IPO is prohibited from selling such shares for a period of six months (12 months for KOSDAQ listed companies).

Labuan, long used by numerous private equity funds as the jurisdiction to incorporate an SPV...has fallen out of favor in recent years.

Like many countries, Korea has a mandatory tender offer regime. Any person, together with certain other related persons, acquiring 5% or more of the issued and outstanding shares of a listed company from ten or more persons during a six-month period (in an off-exchange transaction) must make a public tender offer for all of the listed company's shares. This requirement also applies to existing 5% or greater shareholders who wish to purchase additional shares.

Tax Considerations

Korea has a nominal dividend withholding tax of 25% that can, depending on a transaction's structure, be effectively reduced to as low as 5% pursuant to certain bilateral tax treaties.

The sale of securities of Korean companies generally triggers a Korean capital gains tax equal to the lower of (1) 10% of the sale proceeds from such sale and (2) 25% of the capital gains. Nonetheless, Korea's capital gains tax on sales of listed or unlisted securities can be lowered to nil depending on tax-treaty jurisdiction and non-permanent establishment status. In addition, irrespective of non-permanent establishment status or whether the investor has invested from a bilateral tax treaty country, for listed securities, there is no capital gains if, in the preceding five years, the selling shareholder's interest never exceeded 25%.

Korea has various bilateral tax treaties in place. The Korean tax service (NTS) uses a "beneficial owner" test (although the term is not explicitly defined by law) in determining which treaty, if any, should be applied. The NTS requires that an offshore investor have substantive operations in the relevant double tax treaty country for the preceding three years. What qualifies as "substantive" is also not set forth by the NTS, but factors such as director domicile, board meetings and office space, among others, are thought to be important factors. Labuan, long used by numerous private equity funds as the jurisdiction to incorporate an SPV for investing into Korea because of the advantageous Korea-Malaysia double tax treaty, has fallen out of favor in recent years. Belgium, as an alternative, survives.

CONTINUED ON PAGE 14

ALERT

ERISA and the 25% Exception

Recent changes in the plan assets rules under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), eliminate the need for many private equity funds to obtain the management rights that many were previously required to obtain (and often found difficult to obtain) to avoid operating a fund as "plan assets" subject to the extensive requirements of ERISA. Other funds, including funds of funds and many distressed debt funds, that have operated as plan assets subject to ERISA, with its higher standard of care and other fiduciary constraints, may no longer be required to do so.

These changes were brought about by the Pension Protection Act of 2006 ("PPA"), which broadened the application of the so called "25% exception." Subject to certain exceptions, when a plan subject to ERISA invests in a private equity fund, the fund becomes subject to ERISA if 25% or more of the value of any class of equity interests in the entity is held by "benefit plan investors." Under the PPA, government and foreign plans are no longer considered "benefit plan investors," and accordingly their (often significant) capital commitments are not "counted" in determining whether the 25% test has been met. Thus, for a fund to be treated as holding plan assets, at least 25% of its equity interests must be held by, or attributable to, plans subject to ERISA or section 4975 of the Internal Revenue Code of 1986, as amended (commonly referred to as U.S. corporate benefit plans). Most funds have far less than 25% of the equity interests held by corporate plans.

These changes have been welcomed by private equity fund managers who may no longer have to comply with the venture capital operating company ("VCOC") exception. Under the VCOC exception, at least 50% of a fund's investments (valued at cost) must be "good VCOC investments" (*i.e.*, investments in operating companies in which the fund obtains direct contractual management rights). For distressed debt or mezzanine funds, management rights, such as a board seat or the ability to advise and consult with management of its portfolio companies, can be difficult to secure. Leverage buyout or venture funds, which typically do not have a problem obtaining management rights, may no longer be burdened by other technical details of the VCOC rules. The list of common problems includes: a minority investment through a holding company does not qualify as a "good VCOC investment," the initial long-term investment by a fund must be a "good VCOC investment," and portfolio companies organized in foreign jurisdictions may be subject to laws which conflict with the VCOC management rights or ownership requirements.

For funds of funds that typically do not invest in operating companies, the changes brought about by the PPA are significant. Previously, such funds complied with either the burdensome restrictions of the prior 25% test (which impacted significantly their ability to accept plan investors) or ERISA's fiduciary provisions. When operating a fund in compliance with ERISA's fiduciary standards, a manager needs to satisfy ERISA's definition of an investment manager, which in most cases means becoming a registered investment adviser under the Investment Advisers Act of 1940. In addition, the manager is constrained by ERISA's fiduciary provisions including the prohibited transaction and exclusive benefit rules which may prohibit certain transactions even if it makes good business sense for the plan investor. Funds of funds managers may now free themselves of these restraints and deregister if corporate pension monies in the fund constitute less than 25% of the fund's capital commitments.

Notwithstanding its recent popularity in making the lives of fund managers easier, there are unanswered questions concerning the application of the 25% test. For example, the test is applied on a class by class basis and there is no guidance as to what constitutes a separate "class" of interests in a fund. Side letter provisions that give investors special rights or different economics may be viewed as creating a separate class. In addition, there is no guidance on how the test should be applied in the context of a fund structure where a feeder fund is established to deal with specific regulatory concerns of its investors.

With more funds relying on the 25% exception, perhaps there will be further guidance on these issues. Until then, a fund sponsor should be cautious and consistent in its application of the 25% exception. ■

Michael P. Harrell
mpharrell@debevoise.com

Alicia C. McCarthy
acmccarthy@debevoise.com

Private Equity Activity in Korea and India (cont. from page 12)

To minimize the possibility of a private equity firm being deemed to have a "permanent establishment" in Korea, the general partner should be offshore, all of the substantial decisions regarding the investment should be made offshore and, generally, no "partners" or other decision-makers should be based on-the-ground in Korea.

Domestic PE Fund Developments

In September 2004, the Korean legislature enacted laws under the "Act on Business of Operating Indirect Investments and Assets" allowing local private equity funds to be established in Korea. Such registered funds must focus on buyouts and the provision of strategic and managerial participation in the target company, and a minimum of 50% of the capital raised by a locally registered fund should be deployed within two years. Investments must be held for not less than six months. Some 20 funds have been established under these locally regulated funds, with a combined pool of approximately $5.3 billion of which approximately $2.2 billion had been employed as of the end of 2006.

A foreign financial institution may register as a local private equity fund under this statute, but must have attained "high international credibility" and cannot control more than 10% of a domestic bank in order to do so. But foreign funds are not required to register under this statute in order to make PE investments in Korea and the principal advantage of doing so is really administrative. The real relevance of this new law for foreign PE investors appears to be that it is designed to level the playing field between local and foreign private equity funds, as before the new law, local investors could not "pool" money for investment purposes. Instead, only publicly issued investment trusts were used for this purpose. As such, the law allows local PE firms to compete with foreign PE firms, reflecting an important political sentiment in Korea generally regarding fair trade.

Foreign investment in most sectors of the Indian economy fall within the so-called "automatic route" under applicable foreign investment regulations, meaning no prior regulatory approval is required.

India

Introduction

India has a long history of restricted trade, state intervention, protectionism and barriers to all forms of foreign investment following independence in 1947. A large part of the Indian economy, then and now, is dominated by family-controlled businesses, often passed down through generations. The current round of economic liberalization in India began in 1991 as a result of a severe foreign exchange shortage experienced by the Reserve Bank of India (RBI), the country's Central Bank. Significant liberalization now allows foreign portfolio and direct investments in ever-increasing amounts. As a consequence of these liberalizations, India is now one of the fastest growing economies in the world.

The local stock markets in India are extremely active, large and liquid. There are nearly 6,000 companies listed on the Bombay Stock Exchange and the National Stock Exchange in India, with an aggregate market capitalization of nearly $1.6 trillion.

As for private equity activity, India is the fourth largest market in Asia (after Japan, China and Korea) for new capital raised for private equity investments, with $2.9 billion raised in 2006, an increase of approximately 5% over amounts raised in 2005. India is also the third largest destination for private equity investments in Asia (after Japan and Australia) with $5 billion invested in 2006, a significant increase over the $1.8 billion invested in private equity deals in 2005.

The IT and telecom sectors dominate the private equity landscape in India, representing approximately 46% of private equity investments made in the country in 2006. Average transaction sizes are increasing and, although the dominant position of family-controlled businesses in the Indian economy still frequently impedes buyout transactions, buyouts are nonetheless becoming more prevalent in recent years. Indeed, over time, high sales of family businesses in India will likely drive higher levels of buyout activity.

Foreign Investment Restrictions

Foreign investment in most sectors of the Indian economy fall within the so-called "automatic route" under applicable foreign investment regulations, meaning no prior regulatory approval is required. Some sectors are "automatic" only up to specified caps (*e.g.*, telecoms (74%) or insurance (26%), while other sectors (multi-brand retailing; agriculture) remain closed to foreign investment. If an approval is needed, the relevant regulatory

CONTINUED ON PAGE 34

The Impact of the U.S. Foreign Corrupt Practices Act on Private Equity Deals

Introduction

Given the challenging nature of the current political and public relations environment for private equity sponsors, the last thing a private equity sponsor wants now is to buy itself into corruption exposures that are attracting a similar kind of negative attention. For this reason, private equity firms are well advised to take note of the raft of recent enforcement actions by the U.S. Department of Justice ("DOJ") and the U.S. Securities and Exchange Commission ("SEC") under the 1977 U.S. Foreign Corrupt Practices Act ("FCPA"), and to carefully consider potential FCPA-related exposures at a potential target early in the deal process. Indeed within the past month, following a high profile settlement in connection with General Electric's purchase of Vetco International's oil-and-gas service businesses, U.S. Attorney General Alberto Gonzales made clear that FCPA enforcement is and will remain a top priority.

Assessing FCPA risk creates a unique challenge in M&A deals because of the broad transnational reach of FCPA, and the sometimes counter-intuitive and novel way in which the statute overcomes traditional veil-piercing and scienter requirements (particularly respecting civil liabilities) to impose liability upon corporate parent entities, especially those whose securities are registered with the SEC. But because of the severe direct and collateral legal and commercial consequences arising from buying or selling assets (such as contracts and customer relationships) that currently benefit from, or have historically benefited in some way from corruption, and the practical difficulty of allocating all FCPA exposures to the buyer or seller as a matter of contractual risk allocation, identification and evaluation of FCPA-related exposures should be an essential component of due diligence in any multinational M&A deal.

History of the Statute

FCPA was enacted in response to disclosures made in the early 1970s by U.S. companies, including numerous Fortune 500 corporations, of making "questionable payments" of hundreds of millions of dollars to foreign officials, politicians, and political parties. In response, the U.S. Congress enacted amendments to the U.S. securities laws that (1) prohibit paying bribes to non-U.S. officials; (2) require that a U.S. issuer's books and records disclose, in reasonably accurate detail, the company's transactions and disposition of assets; and (3) require a system of accounting and other internal controls reasonably designed to assure that bribery and other control failures do not take place.

> Assessing FCPA risk creates a unique challenge in M&A deals because of the broad transnational reach of FCPA, and the sometimes counter-intuitive and novel way in which the statute overcomes traditional veil-piercing and scienter requirements.

Anti-Bribery Provisions of FCPA

FCPA makes it a crime punishable under U.S. law, as well as a civil violation, for any covered person or entity "corruptly" to confer payments or benefits on non-U.S. government officials for the purpose of obtaining or retaining business or other improper advantages (such as favorable tax or customs rulings). The standard of knowledge required of the covered person or entity is the "knowing" standard. Conscious avoidance of facts that would cause a prudent manager to believe that there is a risk that bribery is occurring is sufficient to trigger liability.

In addition to applying to a company's employees' or subsidiaries' activities, the statute applies to bribes paid by distributors, agents, brokers, business or joint venture partners, and other intermediaries, including local law firms, travel agents, and the like.

A covered person or entity that knows or consciously avoids knowing that a distributor or other intermediary has paid or promised to pay benefits to a non-U.S. official faces the same risk of prosecution as does a company that knows or consciously avoids knowing that its own employees are making such payments or promises.

The statute defines "foreign officials" as including anyone employed full- or part-time by a non-U.S. government entity, including civil servants, employees of state-owned corporations, provincial or municipal governments, and government-owned educational institutions. "Foreign officials" also include candidates for office, political party officials and employees of more than 75 international organizations, including the UN, EU, and OAS entities, as well as the Asian and African Development Banks, the World Health Organization, and the International Committee of the Red Cross. Payments to non-U.S. political parties are treated as payments to non-U.S. officials.

Potentially any benefit, including an intangible benefit, may be viewed by U.S. regulators as sufficient to trigger the statute's prohibitions. Payments to relatives

CONTINUED ON PAGE 16

of officials, including travel costs for family members accompanying an official on a trip, or a contribution to an official's favored charity have triggered the statute's provisions.

The statute's prohibitions and requirements apply to any issuer of registered securities (including ADRs listed on a stock exchange), any U.S.-domiciled corporation or entity with a principal place of business in the U.S., any U.S. citizen or resident (including green card holders) acting anywhere in the world, and any other persons or entities (regardless of nationality) committing acts that touch U.S. territory. Almost any contact with the U.S. can trigger U.S. jurisdiction.

Books, Records, and Internal Controls Provisions

The recordkeeping and accounting provisions of FCPA were intended to deal with techniques used by SEC-registered corporations to disguise bribes paid to non-U.S. officials by not recording those payments at all or by recording the payments in a dishonest manner (*e.g.*, accounting for bribes as "travel" or "consulting costs").

FCPA imposes two requirements with respect to books and records. First, any company whose securities are registered in the U.S. must make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company. Second, the company must devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that all transactions are executed in accordance with management's authorization and recorded in conformity with generally accepted accounting principles.

Generally, penalties are not imposed for insignificant, technical, or inadvertent violations of the recordkeeping and accounting provisions. Willful concealment of bribery or other misconduct through alteration of a registered company's books and records, however, is a serious violation of FCPA.

But another feature of FCPA's books and records provisions is that, for civil liability to attach, there is no requirement that the parent company have any specific knowledge, or even suspicion, that a subsidiary's books contain any misleading entries. The fact that bribes appear to be booked as innocent transactions at a non-U.S. subsidiary will be sufficient to trigger U.S. regulatory jurisdiction even though an SEC-registered parent company into whose books the subsidiary's profit, loss, and other financial records roll up is completely lacking in knowledge of the underlying misconduct. An SEC-registered parent company is likewise strictly liable for the internal controls failures of its subsidiaries, such as lax enforcement of grant-of-authority procedures.

[E]ven in deals where a buyer is able to negotiate favorable contractual protections for FCPA-related exposures... U.S. regulators may nonetheless seek to assert charges against both the buyer and the seller of the tainted business or assets.

The books, records, and internal controls provisions of FCPA do not contain a "materiality" threshold. Although books, records, and internal controls need be only reasonable, not perfect, under FCPA, the materiality standards governing reporting of material weaknesses and deficiencies under Section 404 of the Sarbanes-Oxley Act do not apply, and less serious books, records, or internal controls problems can still give rise to U.S. regulatory scrutiny, particularly if there is evidence of underlying bribery.

Enforcement Activity Under FCPA

As an increasing number of U.S. and foreign companies are becoming painfully aware, the risks of non-compliance with FCPA are serious and far-ranging, hence raising red flags for buyers of potentially affected businesses. Fines and disgorgement orders imposed as conditions of settlement by the DOJ and SEC can exceed — and recently have exceeded — tens of millions of dollars, and can also include criminal fines. One company, Titan Corporation, settled charges in 2005 by paying more than $28 million in fines and disgorgement as a consequence of allegedly corrupt payments uncovered in the course of due diligence in connection with its proposed merger with Lockheed Corporation. Only very recently, as mentioned above, another firm, Vetco, caused three of its subsidiaries to plead guilty and a fourth to enter into a deferred prosecution agreement resulting in fines of $26 million — the largest set of fines in the 30-year history of FCPA.

A criminal conviction of a U.S.-registered corporation will negatively affect the company's disclosure obligations to the investing public. It can also have a wide-range of other collateral effects: loss of eligibility for U.S. government contracts, benefit program participation, or export licenses; increased U.S. tax liability; private lawsuits brought in a

CONTINUED ON PAGE 18

ALERT

SEC Proposal May Limit Ability of Natural Persons to Invest in Certain Private Funds

Individual investors have never been private equity managers' favorite source of capital and recently proposed SEC rules would make it even more difficult for many wanna-be investors to participate in traditional private equity funds. One of the proposed rules in the SEC's 2006 year-end investor protection project aimed at private funds will impose new restrictions on the ability of Section 3(c)(1) funds (vehicles held by more than 100 beneficial owners and that are not offered publicly) to raise funds from natural persons. Section 3(c)(7) funds will not be affected.

The restriction takes the form of amendments to Regulation D of the Securities Act of 1933, which provides a "safe harbor" for avoiding registration under that Act. Today, Regulation D permits securities to be sold to "accredited investors," which include any natural person with an annual income in excess of $200,000 (or joint income together with a spouse of $300,000) or a personal net worth (or joint net worth together with a spouse) of $1 million.

The proposed rules would also require that a natural person acquiring securities in a Regulation D offering of a Section 3(c)(1) fund (other than a venture capital fund) be an "accredited natural person" — an investor owning $2.5 million of "investments."

The term "investments" is based on the definition of that term used in the Investment Company Act to determine when a prospective investor in a Section 3(c)(7) fund is a "qualified purchaser," and includes most securities and financial holdings. There are some changes, however, from the Section 3(c)(7) approach:

- Only 50% of the value of any investments held jointly with a spouse would count towards the $2.5 million threshold unless the investment is being made jointly.
- The $2.5 million threshold would be adjusted every five years for inflation.

Existing accredited investors in Section 3(c)(1) vehicles who do not meet the new standard would not be grandfathered for purposes of new investments that they make in the pool. It is unclear whether they will be grandfathered with respect to existing commitments not yet drawn upon.

While most private funds rely on Regulation D when offering their securities because it provides certainty, a fund that structures a private placement in reliance on Section 4(2) of the Securities Act, or a non-U.S. fund that offers its securities outside of the United States in reliance on Regulation S, would not be affected by the amendments.

The proposed rules do not address investments by a fund manager's employees. Employees who do not meet the "accredited natural person" standard may have to be counted against the 35 non-accredited investor limit of Regulation D even if those employees are "knowledgeable employees" (and thus need not be counted against Section 3(c)(1)'s 100 beneficial owner limitation). This could undermine sponsors' efforts to align employees' interests with the funds they help manage. Although fund sponsors could seek to rely on Rule 701 of the Securities Act (an exemption for certain employee offerings), this exemption may not always be available in practice.

Venture capital funds would be excluded from the rules because of the perceived benefits they provide to small businesses. A "venture capital fund" would be a fund that meets the definition of "business development company" in the Advisers Act. This definition is not meaningful for most foreign venture capital funds because it requires that investments be made in U.S. small businesses and that the fund be organized in the U.S.

We are preparing a comment letter to the SEC addressing the proposed limitation on Regulation D investor accreditation rules as well as the proposed antifraud rule, which we discuss on page 21 of this issue. ■

Jennifer A. Spiegel
jaspiegel@debevoise.com

derivative capacity; unfair trade practice suits by competitors; civil suits arising under the Racketeer-Influenced and Corrupt Organizations Act; and arbitration proceedings to void the underlying agreements procured through alleged corrupt activities.

For companies in industries that are closely regulated by or involved as suppliers to the U.S. government, such as the financial services, pharmaceutical, or defense industries, the effects of a criminal conviction can be crippling to the company's U.S. business. Pharmaceutical companies may lose the ability to participate in U.S.-funded health insurance programs such as Medicare, Medicaid, or CHAMPUS. Defense companies may lose the ability to bid for military contracts. Banks, insurers, and other financial services firms, together with their subsidiaries, can lose their ability to serve as broker-dealers or pension fund advisors, or forfeit their licenses to sell insurance throughout the U.S.

The United States consequences may be only the beginning, for now each of the country signatories to the OECD anti-bribery convention has its own anti-bribery statute that may govern a particular alleged violation. A company ensnared in a bribery scandal may find itself subject to multiple criminal and civil proceedings in the United States, its country of domicile (if not the United States), as well as any of the jurisdictions where alleged corrupt acts or related money-laundering transactions may have taken place. Plus, of particular relevance to PE buyers of course, is the potential impact of these kinds of scandals on management teams. Individuals who violate FCPA, conspire to violate it, or aid and abet violations, can face many years' imprisonment and civil and criminal fines, not to mention collateral effects.

Risk Allocation Considerations in M&A Deals

FCPA's breadth, together with its largely judicially untested status, creates unique and varied challenges for buyers and sellers of potentially affected businesses with respect to the risk allocation of these potential exposures. First, buyers and sellers must correctly identify and evaluate potential exposures in this high risk context, where spotting violations can be a little bit like finding a needle in a hay stack. And second, as with all liabilities in all deals, buyers and sellers must negotiate, to the extent feasible, the allocation of these risks. Thus, in asset deals, the scope of buyer's assumption of FCPA liabilities, and, in stock and merger deals, the degree and duration of seller's FCPA-related representations and related indemnities, are of course particularly significant in shaping that risk allocation.

But even in deals where a buyer is able to negotiate favorable contractual protections for FCPA-related exposures, it faces collateral economic and even legal risk associated with any identified FCPA liabilities ostensibly left behind with a seller. As a practical matter, for example, even if buyers and sellers agree contractually to allocate all identified FCPA liabilities to a seller, U.S. regulators may nonetheless seek to assert charges against both the buyer and seller of the tainted business or assets. And even if the regulators respect a buyer's and seller's contractual allocation of such liabilities, a buyer of a business with a history of FCPA problems is presumably subject to lost revenues and other consequential damages at the target business. Put most directly, once a bribery scheme is exposed, the benefits obtained may well be forfeited and commercial goods can be significantly eroded.

Indeed, in many ways, given the nature of FCPA exposures, a buyer's most effective contractual protection against it may be simply to pay less for the business, thereby effectively self insuring the exposure.

Effective FCPA Due Diligence

For these reasons, PE and other buyers have a strong interest in identifying and resolving any FCPA-related and similar anti-corruption issues to the greatest extent possible in advance of finalizing a deal's purchase price and other key financial terms. And, as with all potentially messy liabilities, to best evaluate and negotiate the FCPA risks in any particular transaction, the parties must first devise and implement a due diligence review plan to vet the potential risks.

An effective FCPA due diligence plans, like good FCPA compliance programs, must take into account (1) the broad definitions of non-U.S. officials and covered benefits or payments; (2) the applicability of FCPA to payments to agents, intermediaries and other third parties; (3) the impact of FCPA on mergers and acquisitions; (4) the strict liability and lack of materiality standards that apply to books and records violations by parent entities; and (5) the limited protection afforded by the jurisdictional limits upon the anti-bribery provisions in light of the conscious avoidance doctrine and the practical realities of modern communications in the internet age.

Specific steps that should be strongly considered as part of any comprehensive diligence exercise in this regard may include:

- Assessment of the risk profile of countries in which the target company or any of its subsidiaries operate or have historically considered operating.

CONTINUED ON PAGE 36

A Sellers' Deal Market: The View From Europe

Every player in the European private equity market is familiar with the eroding standards of buyer protection being offered up in auction sales of businesses. All too often the seller's first draft purchase agreement is circulated relatively late in the auction process with the stern admonition that extensive markups will place bidders at a competitive disadvantage.

This first draft typically contains only the barest wisps of warranties, generously qualified by the entire contents of the seller's data room. This slim offering is often further restricted by high materiality thresholds and deductible baskets, percentage of purchase price caps on seller liability set in the single digits and/or time bars for claiming breaches of warranty that expire upon completion of the acquisition.

With increasing numbers of funds (and ever larger funds) pursuing a relatively small universe of attractive opportunities and frequently facing sellers that are themselves funds with contractual limitations on providing post-closing protections, sellers have indeed succeeded in substantially reducing the broad scope of warranty and other protections enjoyed by private equity funds in the privately negotiated deals of a decade or two ago. Still, in the right circumstances with the right counsel, we believe buyers can achieve substantial improvement on sellers' initial draft agreements even in highly competitive auctions, particularly with respect to the conditionality, warranties, due diligence and indemnification provisions of most acquisition agreements.

Conditionality

Similar to their U.S. counterparts, one area where the negotiating position of bidders in European auctions has clearly deteriorated is conditions to completion.

Traditionally, privately negotiated acquisitions contained a number of significant conditions permitting a buyer to walk away from a transaction, including absence of material adverse change in the condition or prospects of the business to be acquired, absence of material breach of warranties and, of course, most crucially, obtaining third-party debt financing for the acquisition.

But these kinds of buyer-friendly conditions have eroded in recent years, mirroring in some ways developments in European public deals where a bidder has been required for quite some time to finance fully a public offer prior to launching its offer, and to otherwise narrow its discretion to withdraw public offers based upon subjective evaluations of changes in the target's financial or other condition prior to closing. Indeed, sellers in private auctions are now increasingly taking a similar line with respect to conditions to completion and, in large headline transactions, many private equity houses feel constrained to bid on close to an unconditional basis.

Of course, there are a number of ways that bidders have tried to compensate for the additional risks incurred as a result of reduced conditions to completion. Firm financing commitments (often including a bridge financing to be taken out post-acquisition with high yield debt or other permanent financing) are often negotiated and obtained prior to submission of the final bid. Indeed, many sellers now require evidence of such firm financing commitments as part of the final bid process. To the extent feasible, conditions to the financing are being tailored to correspond to those accepted by the seller in the purchase agreement. Where failure to obtain financing remains a risk because of a gap between the financing conditions and more limited conditions to completion in the acquisition agreement, the buyer may seek to negotiate liquidated damages for failure to complete the transaction in order to avoid open-ended claims for damages by the seller if, in the worst case, the financing fails to materialize.

> Buyer-friendly conditions have eroded in recent years,...and, in large headline transactions, many private equity houses have felt constrained to bid on close to an unconditional basis.

Alternatively, the absence of a material adverse change clause or a right to walk away in the event of breach of warranty can sometimes be partially compensated for through purchase price adjustments or by purchase price formulas that include an earnout feature based upon the continued performance of the acquired business, or by old-fashioned repetition of basic warranties at closing, so as to give a buyer a basis not to close if those basic warranties are no longer true and correct at closing.

Representations and Warranties

Even in cooler markets, vendors typically argue that in circumstances like auctions, where bidders have been permitted ample opportunities to conduct due diligence,

CONTINUED ON PAGE 20

vendor warranties should not be required. In the current market, European vendors have only increasingly resisted providing meaningful representations, warranties and indemnities. However, in our experience, if a buyer's price is competitive, it is usually possible, with tenacity and an eye for creative solutions, to obtain a reasonable level of warranty protection for the buyer.

For instance, vendors typically argue that because bidders have been permitted ample opportunities to conduct due diligence, vendor warranties should not be required. Obviously, due diligence will only uncover matters disclosed and bidders should always seek to obtain basic assurances, through warranties, indemnities or otherwise, that vendors' due diligence disclosures are complete. Most well-advised, price-competitive bidders will therefore insist on reasonably complete warranties in their auction mark-ups, including as to title to and condition of assets, financial statements, absence of undisclosed liabilities or material adverse change, possession of all required permits and approvals, compliance with laws and as to transactions with affiliates, material agreements, intellectual property, environmental matters, employee benefits, and tax and social security matters, to name a few. Bidders will also usually take the position that certain fundamental warranties, such as title to the assets actually being sold, or other key assets owned by the target, not be subject to short-time bars for making claims or low value caps on seller liability. Claims under tax indemnities in particular, generally continue to be uncapped and to be subject only to a requirement that indemnification claims be made within the relevant statute of limitation.

On the other hand, in recognition of sellers' increased negotiating leverage in auctions, bidders have increasingly been willing to tailor more closely their requested protection to fit perceived levels of risk. For example, where previously bidders might seek multiple detailed warranties on various balance sheet items, today's bidders will often live with a few broader warranties on the financial statements as a whole, with requests for specific detailed warranties limited to areas of concern identified in due diligence. Another approach is to request detailed warranties but accept qualification by information "fairly" disclosed in the data room. The buyer would argue that, for example, it will take a chance that it understood the potential for adverse development of lawsuits disclosed during diligence, but not for those that have not. If the buyer can live with only information "knowingly withheld," it is important to keep a wide universe of people whose knowledge is imputed. Finally, some buyers have found that warranty insurance can add additional comfort; of course, such insurance comes at a cost (both money and time) and usually requires the seller to take a small "slice" of the risk insured.

Due Dilligence

One of the very few benefits to buyers in a well-designed European auction is the streamlining of the due diligence process. Typically, prior to commencing an auction, the seller and its financial advisers will prepare an information memorandum, legal and accounting vendor due diligence reports and a data room containing documents summarized in the reports. While the winning bidder's ability to rely legally on such reports is usually limited, in well-run auctions, such reports, backed up by data room documentation, will enable bidders to more rapidly focus on and address key legal and financial issues than was the case in the traditional private sale. As a result, concerns can sometimes be resolved prior to signing the acquisition agreements by further due diligence or by the sellers taking steps prior to signing to ameliorate identified problems.

In other cases, it may be possible to obtain a specific indemnity even where the seller is resisting broader general indemnities. While most sellers will strenuously resist a flat indemnity against all precompletion litigation or other contingent liabilities, for example, many sellers will be willing to consider specific indemnities against specific losses (or even sharing with the buyer certain losses) arising from identified, concrete, precompletion exposures which the seller may be in a better position to evaluate than bidders.

Indemnification

Many bidders have been taking a similar tailored approach to indemnification thresholds, baskets and caps. Certain fundamental buyer protections, such as title warranties, tax indemnification and indemnification for liabilities of businesses to be retained by vendors, typically continue to be uncapped or capped at a high percentage of purchase price, with relatively long periods for making claims. Depending on the business, environmental, product liability, intellectual property warranties or indemnities against indemnified litigation may also have separately negotiated limitations on indemnification claims. Finally, a buyer may agree to limit the time period for claims so long as it can complete an audit of the business. For example, a buyer may agree not to bring claims after the third month following its first audit of the target post-completion. With respect to other matters, it is not unusual to see relatively high claim thresholds or baskets and caps on seller

CONTINUED ON PAGE 22

ALERT

SEC Proposes Antifraud Rule Targeting Private Equity and Hedge Fund Advisers

When the SEC's controversial hedge fund registration rule was struck down last summer by the D.C. Court of Appeals, Chairman Cox promised the SEC would fill in some of the regulatory gaps left by the court decision. In December 2006, the SEC proposed a new antifraud rule under the Investment Advisers Act of 1940 which, together with new and more limited investor accreditation rules for certain private funds (on which we report separately), are designed to address key issues of investor protection. Those who had hoped for the demise of the hedge fund registration rule may regret what they wished for, because the proposed rule applies not only to hedge fund advisers but to all advisers — domestic or foreign, registered or unregistered — of any type of investment fund including private equity funds.

Under the proposed rule, it would constitute a fraudulent, deceptive or manipulative act, practice or course of business for any adviser (registered or unregistered) to a "pooled investment vehicle" to make any untrue statement of a material fact to any investor or prospective investor in the pooled vehicle, or to omit to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. This is the same standard as contained in Rule 10b-5 of the Securities Exchange Act of 1934, but with a twist. Unlike that rule and others that apply to fraud in connection with securities purchases and sales, the proposed antifraud rule applies "regardless of whether the pool is offering, selling or redeeming securities" — essentially, an evergreen approach to private fund investor communications.

"Pooled investment vehicle" includes any issuer that is an investment company or that would be an investment company under the Investment Company Act of 1940 but for the exclusion provided by either Section 3(c)(7) (for vehicles held exclusively by "qualified purchasers" and that are not offered publicly) or Section 3(c)(1) (for vehicles held by no more than 100 beneficial owners and that are not offered publicly). That means the rule would apply to domestic and foreign advisers to hedge funds, venture capital funds, buyout funds, other private equity funds, CDOs and registered investment companies, but not to funds relying on other exceptions from registration under the Investment Company Act, such as real estate investment trusts and oil and gas partnerships.

Other highlights of the proposed rule:

- No private right of action; enforceable only by the SEC.
- Scienter (knowledge by the adviser) not required for liability.
- Applies not only to statements made in the context of a securities offering (*e.g.*, statements in an offering memorandum or "request for proposal") but also those made in investor letters and account statements not involving an offering, including statements regarding investment strategies, experience and credentials of the adviser, investment risks, performance, valuation, operational practices and allocation policies.
- Applies to any non-U.S. adviser that advises a fund offered in the U.S. or that has U.S. investors.

We are preparing a comment letter to the SEC which will address the proposed antifraud rule as well as the proposed investor accreditation rules, discussed on page 17 of this issue. ■

Jennifer A. Spiegel
jaspiegel@debevoise.com

ALERT

The Shopping Spree Continues

As we reported in the last edition of *The Debevoise & Plimpton Private Equity Report*, target company boards have been increasingly successful in negotiating for the inclusion of "go-shop" provisions in going private transactions. Go-shop provisions allow targets actively to solicit offers from other bidders during a pre-agreed period following the signing of a merger agreement. The trend described in the fall continues unabated.

Since October of 2006, there have been approximately 20 going private transactions with go-shop provisions — compared to a total of ten for the first nine months of 2006 and a total of 17 from January 2004 to September 2006. Approximately 20% of going private deals announced since the fall included a go-shop (as opposed to less than 10% for the first nine months of 2006). While the inclusion of a go-shop provision has not led to a richer deal very often, it did in one recent case: On March 19, Community Health Systems, Inc. announced that it had agreed to acquire Triad Hospitals Inc., snatching Triad from two private equity groups that had previously signed an acquisition agreement with a go-shop with Triad. Of course, the same events could have unfolded had Triad used a more conventional fiduciary out and break-up fee structure.

The recently announced go-shop transactions confirm some of the developments we spotted when looking at go-shops in the fall: A significant majority of the new deals have a two-tier break-up fee, with a reduced break-up fee if the transaction is abandoned in favor of a transaction with a party coming forward during the go-shop period. This is consistent with our findings of last year which suggested that the two-tier approach was becoming more prevalent. It also appears that express matching rights of the initial purchaser are becoming more common. Many of the large going privates of the first nine months of 2006 included express matching provisions, and the vast majority of the new transactions follows this sub-trend (the original purchasers in the Triad transaction did not have such a matching right during the go-shop period).

Also of note, the more recent transactions appear to use slightly longer go-shop windows, with half of the recent precedents providing for a solicitation period of 35 days or longer. By comparison, the majority of the go-shop provisions we surveyed for the fall edition of the *Private Equity Report* had solicitation periods of 20 to 30 days.

In sum, the relatively large number of go-shop deals signed in the last months suggests that go-shop provisions are in the process of evolving from a temporary phenomenon to a feature with staying power. Still, going private deals without go-shops continue to remain both viable and frequent. We will continue to monitor the trend in the months to come. ■

Franci J. Blassberg
fjblassberg@debevoise.com

Stefan P. Stauder
spstauder@debevoise.com

A Sellers' Deal Market (cont. from page 20)

liability of 15% to 20% of the purchase price or less.

Conclusion

As in any negotiation, in the final analysis a bidder's ability to achieve favourable contractual terms depends on its negotiating leverage and skill, including the ability to pick its battles selectively. Timing too has a big impact on issue resolution. Sometimes a critical issue can best be addressed at a later stage in the bidding process, when the selected preferred bidder or bidders may have greater leverage as competing bids are eliminated. In other cases, addressing an issue in a creative manner relatively early in the process may give a bid added credibility and competitiveness. Flexibility and creativity also can help: rather than seeking an indemnity, for example, a bidder may address concerns through a purchase price adjustment mechanism or an earnout, which gives the seller a potential share in upside developments or through covenants to take, or refrain from taking, specified actions prior to completion.

All in all, while it is clearly a challenging time to be a buyer in competitive European M&A deals these days, well-advised buyers continue to have many tools to protect their position, just like their counterparts overseas. ■

Geoffrey P. Burgess
gpburgess@debevoise.com

David F. Hickok
dfhickok@debevoise.com

While this obviously limited the ability of PE buyers to structure deals as tender offers, it also impacted strategic buyers as well, particularly with respect to negotiated transactions in which they sought new employment or similar arrangements with a target's managers as part of the transaction.

But at the end of last year, the SEC amended the "best price" rule to clarify the circumstances under which members of management who tender shares could also receive new employment agreements or equity-based compensation. By reducing the ambiguity surrounding the rule and the associated risk of litigation, the rule change should trigger a substantial increase in the number of deals structured as tender offers rather than mergers, principally because tender offers permit more rapid completion of a transaction than a one step merger.

The rule changes may be a boon to tender offer activity, but will private equity buyers be able to take advantage of the tender offer alternative as readily as strategic buyers? Or will the changes subtly tilt the playing field in the direction of strategic buyers because of margin rule and other constraints that historically disadvantaged PE buyers in structuring and financing tender offers, but which recently have been moot because of the general absence of tender offers in negotiated transactions?

Our view, as discussed below, is that while financing tender offers is likely to pose some unique challenges for private equity buyers, private equity firms should be able to benefit from the new rules, albeit perhaps with a bit more effort, every bit as much as strategic acquirors, particularly during the current robust financing market.

Judicial Muddle: Bright Line or Integral Part Test

Prior to the SEC's amendments, the best price rule required that the consideration paid to each holder "pursuant to the tender offer" be the highest consideration paid to any holder "during such tender offer." In other words, all holders needed to be treated equally. But what if key executives of the target received other compensation, for example a retention bonus, new employment agreement or equity award? Is this consideration that, under the best price rule, must be paid to every other security holder?

> But while the amendments create a new tool for M&A tacticians, can the resurrection of the tender offer...[in light of the margin rules]...be utilized equally by private equity buyers and strategic buyers to execute deals?

For many years practitioners read the rule literally and advised their clients that so long as additional compensation was not actually payable in connection with and during the tender offer, they were free to enter into new compensatory arrangements with target management. Traditional employment agreements or even retention bonus arrangements entered into before the formal commencement of a tender offer providing for payment after its conclusion were thought to be safely outside the rule.

But in 1993, the Ninth Circuit Court of Appeals adopted a less formalistic test, instead focusing on whether the new employment arrangement or payment was an "integral part" of the tender offer. Whether an arrangement was an "integral part" of the tender offer generally required a careful assessment of its terms and the facts surrounding it, which raised the spectre that a case would survive a motion to dismiss and get to a jury. Some other circuits, although not all, subsequently adopted the "integral part" test as well.

Because the remedy for violation of the "best price" rule was that any extra payment made to a member of management ("disguised" as salary or a retention bonus) needed to be paid to all holders of securities, an adverse jury finding was potentially disastrous. Indeed under a worst case scenario, the value of the richest of these kind of arrangements (say, for example, $4 million for the target's CEO),would have to be paid to each other shareholder of target.

Given these kinds of potential settlement pots, the "integral part" test rapidly attracted the attention of the plaintiff's bar. Making matters worse, because the best price rule is federal law and because virtually all public corporations have security holders domesticated in every circuit in the country, acquirors could not structure around this problem through the use of governing law and other techniques designed to ensure that any challenge would be decided in a jurisdiction which had embraced the bright line test. To the contrary, plaintiffs could always bring cases in circuits that had adopted the "integral part" test on behalf of security holders domiciled in the circuit, leading to the virtual demise of the tender offer as a viable acquisition structure in negotiated transactions.

CONTINUED ON PAGE 24

The Tender Offer Returns (cont. from page 23)

The Amendments

In its amendments, the SEC declined to embrace either the bright line test or the "integral part" test to the best price rule. Instead, the SEC clarified the language of the rule and adopted certain other amendments which, together with the analysis set forth in the adopting release, makes it much less likely that employment related compensation will be viewed as a disguised tender offer payment.

- The amended best price rule now requires that the consideration paid to any security holder "for securities tendered in the tender offer" be the highest consideration paid to any other security holder "for securities tendered in the tender offer." The new phrases are intended to make clear that the rule applies only to the consideration paid for securities tendered, not for other arrangements that may be "integral" to the tender offer.
- The amendments provide that the best price rule will not prohibit the negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, provided the arrangement is compensation for past or future services or for refraining from performing future services and is not calculated based on the number of securities tendered or to be tendered. The SEC makes clear in the adopting release that equity-based compensation falls within the exemption.
- The amendments also provide a safe harbor for any arrangement approved by the compensation or similar committee of the target's board (whether or not the target is a party) or of the bidder (if the bidder is a party) as an employment compensation, severance or employee benefit arrangement. The adopting release requires that approving directors have specific knowledge of the compensation arrangements as well as of the tender offer to qualify for the safe harbor. The approving committee must consist solely of independent directors. If the target or bidder does not have a compensation or similar committee which is constituted entirely by independent directors, it may form a special committee for purposes of approving the arrangements. The instructions to the rule provide that a determination by the company's board of directors that the members of the approving committee are independent will satisfy the independence requirements of the safe harbor.

> Why is a tender offer followed by a second-step merger a more attractive acquisition structure than a one-step merger? The principal benefit...is speed of execution....[A] one-step merger requires at least two to three months for completion, while a tender offer can be completed in...20 business days....

We believe the amendments provide practitioners with sufficient certainty concerning whether compensation arrangements fall within the best price rule to enable them to structure acquisitions as tender offers with an acceptable level of litigation risk.

The Attraction of Tender Offers

Why does all of this matter? Why is a tender offer followed by a second-step merger a more attractive acquisition structure than a one-step merger?

The principal benefit of a tender offer under most circumstances is speed of execution. This in turn means greater certainty in getting to the finish line and, because of the time value of money, marginally greater value to shareholders in a deal structured as a tender offer followed by a back-end merger rather than a one-step merger.

The accelerated timetable for a transaction structured as a tender offer is principally attributable to the vagaries of the SEC's review process. Whereas a merger proxy must be submitted for review to the SEC and cleared before mailing, a process that can take 30-60 days, tender offer documents may be mailed to stockholders without prior SEC review. Instead the SEC review is completed while the documents are in the hands of stockholders. Thus a one-step merger requires at least two to three months for completion, while a tender offer can be completed in the 20 business days required under the SEC's rules as the minimum period for the offer to remain open. Moreover, if more than 90% of the shares are tendered, the bidder can immediately complete a short form merger to acquire all of the target's shares, thereby further compressing the acquisition's timetable.

For these reasons, the SEC's rule change should generally make tender offers an attractive alternative acquisition structure for would-be acquirors in a

CONTINUED ON PAGE 25

competitive deal environment.

But while the amendments create a new tool for M&A tacticians, can the resurrection of the tender offer be utilized equally by PE buyers and strategic buyers to execute deals? Or will the margin rules and other constraints that have historically disadvantaged PE buyers compared to strategics in financing tender offers, but which have been largely academic recently, now re-emerge as a competitive disadvantage for PE buyers?

Tender Offer Structuring Issues for Financial Sponsors

The margin rules, currently embodied in Regulations U and X, prescribe limits on lenders' ability to extend "purpose credits" — extensions of credit for the purpose of buying margin stock. "Margin stock" includes any security that is publicly traded, so any financing designed to fund the acquisition of publicly traded securities in a tender offer must be structured to comply with the rules.

The margin rules apply only to extensions of credit that are "secured directly or *indirectly* [emphasis added] by margin stock." Therefore, a gating question is whether or not the purpose credit is "secured" within the meaning of the rules — as discussed below, the answer to that question is not straightforward. The margin rules allow purpose credits that are secured by margin stock, but only so long as the amount of the loan does not exceed 50% of the "maximum loan value" of the collateral securing the loan.

The margin rules do not present a problem in a standard sponsored buyout. In a one-step merger, the loans and bonds that finance the transaction are issued by the target company and are secured by the target's assets — not by margin stock. The margin rules also do not present an issue in a tender offer *if* acceptance levels for the tender offer are high enough to allow a squeeze-out merger immediately after settling the tender offer (at least 90% in Delaware). In that situation, the squeeze-out merger will occur at around the same time as the settlement of the tender offer, so that, again, the loans can be considered to be secured by the assets of the target — not by the margin stock acquired in the tender offer.

> A front-end tender offer followed by a back-end merger does implicate the margin rules because between the time of those two closings, the assets of the target are not available to secure loans made to fund the settlement of the tender offer.

But as a commercial matter, most buyers cannot — and do not — condition tender offers on acceptance of the offer by at least 90% of target's shareholders. Instead, most tender offers are conditioned upon a minimum acceptance by 50% of target's stock-holders, in which case the front-end tender offer is followed, months later, by a back-end merger.

A front-end tender offer followed by a back-end merger does implicate the margin rules because between the time of those two closings, the assets of the target are not available to secure loans made to fund the settlement of the tender offer. Indeed, for private equity buyers, unlike strategic ones, the only assets of the acquisition vehicle during that gap will frequently be the shares acquired in the tender offer — margin stock.

The possibility that a buyer will receive fewer than 90% of a target's shares in a tender offer and hence will be required to complete the tender offer with a back-end merger leads to two basic structures for financing a tender offer: First, if the financing is to be secured by margin stock, can the amount of the financing be limited so that it does not exceed 50% of the value of the collateral? Or alternatively, can the deal be structured so that the margin rules do not apply — by providing that the financing not be "secured" by margin stock, or otherwise?

The 50% Solution

The simplest way for a financial sponsor — and its lenders — to structure a transaction to comply with the margin rules is to limit the amount of its borrowing to 50% of the value of the collateral pledged to secure the loan. The rule looks to the value of all of the collateral securing the loan. In a typical sponsored tender offer, the only material asset owned by the entity that launches the tender offer will be the stock it acquires in the tender offer; the only collateral will be the margin stock. In most circumstances, the "value" of the margin stock acquired in the tender offer is the price per share paid pursuant to the tender offer. So, in a tender offer to acquire the shares of Company X at $20 per share, the margin rules will permit the borrower to borrow $10 for every share acquired.

To acquire shares in a tender offer worth $1billion, that's a big equity check for a sponsor to write — $500 million — and the number may actually be higher for a number of reasons. First, banks may request that the sponsor pre-fund interest or fees with equity. While there is

CONTINUED ON PAGE 26

authority that accrual of PIK interest in excess of the maximum loan value does not violate the margin rules, lenders may not be satisfied without a cash cushion. Second, each share acquired in a tender offer is purchased at its full purchase price. This may sound obvious, but sponsors may be accustomed to modeling the cost of the acquisition of options net of their exercise price. In a tender offer, option holders exercise their options and tender them in the offer. The purchaser buys the option shares at the full offer price and therefore cannot calculate the cost of their acquisition on a net basis.

Recycling and Equity Bridges

Of course, the need to write a big equity check up-front does not disqualify private equity sponsors from completing a two-step tender offer — far from it. The additional up-front equity contribution is only short-term — it fills the gap during the period between the tender offer settlement and the completion of the back-end merger. Many private equity funds permit limited recycling of limited partners' capital contributions. Generally a return of capital within two to three months of drawdown will fall within a fund's recycling provisions and therefore not reduce the amount available for future transactions. Therefore, a fund with such provisions could call capital for $500 million to acquire shares having a $1 billion value, and return $300 million to limited partners at the time of the back-end merger — leaving the fund with its desired $200 million equity contribution for that transaction, and $300 million of dry powder for a later deal. But limited partners are likely to be unhappy if they are regularly called upon effectively to provide equity bridges for tender offers. It is not a particularly efficient use of their capital.

An alternative source of bridge equity financing for tender offers is a fund credit agreement. Many funds maintain relatively large lines of credit so they do not need to call capital from their limited partners to provide short-term equity financing. The incurrence of debt by the fund for such a purpose (secured by the commitments of its limited partners) would not create a margin issue, but would reduce the amount of uncommitted capital available for other purposes while the debt remains outstanding. Frequently, funds' credit agreements provide for the issuance of letters of credit supported by limited partners' commitments. Such letters of credit could potentially be used by sponsors to provide credit support for tender financings. Direct guarantees by the fund may also be considered as alternative credit support. Fund credit facilities may well grow both larger and more prevalent to provide temporary equity financing for tender offers.

> [T]he need to write a big equity check up-front does not disqualify private equity sponsors from completing a two-step tender offer — far from it. The additional up-front equity contribution is only short term — it fills the gap during the period between the tender offer settlement and the completion of the back-end merger. Many private equity funds permit limited recycling of limited partners' capital contributions...[or] an alternative source of bridge equity financing for tender offers is a fund credit agreement.

No Security: An Unsecured Solution

The margin rules only apply to purpose credits that are secured "directly or indirectly" by margin stock. It is relatively easy to avoid a "direct" security in margin stock — do not grant a security interest in the margin stock. Lenders may well be willing to extend an unsecured short-term bridge loan. But it is more complicated than it may appear to structure a deal that is not, or is not deemed to be, "indirectly secured" by margin stock. Indeed, many types of arrangements can give rise to an "indirect" security in margin stock.

The Federal Reserve Board ("FRB") elaborated on the indirect security issue in its famous (in this arena) "shell corporation" release in 1986. The release was adopted during the height of the junk bond era in response to the growing use of bonds to finance tender offers by thinly capitalized special purpose vehicles. In the release, the FRB made clear that debt issued or incurred by a shell corporation to finance the acquisition of margin stock was presumed to be indirectly secured by margin stock, even in the absence of explicit security arrangements. The FRB reasoned that the acquisition shell had no business or function other than to hold

CONTINUED ON PAGE 27

the shares of the target company and no assets or cash flow to support the credit used to purchase such margin stock other than the stock itself.

At the same time, the FRB specified a number of circumstances under which this presumption would not apply:

- If the debt securities are issued by an operating company with substantial assets or cash flow to finance the acquisition of margin stock.
- If there is specific evidence that lenders could in good faith rely on assets other than margin stock, such as a guaranty by an entity that has substantial assets or cash flow.
- If there is a merger agreement between the acquiring and target companies entered into at the time the commitment is made to purchase the debt securities or in any event before the loan funds are advanced.
- If the obligation to advance funds to the shell corporation is contingent on the shell's acquisition of the minimum number of shares necessary under the applicable state law to effect a merger between the acquiring and target companies without the approval of either the shareholders or directors of the target company.

These exceptions would appear to be broad enough to accommodate typical tender offer acquisition structures. As noted above, a private equity sponsor could provide a guarantee of the tender vehicle's obligations or a letter of credit, qualifying a transaction for the second exception. Other than in a hostile deal — which, because of constraints on hostile bids in most fund agreements generally will not be the basis for private equity backed tender offers — a bidder will sign a merger agreement with the target providing for the merger of the target with the acquisition vehicle upon consummation of the tender offer, qualifying a transaction for the third exception.

But there are two significant limitations to these qualifications to the 1986 release.

The joint tender offer structure offers the possibility of putting in place a permanent financing structure at the time of the tender offer closing, rather than at the time of the back-end merger. Because the financing is secured by the assets of the target — not the acquired stock — the margin rules do not apply.

First, if the financing contains covenants restricting the use or disposition of the margin stock, the credit could still be considered to be "indirectly secured," regardless of the existence of a merger agreement or one of the other exceptions. This is significant because as difficult as it may be to convince a lender to finance a tender offer on an unsecured basis, it is another discussion entirely to persuade it to accept the absence of any covenants with respect to that stock.

Second, because the exceptions are not structured as a safe harbor, satisfying one of the exceptions takes a tender offer facility outside of the *presumption* that a loan to a shell corporation to fund a tender offer is indirectly secured, but it does *not* mean that the transaction is *not* indirectly secured.

Still, some transactions can be structured to take advantage of these exceptions. It certainly seems plausible that a lender, with a nudge from one of its regular and sizeable private equity clients, will find a way to get comfortable with a tender offer facility that is wholly unsecured, with carve-outs in any covenants so that they do not apply to the margin stock acquired by the acquisition company. Such structures may well become more prevalent in this new era of tender offers and during this private equity-friendly financing environment. But they are complicated and lenders are, by nature, conservative.

Funds considering this approach will need to grapple with UBTI issues if the bridge loan remains outstanding for a significant amount of time.

Joint Tender Offers: A Solution a Bank Could Love

Another structuring alternative is the joint tender offer. In a joint tender offer, the sponsor makes a tender offer for a percentage of the target's stock — say 20%. At the same time pursuant to the terms of its merger agreement with the sponsor, the target company makes a tender offer for the remainder of its stock — 80%. The sponsor's tender offer is funded with its equity. The self-tender by the target is funded by a new acquisition financing package borrowed by it at the time that the tender offer is settled.

The joint tender offer structure offers the possibility of putting in place a permanent financing structure at the time of the tender offer closing, rather than at

CONTINUED ON PAGE 28

The Tender Offer Returns (cont. from page 27)

the time of the back-end merger. Because the financing is secured by the assets of the target — not the acquired stock — the margin rules do not apply. Lenders appreciate the structure because a full collateral and covenant package can be put in place at the time of the initial closing and they do not need to bear any risk of remaining unsecured — or secured only by margin stock — during the bridge period.

The drawbacks to a joint tender offer, though, are also numerous. First, incumbent boards are generally reluctant to incur any liability in connection with a sponsor's financing until after the closing of the back-end merger. The joint tender offer structure requires that the target's board agree to incur substantial debt and to grant liens on the company's assets to effect a potential transaction.

Second, shares acquired by the target in the self-tender portion of the joint tender do not vote. Therefore, a target may view a joint tender offer as effectively imperiling deal execution by increasing the hold up value of non-tendering stockholders.

Third, one advantage of the joint tender offer structure — the fact that a permanent financing is put in place at the time of the tender offer closing — also poses a timing challenge. It means that a permanent financing structure must be in place 20 business days after the launch of the tender offer. That is a compressed schedule for complicated financings, thereby increasing the likelihood that the lenders will be required to fund — and the sponsor will be required to pay for — an unsecured bridge loan.

* * *

Strategic investors are less concerned about structuring the financing of a tender offer to comply with the margin rules for one simple reason — the borrower typically will own other assets in addition to the margin stock acquired in the tender offer. The value of those other assets is counted on a "good faith" basis when determining whether or not the aggregate value of the collateral pledged to support the purpose credit satisfies the margin rules. If the value of the margin stock pledged to support a purpose credit is less than 25% of the aggregate value of the collateral, the credit is not deemed to be "indirectly secured" by the margin stock. Sponsors may benefit from theses same principles by conducting a tender offer through an existing portfolio company.

So, do strategic buyers have an advantage over private equity sponsors in utilizing tender offers as an acquisition mechanism? Although strategic buyers have operating assets and cash flow that generally will allow them to structure tender offer borrowings without regard to the margin rule concerns described above, they may well have existing debt that subjects them to covenant restrictions. They therefore will often face refinancing costs and, in the case of public debt, time-consuming consent solicitations that will not present an issue for private equity buyers.

Private equity sponsors, perhaps with a bit more difficulty then corporate buyers, should benefit from the changes to the best price rule, and in the existing credit environment, may find tender offers a significant acquisition tool. ■

Andrew L. Sommer
alsommer@debevoise.com

Gregory H. Woods
ghwoods@debevoise.com

So do strategic buyers have an advantage over private equity sponsors in utilizing tender offers as an acquisition mechanism? Although strategic buyers have operating assets and cash flow that generally will allow them to structure tender offer borrowings without regard to the margin rule concerns…private equity sponsors, perhaps with a bit more difficulty then corporate buyers, should benefit from the changes to the best price rule, and in the existing credit environment, may find tender offers a significant acquisition tool.

portion of the future income of the enterprise that he had helped to build. Forfeiture provisions may vary and will undoubtedly be the result of lengthy negotiation. The Fortress forfeiture provisions, which provided for an 82.5% forfeiture for a departure in the 1st year to a 16.5% forfeiture for a departure in the 5th year, are but one possible approach. Although the preliminary prospectus filed by Blackstone in March did not provide for such forfeiture provisions, Blackstone's inclusion of non-compete and non-solicit provisions, together with some degree of vesting, transfer restrictions and priority distributions to public unitholders during the two-year period following any IPO, may effectively achieve the same result.

Clawback Obligations: Sharing the Burden with the Public. Allowing the public to share in its proportionate share of the collective profits of a Manager without sharing a commensurate exposure to its liabilities would be an unattractive proposition for the Manager's principals. One of the most significant liabilities that a principal of a private equity firm faces is the so-called "GP clawback," which ensures that (1) the general partner (or other carried interest vehicle) of a fund (typically an affiliate or subsidiary of the Manager) receives its carried interest only if investors have received a return of their invested capital and (2) the general partner (or other carried interest vehicle) has received no more than 20% (assuming a 20% carried interest) of the net profits over the life of the fund. If a general partner (or other carried interest vehicle) has received more than 20% of net profits because, for example, the fund partnership agreement provides for deal-by-deal distributions and early fund investments generate significant profits but later fund investments yield losses, the fund would be entitled to "claw back" some of the profits previously distributed to the general partner (or other carried interest vehicle). For this reason, the principals of a Manager going public will want to secure an obligation from the public issuer to indemnify the principals for an appropriate share of any clawback obligations to which they may become subject upon termination of a private equity fund.[1]

Problems Facing the Registered Manager. If the Manager is registered with the SEC under the Investment Advisers Act, its management contracts will contain a provision prohibiting an assignment without the consent of the client. If the clients include registered investment companies, the management contracts would terminate in the event of an assignment. It may be possible to structure the IPO that no such change in control occurs, but obviously this issue could affect the overall structuring and other business considerations.

Problems Facing the Unregistered Manager. If the Manager is not registered, its exemption from registration under the Investment Advisers Act requires that it not hold itself out to the public as an investment adviser. Although taking the Manager public would not necessarily mean that it would be holding itself out to the public, the requirement that the Manager, as a public company, make certain disclosures to the public may create some challenges in maintaining its exemption from investment adviser registration. Indeed, it is likely that a newly public Manager would need to register as an investment adviser even if it had not been required to do so previously.

Keeping the Private Funds Private. Whether registered or not, a Manager that goes public would need to ensure that the disclosure in the offering prospectus and in its periodic reports concerning its private funds, particularly those private funds that are in the process of fundraising, do not jeopardize the private placement exemptions on which the funds rely. Satisfying prospectus disclosure requirements while preserving these private placement exemptions may require some particularly skillful drafting.

Other Regulatory Concerns

Who is Going Public and Other Regulatory Issues. The Fortress IPO was accompanied by abundant press coverage, some of which suggested that Fortress was the first "publicly traded hedge fund." If this had been true, the Fortress offering would have been even more remarkable than it was, since hedge funds and other private funds generally operate under exemptions from Investment Company Act regulation that explicitly preclude the fund from making a public offering.

This loose characterization of the offering was incorrect, of course. Fortress is an alternative asset manager, not a hedge fund, and there is a significant difference between being a Manager and an investment company. Indeed, there are a number of publicly-traded investment managers, although Fortress is the first offered in the United States that focuses on hedge funds and other alternative asset classes.

But the confusion concerning that characterization of the public issuer by the press is understandable given the general lack of understanding of how private investment funds and firms operate. A Manager or its principals own, directly or indirectly, general partner or similar interests in the funds it manages, and these interests entitle the Manager or its principals to receive carried interest from the funds. If these general partner interests are "securities," and constitute the Manager's primary assets, the Manager would indeed be an "investment company" under the Investment Company Act as a technical

CONTINUED ON PAGE 30

[1] *Note that clawbacks are not generally used in hedge funds.*

matter, even if it is not a hedge fund or a private equity fund from a practical business perspective.

The Investment Company Act defines an "investment company" as an issuer that:

- is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; or
- is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis (the "40% Test").

If a general partner interest is a security, a Manager might be an investment company under the 40% Test, thereby subject to Investment Company Act regulation upon going public. It is generally accepted, however, that a general partner interest is not a security for purposes of the Investment Company Act. It would be impractical for a Manager to operate as a registered investment company. The Investment Company Act imposes a number of obligations and restrictions, including limitations on capital structure, governance provisions, prohibitions on affiliated transactions and, perhaps the ultimate show-stopper, strict limitations on equity-based compensation.

There are also other approaches to concluding that a Manager is not an investment company. For example, the Investment Company Act provides that an issuer that might be an investment company under the 40% Test is not an investment company if it is primarily engaged, directly or through *wholly-owned subsidiaries*, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. According to the Fortress prospectus, Fortress believes that it is not an investment company under this provision, but notes that the characterization of its assets might change if its operating subsidiaries ceased to be wholly-owned. Similarly, in its preliminary prospectus, Blackstone states its belief that it is not an investment company under either test.

> [Some converage of] the Fortress IPO...suggested that Fortress was the first "publicly traded hedge fund." If...true, the Fortress offering would have been even more remarkable than it was since hedge funds and other private funds generally operate under exemptions from Investment Company Act regulation that explicitly preclude the fund from making a public offering. This loose characterization of the offering was incorrect, of course. Fortress is an altern-ative asset manager, not a hedge fund, and there is a significant difference between being [such a M]anager and an investment company.

In addition, under Rule 3a-1 of the Investment Company Act, an issuer is not an investment company if no more than 45% percent of the value of the issuer's total assets (exclusive of Government securities and cash items) consists of, and no more than 45% of the issuer's net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than U.S. government securities, securities of majority-owned subsidiaries and certain controlled companies that are not investment companies. According to the Fortress prospectus, Fortress believes that it is not an investment company "because the nature of our assets and the sources of our income" meet the requirements of Rule 3a-1. This determination, however, is likely to have been based on the conclusion that general partner interests are not securities and that the carried interest is for these purposes an advisory fee rather than income derived from securities, a determination made more explicit in Blackstone's preliminary prospectus.

Note that Rule 3a-1 does allow a significant portion of the Manager's assets to consist of securities and a significant portion of its income to be derived from investments in securities. The amount of securities that the Manager may own, however, will depend upon the nature of its other assets and the net income that these assets produce.

Tax Considerations

Pass-through Entity as Issuer

A threshold decision in structuring an IPO of a Manager will be whether to use a corporation or a pass-through entity as the issuer. A corporation is certainly the most common vehicle for public offerings;

CONTINUED ON PAGE 31

however, using a partnership, limited liability company or other pass-through entity as the issuer (as Fortress did) would have some distinct tax advantages, as discussed below.

Avoiding "double tax" on earnings. An issuer treated as a corporation for tax purposes would be subject to corporate level tax on all income derived from the investment management business (carried interest from portfolio gains, management fees, etc.). The public investors in the issuer would then be subject to another level of tax when any net earnings were distributed as dividends. By contrast, if the issuer is treated as a partnership for tax purposes, it will not be subject to entity-level taxation, except for any income earned through corporate subsidiaries. Instead, the investors will be taxed on their distributive share of the issuer's earnings (whether or not distributed). The elimination of entity-level tax on significant portions of the issuer's income can of course dramatically increase returns to investors.

Preserving capital gains treatment. One of the primary tax benefits of private fund structures is the ability to obtain favorable capital gains treatment on the carried interest allocated and distributed to an affiliate of the Manager in respect of gains on portfolio investments, as well as certain dividends. (Depending on how they are structured, and the nature of their trading strategies, this may be true of hedge funds' performance allocations as well.) A pass-through issuer would actually permit capital gains treatment to flow through to public investors that are individuals, including any Manager principals that exchanged their interests in the Manager for shares of the public issuer. (In Fortress, and as anticipated in Blackstone, the principals retained their economic interests in the underlying operating pass-through entities, rather than rolling into the public issuer, although they retained the right to exchange their interests for public shares as discussed below.)

Income requirements for pass-through treatment. In general, entities that are publicly traded are treated as corporations for tax purposes, regardless of the type of legal entity. There is an exception for publicly traded partnerships that derive 90% of their income in the form of "qualifying income." Qualifying income includes dividends, interest, gains from sales of stocks and securities, and similar items. Qualifying income would not include management fees, income from investments in operating partnerships or certain income from activities like loan origination. As a result, if the plan is to use a pass-through issuer for the Manager IPO, care would need to be taken to structure the Manager's operations to ensure that the qualifying income test is always satisfied.

> If an IPO were structured as a sale by the principals of a portion of their equity to the public for cash in a secondary transaction ..., as would typically be the case, the sale would be fully taxable to the selling principals. It may be possible to achieve a better tax result ... if, prior to the IPO, the Manager borrows and distributes cash to the principals.

There are a number of potential structuring techniques in this regard. For example, in Fortress, the public issuer did not directly derive management fees from the various funds, but instead derived its share of management fees (as well as incentive fees from certain hedge funds) through a wholly-owned corporate subsidiary (any dividends from which are qualifying income). Similarly, the Blackstone structure contemplates the use of several corporate "blockers." As a result, the public issuer's portion of the management fees will be subject to corporate taxation. (In Fortress, a pass-through subsidiary of the public issuer loaned money to the corporate subsidiary, presumably to give the corporate subsidiary interest deductions to offset its income, with the corresponding interest income on the debt being qualifying income for the issuer.)

In addition, the need to meet the qualifying income test may cause a Manager to avoid having its underlying funds invest in operating partnerships or engage in other activities (such as certain types of loan origination) that may generate non-qualifying income, or to cause the funds to engage in such activities through blocker corporations, either of which may in turn adversely affect after-tax returns.

Note that the qualifying income test must be met every year; once failed for one year, the issuer would be treated as a corporation going forward, even if it met the qualifying income test in a later year.

Other tax implications of public pass-through entities. As owners of an entity treated as a partnership for tax purposes, the public shareholders will be taxed on their proportionate share of the issuer's taxable income, whether or not any distributions are made. As a result, unlike an investment in corporate shares, an investment in a publicly-traded pass through entity can give rise to "phantom" income to its

CONTINUED ON PAGE 32

Taking Private Managers Public: Structuring Issues (cont. from page 31)

shareholders. (In Fortress, the issuer stated that it generally intends to cause its lower-tier entities to make "tax distributions" to permit the principals and the issuer's corporate subsidiary to pay taxes, but no assurance is given to make similar distributions to the public.) In addition, certain income of the entity may be viewed as either U.S. trade or business income, subjecting non-U.S. investors to U.S. taxation (for example, income from fund investments in so-called "FIRPTA" companies or certain REIT dividends) or "unrelated business taxable income" (known as UBTI), subjecting tax-exempt investors to tax (income associated with borrowings used to make investments would give rise to UBTI). As a result, an investment in a publicly traded pass-through may be unappealing to such investors.

Tax Implications of Exchange Rights and Basis Step-up. In Fortress, the Manager's principals have, and in Blackstone, the Manager's principals anticipate having, the right to exchange their equity interests in the lower-tier operating entities for shares of the public issuer. It appears that these exchanges are deliberately intended to be structured as taxable transactions, even though they could be structured as tax-free. This may be costless to the exchanging principal, since presumably a principal would only undertake the exchange in order to obtain liquidity; thus, the exchange would be shortly followed by a sale of shares that would have triggered tax anyway. (In this regard, Fortress permits, and Blackstone anticipates permitting, a tax-free exchange where the principal is making a charitable contribution of the shares received.) Structuring the initial exchange as taxable causes a step-up in asset basis for corporate taxpayers in the group. In Fortress and as expected in Blackstone, the issuer will compensate the exchanging principal in an amount equal to 85% of the tax benefit from the step-up.

Pre-IPO Structuring Possibilities. If an IPO were structured as a sale by the principals of a portion of their equity to the public for cash in a secondary transaction (or in a primary offering followed by an immediate redemption), as would typically be the case, the sale would be fully taxable to the selling principals. It may be possible to achieve a better tax result on the cash extracted by the principals in connection with the IPO if, prior to the IPO, the Manager borrows and distributes cash to the principals. Such a leveraged distribution from a pass- through vehicle would not be a taxable event in and of itself; however, the principals may be taxed to the extent that the IPO proceeds are used to repay debt that financed prior cash distributions to the principals. (The reduction of existing debt is a deemed distribution to the principals, taxable to the extent it exceeds the principals' remaining tax basis in their interests.) In Fortress, the principals received cash in part from the sale of interests in the lower-tier entities to the issuer in connection with a significant investment by Nomura in the issuer, and in part from a pre-IPO distribution funded partially with debt and partially with collected fees (including previously deferred fees from offshore hedge funds). The IPO proceeds were used to repay debt and to fund commitments to underlying private equity funds. The Blackstone IPO will feature preliminary cash distributions to the principals, as well as sales of some of the principals' vested units in lower-tier entitites to the issuer following the IPO.

Managers...should...weigh the impact that an IPO will have on the culture and day to day operations of what had been a privately owned and managed firm. Despite its many (in particular economic) advantages, going public is unlikely to be the right step, or even practically possible, for most alternative asset managers.

Lessons from the Trailblazers

Managers flirting with the idea of taking themselves public may be swayed by the immediate success of the Fortress IPO and the media hoopla surrounding the Blackstone IPO. However, as discussed above, going public is not a project to be taken lightly. There are many structural, economic and regulatory issues that a Manager needs to bear in mind. Managers also should, and will, weigh the impact that an IPO will have on the culture and day-to-day operations of what had been a privately owned and managed firm. Despite its many (in particular economic) advantages, going public is unlikely to be the right step, or even practically possible, for most alternative asset managers. ■

Katherine Ashton
kashton@debevoise.com

Kenneth J. Berman
kjberman@debevoise.com

Peter A. Furci
pafurci@debevoise.com

Michael P. Harrell
mpharrell@debevoise.com

Jennifer A. Spiegel
jaspiegel@debevoise.com

Fund Formation in Emerging Markets (cont. from page 10)

Fund managers also need to take special steps to ensure compliance with applicable anti-corruption laws and rules, in particular the Foreign Corrupt Practices Act, both at the initial due diligence stage and throughout the life cycle of the investment. For further discussion of these issues see "The Impact of the U.S. Foreign Corrupt Practices Act on Private Equity Deals" elsewhere in this issue.

Foreign Currency and Exchange Control Issues

Funds that hold assets in local currencies are exposed to risks of inflation, potential shortages in the supply of hard currency for exchange and the inherent unpredictability of government policies regarding currency supply. Changes in foreign currency exchange rates may also affect the value of securities in the portfolio. One question investors should ask when investing in a fund is what steps the fund's manager expects to take to address these issues. Some funds engage in currency hedging as a regular part of their strategy, while others find the currency hedging process a diversion from their business of investing and prefer to try to time purchase and exits at favorable times for the relevant market(s).

There is also foreign exchange control risk. Repatriation of investment income, capital and the proceeds from sales of securities by foreign investors may, depending on the country, require governmental registration and approval in various emerging markets. Government authorities in emerging markets control, to varying degrees, the repatriation of capital and profits that result from foreign investment. Capital markets can, in some instances, be highly regulated, and in other instances, the enforcement of regulations can be haphazard, allowing market manipulation that can be discriminatory to minority or foreign shareholders or participants. The pattern of enforcement in emerging markets is often opaque, and there is no certainty that such markets will become more open and fairly administered. There is no single proven way to protect against these risks, though, as always, partnering with strong, respected, well-connected local groups can be invaluable in navigating these waters.

Funds that hold assets in local currencies are exposed to risks of inflation, potential shortages in the supply of hard currency for exchange and the inherent unpredictability of government policies regarding currency supply.

Accounting Standards; Limited Availability of Information; Due Diligence

Accounting standards in emerging markets do not generally correspond to international accounting standards and investors in emerging markets generally have less access to reliable and detailed information, including both general economic and company-specific commercial information than investors in more economically sophisticated countries. This lack of transparency means that fund managers must conduct due diligence with fewer and less precise tools than they have available for similar kinds of investments in more developed markets. This is yet another reason it is critical for an emerging markets fund's manager to have a strong in-country team that not only speaks the language and knows the business customs of the relevant country, but can decipher the information that is available to it and compare it to other companies or industries in the relevant market.

* * *

Because of this enhanced risk profile associated with operating a PE fund in an emerging market, emerging market funds typically charge higher management fees than funds in developed markets (frequently in the range of 2.5-3% a year, as opposed to 1.5-2% a year in the general market for similarly sized deals). As illustrated above, these in-country factors come into play at each stage in the investment cycle: awareness of and access to deal flow, initial assessment of target opportunities, due diligence (of the operating assets, local co-investors and the target managers), negotiation and structuring of the investment itself, oversight and management of the investment and timing and structuring of exit.

But the flip-side of the risk of course is the opportunity, and emerging markets can indeed represent a tremendous opportunity for skilled managers and savvy investors. The foregoing is only a very general discussion of some of the legal, tax and risk issues relevant to investments in those markets. Investors will need to evaluate the specific issues presented by an investment in any particular fund or market more generally. ■

Michael J. Gillespie
mjgillespie@debevoise.com

Jennifer J. Burleigh
jjburleigh@debevoise.com

Private Equity Activity in Korea and India (cont. from page 14)

authority is the Foreign Investment Promotion Board (FIPB); approvals (if forthcoming) take 4-8 weeks. Other regulations governing foreign direct investments prescribe minimum pricing requirements for entries and exits (in certain industries based on a formula). As discussed below however, certain exemptions are available for private equity investors registered with the Securities and Exchange Board of India (SEBI) as a "foreign venture capital investor."

Foreign Exchange

The Foreign Exchange Management Act 1999 empowered the RBI to frame detailed regulations liberalizing all aspects of foreign exchange controls, including those affecting foreign investment into India. Still, the absence of the complete convertibility of the Rupee impedes a number of important aspects of private equity such as acquisition financing due to impediments that offshore banks have in lending local currency funds, and additional impediments that on-shore borrowers have in servicing offshore, non-Rupee denominated debt without RBI licensing.

Competition Commission

The Competition Act 2002 governs M&A activity that is likely to cause an adverse effect on competition in India. The operative body is the Competition Commission of India (CCI). The CCI has a mandatory review process based on various different asset values or turnover of the combining entities, and can provide early guidance to private equity firms considering an M&A transaction through advance ruling procedures. CCI can direct that a combination not take place, or unwind completed transactions, if considered anti-competitive.

Securities Laws

India's very large capital markets are an obvious potential exit strategy for private equity investors. SEBI was established in 1992 to regulate India's primary and secondary capital markets. Important features of applicable regulations from a PE prospective include a requirement that an Indian company go public in India prior to or simultaneously with an IPO outside of India. Pure "offshore IPOs" (Infosys, Wipro, others) by Indian companies are no longer permitted. No simultaneous Indian/offshore IPO has yet been done. In addition, pre-IPO shareholders of a company that goes public in India are required by law to be locked up for one year following the IPO.

India lacks any "traditional" LBO financing model as that term is commonly understood in other markets. Still, leveraged Indian acquisitions have been completed using a "share redemption" model or a "merger" model.

Tax Considerations

Virtually all investments into India are made using an investment vehicle domiciled in a country with which India has a double tax treaty. Over the years, Mauritius has been the most popular jurisdiction through which foreign investors would structure their investments, although Cyprus, Singapore and the UAE also enjoy favorable double tax treaties with India.

Under the India-Mauritius double tax treaty, capital gains earned by a Mauritius entity on shares of an Indian company are exempt from Indian tax. Business profits of a Mauritian offshore company are taxable at an effective rate of only 3%. There is no dividend withholding tax regime in India, although Indian companies are required to pay a dividend distribution tax of 12.5% (proposed to be increased to 15% in India's recently announced 2007/08 Budget). It is crucial for the Mauritian entity to avoid having a "permanent establishment" in India in order for that entity to enjoy the benefits of the tax treaty.

Financing

In addition to the Rupee convertibility issue discussed above, local banking restrictions prohibit the extension of credit to a target company or an acquisition vehicle in order to acquire the target's shares. Moreover, offshore banking restrictions prohibit non-Indian lenders from stepping in. Therefore, India lacks any "traditional" LBO financing model as that term is commonly understood in other markets. Still, leveraged Indian acquisitions have been completed using a "share redemption" model or a "merger" model. In both cases, the acquisition financing is incurred offshore, and is serviced by periodic share redemptions or by merging the offshore debtor (*e.g.*, a special purpose Mauritian acquisition vehicle) into the onshore target.

Foreign Venture Capital Investor

India permits a private equity investor to register as a "foreign venture capital investor" with SEBI. Some of the advantages of such registration are (1) certain restrictions on "automatic route"

CONTINUED ON PAGE 35

Private Equity Activity in Korea and India (cont. from page 34)

investments are relaxed, (2) unrestricted entry and exit pricing is permitted on deals which would otherwise be subject to limitations, (3) transfers to promoters are exempt from public offer provisions of the Takeover Code, and (4) exemption from the mandatory one-year post-IPO lockup discussed above.

Some of the disadvantages of such registration are (1) certain investment limits/allocations apply and (2) ongoing reporting and disclosure requirements with SEBI.

Conclusion

Identifying universal issues and trends in private equity transactions in Asia is a bit of an academic exercise given that private equity transactions — how they are structured, how they are regulated and how they are exited — differ significantly from country to country. Indeed, at this stage, at least, the billions of dollars of new private equity capital committed to pan-Asian investments will all likely be invested pursuant to individualized structures depending on the specific country and other circumstances involved. Consequently, transactions in Korea and India will bear some similarities — such as the viability of a local stock exchange listing for exits — and numerous other differences — such as how the transaction can be leveraged. For these reasons, local knowledge and expertise about each country is essential to successful, regional strategies for private equity firms. ■

Thomas M. Britt
tmbritt@debevoise.com

Mark J. Lee
mlee@debevoise.com

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.

The Impact of the U.S. Foreign Corrupt Practice Act on PE Deals (cont. from page 18)

- Analysis of the risk profile of the applicable industry or business (for example, is the industry or activity involved one in which a single official or a few key officials may have disproportionate influence, *e.g.*, defense procurement, extraction of oil, gas, and other natural resources, privatization of state-owned assets, or registration of pharmaceuticals?).
- Evaluation of the risk profile of any persons associated with the target (have any managers been accused of unethical or criminal conduct?).
- Review of the internal audit reports and internal investigations conducted by the target's internal audit, corporate security, and legal departments, as well as any documents reviewed by the target's outside legal counsel.
- Identification of the names of all senior elected officials in the countries in which the target operates, and comparison of the resulting list with the list of the payees of the target company or the seller.
- Interview of managers and employees of the target or seller who may have had contact with officials able to influence the target's or seller's business.
- Review of the records, reports and analyses prepared by the target's or seller's external auditors or accounting firms, if commercially feasible.
- Retention of an investigative agency to conduct an independent review of possible ways in which bribes may have been paid.

The above steps are likely to ferret out certain FCPA-related exposures.

But perhaps the most important matter that should be analyzed in a buyer's diligence exercise is the FCPA compliance program at the target (or that otherwise applied to the assets being conveyed). Just as vigorous implementation of a robust compliance program, training, and periodic reviews and audits of the compliance program are the best defense against liability in the first instance, such steps can mitigate, on a legal, practical, and market level, the risks of financial losses arising from the activities of rogue employees who may have paid bribes to foreign officials in a potentially remote corner of the world. Put another way: the most important FCPA-related diligence a buyer may conduct in its review of the target is to assess just how seriously the target took the potential exposures prior to the potential M&A transaction, as evidenced by the scope of its FCPA compliance program. ■

Paul R. Berger
prberger@debevoise.com

Steve Michaels
smichaels@debevoise.com

Did you know you can receive the Debevoise & Plimpton Private Equity Report by email?

If you would like to take advantage of this service, indicate the delivery method you prefer and your email address. Please also take this opportunity to update your contact information or to add additional recipients by copying and filling out the following form and returning it to us.

Name of Contact ______________________________
Title ______________________________
Company Name ______________________________
Address ______________________________
City ______________ State or Province ________ Postal Code ________
Country ______________ E-mail Address ______________
Telephone ______________ Direct Dial ______________
Fax ______________ Direct Dial Fax ______________

I would like to receive my reports:
- ❑ **via email**
- ❑ **via email and regular mail**
- ❑ **via regular mail**

To reply, please send information by fax to 1 212 521 7978 or by email to privateequity@debevoise.com

By mail:
Carmen Garcia, Marketing Department
Debevoise & Plimpton LLP
919 Third Avenue, New York, NY 10022