DEBEVOISE & PLIMPTON
PRIVATE EQUITY REPORT

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Cracking the Crunch

Leveraging a Target's Existing Debt to Finance a Buy-Out

Change of Control Clauses

Have you heard the words "credit crunch" one time too many in the last six months? Obviously, the current state of the financing markets is impeding your (and everyone else's) ability to sign and close private equity deals. Although we do not have a master key to unlock new leveraged financing in today's market, we do think that there are some ways to finance private equity transactions by leveraging a target's existing debt rather than obtaining new debt facilities. In most cases, this approach will entail either consent fees and other concessions to the target's lenders or accepting atypical constraints on governance and exit matters, but in this environment, all financing alternatives are worth exploring.

Because a significant portion of the financing package for a typical LBO is used to refinance the target's existing debt, leaving a target's debt in place has always been an option to consider. Among other advantages, it reduces the amount of debt necessary to complete a transaction, making it possible to proceed with a smaller incremental amount of debt or, perhaps, with equity alone. This approach is even more attractive in today's markets because the target's existing debt is likely to be less costly than any potentially available refinancing facility would be, thereby reducing the deal's total financing cost. It also obviates potentially difficult negotiations with new financing sources and reduces any risk that these sources will attempt to escape an underwater commitment at closing.

Leaving the target's debt in place, however, is not simple. A number of typical provisions in debt instruments impede an acquiror's ability to do so. These include restrictions on the ability of the target to merge with the acquisition vehicle and negative covenants, including debt restrictions

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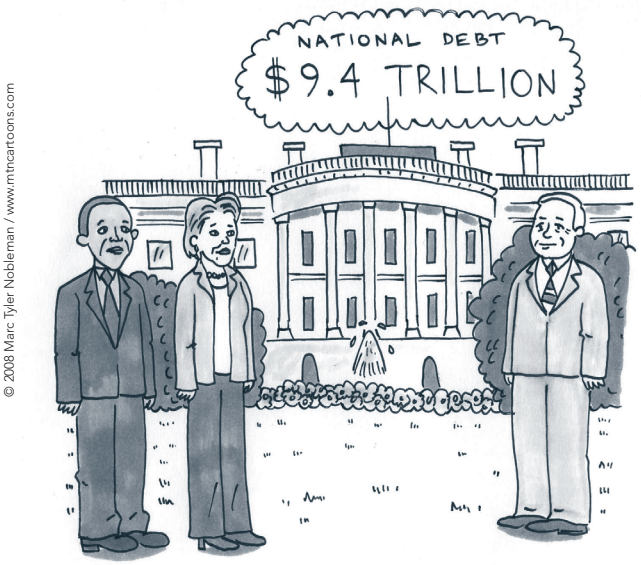

Hopefully the debt doesn't get triggered on a change of control.

WHAT'S INSIDE

Letter from the Editor

We wish we could be the first to tell you that the credit crunch was behind us and that the private equity world was back to normal. As we all know, however, while the private equity scene continues to evolve, normalcy has never been one of its prime attributes. Our goal is to help guide our readers in the private equity industry through this challenging cycle.

In this issue's cover article, we explore ways to leverage a target's existing debt to facilitate a transaction. We suggest, among other things, that a close reading of change of control clauses may provide private equity buyers teaming with existing shareholders the opportunity to retain existing debt facilities. Separately, we offer a survey of market terms in recent going–private transactions to analyze the allocation of deal risk in today's environment. We find, perhaps surprisingly, that financing conditions have not re-emerged and that reverse termination fees are increasingly the sole recourse against defaulting buyers. We are also pleased to present a two-part series on the impact and opportunities of "green" investing.

Although the furor over taxation of carried interest has not risen to the level of the election debate in the U.S., the taxation of foreign — source carried interest in the UK is still a hot topic. Richard Ward of our London office focuses on that issue and explains why it is such an emotional and potentially expensive topic in the UK.

Private equity firms have always been accustomed to uncertainty surrounding government regulation. But amendments to the Exon-Florio legislation, which permits the President to prohibit acquisitions that might threaten national security, are hard for even the most hardened veterans of ambiguity to comprehend. In this issue, Robert Quaintance explains that recently proposed regulations may require U.S.–based private equity funds to consider whether they are deemed "foreign persons" based on the identity and power of their limited partners and, in that connection, to assess whether advance notification of certain of their future acquisitions to the U.S. government is warranted.

It was not long ago that most in the private equity industry scoffed at the emergence of SPACs. With the decline in IPO exits for private equity portfolio companies and the scarcity of deal financing, however, we review why SPACs may be worth a second look for private equity sponsors.

Also in this issue, we remind private equity sponsors and their portfolio companies that there is only a short window to fix deferred compensation plans to avoid potentially draconian penalties. We also warn private equity funds that there is now unnerving regulatory precedent that holds a private equity fund liable for the unfunded pension liabilities of its portfolio companies and suggest ways in which to avoid that unthinkable result.

Franci J. Blassberg
Editor-in-Chief

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ALERT

Going-Private Deal Terms

Allocating Risk in Today's Troubled Markets

The clampdown on private equity-led going-private deals that began late last summer has shown little sign of abating. A handful of deals, however, with transaction values generally in the $1 billion range, have been signed during this period. Although it is clearly still too early (and the number of deals too few) to trumpet the arrival of any new "market" practice, we did want to summarize a few of the recurring terms we are seeing in today's going-private deals. They provide an interesting view into how private equity professionals and target company boards are allocating deal execution risk in a market in which getting a deal to the finish line can be a bit more complicated than it used to be.

Financing Outs

Many have wondered whether private equity buyers, who have faced some sticky situations recently in getting sandwiched between a target company and waffling lenders, would insist on restoring a financing closing condition in their purchase agreements. Financing conditions were the norm in private equity deals until early 2005 when sellers in going-privates or hot auctions started resisting them. But the pendulum has not swung back as of now: none of the announced deals gave the buyer a financing condition.

Most of these deals do, however, provide that the buyer's obligation to close does not arise until after the buyer has had the benefit of a "debt marketing period" of 20 to 30 days (with appropriate blackout periods around certain holiday periods). A debt marketing period does not commence until, among other things, seller provides buyer with a defined set of materials to be used in the marketing efforts. How broadly or narrowly this set of materials is defined, and there has been a range of practice on this, will give the buyer more or less flexibility in discussions about whether or not the debt marketing period has begun. Given the state of the market, it should not be surprising that more than a few recent deals defined the required materials broadly, even including any material customarily included in a registration statement or other offering document or otherwise required or advisable in connection with the financing. Also, a few of the deals did include a minimum EBITDA closing condition, which likely mirrors an identical condition in the buyer's commitment papers and obviously adds a layer of conditionality not seen until recently.

Specific Performance

The absence of a financing condition in the purchase agreement has been touted in press releases by a few of the selling companies in these deals. But the absence of a financing condition is not the same thing as having a legal right to force the buyer to close if all of the other conditions are satisfied. United Rentals learned that painful fact after seeking to force Cerberus's acquisition vehicle to close the going-private they signed in July 2007. As we reported in our last issue of the *Debevoise & Plimpton Private Equity Report*, the Delaware Chancery Court rejected United Rental's claim, finding that the language in the agreement, although somewhat internally inconsistent, did not permit the legal remedy of specific performance. (See "Are You a Forthright Negotiator?" in the Winter 2008 issue of the the *Debevoise & Plimpton Private Equity Report*). This is one issue on which private equity firms have not shown any willingness to yield: all of the deals signed since last October have explicitly provided that the seller will have no right to force the closing. At least one deal did allow the seller the right to seek specific performance of the financing covenant (*i.e.*, the obligation of the buyer to seek to obtain the financing), but for most, the only remedy if a buyer just refused to chase its lenders would be a claim for damages.

Reverse Termination Fee

Without exception, these recent deals limit the recourse of a target against a defaulting buyer to a limited amount of damages. As a percentage of equity value,

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Peter Hockless – London
Alan V. Kartashkin – Moscow
Pierre Maugüé
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Going Private Deal Terms (cont. from page 3)

a termination fee of between 2% to 3.5% was common. Interestingly, some of these deals provided for a two-tier recourse regime. The first tier was recourse to the termination fee, which could be collected without the need to prove damages. The target would then also have the right to seek to prove and recover damages in excess of the first tier of the termination fee up to an additional specified amount, which was generally no higher than 7% of equity value. This two-tier regime was found in some deals a few years ago, but may be making a resurgence now as target companies argue for greater compensation in the event the time and opportunity cost sunk into a deal is wasted. Of course, there is a question of whether a target (as distinguished from the target stockholders who will likely see the value of their public shares drop meaningfully if a deal busts) will actually be able to prove damages in excess of the first tier of the termination fee.

Strategic Deals: Moving to the Private Equity Paradigm?

Interestingly, the paradigm outlined above regarding specific performance and termination fees is consistent with the recently announced $23 billion dollar strategic acquisition of Wm. Wrigley Jr. Company by Mars, Incorporated. Wrigley has no right to seek an injunction or to seek to specifically enforce the obligations of the Mars parties (other than to prevent disclosure of confidential information). And the financing covenant expressly provides that the Mars entities have no obligation to commence litigation or commence an action against their financing sources, which is perhaps not surprising given that one of the financing sources is Berkshire Hathaway.

In exchange for these limitations on recourse, Mars has agreed to pay a termination fee of $1 billion if the deal doesn't close in certain circumstances. Obviously, this isn't a small amount of money. But measured as a percentage of the deal, this fee isn't substantially larger than recent PE-led deals, especially given that a merger of strategics such as this can sometimes give rise to regulatory scrutiny and this deal could therefore linger in pre-closing mode and be exposed to market risks for a considerable period. Whether this is a "one off" situation driven by the comfort the parties have in each other and the deal financing or if it is indicative of a new "market" in strategic mergers remains to be seen. If it is the latter, it would seem to provide further evidence that the allocations of risk in the PE-led deals that we have described above are here to stay.

* * *

We will continue to monitor trends in deal terms as the PE M&A market (hopefully) continues to return to life and will provide you with updates from time to time. ■

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Recent and Upcoming Speaking Engagements

April 3-4
Friedrich E. F. Hey
Tax Planning Strategies U.S. and Europe
Private Equity and Hedge Funds: Tax Efficient, Investment Advisory, Compensation Arrangements
American Bar Association and International Bar Association
Madrid, Spain

April 22-23
Gavin Anderson
Private Equity International Forum: Asia 2008
Exploring the LP/GP Partnership
PEI Media Ltd.
Hong Kong

April 22-23
Sidharth Bhasin
The Private Equity International Forum: Asia 2008
Frontier Markets Focus
PEI Media Ltd.
Hong Kong

May 7, 2008
Tom Britt
Geoff Burgess
Lord Peter Goldsmith
Outbound M&A in India
Amarchand & Mangaldas and Debevoise & Plimpton
Bangalore, India

May 15-16
David H. Schnabel
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances
Drafting Partnership Agreements for Substantial Economic Effect
Practising Law Institute
Chicago, IL

June 14-15
Adele M. Karig
PLI Ninth Annual Private Equity Forum
How to Structure a Private Equity Fund
PLI New York Center
New York

Climate Change Issues Are Turning Up the Heat on Businesses in the U.S.

Even in an era of "Superfund liabilities," no environmental issue has captured the attention of the business community quite like climate change (f/k/a, global warming). Many industry leaders, financial investors, environmental groups and others are actively engaged in educational, conservational and legislative initiatives to address the issue. Reflecting this sense of urgency, legislation is pending, and in some cases, has already been enacted, which could have a dramatic impact on the operations of carbon-intensive businesses and also provide important incentives to the development of renewable energy alternatives.

This article briefly summarizes some of the pending legislative and other initiatives relating to carbon dioxide and other greenhouse gases ("GHGs") and identifies the impact of these initiatives on private equity M&A deals and portfolio companies. Next, starting on page 7 of this issue of the *Debevoise & Plimpton Private Equity Report*, our article entitled Green Gold Rush or Green Bubble, analyzes some of the drivers, challenges and opportunities for private equity and other investors in renewable energy assets.

Climate Change

Climate change generally refers to the increase in the earth's temperature resulting from various human activities. Many scientists believe the earth is warming at an accelerating rate as large amounts of GHGs are emitted from industry, power generation, automobiles and other sources. They believe temperatures have been rising at alarming levels, leading to changes in the amount and distribution of rainfall, severe weather and heat waves, species extinction, melting of polar ice caps and rising sea levels. Many industrialized nations have ratified the Kyoto Protocol, an agreement under which countries commit to reduce GHG emissions or purchase emissions allowances; the U.S. has not ratified the protocol.

Legislative and Other Initiatives

Lieberman-Warner Climate Security Act. The Lieberman-Warner Climate Security Act ("Lieberman-Warner") is the Congressional climate change bill closest to passage. Introduced in October 2007, it was favorably reported out of the Senate Committee on Environment and Public Works in December 2007. The full Senate is expected to consider the bill in June. Lieberman-Warner seeks to establish a federal "cap-and-trade" program covering approximately 80% of U.S. GHG emissions. It employs a cap on emissions that declines over time and seeks to reduce GHG emissions to 15% below 2005 levels by 2020 and up to 70% below 2005 levels by 2050. Covered facilities — such as those using more than 5,000 tons of coal annually, those that process or import natural gas and those that produce or import petroleum- or coal-based liquid or gaseous fuel emitting GHGs — must reduce their GHG emissions each year below their emissions caps. If they cannot emit below their caps, they will generally have to purchase emissions allowances. Under certain circumstances, they may be able to use a portion of "banked" allowances saved from previous years, purchase certified offsets for a portion of their allowances or "borrow" a portion of allowances from future years. Conversely, facilities that emit GHGs below their caps may sell their emissions allowances.

The Bush Administration has opposed Lieberman-Warner because of its potential economic implications and because developing nations are not bound by similar restrictions. But the three leading presidential candidates generally support Lieberman-Warner, reflecting an evolving public consensus on the causes of global warming and strong public sentiment in favor of climate change legislation. For these reasons, the question seems to be not if the United States will adopt comprehensive emissions limits, but when they will be adopted and in what precise form. Still, given the politically sensitive nature of these issues, it seems unlikely that any federal legislation will be enacted prior to 2009.

State and Regional Initiatives. Frustrated by the failure of the Bush Administration to regulate GHG emissions, some states have begun passing their own climate change laws. There are also various regional climate change programs, including the Regional Greenhouse Gas Initiative

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Climate Change Issues Are Turning Up the Heat on Businesses (cont. from page 5)

("RGGI"), an agreement by various northeast states to reduce GHG emissions from power plants. RGGI implements a multi-state cap-and-trade program with a market-based emissions trading system that will require electric power generators in participating states to reduce carbon dioxide emissions. After the cap-and-trade program for power plants is implemented, the RGGI states may expand the program to cover other sources of GHG emissions.

Other Initiatives. In September 2007, the New York State Attorney General initiated an investigation into whether five energy companies adequately disclosed in their Form 10-Ks the climate change risks inherent in their plans to construct new, conventional coal-fired power plants. The companies were served with subpoenas seeking documents relating to their alleged failure to disclose material information to shareholders, including the financial, regulatory and litigation risks associated with GHG emissions and regulations.

Contemporaneously, a coalition of pension fund managers, institutional investors, environmental advocates and state comptrollers and treasurers petitioned the SEC to require corporate registrants to disclose climate change risks. The petitioners sought an interpretive release explaining registrants' obligations under existing regulations to assess and disclose material risks related to climate change. To date, the SEC has not acted on the petition.

The potential passage of Lieberman-Warner and other foreign, regional and state initiatives is expected to increase climate change due diligence on deals. For instance, purchasers will want to assess whether climate change initiatives affect the target company's facilities, including the extent to which such facilities must purchase or may be able to sell emissions allowances.

Deal Execution and Operational Implications

Mergers & Acquisitions. Climate change initiatives are beginning to affect private equity acquisitions and M&A deals more generally. Acquisitions of energy companies, for example, already require an analysis of initiatives such as RGGI. The potential passage of Lieberman-Warner and other foreign, regional and state initiatives is expected to increase climate change due diligence on deals. For instance, purchasers will want to assess whether climate change initiatives affect the target company's facilities, including the extent to which such facilities must purchase or may be able to sell emissions allowances. Purchasers will also want to know whether a target company is the subject of climate change litigation, such as actions brought by environmental protection groups or claims by others alleging property damage or other economic losses arising from GHG emissions.

Purchasers may also want to assess whether a target's facilities and physical assets are located in areas that may be harmed by climate change-related disasters. These purchasers may evaluate whether the target's facilities have the necessary infrastructure in place to withstand flooding and other climate change-related issues. Moreover, purchasers will want to consider the potential effects of climate change on the target company's industry. Extreme weather events may have significant effects on certain industries, such as insurance, forestry, food and agriculture. Purchasers may also be well advised to consider whether a target company's public disclosure adequately discloses the risks climate change and climate change legislation present.

Financings. The specter of climate change legislation is also affecting the lending community. In February 2008, Citigroup, JPMorgan Chase and Morgan Stanley announced guidelines for financing coal-fired power plants. The guidelines, known as "The Carbon Principles," were aimed at reducing the banks' financial risk and supporting activities that reduce GHG emissions. "The Carbon Principles" provide that the signatory banks consider potential future costs for GHG emissions when calculating a project's financial viability. Companies seeking financing for coal-fired plants from the signatory banks must demonstrate the plants will be viable given the caps on GHGs expected to be passed.

In April 2008, Bank of America announced that it was adopting "The Carbon Principles." Other banks may soon follow suit or adopt stricter climate change lending guidelines as they start feeling pressure from interested third parties to "lend responsibly."

It is too early to tell how "The Carbon Principles" and similar internal lender

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Green Gold Rush or Green Bubble?

Introduction

Renewable energy assets seem to be red hot. The media bombardment about "going green" is relentless. Open the newspaper on any given day, and you will probably learn of some amazing new technology that is introduced as the "silver bullet" for climate change.

But despite all this media attention, investment in renewables remains a small piece of total investment in the energy sector. In 2007, $84.5 billion of new money was invested in clean energy infrastructure, representing less than 10% of estimated global investment in energy infrastructure during that year, according to *New Energy Finance*. The estimated private equity activity (excluding direct investment) in infrastructure assets was approximately $6.3 billion in 2007.

This relatively modest investment activity to date is attributed by industry insiders to the untested nature of some of the new technology, the difficulty of scaling much of the renewable technology for larger projects, continuing uncertainty over the future of federal and state subsidies for this sector, prevailing credit market conditions and even concerns, in some corners, that the renewables sector may be the next bubble to burst.

However, the pace of investment in this area can be expected to increase. As many private equity and other investors want to take advantage of the impending legislative and regulatory framework to spur investment in this area and otherwise be in a position to latch on to one of those "silver bullets." This article describes some of the drivers and challenges relating to such investments and highlights some of the significant investment activity to date. It concludes with observations that may shape future investment activity in this sector.

Drivers

Demand for renewable energy has been driven up by economic factors, tax policies and new state laws imposing mandatory use of renewable energy sources on power producers. The principal economic driver is well known — the increased cost of fossil fuels due to rising global demand, global turmoil and increasing production costs. Expected financial and legal costs associated with complying with a Green House Gas ("GHG") emissions "cap and trade" regime along the lines of the proposed Lieberman-Warner legislation described in our article "Climate Change Issues are Turning Up the Heat on U.S. Businesses," on page 5 of this issue, is also likely to drive the appeal of renewable energy. So too is the deep nationwide political opposition to new coal plants and the emerging but counterintuitive appeal — particularly for those of us who remember Three Mile Island and Chernobyl — of nuclear power.

Challenges

Legislative and Regulatory Uncertainty

The technology supporting renewable energy generation on the current scale is new, rapidly changing and sometimes untested. Much of it is not likely to be competitive with traditional sources in the short term unless it receives some sort of governmental support during this developmental phase. Not surprisingly, investing in green assets seems to be inhibited to a degree by the absence of comprehensive legislation and related rulemaking in this area and the complex turf wars between different federal agencies and commissions, between state and local governments and between the states and the federal government.

For instance, notwithstanding Congress's ostensible support for renewables, it has yet to back up its development with legislation providing subsidies on which investors can depend for the long term. The energy bill passed in the fall of 2007 initially included so-called renewable portfolio standards that would have required utilities to source a minimum amount of their power from renewable sources. This provision was dropped at the last moment. On the biofuel front, Congress continues to wrestle with the extent to which it will support ethanol and other biofuels, as evidenced over the past several months by news coverage of the Farm Bill negotiations. This is complicated by the sudden backlash against biofuels in the popular media based on assertions that the current rise in global food commodity prices is being caused by the diversion of food crops and agricultural land to biofuel feedstock, although others believe that rising food prices are primarily due to other factors not related to ethanol.

By the same token, the Production Tax Credit, which provides 1.5-cent per KWh credit for wind, solar, geothermal and "closed-loop" bioenergy, is set to expire at the

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Green Gold Rush or Green Bubble? (cont. from page 7)

end of 2008 and will only benefit producers generating renewable energy before the expiration date. That means that, if the proposed extension does not pass by this Summer, several wind projects currently set to go online in 2009 or later may be put on hold. The American Wind Energy Association reports that the U.S. is on pace to install a record 5,600 megawatts of new wind power in 2008, driven in part by the desire to complete projects this year before the credits expire. Whether these subsidies are sensible as a policy matter is debatable. However, it is clear that the lack of certainty on the subsidies front is affecting investment decisions.

In the absence of federal leadership on greenhouse gas and alternative energy policy, states have begun adopting their own policies, either alone or as part of regional initiatives. For example, roughly half the states and the District of Columbia have adopted some form of mandatory renewable energy portfolio standard or "RPS." Under these programs, power producers are obligated to produce a minimum percentage of the power sold through the grid from renewable sources such as wind, solar and hydroelectric. Generally, the applicable percentage will ratchet up over time. Requirements vary widely from state to state, and, as noted below, in many states regulations are not final or the infrastructure needed to achieve these goals is not in place. Similarly, in some regions, states are voluntarily forming regional initiatives to introduce their own cap and trade polices, as is the case in the northeast United States, with the Regional Greenhouse Gas Initiative (RGGI). This patchwork of laws and standards creates complexity and uncertainty which again can cause some reluctance to invest.

Overall, RPSs and other state and regional initiatives promise to generate massive demand for renewable energy that traditional utilities may struggle to meet. Such projects may offer fertile ground for private equity investors who wish to build a portfolio of renewable assets with a view to selling such assets to utilities. But though legislation has been enacted in these states, many of the rules implementing key aspects of these RPSs, such as what assets qualify (for example, some states give credit for existing clean energy sources, such as old hydropower projects, others do not), are not yet finalized, thereby engendering continuing uncertainty among investors who have adopted a wait and see approach.

Commercial Considerations

Legislative and regulatory uncertainty are not the only investment challenges for renewable energy assets. Other more "ordinary course" hurdles include intermittency of production (wind turbines only generate power when the wind blows) and transmission constraints (new generation is useless if not connected to the grid by new power lines). Renewable energy investment is also not a natural fit for private equity. Most of the investment is in early stage projects and exit opportunities in connection with green investment projects are uncertain at best. The current unstable credit market and the complexity of applying a historical leveraged model to energy assets are further impediments to making renewable energy investment a darling of the private equity community.

Current Activity

Notwithstanding the uncertainties and in spite of the challenges, investors in general and private equity firms in particular have been moving into the renewable energy sector in increasing numbers over the past several years, enticed by strengthening economics, high oil prices, public incentives and, in some cases, a desire for more "green" projects in a portfolio. Others are attracted to the prospect of being at the forefront of a movement that may vastly change global industry.

Who are the players?

Strategics

There are some pure play green independent power producers (IPPs) such as Renegy Holdings, Inc. Diversified IPPs are also making investments. Not surprisingly, in the U.S. most of the investment has been made by IPPs rather than regulated utilities since more speculative investments that could be subject to prudence reviews if they fail are difficult for utilities, and their cost structure won't usually reward the risk. This may fade if the new renewable portfolio standards and other legislation favoring clean energy encourages utilities to make further investments. Recent experience would suggest, though, that utilities are more likely to acquire completed projects than invest in startups. In Europe, the large utilities are making massive investments in renewables, no doubt spurred by EU-mandated portfolio targets, with varying degrees of enthusiasm depending on the utilities jurisdiction — German utilities are at the forefront, given that the country has been a leader in promoting and mandating use of clean energy.

Energy industry and technology corporations are also making direct equity investments in green and clean technology, spanning from minority stakes to vertically integrated partnerships. Recent announcements here include Google's pledge to invest hundreds of millions of dollars in renewable energy, as well as GM's announced partnerships with advanced technology ethanol companies Coskata Partners and Mascoma Corporation, ConocoPhillips' investment in an Iowa State University research facility, and

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To Tax or Not to Tax

Developments in the UK Regarding Taxation of Foreign Sourced Carried Interest

During the first half of 2007, there was significant comment in the non-financial press in the UK about the scale of profits earned by the private equity community, and in particular, the favorable tax treatment in the UK of carried interest. This attention had been initially stoked by a union in connection with a dispute with a private equity portfolio company. The torch was then taken up by a somewhat hawkish Parliamentary sub-committee which took rather unseemly pleasure in grilling — in public — a number of senior members of the private equity community about the nature, and profitability, of the private equity market.

Thus, by the Autumn, when the government was due to publish its initial thoughts (in the "Pre-Budget Report") for the forthcoming financial year (which, in Britain, for reasons few can remember, starts on April 6 rather than January 1), there was widespread expectation that the tax rate on carried interest would be increased.

Tax Treatment of Carried Interest

The taxation of carried interest is complex. With appropriate structuring, carried interest can be taxed in the UK, as in the U.S., as capital gains, which at the time of the Pre-Budget Report, were charged at rates of between 10% and 40%. Normally carried interest was capable of attracting the 10% rate, at least in the context of LBO and real estate funds.

But the law allowed some foreign nationals, including many people employed in the private equity community in the UK, to pay even less than that. Since the nineteenth century, the UK has operated special rules for the foreign income and gains of those persons who, whilst UK tax resident, and therefore in principle subject to UK tax, were not domiciled in the UK (known colloquially as "non-doms"). Domicile is also a complex matter under the law, but a good proxy for it is nationality (except in relation to the more recently ceded former British colonies).

These rules provide that a non-dom is taxed on foreign source income and gains only if they are remitted to the UK Although remittance is a fairly broad concept, a non-dom would typically be able to avoid any remittance of offshore income and gains as long as all his or her UK expenditures were not met from the foreign bank accounts into which such income and gains had been paid. It was also possible to set up an offshore mortgage for a UK real estate purchase, which could be funded out of foreign income or gains, but not give rise to any UK tax on such income or gains.

A further, and very significant, benefit of being a non-dom has been that a range of anti-avoidance rules relating to offshore trusts and companies which apply to a UK resident did not apply to non-doms. This allowed non-doms to reduce the tax on carried interest distributions to nil. Not only that, but distributions routed through offshore trusts could be remitted to the UK free of UK tax. The end result, therefore, was that a suitably advised private equity professional in the UK with non-dom status could avoid UK tax altogether on carried interest distributions, whilst enjoying them in the UK

Obviously, in the case of a U.S. citizen, U.S. tax would still have to be paid on these gains. Whilst UK and U.S. taxes are generally creditable against each other, there are important exceptions (*e.g.,* the tax treatment of distributions from a U.S. LLC). In addition, the UK is very close to a gross system of tax for individuals, with a limited range of deductible items. Because of this, many U.S. foreign nationals have still reduced their aggregate tax exposure, sometimes significantly, due to their non-dom status.

The Government's First Announcement

The Pre-Budget Report proposed to impact the treatment of carried interest outlined above in two ways (both to be effective from April 6, 2008). The first was that the taxation of capital gains would be greatly simplified by the introduction of a flat rate of tax of 18% (as opposed to the range of 10% to 40% in place at the time). This proposal attracted, and continues to attract, widespread criticism because, whilst expressly stated to be aimed at private equity taxation, it increased the capital gains rate for all business assets, including those owned by an individual, by up to 80%, whilst reducing the rate on investment gains by up to 45%. For many, it was hard to discern the connection between this result and the government's stated aim of encouraging entrepreneurial behavior.

The second proposal, which attracted far less press comment, at least initially, related to non-doms. The government's initial announcement was that non-doms who had been resident in the UK for at least seven years would be able to continue to take advantage of the remittance rules for foreign income and gains only by paying a tax charge of £30,000 a year. In addition, the government announced — without any specifics — that various anomalies in the treatment of non-doms would be rectified, which was viewed by many as code for removing some or all of the planning arrangements commonly used by non-doms, including the use of offshore trusts and other devices to avoid tax on foreign source income and gains enjoyed in the UK The government promised that draft legislation covering this proposal would be published for comment

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before the end of the year. In addition, the government said – again with scant detail – that it would be extending the meaning of remittance, creating doubt over whether offshore mortgage arrangements of the type described above would continue to work.

Whilst the government's announcement was short on detail, one point that seemed immediately problematic was the treatment of the flat tax of £30,000 for U.S. non-doms. Because the flat tax might not be creditable against U.S. taxes, non-doms could be faced with choosing between two potentially unattractive alternatives: being fully subject to UK tax and reporting on worldwide income and gains on the one hand, and having to pay $60,000 (based on an assumed 2:1 exchange rate) of non-creditable tax on the other.

The Government's Second Announcement

The draft legislation implementing aspects of the Pre-Budget Report was published on January 18, 2008. The legislation did not provide comfort to non-doms and their advisers. The new rules on remittances were opaque, for example, on the position of offshore mortgages. Perhaps of most concern, however, were the proposed new rules on offshore trusts. The government was proposing that the full range of anti-avoidance rules applicable to trusts in which UK doms were interested would apply to those in which non-doms were interested, more or less, lock, stock and barrel. Making matters worse, the proposed legislation did not grandfather either existing trusts or existing income and gains of trusts.

One example of the many anomalies this would create was the treatment of any carried interest distribution relating to a non-UK portfolio investment (and, therefore, foreign source) to be made after April 6, 2008, when all the new rules were due to come into force. If the distribution were received offshore by the carried interest participant, and he or she had non-dom status (through either paying the flat tax or not having been resident in the UK. sufficiently long to be subject to it), no tax would be paid as long as the distribution was not remitted to the UK On the other hand, if the participant held his or her carried interest through an offshore trust, the distribution would be immediately taxable, irrespective of whether it were remitted to the UK and irrespective of whether the participant had non-dom status.

The effect of these proposals was to make offshore trusts potentially toxic vehicles for holding assets. It is unclear whether this was intended or whether the government did not have the time to think things through (though when the draft legislation was published, the government acknowledged that it was flawed and needed to be amended).

The Government's Third Announcement

Budget Day is the most important day in the financial year, being the day on which the government's fully developed proposals for the next financial year are announced, some, but not all of which, will have been anticipated in the preceding Pre-Budget Report. On Budget Day this year, March 12, 2008, the government, having been subject to hard lobbying on behalf of non-doms, (although perhaps a bit too little too late in some respects) has watered down some of the proposals mentioned above. Some highlights are as follows:

First, some of the more draconian aspects of the proposals on offshore trusts have been removed or modified. For example, non-doms will not be taxed on the gains from their trusts as such gains arise to the trusts but will be taxed only when distributions are received by a beneficiary from the trust and, in the case of foreign source gains, remitted to the UK where the beneficiary benefits from non-dom status (thereby removing the anomaly described above).

This modification removes some of the penal aspects of the original proposals on offshore trusts and the disadvantages that could have resulted from a non-dom holding assets through an offshore trust rather than personally. In addition, a degree of grandfathering has been introduced for existing assets held within existing trust structures. However, there will remain disadvantages in holding assets through trust structures, not least that there is a forced ordering of remittances from trust distributions, which of course works to the advantage of the UK Exchequer.

Second, the flat rate of tax has been remodelled so that it is intended to qualify for U.S. tax credit relief. It is understood that the UK tax authorities are trying to reach an agreed position with the IRS on this issue. In the interim, the government has taken the unusual step of publishing a tax opinion of a leading U.S. firm on the creditability position.

Third, the government's position on the new remittance rules has been clarified in relation to offshore mortgages. In principle, any interest on an offshore mortgage will be treated as a remittance of the income or gain from which it is paid. However, mortgages in existence on Budget Day are grandfathered from the new rules unless they are varied after Budget Day.

Conclusion

It will take some time before the implications of the new regime have been fully digested and new strategies developed to cope with them. Many existing offshore trusts were closed down before Budget Day, and it remains to be seen what sort of phoenix or phoenixes will rise from the ashes. We intend to monitor the position and will report further in subsequent editions of the *Debevoise & Plimpton Private Equity Report.* ■

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ALERT

Deferred Compensation Plan's Compliance Window Closing Soon – And This Time The IRS Means It

Private equity firms and their portfolio companies have no further time to postpone reviewing their deferred compensation arrangements. That applies to both those arrangements that they and their employees recognize as deferring compensation and those that the IRS might interpret to do so, notwithstanding how counterintuitive the IRS's conclusion may be to the rest of us.

In 2004, Congress enacted Section 409A of the Internal Revenue Code, imposing an entirely new regulatory regime on "deferred compensation." "Deferred compensation" is generally defined under the statute to cover any promise made in one year to pay compensation in a future year. Because of the breadth and complexity of the statute, and because the IRS's own views on the statute have evolved since its enactment, the IRS initially established, and then extended, a period of transition relief during which deferred compen-sation plans were not required to be in documentary compliance with the statute. The transition relief is set to expire on December 31, 2008. IRS officials have stated that the period of transition relief is not likely to be extended, notwithstanding many basic and complicated questions about the statute and related Treasury Regulations that remain unanswered. The good news is that there is still time to avoid the effects of this draconian statute, but the window is closing.

If you have not already done so, you need to take action to bring your plans into documentary compliance now.

Here's why:

Punitive Effect on Employees (and Employers). Section 409A has a punitive effect on employees who are subject to a noncompliant deferred compensation arrangement. The statute imposes a 20% additional tax on noncompliant deferred compensation, and, potentially, interest and penalties. In addition, because of plan aggregation rules, a single non-compliant arrangement could have a domino effect and cause otherwise compliant arrangements to fail. This effect is largely the employee's problem because the employee bears the tax (absent a contractual agreement to the contrary). However, an employer with noncompliant arrangements will likely have disgruntled employees on its hands, in particular because the task of maintaining compliant arrangements would normally rest with the employer. Section 409A also disregards contractual payment terms and causes noncompliant deferred compensation to be includible in income as soon as it vests. As a result, it may be the case that the employer would have a withholding obligation earlier than the scheduled payout date (although the employer withholding rules are yet another unclear area). For now, the employer has no obligation to withhold the additional tax, but the IRS is considering imposing a withholding obligation with respect to the additional tax.

Limited Creative Planning. Under the current transition relief, employers and employees can modify deferred compensation arrangements — even compliant deferred compensation arrangements — in ways that will not be available after the end of the year. For example, deferred compensation plans must now designate in writing an objectively determinable distribution amount upon one or more of the permissible payment events — separation from service, change in control, unforeseeable emergency, specified fixed date or fixed schedule of payments and death or disability (all of which — except, not surprisingly, death — have a specific and detailed regulatory gloss). Between now and the end of the year, employers and employees may be able to modify the time and form of payment of deferred compensation (for example, by electing to have deferred compensation payable on a fixed date rather than on termination of employment). Under certain conditions, arrangements may be able to be modified to comply with one of the many available exemptions and remove them from the statute's reach. But effective Janary 1, 2009, these planning opportunities will disappear.tax.

It's Going to Take Some Time. Section 409A covers a wide variety of arrangements such as employment agreements, severance and change-in-control plans and agreements, single- and multi-year bonus arrangements, exit bonuses, non-qualified pension plans, equity compensation plans, phantom carried interest arrangements, expat arrangements and reimbursement policies, as well as traditional deferred compensation plans. As with other significant changes to an employer's compensatory programs, the Section 409A compliance review will require

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employers to develop roadmaps, draft new plans and/or plan amendments, educate boards of directors and their compensation committees and obtain appropriate approvals and/or new elections. For employment and severance agreements, employee consent and individual negotiation may be required. Because of the breadth of the statute's application, it will also take some time to identify all affected compensation arrangements, particularly for companies with far-flung or decentralized operations. In this regard, the statute applies to all arrangements subject to U.S. taxation, including compensation earned under non-U.S. arrangements by U.S. taxpayers. Employers, even small employers, should not underestimate the amount of time and effort that a compliance review under Section 409A will entail.

Coming Soon: Reporting of Deferred Compensation. Noncompliant deferred compensation is required to be reported on an employee's Form W-2 for the year of vesting. However, Section 409A also requires that compliant deferred compensation be reported in the year of deferral. For now, no one — not even the IRS — knows how to perform these calculations (for example, it's anyone's guess how a severance entitlement, which may or may not be paid years in the future, should be reported). Accordingly, these rules will remain suspended for now. As part of its compliance project, employers will need to identify the types of deferred compensation under their arrangements so as ultimately to be able to implement IRS reporting guidance when it is issued.

Additional Burden on Private Equity Firms. Private equity firms will shoulder a heightened burden in this compliance review, as they will need to look at both their own arrangements and the arrangements in place at their portfolio companies. Private equity firms should expect that a portfolio company's compensation arrangements will be scrutinized when the portfolio company is sold, and any noncompliance that rises to a material threshold could affect price, deal terms (such as indemnifications), and negotiations with management.

Think You're Done? Take a Second Look. The IRS issued final regulations under Section 409A in early 2007. Although the final regulations in large measure track earlier IRS guidance, there were some changes, a few of them significant. In addition, a body of "lore" is slowly building up as practitioners and their clients work through the statute's complexities. Employers who conducted their Section 409A review prior to the issuance of the final regulations should take a second look at their arrangements to identify any further necessary changes. ■

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The Unthinkable – Private Equity Fund Found Liable for Unfunded Pensions

Introduction

Everyone in the private equity business knows better than to suggest that their fund conducts a "trade or business" for federal income tax purposes. The Pension Benefit Guaranty Corporation (PBGC) in an Appeals Board letter dated September 26, 2007, surprised many when they disagreed with that position and held that a private equity fund was a "trade or business" for purposes of ERISA. The consequence of that view is that a private equity fund could be liable for the unfunded pension liabilities of portfolio companies in which it has an 80% or greater interest. This unanticipated ruling has an obvious immediate impact on a private equity fund's assessment of its exposure to potential pension liabilities. And, perhaps even more startling, this holding could, carried to its logical extreme, support changing the characterization of any gain on the general partner's interest in a fund from capital gain to ordinary income for federal income tax purposes—without any legislative change.

Here's the background:

Controlled Group Concept.

ERISA's pension provisions impose joint and several liability on the sponsor of a pension plan and each member of its "controlled group," which is defined to consist of "trades or businesses" under common control. The determination of controlled group status is based on a set of complex rules, which are based in large part on the tax rules for affiliated companies filing consolidated tax returns. For example, under these rules, any contributing sponsor of a pension plan, together with the sponsor's subsidiaries in which it has an 80% or more greater interest, will be treated as one entity for pension liability purposes under ERISA.

PBGC Appeals Board Decision.

The situation addressed by the PBGC involved a private equity fund with a standard organizational structure. The fund consisted of a partnership established for the principal purpose of making investments in United States industrial businesses and managing and supervising such investments. The fund had a typical management arrangement in which it delegated full control of the fund's operations to a general partner which in turn hired a manager to manage the fund's assets. Under the terms of the management agreement, the general partner reserved decision-making authority. The general partner was entitled to a 20% carried interest, and the fund paid the manager for investment advisory and management services.

Private equity fund sponsors have consistently taken the position that, under this now standard structure, the fund is not a "trade or business" for federal income tax purposes. The authority for this position has been by analogy to a series of somewhat older tax cases concluding that a person investing his or her own money in a business enterprise, but without an otherwise applicable role in that business, was just a passive investor, and not conducting a "trade or business."

Citing these very same tax cases, the PBGC rejected the characterization of the fund as a passive investment vehicle and determined that the fund was a "trade or business" actively involved in its investments. In reaching its conclusion, the PBGC focused on the terms of the partnership agreement, the fund's tax return which identified the fund's business as investment advisory, the size of the fund, the profits generated and the management fee. Of particular significance was the fact that the fund obtained a controlling 96.3% interest in its portfolio company, the contributing sponsor of the pension plan, and such control was consistent with the fund's stated purpose of managing and supervising investments, albeit through a separate (but affiliated) manager. The PBGC also attributed the activity of the manager to the fund, concluding that the manager was the fund's agent and that "all of [the manager's] acts within the scope of such agency are attributable to the fund."

Impact of Controlled Group Status.

In light the PBGC Appeals Board letter, private equity funds should assess their exposure to unfunded pension liabilities of their portfolio companies and how that exposure may affect the valuation of the rest of their portfolio. Other areas of concern include:

- *Withdrawal Liability.* Imposition and calculation of withdrawal liability under multiemployer plans (plans covering union employees of unrelated employers) is also based on the PBGC's interpretation of the controlled group rules. Liability may be assessed when an employer reduces or ceases its obligation to contribute to a multiemployer plan.
- *Credit Agreements.* Provisions in credit facilities entered into by a fund or any of its portfolio companies take into account pension liabilities of portfolio companies of the fund in the same controlled group.
- *Current Exposure.* If a fund already has a portfolio company in its controlled group with an underfunded pension plan, an analysis should be conducted to determine whether such exposure can be minimized. In this circumstance, special attention should be paid to Section 4069

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of ERISA, which imposes liability for an underfunded pension plan on a person not in the sponsor's controlled group as a result of a transaction a principal purpose of which was to avoid or evade pension liability.

- *Planning future transactions.* With respect to an acquisition of a portfolio company with a defined benefit pension plan, consideration should be given to whether the transaction (within the business requirements of the deal), can be structured to avoid potential liability for the fund and its portfolio companies.

Future Developments.

The PBGC letter comes at a time when there is at least intermittent momentum in Congress to change the rules regarding the taxation of the general partner's interest in a fund as compensation for services. While relying on authority in somewhat analogous tax cases, the PBGC took matters into its own hands. Whether the PBGC will prevail if its position were to be litigated remains to be seen. In the meantime, every private equity fund should evaluate the risk of being characterized as "trade or business" for employee benefit matters. ■

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Climate Change Issues Are Turning Up the Heat on Businesses (cont. from page 6)

guidelines might be extended to affect private equity-related leveraged financings once a new legislative regime relating to carbon dioxide and other GHGs takes shape and the financing markets return. Still, at a minimum, it seems clear that in many deals lenders may pressure private equity firms to conduct the kinds of additional environmental diligence described above, even in circumstances when a private equity firm feels it is unwarranted. One would expect that these lenders will also wish to have access to the results of the sponsor's diligence in this regard. More requirements seem likely as the legislative landscape settles in this area. Additionally, if securities are issued to help finance an acquisition, private equity firms will need to consider the extent to which climate change issues should be disclosed in the securities offering documentation.

SEC Disclosure. Public companies, as noted above, are under increasing pressure to disclose climate change issues in their SEC filings and securities offerings. Many companies are disclosing the status of federal legislation and applicable foreign, state or regional climate change initiatives. Some have disclosed the potential effect of an April 2007 U.S. Supreme Court decision that prompted the EPA to regulate GHG emissions. Companies with facilities emitting significant quantities of GHGs often disclose the potential need to purchase emissions allowances, install pollution control equipment or take other steps to reduce GHG emissions. Some environmental groups are pressing companies to disclose (1) whether climate change presents material risks to a company's physical assets (such as through hurricanes or rising sea levels) and (2) their initiatives to reduce GHG emissions. These disclosure-related developments will be of particular relevance to private equity firms with public portfolio companies.

Some environmental groups are pressing companies to disclose (1) whether climate change presents material risks to a company's physical assets (such as rising sea levels) and (2) their initiatives to reduce GHG emissions. These disclosure-related developments will be of particular relevance to private equity firms with public portfolio companies.

Conclusion

Climate change developments are expected to move rapidly over the next few months as Congress debates Lieberman-Warner and a new president supporting the legislation is elected. The private equity community and others will need to monitor these developments as the race to reduce Corporate America's carbon footprint heats up. ■

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How the New Exon-Florio Rules Affect Private Equity

The days when Exon-Florio was of little import for U.S. private equity funds may be over. As you may recall, Exon-Florio authorizes the President to prohibit an acquisition of a U.S. business by a foreign person if the President finds the acquisition might threaten national security. Because U.S.-based private equity funds traditionally did not think that they could be deemed foreign persons, they did not worry about the impact of Exon-Florio on their acquisitions.

However, in July 2007, in response to growing concerns about foreign investment in the United States, Congress amended Exon-Florio by enacting the Foreign Investment and National Security Act of 2007 (FINSA), and in April 2008 the Treasury Department proposed new regulations to implement FINSA. If adopted, the proposed regulations may create confusion about whether an entity, especially a private equity fund, is foreign for purposes of Exon-Florio. In particular, funds in which 50% or more of the partnership interests are directly or indirectly held by foreign investors may be deemed foreign, notwithstanding that the general partner and manager are owned and run by U.S. persons. When such funds contemplate investments in businesses that impact national security, they will have to consider Exon-Florio more carefully than in the past.

The Law

As amended by FINSA, Exon-Florio authorizes the President to suspend, prohibit or require the unwinding of any transaction by or with a "foreign person" which could result in foreign "control" of a "U.S. business," if the President concludes that (1) the foreign interest exercising control might take action that threatens to impair U.S. national security and (2) other laws do not provide adequate protection.

Parties to an acquisition or merger who are concerned that their transaction may be subject to Exon-Florio and who do not want to live with the threat that the President could order the transaction unwound, may request a pre-closing review by the Committee on Foreign Investment in the United States (CFIUS), an interagency body headed by the Secretary of the Treasury. CFIUS also may initiate a review of a transaction on its own. If CFIUS concludes a review without taking further action, the parties can proceed without fear of presidential interference (subject to CFIUS's ability to reopen a review if any party submitted false or misleading material information).

The Key Questions

The key questions to be answered in determining whether to request a pre-closing review by CFIUS are: (1) is the proposed transaction by or with any foreign person?; (2) could the transaction result in foreign control of a U.S. business?; and (3) might the U.S. government conclude that the transaction threatens to impair national security? Prior to the enactment of FINSA, it was usually not difficult to determine whether an acquirer was foreign, and, accordingly, most decisions to request CFIUS review turned on whether the business of a target company could be said to affect national security. However, changes introduced by FINSA and the proposed regulations make the determination regarding "foreign" status more difficult.

Foreign Person

As defined in the proposed regulations, a "foreign person" is (i) any foreign national, foreign government or *foreign entity*, or (ii) any entity *over which control is exercised or exercisable* by a foreign national, foreign government, or foreign entity (emphasis added). "Foreign entity" includes any entity organized under the laws of a foreign state in which foreign nationals hold, directly or indirectly, at least 50% of the outstanding ownership interest. (Foreign nationals are individuals who are not U.S. nationals.) Such an entity need not be controlled by foreign nationals in order to be a "foreign entity." Accordingly, a fund organized in an offshore jurisdiction by a U.S. private equity sponsor would be a foreign entity if 50% or more of its partnership interests are held, directly or indirectly, by individuals who are not U.S. nationals, even if its general partner and manager are owned and run by U.S. persons.

The reference in the definition of "foreign entity" to *direct* or *indirect* holdings by foreign nationals may further complicate the determination of whether a private equity fund is a "foreign entity." The proposed regulations do not indicate to what extent a private equity fund must "look through" its direct institutional partners to determine indirect ownership.

The second prong of the definition of "foreign person" retains the traditional Exon-Florio focus on control, but the proposed regulations make clear that the Treasury Department views the concept of control very broadly. For example, a veto right over the termination of senior managers constitutes "control," as does control that is not presently exercisable but may become exercisable in the future.

Although most private equity funds are controlled, as the term is commonly understood, by the general partner and the manager, limited partners usually have some rights that may constitute "control" for Exon-Florio purposes. For example, in

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most funds the limited partners have the ability, under certain circumstances, to replace the general partner. If such replacement is within the control of the limited partners (for example, if the limited partners may remove the general partner at any time by a majority or supermajority vote), the limited partners are likely to be found to control the fund. When 50% or more of such a fund's partnership interests are held by foreign investors, it may be a "foreign person," even if it is organized in the U.S. and has a U.S. general partner and manager, unless the fund sponsors are able to persuade CFIUS that the foreign ownership is too broadly dispersed for the foreign investors to control.

Foreign Control

The second question in the Exon-Florio analysis is whether the proposed transaction would result in foreign control of a U.S. business. Where an acquirer of a majority interest in a U.S. business is a foreign person by virtue of its being controlled by a foreign national, foreign government or foreign entity, the proposed transaction will almost always result in foreign control.

When the acquirer is a foreign person by virtue of being a foreign entity — a conclusion that may be reached without an analysis of control — the parties will have to engage in a separate control analysis similar to that described above. Consistent with Treasury's corporation-centric view of the world, the proposed regulations do not contemplate that an entity might be majority-owned by foreign investors but controlled by U.S. persons, and presume that if a foreign entity has direct control of a U.S. business, there is no need to inquire whether the foreign entity itself might be controlled by a U.S. person.

Sovereign Wealth Funds

On a related topic of current interest: Most foreign sovereign wealth funds (SWFs) will be foreign persons. Accordingly, Exon-Florio should be considered in connection with an investment by an SWF in a U.S. private equity sponsor and, if the SWF could be said to "control" the investee (including by virtue of its contract rights), in connection with subsequent transactions by the investee. Of course, Exon-Florio will be relevant only if the investment has national security implications.

We believe that certain recent investments by SWFs relied on the pre-FINSA rule that the acquisition by a foreign person of 10% or less of an entity's voting securities, solely for the purpose of investment, was exempt from Exon-Florio. That rule, in slightly different form, survives in the proposed regulations, but Treasury makes clear that "solely for the purpose of investment" will be narrowly construed. For example, investments in connection with which a foreign person acquires "contractual rights that give it the right to control important matters" or "the right to appoint one out of 11 [board] seats" are not "solely for the purpose of investment."

The relevance of Exon-Florio to subsequent transactions by a U.S.-based private equity sponsor that has a SWF as a significant investor will depend on the specific terms of the SWF's investment, including in particular how much control the SWF shares. The definition of "control" in the proposed regulations includes a list of "minority shareholder protections" that are deemed not to confer control, but the list is narrow and the examples of rights that do confer control (such as the right to veto the dismissal of senior executives) suggest that in some cases SWFs investing in sponsors will likely be deemed to have control.

National Security

The term "national security" is undefined. Prior to the enactment of FINSA, Exon-Florio filings were most frequently made for transactions in the military, defense and financial sectors and where the targets held sensitive, classified or export-controlled technology. Transactions involving targets that were suppliers to the United States government, especially sole source suppliers, were more likely to be the subject of filings. FINSA requires consideration of an expanded list of factors and, post-FINSA, filings are likely to increase for transactions involving the energy and infrastructure industries and a broader range of technology businesses.

Conclusion

If adopted, the proposed regulations may require private equity sponsors to monitor their funds' foreign investors and, if the funds may be deemed foreign controlled, the national security implications of the funds' proposed investments. These additional burdens should be manageable and should not have a significant impact on deals, but we expect that Exon-Florio filings by private equity funds will increase. ■

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Warming up to the Trust Fund Babies: Do SPACs Present Attractive Opportunities?

Special purpose acquisition companies, or SPACs, have made headlines for much of last year and for the first months of 2008. The hype is driven, primarily, by two factors. One is numbers: SPACs accounted for approximately 23% of all U.S. initial public offerings in 2007. The other is celebrity worship: everyone from Ashton Kutcher to Ron Perelman appears to be involved with a SPAC these days. While much has been written about how SPACs enable "retail investors" to participate in the private equity game, we thought it was time to look at the SPAC phenomenon from the opposite direction: What opportunities does the SPAC market present for private equity sponsors?

SPACs in a Nutshell

Before we pursue this question further, here is a quick refresher on SPACs:

SPACs commence life as empty shell companies. They then set out to raise capital to be deployed in a business combination with an operating company. The lion's share of the funds for the business combination is raised from public investors — many of them hedge funds, not retail investors — in an initial public offering. SPAC investors acquire units, which typically consist of one share and one warrant, exercisable after the closing of a business combination usually at 75% of the per-unit IPO price. More than 95%, and in recent SPAC deals increasingly close to 100%, of the IPO proceeds are deposited in a trust fund until the SPAC completes a business combination. The balance of the proceeds and a specified amount of the interest earned on the funds held in trust are used to cover expenses incurred in connection with identifying and negotiating a business combination.

The remainder of the funds for the business combination, typically around 3% of the total IPO offering size, comes from the SPAC's sponsors who, in return, are issued warrants. In addition to the warrants, SPAC sponsors are issued the sponsor promote, *i.e.*, shares representing 20% of the SPAC's total shares in exchange for a nominal investment of a few thousand dollars. SPAC sponsors also fund the fees and expenses it takes to bring a SPAC to market. To the extent that the portion of the IPO proceeds earmarked to cover expenses in connection with a business combination does not suffice, SPAC sponsors also front those expenses. Finally, in a more recent development (since mid-2007 or so), SPAC sponsors often commit to purchase an additional amount of shares after the IPO, either in the market at the per-share trust liquidation price to support the trading price of the shares or, if these "market support" purchases do not consume the entire committed amount, as additional sponsor co-investment units at the IPO price.

How SPACs Do Deals

The organizational documents of a SPAC require a prospective target to have a fair market value of at least 80% of the amount held in trust. In addition, some SPACs commit to source their targets within particular industries. Beyond these restrictions, SPAC sponsors enjoy wide discretion with respect to the prospective business combination partner. The same applies with respect to the structure for a business combination. Specifically, SPACs may use the cash in the trust fund, SPAC stock or both as acquisition currency. SPACs may also add leverage. Using stock, leverage or both, SPACs can "acquire" targets many times their own market capitalization, thus effectively facilitating a reverse IPO. A recent example of such a transaction is the announced acquisition of Complete Energy Holdings, a $1.3 billion company, by GSC Acquisition Corp., a SPAC with a market capitalization of $190 million.

A key feature of SPAC deal making is the need to beat the clock. Typically, SPACs have 18 months from the date of the IPO to consummate a business combination. The period automatically extends to 24 months if either a letter of intent or a definitive acquisition agreement is signed within the initial 18 months period, although recent deals have gone with a 24 to 30 month structure. Once a SPAC runs past its outside date, it must liquidate. In a liquidation scenario, the SPAC sponsors' promote and warrants remain worthless and fees and expenses funded by the sponsors will not be reimbursed. Given these consequences, it is not surprising that SPAC sponsors tend to pursue several acquisition candidates simultaneously in an effort to get at least one of the candidates across the finish line.

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While much has been written about how SPACs enable "retail investors" to participate in the private equity game, we thought it was time to look at the SPAC phenomenon from the opposite direction: What opportunities does the SPAC market present for private equity sponsors?

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Once a definitive acquisition agreement is signed, a proxy statement, or if the proposed target's shareholders are to receive SPAC stock in the business combination, a Form S-4/proxy is prepared, reviewed and commented on by the SEC and mailed to the SPAC's shareholders. In parallel, the SPAC sponsors embark on a road show to promote the deal.

Any proposed business combination must overcome two hurdles. It must receive the blessing of at least a majority of SPAC shares issued in the IPO and voted on the business combination. In addition, since SPAC shareholders that vote against the business combination are eligible to redeem their shares and receive a *pro rata* share of the trust fund, the deal cannot go forward if SPAC shareholders in excess of a specified percentage want their cash back. The relevant threshold is 20% for many SPACS, although more recent SPACs have provided for a 30% and, in some cases, a 40% threshold. As long as the cash converters' number remains below the applicable threshold, the deal can go forward. However, the combined entity ends up with a reduced amount of working capital and some SPACs seek to pass along that shortfall to the target shareholders, *i.e.*, by substituting stock for cash consideration.

What's in it for Private Equity?

Given the fact that both IPOs and secondaries pose significant challenges in today's environment, should private equity sponsors consider selling a portfolio company to a SPAC?

Clearly, certain of the characteristics of the SPAC structure seem to make an exit to a SPAC an intriguing option. After all, SPAC sponsors who are faced with the dual risk of losing the ability to recover fees and expenses and foregoing significant upside if they don't succeed in consummating a business transaction by a time certain may be more interested in getting any deal done than in the exact terms on which a deal gets done. These pressures, coupled with the fact that many SPACs pursue multiple targets at the same time and often with limited human resources, may also translate into reduced or less thorough business and legal due diligence and, possibly, a faster time line to signing and more seller-friendly risk allocation terms. Add the fact that numerous SPACs are coming up against their outside dates – according to data gathered by one research firm, as of mid-April, more than 70 SPACS had yet to announce a business combination – and there appear to be many of the ingredients for a sellers' market.

Perhaps it is no coincidence then that recent months have seen an upward trend in portfolio company sales to SPACs. But while selling to a SPAC may seem appealing at first glance, private equity sponsors should be wary of several potential snags.

First, SPAC deals present significant deal consummation risk given that the SPAC structure vests the SPAC shareholders — *i.e.*, often activist hedge funds — with the power to derail a proposed business combination relatively easily. To date, SPAC shareholders have rejected at least 15 proposed business combinations, not an insignificant number in light of a total of approximately 50 completed and approximately two dozen announced SPAC transactions. Importantly, hedge funds may exert their leverage not only by voting down a proposed transaction. Increasingly, hedge funds seek to extract concessions from the potential business combination partner (more favorable deal terms, including price), the SPAC sponsors (forfeiture or transfer of a portion of the sponsor economics) or both, as the cost of admission for their consent, effectively turning the shareholder approval process into a three-way food fight. We would not be surprised to see those food fights get even nastier in light of the large number of later-stage SPACs that are in the market for business combination partners.

Second, even when SPAC deals end up getting done, they take a long time to close. While the average time from filing a SPAC proxy statement with the SEC to closing has been getting shorter in recent months, in part as a result of the SEC becoming more comfortable with SPACs, closing a SPAC transaction still takes longer than consummating other forms of exit. Private equity sponsors may not find it attractive to lock arms with a SPAC for a long period of time, thus foregoing other exit options that may present themselves again as the markets improve.

Third, private equity sponsors interested in exploring a SPAC exit for a portfolio company should consider that the proxy process will result in the disclosure of sensitive financial and other information about the portfolio company. In the context of a SPAC transaction, this may not be the most attractive proposition. If the deal consummation risk materializes and the portfolio company is left at the altar, it must live with the disclosure and the potential consequences. What's more, a target's disclosure and its "fall-out" (*i.e.,* customer issues in response to the target's disclosure of attractive profit margins) may very well deliver hedge funds the very ammunition they need to shoot down a proposed business combination or to extract more favorable terms. The SPAC structure thus shifts many important risks associated with the disclosure — including the deal announcement risk itself — back to the target.

Private equity sponsors should carefully consider these risks and others, such as lock-

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Warming up to the Trust Fund Babies (cont. from page 18)

ups to the extent that SPAC stock is part of the consideration mix payable in the business combination.

In the end, the viability of a SPAC exit will depend on a number of circumstances, chief among them the identity of the portfolio company. Selling to a SPAC may be an attractive exit for portfolio companies — and their management — that would not otherwise qualify as a plausible IPO candidate given their size or other characteristics. Similarly, given the possibility to structure a SPAC business combination in a manner that preserves cash from the trust fund for the combined company, SPACs may well be a suitable fit for portfolio companies in need of a liquidity infusion.

Co-Investments, White Knights and Going-Privates

SPACs may also represent a number of other, less obvious opportunities for private equity sponsors.

First, private equity sponsors may want to explore side-by-side investments with SPACs. That may still sound like a curious proposition since, historically, there has not been much overlap between SPAC and private equity targets. However, the growing number of portfolio exits to SPACs and the proven ability of SPACs to pull off larger and leveraged transactions may be an indication of convergence.

Needless to say, SPACs would stand to profit from a union with private equity as a private equity firm's reputation, expertise and relationships may well enable a SPAC to pull off deals that it couldn't do on its own. But co-investments may also entail benefits for private equity sponsors. The SPAC sponsors' promote — 20% of the aggregate SPAC equity, at least until leaner structures find followers — and the large number of warrants represent a sizeable bag of goodies that SPAC sponsors can and, given the pressures described above, may well be prepared to share with a potential co-investor. That being said, the co-investment model is obviously not free from challenges, including the shareholder rejection risk described above, questions pertaining to control of the acquisition consortium before and after the closing, as well as issues more generally associated with an investment in a public company.

Second, private equity sponsors could step in to acquire a SPAC's prospective business combination target, either before or, more likely, after the SPAC's shareholders vote. In the first variant, the private equity sponsor would approach the target either shortly before or after the signing of a definitive acquisition agreement with a SPAC. Using the SPAC terms as a benchmark, an interloping private equity sponsor could offer the target a much faster timeline to closing and reduce deal consummation risk in exchange for significantly reduced pricing terms. However, exclusivity or no-shop provisions in the target's agreement with the SPAC may complicate overtures at that point in the process.

In the second variant, the private equity sponsor would approach the target after the SPAC shareholders voted down the deal. Sellers of a business rejected by a SPAC's shareholders may suffer from deal fatigue and management distraction from the proxy process may have left the business in strategic or operational disarray. However, if these factors don't render the business incapable of being acquired altogether, they may put a white knight in a very favorable negotiating position. In addition, the target will at this point have been through SEC review of its disclosure, which should significantly facilitate acquisition due diligence and deal financing by the private equity sponsor.

Finally, private equity sponsors may consider taking private a SPAC that has consummated a business combination. This may be an interesting path where the combined public entity is significantly undervalued, *i.e.*, because the stock does not have the proper analyst coverage, the business is in a muddle due to the long acquisition process, or the company has become overwhelmed by meeting the challenges associated with public company status.

Conclusion

Whether SPACs are here to stay remains to be seen. It appears, however, that private equity sponsors are beginning to warm up to, and seize the opportunities presented by, these "trust fund babies." So far, this is demonstrably true only with respect to portfolio company exits, but we would not be surprised to see other forms of commercial interaction between SPACs and private equity funds. ■

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and affiliate transactions, which were likely not designed in anticipation of private equity ownership. The first and most problematic hurdle, however, is typically the change of control provision. This article focuses on that restriction. In subsequent issues of the *Debevoise & Plimpton Private Equity Report,* we expect to address other considerations associated with inheriting a target's existing debt, including managing a portfolio company within the operational constraints created by the negative covenants.

Change of Control Triggers

Lenders and bondholders seek protections against a change of control for a number of reasons. They want to ensure that the company's policies continue to be managed by the equityholders in control at the time of their investment. Strong shareholders — in particular, highly rated corporate parents, but also strong private equity sponsors — are frequently viewed as providing an umbrella of support for their subsidiaries: even if the shareholder is not legally liable to support the subsidiary pursuant to a guarantee or keepwell, lenders expect it will take steps to ensure that its subsidiary will not default on its debt. Plus, for many lenders and bondholders, a change of control transaction is, simply put, a "money maker" — a transaction that requires the prepayment of their debt, frequently at a premium.

The impact of a change of control trigger differs between credit agreements and bond indentures. A "change of control" provision in a typical credit agreement gives rise to an event of default, requiring an immediate payment of the debt at par. In bond indentures (and many mezzanine financings), a change of control obliges the company to make an offer to redeem the bonds often at greater than par within a specified period after the closing.

Paying One's Way: Obtaining Investor Consent

The most straightforward way to address a change of control provision is to obtain the consent of the target's debt holders to the change of control transaction. In many deals, this may be the only option because the structure of the deal and post-acquisition shareholdings may foreclose any argument, along the lines we discuss below, that the transaction does not trigger a change of control.

Though credit documents always require unanimous lender approval of certain actions deemed fundamental to the credit, *i.e.*, a change to the maturity date of the loan, most credit documents require only a majority of the lenders to consent to a change of control transaction, which then binds all of the other lenders. This creates an opportunity for sponsors since the terms of a consent need not satisfy all lenders, making it possible to pitch terms for a consent that represents a reasonable middle ground for the borrower and the lender group.

Crafting a proposal for a consent may, however, be a difficult proposition. The economic incentive of the sponsor and the target is to determine and then pay the target's debt holders a "market clearing" price — *i.e.*, the lowest combination of fees and pricing increases the sponsor and target need to offer to obtain majority lender approval for the change of control. In today's market, that price will be influenced by the possible absence of alternative financing or the relationship between the cost of a consent fee to the target's lenders and an increase in the interest rate of the target's existing debt to the "all in" costs of an entirely new financing.

It will also be influenced by the fact that the credit crisis has caused outstanding leveraged loans and high-yield bonds to decline considerably in value. As a result, many debt holders view a change of control as an opportunity to recoup some of their losses, by requiring a substantial interest rate increase or an amendment fee as a concession for any consent. Others may genuinely be interested only in being repaid at par or at a premium in connection with the transaction. Either way, lenders generally perceive themselves as having hold-up value in these kinds of change of control negotiations, thereby complicating the sponsor's ability to establish a market clearing price.

When seeking a consent, the sponsor can try to persuade the debt holders that a transaction is in their economic interest. If the acquisition does not happen, the sponsor argues, the lenders' position will not change: any outstanding debt that is underwater will remain so. What's worse, or better, as the case may be, the target's existing credit facility may allow it to incur additional indebtedness, repurchase stock or make permitted acquisitions to an extent the lenders are not comfortable with in today's environment. If, however, the

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lenders consent to the transaction, they can be compensated with fees and interest rate increases, which should immediately increase the market value of their debt, and, possibly, negotiate more restrictive covenants. Economically, it seems, lenders should consent to a change of control if the terms are right — the hard question is how those terms should be set.

Complicating this exercise is the fact that the debt holders may not have a uniform view on the appropriate level of payment necessary to approve a change of control. Commercial banks, institutional investors and hedge funds all have different perspectives on a target's credit quality, return on investment, and current debt values, and may each seek different concessions. The multitude of types of institutional investors now providing leveraged loans and high-yield bonds makes it very difficult to predict how any single lender group will respond to proposed concessions given in connection with any consent.

Note though that attempts to avoid engaging multiple lender constituencies in connection with recent buy-outs have met with limited success. In connection with BC Partners' buy-out of Intelsat, Intelsat offered the first 51% of lenders approving the transaction a higher fee than the other approving lenders. While BC Partners did receive the requisite approval, the press has reported that the lending syndicate felt "coerced" into approving the amendment. Because of lender discontent, Intelsat ultimately had to pay all of its lenders approving the change of control consent the full fee.

In many consent solicitations, the administrative agent or lead arranger will understand the positions of the various lenders and will be able to help the borrower and sponsor develop a proposal. Conversely, lack of support from the administrative agent can adversely affect the solicitation of consents; however, the support of the administrative agent does not guarantee success — only a majority lender vote does. Consent requests supported by the administrative agent are frequently rejected by lender syndicates.

Ultimately, the sponsor and the target need to consider carefully the appropriate amount of compensation to offer the target's debt holders, taking into account the many different constituencies and their different needs. If the sponsor and target offer too little, they run the risk of alienating the target's debt holders. This may make the transaction more difficult to complete and creates a group of debt holders that may be less accommodating in the future.

Co-existing with Change of Control Provisions

For a sponsor, an even better outcome than negotiating for a lender consent may be to complete its contemplated acquisition without needing that consent at all — and yet still leaving the target's debt in place. In most situations, however, this result will be possible only if a sponsor acquires a pure economic interest in the target and does not have any rights to control board composition, governance or exit in the manner typically required by buyers in sponsored deals. This may be sub-optimal, but in a difficult financing market, some sponsors may like the idea of making a leveraged investment even if it is a pure economic play. Structuring an investment in compliance with the target's change of control provision will turn on a close reading of the provisions of each agreement. This is not an exercise for the faint of heart. As the BCE bondholder litigation has shown, lenders can often get far more from a sympathetic court than the actual language would lead most veteran deal junkies to expect.

The language of change of control triggers differs — sometimes dramatically — from deal to deal. Nuances in language are critical, but the basic structure of the provisions remain the same. First, the provision establishes a benchmark describing, in broad strokes, the permitted group of shareholders — the "Permitted Holders." In a sponsored transaction, this group usually includes the sponsor, its affiliates and members of management. For a company controlled by an individual, or "Mr. Big," the "Permitted Holders" definition generally includes Mr. Big and members of his immediate family. With that group defined, a change of control is triggered when someone other than the Permitted Holders acquires enough equity to control the company. A typical clause usually uses language along the following lines:

> any 'person' or 'group' other than a Permitted Holder becomes the 'beneficial owner' (as such terms are defined in Section 13(d) of the Securities and Exchange Act of 1934) of more than a certain percentage of the target's equity (often 50% prior to an initial public offering or 35% for a public company).

While many of these provisions seem straightforward, they contain traps for the unwary — chief among them, the incorporation of terms from the securities laws — "beneficial owner," "person" and "group" — into most change of control provisions. These terms are defined by reference to Section 13(d) of the Securities and Exchange Act of 1934 (the "Exchange Act"). Section 13(d) requires any "person" or "group" that directly or indirectly acquires "beneficial ownership" of more than 5% of certain types of the equity securities of an issuer to file a report with the SEC. These terms have been interpreted broadly by the courts and the SEC.

Beneficial Ownership

"Beneficial ownership" is very different from

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simple legal ownership of a stock. Under Rule 13d-3 of the Exchange Act, a "beneficial owner" of a security is not just the direct legal owner of stock, but also any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares: (1) voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power which includes the power to dispose of, or to direct the disposition of, such security.

Three basic elements of beneficial ownership should be highlighted here: First, more than one person can beneficially own the same shares. Second, many of the standard governance provisions in a shareholders' agreement — puts/calls, rights of first refusal, voting agreements, among others — can result in each shareholder being attributed beneficial ownership of shares legally owned by others. Third, "beneficial ownership" looks at "indirect" as well as direct ownership of stock — a purchaser can become the beneficial owner of shares legally owned by another entity.

To put this in context, let's look at an example. Imagine that two unaffiliated parties wish to partner to buy a target. Under the target's indenture, the acquisition of beneficial ownership of more than 35% of the target's shares triggers a change of control. Each buyer separately buys 34% of the target and enters into a shareholders' agreement with each other which provides for joint decision making with respect to the shares. Although each shareholder is the legal owner of 34% of the target's shares, each is likely to be the beneficial owner of *all* of the shares subject to the shareholders' agreement — 68%. Because the change of control provision uses the term "beneficial owner" rather than legal owner, a change of control results.

A person can also be the beneficial owner of all of the shares owned by an entity that it controls. For example, imagine that an acquisition vehicle buys 100% of the stock of the target. The acquisition vehicle is owned 49% by shareholder A, 49% by shareholder B and 2% by shareholder C. Shareholder C is the managing member of the acquisition vehicle. Since C, through its control of the acquisition vehicle, controls the disposition and voting of the shares of the target, C is the "beneficial owner" of 100% of the target's shares. As this example illustrates, there is no attribution rule for beneficial ownership; because of its control rights, C is the beneficial owner of 100% of the target's shares, not just 2%, its percentage ownership in the acquisition vehicle.

The fact that beneficial ownership looks to voting and investment power creates interesting opportunities — and challenges — for structuring transactions without triggering the change of control provision. Let's look at a variation on the example described above. An acquisition company, structured as a limited partnership, buys 100% of the shares of the target. The equity holders of the acquisition company are A, which holds a 90% limited partnership interest in the acquisition company, and B, which owns 10%. In this example, B is the general partner of the acquisition company and can make decisions about the voting and disposition of the shares of the target. In this example, as above, equityholder B is the beneficial owner of 100% of the shares of target, but what about A? It clearly owns 90% of the acquisition company, but is it the beneficial owner of any shares of the target? Interestingly, under certain circumstances, the answer may be no.

At least one court has held that a principal of a corporation that was a limited partner in another entity which beneficially owned the stock of a corporation was not itself a beneficial owner of the stock of the corporation. The court reasoned that attributing beneficial ownership to the person was inappropriate because the partnership agreement gave the limited partner no rights concerning the running of the partnership and no rights regarding receipt of property and distributions, other than the right to receive cash in consideration for its partnership contribution. In essence, because the limited partnership interest did not confer the ability on the individual to direct the voting or investment power of the shares of the corporation owned by the partnership, the individual was not deemed to beneficially own the shares of the corporation. By analogy, in our example above, A, because it has no rights to control the acquisition vehicle, could be found to be the beneficial owner of no shares of the target, even though it has a large economic interest in the company.

What is the impact of this feature of beneficial ownership for a change of control analysis? Imagine now that shareholder B, the general partner of the acquisition vehicle with voting and investment power over the shares of target, is Mr. Big himself, who is a "Permitted Holder" under the existing debt agreements. If the change of control provision of the existing debt agreement is triggered by the acquisition of "beneficial ownership" of more than 50% of the shares of the target by someone other than a Permitted Holder, the sale of 90% of the acquisition vehicle may, under this structure, simply not register. Shareholder B still *beneficially* owns 100% of the shares of target since he controls them all — even though he is the legal owner of only 10% of the acquisition vehicle.

If a buyer decides to employ this structure, it needs to be careful that the agreements it has with the Permitted Holder do not result in "beneficial ownership" over the shares owned by the Permitted Holder, which could result in a change of control. Likewise, as noted

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above, direct rights with respect to the shares of the target of the kind normally enjoyed by private equity buyers — such as the right to require a sale of the company — may confer voting or investment power over the shares of the target, which may also trigger a change of control provision.

"Groups" and "Persons"

A typical change of control definition will prohibit any "person" or "group" o*ther than a Permitted Holder* from obtaining beneficial ownership in excess of a certain percentage of the target's shares. Rule 13d-5 of the Exchange Act defines a "group" as "...two or more persons [who] agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer...." Courts interpreting this rule have held that an agreement to form a group need not be in writing, and constituent members do not need to commit to acquiring shares on specific terms. It is important to note that Section 13(d)(3) of the Exchange Act defines a "person" to include a "group." Thus, even if a change of control provision only prohibits a "person" from obtaining beneficial ownership in excess of a certain percentage — rather than a "person or group" — the same issues implicated with respect to "group" ownership discussed here must be considered.

The fact that a "group" can be formed in the absence of a written agreement can make it difficult for a sponsor or other buyer to team up with a Permitted Holder to buy shares in a target. Let's again look at an example. Imagine that A and B are each private equity funds looking to acquire a stake in a public company target. C is the target's CEO — again, Mr. Big, a "Permitted Holder" under the target's existing debt instruments. There is no written shareholders agreement, but A, B and C agree that A and B will each separately buy 24% of the company and C will buy all of the remaining 52% of the company's shares. A change of control is triggered if "any person or group other than a Permitted Holder owns more than 50% of the [target's] voting stock."

Interestingly, although 52% of the stock is owned by C, and A and B each separately own only 24% of the company's stock, a change of control may have been triggered. Why? Because by agreeing to act together to take the company private, even in the absence of a written agreement among the parties, A, B and C formed a "group" that collectively owns 100% of the target's shares. Critically, the change of control provision treats the "group" as an entity separate from the Permitted Holder. This means that even if the change of control provision includes an exception allowing a Permitted Holder to own more than a specific percentage of stock, a "group" including a Permitted Holder formed to take a target private will not fit within the exception unless the exception specifically permits transactions by "groups" of which a Permitted Holder is part, as opposed to transactions by the Permitted Holder itself.

Importantly, courts have found that a person needs to beneficially own the shares of a target in order to be considered a member of a "group" acquiring the shares of the target. Those courts reasoned that the purpose of subjecting "groups" to Section 13(d) is to "prevent a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns [the requisite amount] of the [issuer's] securities." This purpose is not served if a person has no securities to "pool."

The concept that a person must beneficially own the shares in an entity's stock in order to be a member of a "group" formed to acquire it also provides interesting opportunities. If, in the example above, A and B did not directly acquire shares in the target, but were instead each 24% limited partners in an acquisition vehicle 52% owned and controlled solely by the existing Permitted Holder C, it is likely that no change of control would occur. Although A and B have the same economic interest in the target and teamed with C to acquire it, they have no beneficial ownership in the target's shares, and thus, no "group" has been formed and no change of control has occurred.

Conclusion

Ultimately, the approach to a change of control provision is going to be driven by the structure of the deal and the specific words of the target's debt agreements. This article has illuminated some of the complexities of navigating the change of control provision, but far from all of them. While there are many opportunities to structure transactions so as to comply with change of control provisions, in most transactions, sponsors will seek a consent from the existing debt holders, which, even in today's market environment, is likely to be more cost effective than new financing. Note, though, that obtaining that consent could get harder in the next credit crunch. That is because some lenders are now advocating that approval of such transactions should require supermajority — perhaps as high as 80% or 90% — or even unanimous lender consent in the same way that their predecessors convinced the market to include change of control provisions or event risk provisions in debt documents now in place. ■

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Green Gold Rush or Green Bubble? (cont. from page 8)

Chevron's and Shell's investments in algae-based biofuels companies.

VC Firms and Hedge Funds

Venture capital funds, which are particularly well suited to the development stage of new technologies, have also been active in the sector over the past several years. VC funding for the green and clean industries during the first quarter of 2008 increased to $1 billion, a whopping 57% over the same period last year, according to *New Energy Finance*. This statistic seems particularly remarkable given the current state of the credit markets, although it is still small when compared to investments in the energy sector generally. Hedge funds and investment arms of banks are in the mix as well through equity and convertible debt private placements and building up positions in publicly-traded securities. The amount of money raised for green investments appears to be growing at a rapid pace. As an example, in April 2008, Finavera Renewables announced a $10 million convertible notes placement with Trafalgar Capital Specialized Investment Fund, FIS. According to a UN Environment Programme report, as of March 2007, there was at least $18 billion under management by VC funds, hedge funds, institutional investment funds, private equity funds and other investment funds seeking investment opportunities in clean energy.

Private Equity

Private equity players are continuing to step directly into this area. Several prominent firms have raised funds dedicated to clean energy, renewables, energy infrastructure and generation and we know that many other funds are in the early formation stages. First Reserve, a leading energy-focused fund, announced that it intends to eventually devote 15% of its funds to the clean energy sector. First Reserve announced in early May a $300 million investment in barley ethanol production at Virginia-based Osage Bio Energy. Other private equity players have entered the space through joint ventures with others having more experience in the industry. For example, the Carlyle Group teamed up with its long-time partner Riverstone Holdings LLC in 2006 to form and co-manage the Carlyle/Riverstone Renewable Energy Infrastructure Fund. More recently, Riverstone and the IPP AES Corporation announced a partnership to invest up to $1 billion globally in solar energy projects through a new entity, AES Solar. Goldman Sachs Group Inc. and CDH Investments have teamed up to invest about $100 million in Himin Solar Energy Group Co., a Chinese solar water-heater manufacturer, and Credit Suisse has announced it will invest $300 million in the space through PE firm Hudson Clean Energy Partners.

What's Next?

Many of the factors that make investments in renewable assets uncertain are likely to be addressed in the next few years. The technology is improving and maturing rapidly. The high price of fossil fuels, geopolitical discord and a more widespread belief that climate change is real are spurring this trend. In Washington, legislation adopting some sort of cap and trade system and renewable portfolio standards seems likely regardless of which candidate wins the U.S. presidential election in November. One hopes that the credit markets will stabilize even sooner than that. Still, a fundamental question for private equity and other investors is whether to wait until some of these issues are sorted out or to jump in to gain "first mover" advantage.

For some investors, the industry is not in a start-up phase anymore. These investors see roll-ups of smaller wind farms and similar operations by medium-size players or special divisions of large companies. Private equity may have a natural role to play as a consolidator of these assets in preparation for sale to traditional utilities which will eventually need to diversify their generating sources to comply with renewable standards. That type of exit opportunity would seem to be an attractive one for private equity investors.

Other investors believe that we are in the middle of a "green bubble": assets are being bought and sold on uncertain premises and unclear prospects. If the expected federal regime of production tax credits expires or is changed, many projects currently under consideration could cease to be economic. These investors say it will be better to wait a bit, see how the dust settles and then pickup the more attractive survivors as part of a roll-up of a maturing sector. It is hard to tell who has the better investment thesis or crystal ball. What seems clear, though, is that renewable energy plays are here to stay. ■

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