

How to Talk About Research You Haven't Read An Abridged Guide to Recent Private Equity Research¹

It is daunting enough these days for private equity players to keep abreast of the industry news on fundraising, deal announcements, deal terminations and the ever so slow resurgence of the financing markets, without also focusing on the latest academic research on private equity. In case you have been unable to keep up with the

latest empirical studies and have other reading planned for your end-of-summer vacations, we have a quick fix on some of the most interesting private equity research over the last year or so.

For those of you who relied on *Cliffs Notes* in college, we suspect this approach will be very familiar. For those of you who need a more intellectual rationalization for succumbing to this approach, we recommend Pierre Bayard's bestselling book, *How to Talk About Books You Haven't*

¹ For a synopsis of some recent empirical academic research on the impact of go-shop provisions on deal pricing and process, see "Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications" on page 7.

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You still read?

I just download the latest private equity research and listen to the podcast.

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Letter from the Editor

There is little positive financial news these days. Perhaps the only good news for those in the private equity business is that the quieter market has muted criticism of private equity in the mainstream press.

During the past year or so, there has been a significant amount of academic and other research focused on private equity, much of it not reported in the business press. The volume is, in fact, daunting. There are close to 250 articles with the words “private equity” in the title posted on the Social Science Research Network alone! We thought a lull in the deal market might give you an opportunity to catch up on some of the research, but, given its volume and the fact that we don’t want to overstay our welcome on your vacation reading list, we thought it best to provide a brief(ish) primer that illustrates how your daily life is translated into academic and other research.

First, we provide the quintessential “cheat sheet” of recent research (by message, messenger and methodology) in order to permit you to be able to “Talk About Research You Haven’t Read.” In our Guest Column, Professor Guhan Subramanian of Harvard Law School summarizes the findings of the first empirical study on the effect of go-shop provisions on deal pricing and process.

Elsewhere in this issue, we focus on how the current economic scene has turned conventional wisdom about the tax structuring of deals on its head. We also update our readers on the state of private equity in Russia and Germany. First, we explain that

recent legal changes in Russia are a mixed bag for private equity investors, but that business factors may indicate (at least before the recent turmoil in Georgia) that the Russian private equity market is finally poised to take off. We also report on several recent regulatory changes in Germany, including rules that provide for an increase in the taxation of carried interest, which may convince some to accelerate fund formation plans through the end of the year, and rules that target financial investors for enhanced disclosure and transparency.

We also alert you to several other regulatory and legal developments, including reaction by the influential London-based Loan Market Association to debt buy-backs, recent case law that highlights the importance of indemnification agreements for officers and directors of portfolio companies, and SEC relief for private issuers who want to issue options in broad based employee plans without inadvertently becoming public companies.

We hope this issue keeps you up-to-date on the research and news affecting private equity players without overtaxing your uncharacteristically calm summer. As always, if you identify other issues of interest to you and your colleagues that you would like covered in these pages, please let us know.

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ALERT

D&O Liability

Portfolio Company Directors and Officers May Need Separate Indemnification Agreements

A recent Delaware case makes clear that a corporation can retroactively eliminate director and officer indemnification rights by amending its bylaws. In *Schoon et al. v. Troy Corporation*¹, the court ruled that bylaws may be amended to deprive a director or officer of indemnification rights in respect of a claim arising out of pre-amendment conduct, if the claim is brought after the amendment.

In light of *Schoon*, private equity sponsors who wish to be sure of the indemnification rights of their professionals who serve as directors or officers of portfolio companies should not rely solely on bylaw indemnification provisions but should have the companies and the directors and officers

enter into separate indemnification agreements, which cannot be amended without the director's or officer's consent. Sponsors and their professionals need to be particularly wary of retroactive tampering with bylaw indemnification provisions after a portfolio company is sold or when a sponsor holds only a minority interest in the company (although in either case contractual agreements not to amend the bylaw provisions can mitigate the risk).

The Case

Bohnen was a director of Troy Corporation, a Delaware corporation. Following Bohnen's resignation in February 2005, Troy amended its bylaws to eliminate the right of former directors to advancement of expenses incurred to defend claims. A few months later, Troy sued Bohnen and another Troy director for breach of fiduciary duty. Bohnen, who believed that his indemnification

rights should be determined by the bylaws in effect during his tenure as a director, asked Troy to advance his defense costs. When Troy declined, Bohnen sued. The Chancery Court ruled against Bohnen, holding that while a bylaw amendment cannot rescind a vested contract right, Bohnen's right to advancement was not vested at the time of Troy's bylaw amendment because no claim had been made against him at that time.

The Ramifications

Troy's bylaw amendment only eliminated Bohnen's right to advancement. He was still entitled to be indemnified if his conduct met the applicable standards under Troy's bylaws or Delaware law. However, while the Chancery Court hints that the result might be different if a company knows that it is going to sue a director or officer at the time that it amends its bylaws to eliminate an indemnification right, it is clear at least under the facts of *Schoon* that Troy could have deprived Bohnen of all right to indemnification by amending its bylaws before suing him.

The notion that bylaw indemnification rights vest (*i.e.*, become non-rescindable) only when a claim is made against an indemnitee will strike many as unfair and, from a public policy point of view, misguided. After all, the indemnitee cannot go back after an amendment and undo the pre-amendment service that gives rise to claims against which the indemnitee is no longer indemnified.

What to Do in Response

While directors and officers of a portfolio company may have little reason for concern so long as the sponsor that appointed them controls the company, the only sure way to avoid Bohnen's fate is to insist that the company provide indemnification rights via a separate agreement which, as a real contract, cannot be amended without the indemnitee's consent. Sponsors may also

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¹ No. 2362-VCL, 2008 WL 821666 (Del. Ch., March 28, 2008).

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How to Talk About Research You Haven't Read (cont. from page 1)

Read. Among the useful tips that Bayard offers are: reading by skimming; skipping and sampling; and, for that awkward moment at the next barbecue or private equity conference when you're caught face to face with the author, "praising the work without going into detail."

Bayard's main premise (and potentially good news for our readers) is that reading anything cover to cover is passé. He claims that the real secret to talking intelligently about things you have not read is being able to position them within the collective library, the cluster of other reading to which a given work relates. For example, Bayard asserts, "I've never read Joyce's *Ulysses*. And it's quite possible that I never will ... but I know that it is a retelling of *The Odyssey*, that its narration takes the form of stream of consciousness ... as a result I often find myself alluding to Joyce without the slightest anxiety."

In the spirit of equipping our readers to discuss the collective library of recent private equity research without anxiety (or having to read it), we briefly summarize the key findings of several recent research projects below. Since these reports generally address different questions and use different methodologies, data and

sample sizes, they are not directly comparable. A review of the methodology is often as informative as a review of the conclusions and findings. Collectively, however, their effective use of extensive transaction data over the last 20-30 years portrays an industry we all know well, but can now speak about more authoritatively — one that has changed significantly from the 1980s, the period that primarily informed previous private equity research.

If you've missed the public discussion of some of these studies, you are not alone. Press coverage has been relatively light for some of these reports, and in many instances, rather superficial. Many of the findings simply did not have sound bite quality. For that reason, our synopsis highlights some of the most interesting information that didn't necessarily make the headlines.

World Economic Forum Report

The Globalization of Alternative Investments Working Papers Volume 1: The Global Economic Impact of Private Equity (January 2008)

(www.weforum.org/en/media/publications/PrivateEquityReports/index.htm)

Background

This study is probably the most extensive and rigorous analysis of the private equity industry conducted to date. It was commissioned by the World Economic Forum which released the results in Davos in January. The core research team was led by Josh Lerner of the Harvard Business School and the project was guided by an advisory board that included leading academics, institutional investors, labor representatives and private equity sponsors and investors. (We acted as counsel to the World Economic Forum for the project.)

The core of the report details four large sample studies that covered broad topics: the demography of private equity firms; investment time horizons; employment levels in the U.S.; and, finally, corporate governance repercussions in the UK. The four analyses were supplemented by case studies of six recent high profile LBO transactions, two each in Europe, China and India.

Demography Study

Based on a review of over 20,000 private equity transactions between 1970 and 2007, the study identified the following:

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D&O Liability Alert (cont. from page 3)

consider including in portfolio company bylaws a provision intended to override the Schoon principle — such as a clause to the effect that "no amendment to these indemnification provisions shall affect any right in respect of acts or omissions of any indemnified person occurring prior to such amendment."

There is no downside to including such a provision, but following the Schoon decision it would be dangerous to rely

solely on such language to provide an unalterable right to indemnification. A Delaware court might well permit it to be amended away — just like Bohnen's right to advancement.² ■

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² In order to avoid the result in *Levy et al. v. HLI Operating Company, Inc.*,³ 2007 WL 1500032 (Del. Ch., May 16, 2007), those considering putting indemnification agreements in place should remember to provide expressly for the relative priority of indemnification obligations among the portfolio company and other indemnitors, such as funds and fund sponsors. See "Look Out for Double Indemnity: Director Protections Take a Hit in Delaware" in the Summer 2007 issue of *The Debevoise & Plimpton Private Equity Report*.

Germany Adopts New Rules Targeting Financial Investors

In response to growing public concern about unsolicited activity in the stock of German public companies on the part of financial investors, on July 4, 2008, the German Bundesrat adopted the “*Law for the Limitation of Risks Associated with Financial Investors*” (*Gesetz zur Begrenzung der mit Finanzinvestoren verbundenen Risiken*). According to the legislative materials, the so-called Risk Limitation Act seeks to make it “*more difficult for those financial investor activities undesirable to the economy as a whole, while not negatively affecting finance and M&A transactions.*” Here is a short *tour d’horizon* of those provisions of the new legislation that are of particular relevance for private equity professionals.

Acting in Concert

The Risk Limitation Act broadens the “acting in concert” definition in the German Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*). Coordinated conduct now includes any form of cooperation between shareholders aimed at having a significant and sustained effect on the corporate strategy of a target company. Such cooperation is not limited to coordinated voting activities at a shareholders’ meeting. It also applies to concerted actions regarding the acquisition of shares.

The change is of relevance since voting rights of parties “acting in concert” are aggregated. As a consequence, relevant thresholds in the German Takeover Act tied to the acquisition of voting rights — such as the 30% threshold requiring launch of a mandatory takeover bid for the remainder of the outstanding shares — may be reached more easily.

Aggregation of Shares and Other Financial Instruments for Notification Purposes

The Risk Limitation Act also expands the ownership reporting requirements of the German Securities Trading Act. Currently, any holder, who acquires or falls below 3, 5, 10, 15, 20, 25, 30, 50 or 75% of the voting rights of a public German issuer, has to notify the issuer and the German Federal Financial

Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) without undue delay. Such a notification must also be made when a person holds other financial instruments that give such person the right to acquire at least 5% of the voting rights. The term “financial instrument” is broadly defined and includes, among other things, physically-settled call options and forward purchases of shares.

Prior to the adoption of the Risk Limitation Act, shares and derivative positions triggered separate reporting requirements. By aggregating shares and derivatives, the Risk Limitation Act makes it more difficult to “sneak up” on an issuer without notification. Note that the new rules generally should not apply to cash-settled options or total return equity swaps. Such financial instruments were used, for example, by Porsche in accumulating its position in Volkswagen and Schaeffler in its attack on Continental. Schaeffler’s unsolicited takeover bid, however, has led to heated public debate regarding the question of whether a factual influence on the voting rights represented by the underlying shares could suffice to trigger a disclosure obligation or whether Germany needs new legislation to close this loophole.

Disclosure Requirements for Investors Acquiring a Material Interest

Another change introduced by the Risk Limitation Act closely mirrors Regulation 13D under the U.S. Securities Exchange Act. It requires investors acquiring 10% or more of the voting rights of a public German issuer to disclose the purpose of the acquisition and the source of funds used to acquire the securities. In addition, the investor also must disclose whether (1) the acquisition serves long-term strategic or short-term financial goals, (2) it plans to acquire additional voting rights within the next twelve months, (3) it seeks to influence the composition of the supervisory board or the management board, and (4) it plans to materially change the capital structure of the issuer, notably with respect to the debt/equity ratio of the issuer

and its dividend policy. The investor has to provide this information within 20 trading days after exceeding the relevant threshold and any changes to such information have to be reported without undue delay. Note that an issuer’s articles of association may provide for an exemption to such disclosure requirements.

Harsher Sanctions for Violations of Notification Obligations

The Risk Limitation Act also introduces harsher sanctions for a violation of the notification obligations under the German Securities Trading Act. If an investor willfully fails or is grossly negligent in failing to make a threshold notification, it loses most of its shareholder rights (except the right to receive dividends and liquidation proceeds) for a period of six months starting on the date the notification is eventually made. This is in addition to already existing administrative fines.

Disclosure of Identity of Holders of Registered Shares

The Risk Limitation Act attempts to increase transparency regarding the ultimate beneficial ownership of registered shares in public corporations. Up until now, many shareholders made use of nominee or street name arrangement that obfuscated who had ultimate control over shares. In the future, share-holders have to disclose, upon request of the issuer, for whom they hold their shares. Noncompliance triggers a temporary loss of voting rights and administrative fines. As with the rules on ownership reporting, an issuer is permitted to partially “opt out” of the new transparency rules by establishing, in its articles of association, minimum holding requirements below which no such disclosure is required.

Employee Information Obligations

The Risk Limitation Act amends the German Works Constitution Act (*Betriebsverfassungsgesetz*) by requiring a company’s management to inform the economic committee (*Wirtschaftsausschuss*), a

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Private Equity Developments in Germany: Higher Taxation of Carried Interest

On July 4, 2008, German legislators approved a new law, the Law on Modernization of the Legal Framework for Financial Investments (MoRaKG) that, in addition to granting limited benefits to venture capital investment companies, provides for an increase in the taxation of carried interest in Germany. Private equity sponsors who want to avail themselves of the existing more favorable tax regime for carried interest should, where possible, accelerate any fund formation plans and seek to complete them by year-end. Funds formed prior to that date will be eligible for a grandfather provision included in the new legislation.

Originally, the MoRaKG was aimed at improving the legal environment for private equity investments in Germany in order to induce the private equity community to relocate from tax friendlier jurisdictions. However, the final version of the MoRaKG falls short of that goal and merely provides for very limited tax incentives in favor of early stage venture capital investment companies, which benefits come at the expense of compliance with regulatory

requirements effectively depriving the new regime of practical use.

Under the MoRaKG, the current, favorable tax regime, which provides for a 50% exemption of carried interest, will give way to a reduced 40% exemption, applicable to all funds established after December 31, 2008. Accordingly, 60% of the carried interest received from “non-trading” funds established after such date will be taxed at ordinary progressive rates (the top rate is currently 47.475% including solidarity surcharge). However, funds formed prior to year-end will continue to be eligible for the 50% exemption. The new law retains the requirement that the fund be “non-trading.” Thus, sponsors who want to accommodate the tax needs of their German professionals must continue to jump through several “German tax hoops” to ensure non-trading status like compliance with certain criteria prescribed for PE funds in a 2003 tax ruling and establishing so-called “designated limited partners” with co-management authority. While the latter is only a nuisance, the former can give rise to tensions with business objectives.

This grandfather clause was subject to harsh criticism by Germany’s Second Chamber (the “*Bundesrat*”). The *Bundesrat* wanted to apply the reduced 40% exemption to all carried interest generated from the disposition of portfolio companies acquired after December 31, 2007. The Federal Government dismissed that position, arguing that carry taxation should be tied to the date of the fund’s formation and not on the acquisition of the underlying portfolio companies.

While it cannot be ruled out that the German tax authorities will seek to apply the new, less favorable carry taxation to funds formed prior to year-end if the fund at issue does not have significant activity prior to December 31, 2008, the explicit wording of the statute, along with its technical explanation, should give German private equity professionals a strong argument in favor of the applicability of the grandfather clause. ■

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company-wide employee representative body, of “a takeover of the company if this implies a change of control.” If a company does not have an economic committee, management has to inform the works council (*Betriebsrat*) instead. The German Takeover Act already contains comprehensive employee information requirements for public companies.

For privately-held companies, however, German law did not previously contain such an information obligation in the private company context (although case law has recognized certain obligations for a number of years).

The information must be provided in a timely and comprehensive manner and

include details regarding the potential buyer, its plans regarding future business activities of the company and the effects of such plans on the employees. The information requirement also applies with respect to a contemplated auction process. A carve-out applies to the extent that divulging the information would put business secrets of the company at risk.

The Risk Limitation Act leaves two crucial questions unanswered, which will likely spark debate. When exactly must the information be provided? And what if a company’s management is in the dark about a takeover proposal contemplated by a significant shareholder?

Effectiveness

Most of the provisions of the Risk Limitation Act take effect on the day of the promulgation (official publication) of the new law, which is expected for the fall of 2008. The aggregation rule for shares and derivatives described above becomes effective only on the first day of the seventh month after such promulgation and the new disclosure requirements for investors acquiring a material interest will begin to apply on May 31, 2009.

We will, of course, continue to keep you informed of legal developments in Germany that may impact the private equity scene. ■

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GUEST COLUMN

Harvard Professor Guhan Subramanian caught our attention when he published an article in the Business Lawyer presenting the first empirical study on the effect of go-shop provisions on deal pricing and process. We asked Professor Subramanian if we could publish an abridged version of his article designed for a non-legal audience, and he graciously agreed to let us do so. While each of us have our own perspective on the relationship between empirical and experienced-based data, everyone focused on private equity transactions should be aware of this evidence and analysis.

Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications

Go-shop provisions have changed the way in which private equity firms execute public-company buyouts. While there has been considerable practitioner commentary on go-shops over the past three years, a recent article I wrote for The Business Lawyer presents the first systematic empirical evidence on the effect of this new dealmaking technology on deal pricing and deal process. This article is a summary of those findings designed for a non-legal audience. Contrary to the claims of prior commentators, I find that: (1) go-shops yield more search in aggregate (pre- and post-signing) than the traditional no-shop route; (2) “pure” go-shop deals, in which there is no pre-signing canvass of the marketplace, yield a higher bidder 17% of the time; and (3) target shareholders receive approximately 5% higher returns through the pure go-shop process relative to the no-shop route. I also find no post-signing competition in go-shop management buyouts (“MBOs”), consistent with practitioner wisdom that MBOs give incumbent managers a significant advantage over other potential buyers. Taken as a whole, these findings suggest that the Delaware courts should generally permit go-shops as a means of satisfying a sell-side board’s Revlon duties but should pay close attention to their structure, particularly in the context of go-shop MBOs.

The “go-shop” clause has emerged as an important new deal-making technology during the private equity boom of 2005-2007. Under the so-called Revlon duty, the seller’s board of directors must obtain the highest possible price in the sale of the company. Traditionally, the board would satisfy its Revlon duty by canvassing the market (through investment bankers), identifying serious bidders, holding a formal or informal auction among them, and signing a deal with the winning bidder. The merger agreement would typically include a “no-shop” clause, which would prevent the target from talking to potential “deal jumpers,” unless the target board’s fiduciary duty required it to do so (a

“fiduciary out”). The go-shop clause turns this traditional approach on its head: rather than canvassing the marketplace first, the seller negotiates with a single bidder, announces the deal, and then has thirty to sixty days to “go shop” to find a higher bidder. At the highest level, then, the traditional route involves a market canvass followed by exclusivity with the winning bidder; while the go-shop route in its pure form involves exclusivity with a bidder followed by a market canvass.

While there have been numerous practitioner commentaries on go-shop provisions in the three years since companies first used them (including in *The Debevoise & Plimpton Private Equity*

Report), go-shop clauses have been largely ignored by academic commentators to date. This article summarizes the first systematic empirical evidence on the effect of go-shop provisions in private equity deals, which account for the vast majority of all go-shops.¹ I construct a new sample of all going-private deals between January 2006 and August 2007 that include a private equity sponsor (n=141) and examine the solicitation feature (no-shop or go-shop) in each deal.

Go-Shop Structuring and Outcomes

The data reveals two different kinds of go-shops: a “pure” go-shop, in which the seller negotiates exclusively with a single buyer and then shops after the deal is announced; and what I term an “add on” go-shop, in which the go-shop provision is included after the target has already conducted a pre-signing canvass of the marketplace. Sixty percent of go-shops are “pure” go-shops. While the contractual language in the merger agreement is generally the same across pure and add-on go-shops, the

¹ *The more detailed analysis can be found at Guhan Subramanian, Go-Shops vs. No-Shops in Private Equity Deals, The Business Lawyer, Vol. 63, May 2008.*

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Go-Shops vs. No-Shops in Private Equity Deals (cont. from page 7)

important difference in the deal context has implications both for the deal process and for the econometric analysis. My data shows that in the no-shop process, the seller does not contact any further bidders (as is required by the merger agreement), but an unsolicited bidder appears approximately 8% of the time. This finding is consistent with prior work finding a 3-7% jump rate in the typical market canvass/no-shop process.²

In contrast, in go-shop deals the seller's bankers contact a very large number of potential buyers: 33.0 on average in the add-on go-shop case and 39.6 in the pure go-shop case. When pre-signing and post-signing canvassing

² See John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory & Evidence*, 53 *Stan. L. Rev.* 307, 331-35 (2000).

are considered together, go-shop deals actually solicit more potential buyers than the no-shop deals: 48.9 are solicited in add-on go-shops (15.9 +33.0) and 40.6 are solicited in the pure go-shops (1.0 + 39.6), compared to 31.6 in the no-shops. This finding cuts against perceptions that the go-shop process is illusory. However, a striking finding is the number of potential buyers who sign confidentiality agreements during the post-signing go-shop process: 1.5 in add-on go-shops and 3.2 in pure go-shops, far fewer than the 16.1 buyers who sign confidentiality agreements in no-shop deals. After examining this non-public information, the go-shop successfully generates another offer 5% of the time in an add-on go-shop and 17% of the time in a pure go-shop, consistent with the intuition that the go-shop should yield a higher-value buyer more often when there has been no pre-signing shopping.

In short, the overall assessment of the go-shop solicitation process is mixed: *more* potential buyers contacted in go-shop deals than in no-shop deals but substantially *fewer* bidders signing confidentiality agreements. One straightforward explanation for these results is that the “bird in hand” that exists in a go-shop deal creates a price floor, and potential buyers who are below this floor will decline to go forward by signing a confidentiality agreement. The puzzle is why these prospective bidders should drop out before gaining access to confidential information; that is, before they would know with any certainty whether their offer would be higher or lower than the outstanding offer. Far more understandable would be an equal number signing confidentiality

agreements in go-shop deals but fewer actual bids in the go-shop sample compared to the no-shop sample. In fact, the announced deal should send a signal to the marketplace that the company is worth *at least* the announced deal price, and therefore more (not fewer) bidders should be interested in signing confidentiality agreements. The concern of course is that the announced deal in a go-shop process does more than create a price floor; it also deters potential higher-value bidders from even conducting due diligence because of the non-level playing field created by the breakup fee and match right, in addition to other deal protection features.

Target Shareholder Returns

In examining returns to target shareholders by the deal process used, I calculate for each deal cumulative buy-and-hold abnormal returns (“CARs”), net of the S&P Composite Index, from thirty days prior to deal announcement through thirty days after announcement. In unreported analyses, I find no meaningful difference in pre-signing run-up between the go-shop and no-shop samples over longer event windows (beginning sixty days prior to deal announcement), contrary to practitioner impressions that go-shop deals are less likely to be leaked and therefore less likely to generate run-up. One possible explanation is that the pre-deal run-up in target companies in general is not due to the leakage of inside information but rather due to analyst assessment of public information that the company is likely to be a takeover target. If correct, this conclusion would suggest that the perceived benefit of go-shop processes as a way of reducing pre-deal run-up is small at best.

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When pre-signing and post-signing canvassing are considered together, go-shop deals actually solicit more potential buyers than the no-shop deals: 48.9 are solicited in add-on go-shops and 40.6 are solicited in the pure go-shops, compared to 31.6 in the no-shops. This finding cuts against perceptions that the go-shop process is illusory.

Private Equity in Russia

Despite the tremendous growth of M&A activity in Russia, Russian private equity has not experienced the boom that many expected. While the turmoil in Georgia creates new uncertainties, this article will review the state of the Russian private equity market in the context of major new legislation governing the acquisition of Russian corporations in activities of “strategic importance” to the Russian state as well as the overall Russian M&A market.

2007 was the third record year for M&A activity in Russia, both by value and volume of transactions. After two years of a balanced mix of Russian M&A activity across the consumer, financing, energy and mining sectors, the energy and mining industries accounted for over half of the 2007 M&A activity in Russia (by both value and volume).

Highlighting the year were the reorganization of Unified Energy System of Russia (RAO UES), the country’s power monopoly, with the spin-off and privatization of its key assets into some 25 separate companies having a combined value estimated at around \$60 billion, as well as the continued sale of the former Yukos’ assets in transactions with an aggregate value of around \$20.78 billion.

The private equity story, however, was very different. Notwithstanding the fact that in most other parts of the world, private equity activity accounted for a record share of M&A activity during 2007, private equity activity was only between 1% – 7.5% of Russia’s 2007 M&A activity. Private equity, with its historically shorter-term return perspective, did not participate significantly in the natural resource sectors, but rather was mostly prevalent in the telecommunications, media and technology (TMT), consumer and financing services sectors. Nonetheless,

the average size of Russian private equity transactions grew from \$8 million in 2005 to \$26 million in 2007 and included, among other things, minority investments, control investments and leveraged buyouts, including an investment by Allianz in Rosno, the Russian insurance company, the acquisition of Bazovy Element Company, a Russian juice producer, and the acquisition of a Russian telecom company, PeterStar.

Legal Developments

Two recent changes in Russian law are expected to impact private equity transactions.

In 2006, Russia amended its joint-stock company act to introduce a comprehensive set of takeover laws. As in many European jurisdictions, purchasers who make acquisitions and thereby become holders of more than 30%, 50% or 75% of the shares in a Russian open joint-stock company are now obligated to make a “buy-out” offer to the remaining shareholders. The “buy-out” price is determined by mandatory guidelines, which use a share trading price formula (higher of six-month average trading price or highest price paid by an acquiror during the same six-month period) for public companies and fair market value as determined by an independent appraiser for private companies. The new law also provides for the possibility for minority “squeeze-outs” once a 95% ownership threshold is reached.

This law is expected to make Russian takeover law more compatible with the laws applicable in other European jurisdictions. (However, unlike some European jurisdictions, the law applies to private as well as public companies.)

More importantly, on May 5, 2008,

Vladimir Putin, in one of his last acts as President, signed into law a new regime “On Procedures for Foreign Investment in Russian Commercial Entities of Strategic Importance for the National Security of the Russian Federation.”

Legal rules and restrictions on foreign investment in Russian companies engaged in business activities deemed to have strategic significance are nothing new or unexpected. This new law, however, creates a comprehensive framework for reviewing foreign investment. It clearly reflects the thinking and policies of the Putin years about the prudence and benefits of controlling strategic industries

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Private Equity in Russia (cont. from page 9)

and resources. At the same time, it is an effort to clarify the rules and process for strategic sector acquisitions by foreign investors.

The law creates the requirement for a multi-layered Russian governmental review and approval of transactions, within defined time periods, which would result in the acquisition of “control” over a Russian company engaged in an activity of strategic importance to Russian national security. One form of “control” is the acquisition by a foreign investor (directly or through Russian or other intermediaries) of either 50% or more of the share capital of a Russian company engaged in strategic activities or 10% or more of the share capital of a Russian company holding a license to develop certain oil, gas, metal and mineral deposits. Where the foreign investor is owned or controlled in whole or in part by a foreign government the thresholds drop to 25% and 5%, respectively. The law defines the “control” concept broadly and reaches transactions and arrangements (such as designated or controlled board seats and CEO and other key executive appointment rights) where the foreign investor (either directly or through Russian or other intermediaries) exerts management control or influences decisions of the company which have strategic importance.

The law also significantly expands the list of “strategic sectors” from 25 (under the prior laws) to 42 designated industries and areas. As expected, Russian companies operating in the defense, cryptographic, aviation, aerospace and nuclear industries, the production and sale of metals and alloys used in defense related industries and the production of goods and the supply of

services related to “natural monopolies” under Russian law (such as the dispatching of power, railways, seaports and airports and oil and gas pipelines) are included in the law’s list of “strategic sectors.” However, the list of “strategic sectors” also includes many other areas, such as television, radio, dominant entities in communications, printing and publishing, major fixed-line telecom providers, fishing, the development of the Russian continental shelf and the surveying, exploration and development of strategic oil, gas, metal and mineral deposits.

Although the new law should clarify what is and is not included in the “strategic sectors” and should create a process, with defined time limits, for reviewing proposed acquisitions, the law does not contain criteria for the granting or denying of approvals nor does it require that the grounds for the denial of an approval be given.

At the time this article was written, the new law was awaiting implementing regulations, which are expected to be issued in the last quarter of 2008. Until the implementing regulations are issued, it is not possible to process transactions under the new law.

The new law on investment into strategic industries is clearly a major development on the Russian M&A landscape. The way in which the Russian government implements the law will ultimately determine whether it provides certainty to foreign investors (which the law’s drafters and sponsors have publicly stated is one of its goals).

Market Outlook: Russian PE Set to Take Off?

Although private equity in Russia has been slow to develop and the military intervention in Georgia creates new

political uncertainties, there are many market participants who believe that the Russian private equity market is set to take off.

First, the players have changed. International finance institutions, such as the European Bank for Reconstruction and Development and the World Bank’s International Finance Corporation and wealthy individual investors dominated the private equity market in the early years. This has changed, and professional Russian and Western private equity funds now predominate. Large funds with Russian sponsors, such as Renova Capital and Alfa Capital Partners, are active market players. After a slow start, major Western private equity funds are also coming to Russia. TPG Capital opened a Moscow office in the last year. Major Western houses such as Blackstone and Permira are reportedly to be actively looking at Russian investment opportunities.

Second, fundraising is up. In 2007, an estimated \$5.5 billion of funding raising was either completed or in progress. Foreign investors now account for approximately three-quarters of all funding. Russian sponsored funds are receiving significant amounts of funding from foreign investors. For example, Baring Vostok Capital Partners, a private equity company with a long-standing presence in Russia, raised a market record \$1 billion Russia and CIS fund in the spring of 2007.

Third, investment professionals have an increasingly open mind to the investment possibilities that Russia holds for private equity investment. In particular, Russia presents significant opportunities to invest in rapidly growing small- and medium-sized

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Finally, Some Good News for Private Fund Placement Agents

Private fund managers who are registered investment advisers may now have greater flexibility in entering into and disclosing arrangements with finders who solicit and refer prospective fund investors. However, that flexibility is dependent upon the finder solely soliciting for a private fund rather than for other investment arrangements (such as managed accounts) that the manager may offer.

This flexibility arises as a result of an SEC staff interpretive letter issued in July clarifying the application of the cash solicitation fee rule under the Investment Advisers Act of 1940 (the “Advisers Act”).¹ Rule 206(4)-3 (the “Rule”) makes it unlawful for any registered investment adviser to pay a cash fee, directly or indirectly, to a solicitor unless the payment is made in compliance with the conditions set forth in the Rule, which, among other things, requires that the solicitor provide the prospective client with a separate disclosure document that includes information regarding the solicitation arrangement and the solicitor’s compensation and obtain a signed acknowledgment from the client of receipt of the solicitor’s disclosure document. This process can be quite cumbersome for placement agents and fund managers.

In its interpretative letter, the staff clarified that the Rule does not generally apply to an adviser’s cash payments to a solicitor solely to compensate that solicitor for soliciting or referring prospective investors to an investment pool managed by the adviser.

The no-action letter is a response to *Goldstein, et al. v. SEC*, a 2006 decision in which the U.S. Court of Appeals for the District of Columbia Circuit struck down

an SEC rule that required investment advisers to “look through” certain types of private funds to the underlying investors in order to determine the number of clients they had for purposes of the Advisers Act exemption for advisers with fewer than 15 clients. The Court concluded that investors in a pooled investment vehicle are not clients of the adviser for purposes of the Advisers Act anti-fraud provisions. Consistent with the Court’s holding in *Goldstein*, the staff concluded that the Rule generally does not apply to a registered investment adviser’s cash payment to a person solely to compensate that person for soliciting investors or prospective investors for, or referring investors or prospective investors to, an investment pool managed by the adviser.

The key in the analysis is determining whether a payment made to a solicitor is *solely* to compensate that solicitor for soliciting or referring prospective investors in a pool managed by an adviser. The SEC staff suggested that the most pertinent facts to consider in this regard relate to the nature of the arrangement between the solicitor and the adviser, the nature of the relationship between the adviser and the solicited person and the purpose of the cash payment to the solicitor. For example, the Rule would apply where an adviser that manages both pools and individual accounts compensates a solicitor for referring persons as prospective advisory clients and not simply as pool investors.

The SEC staff also noted that, whether the Rule applies or not, a solicitor may be viewed as an investment adviser and thus be subject to the anti-fraud provisions of the Advisers Act. (A placement agent whose only provides investment advice in connection with the sale of securities, including interests in private funds, and

who is not separately compensated for that advice, would typically not be viewed as an investment adviser.) As such, a solicitor would be required to disclose material facts to clients concerning conflicts of interest arising out of any solicitation arrangements, whether or not the solicitor is subject to the conditions of the Rule. A private fund manager, whether or not registered under the Advisers Act, should assure itself that the solicitor is making appropriate disclosures to prospective investors, particularly with respect to conflicts of interest. The key disclosures would be that the solicitor is being compensated for its efforts and thus has a financial interest in the prospective investor acquiring an interest in the fund.

The SEC staff also made a point of *not* addressing whether the solicitor’s receipt of cash compensation from an investment adviser of a private fund would result in the solicitor being considered a “broker” under Section 3(a)(4) of the Securities Exchange Act of 1934. Thus, the manager of a private fund should determine whether the solicitor is a registered broker-dealer and, if not, the basis for the solicitor not being registered.

For example, the solicitor may be relying on SEC staff positions relating to “finders” who do not have to register as broker dealers. The so-called “finders” exception from broker-dealer registration is extremely narrow — and seems to get narrower whenever the SEC staff addresses its scope. The consequences of selling fund interests through an unregistered broker-dealer may be severe — including potential rescission of the transaction and regulatory action. *This is also an issue that should be addressed by a private fund manager that is not registered under the Advisers Act.* ■

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¹ *Mayer Brown LLP, SEC Interpretive Letter, Division of Investment Management, July 15, 2008.*

Private Equity in Russia (cont. from page 10)

companies and in particular industry segments and sectors (as witnessed by the recent Russian infrastructure investment funds organized by Renaissance Capital and Macquarie). While these small- and medium-sized transactions may not make the headlines of the financial pages, they are investments which avoid the political risks and problems that sometimes characterize large Russian M&A transactions.

Fourth, marketplace forces are now working in favor of private equity as an alternative when compared to IPOs and other capital market solutions. After a period of explosive growth in IPOs of Russian companies and rising Russian stock prices, valuations of listed companies have become stretched and post-floatation performances of IPO

companies has often proved to be disappointing. Investors and companies are rethinking alternatives and private equity is widely seen as an increasingly attractive option.

Fifth, many market observers believe that leveraged buyouts, which have been virtually non-existent, will enter and take their place on the Russian market, notwithstanding difficult credit markets. For example, the UK-based private equity firm, Lion Capital, completed a \$350 million leveraged buy-out of the Russian juice manufacturer, Nidan Soki in August 2007.

Sixth, as strategic investors enter the Russian markets, exits for private equity investors are becoming easier.

Market participants and commentators continue to cite lack of corporate transparency and corruption

and political interference as negative factors which impede the growth of the Russian private equity market. However, the continued strong growth of the Russian economy and the Russian investment story as well as the other factors outlined should serve to alleviate these concerns. The real question is how that story will unfold. ■

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Recent and Upcoming Speaking Engagements

June 2

Paul R. Berger

Senior Legal Officer Discussion Forum
Foreign Corrupt Practices Act Requirements
National Association of Real Estate
Investment Managers
Denver, CO

June 2

Jennifer J. Burleigh

Rebecca F. Silberstein

19th Annual Conference on the
Globalisation of Investment Funds
*Discussion Group: The Role and Impact of
Sovereign Wealth Funds*
IBA
Bermuda

June 5

Kenneth J. Berman

SEC Historical Society Ninth Annual
Meeting
*Exemptive Authority: The Mandate of the
Division of Investment Management*
Securities and Exchange Commission
Historical Society
Washington, DC

June 18

Paul R. Berger

Inside the SEC
*Consequences of the Globalization of SEC
Enforcement Activities on U.S. Markets*
American Conference Institute
Washington, DC

June 18

Michael P. Harrell

PEI Investor Relations & Communications
Forum
*Deciphering the Changing Legal and
Regulatory Landscape*
PEI Conferences
New York

July 14-15

Jennifer J. Burleigh

Raising a Private Equity Fund

Adele M. Karig

How to Structure a Private Equity Fund
Ninth Annual Private Equity Forum
New York

Conditions to Regulatory Approvals: Lessons from ADS

As the credit crisis continues to generate opportunities for private equity investment in financial institutions looking to shore up their capital, there are important lessons to be drawn from the Blackstone Group's recent experience in its terminated deal to acquire Alliance Data Systems Corp. ("ADS"). Financial sponsors contemplating an investment in a financial institution are well advised to assess carefully the scope of the buyer's obligations in obtaining pre-closing regulatory approvals imposed by acquisition agreement regulatory covenants and related closing conditions and the extent to which those obligations could run not only to the sponsor's shell acquisition vehicle, but also to its fund.

Background: The ADS Dispute

On May 17, 2007, Blackstone announced that its private equity fund, Blackstone Capital Partners V L.P., had agreed to acquire ADS, a publicly traded credit card service provider, for \$7.8 billion (including the assumption of debt), approximately a 30% premium over ADS's market capitalization at the time. The transaction was subject to customary closing conditions, including approval of ADS's shareholders and of applicable regulatory authorities. The deal was expected to close by year-end.

On August 8, 2007, ADS's shareholders overwhelmingly voted in favor of the transaction, and on August 31, ADS permitted Blackstone immediately to acquire 5% of ADS's stock. Rumors quickly began circulating, however, that the deal was in trouble as the financial markets became more turbulent and, notwithstanding a November 29, 2007 ADS press release addressing the rumors and announcing

that the deal was still on track, the end of the year passed without a closing.

ADS reported on January 28, 2008 that Blackstone had notified the company that while it remained committed to completing its acquisition of ADS, due to conditions that the U.S. Office of the Comptroller of the Currency (the "OCC") had placed on its approval of the transaction, Blackstone did not believe the conditions to the closing of the transaction could be met. On January 30, ADS sued Blackstone, claiming that in breach of its merger agreement with ADS, it had failed to exercise "reasonable best efforts" to consummate the transaction and seeking specific performance of those obligations.

Among ADS's subsidiaries is a credit card bank, World Financial Network National Bank, over which the OCC has regulatory authority. It is customary for the OCC to seek a guarantee from a credit card bank's parent of the bank's obligations, and as a condition to its approval of the acquisition by Blackstone, the OCC insisted on a guarantee of \$400 from Blackstone Capital Partners V L.P., the Blackstone fund providing the equity for the deal. There is some dispute between the parties as to the exact nature of discussions among ADS, Blackstone and the OCC, but it is clear that Blackstone was not willing to offer a guarantee of more than \$100 million, which was unacceptable to the OCC.

ADS dropped its lawsuit against Blackstone on February 8, 2008 to try to reach a negotiated compromise acceptable to both Blackstone and the OCC in order to secure the closing of the merger. However, on March 17, ADS delivered a notice to Blackstone, again claiming a breach of the merger agreement. On

April 18, 2008, each of Blackstone and ADS delivered to the other a notice of termination of the merger agreement, and ADS once again filed suit against Blackstone, seeking payment of a reverse breakup fee of \$170 million and reimbursement of certain of its transaction expenses. ADS claimed that Blackstone did not make a real effort to come to a resolution of the OCC approval issue. ADS asserted that it even proposed reducing the price to be paid by

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Conditions to Regulatory Approvals: Lessons from ADS (cont. from page 13)

Blackstone by \$400 million and using the savings to fund the OCC's backstop requirements, but that Blackstone refused. Blackstone countersued, seeking a declaratory judgment that it did not breach the merger agreement and therefore does not owe ADS the reverse breakup fee payment.

Merger Agreement Lessons

The merger agreement between ADS and the merger vehicles set up by Blackstone provided that each party was to use its "reasonable best efforts" to take the actions necessary to consummate the merger, including filing for, and taking other actions necessary to obtain, all required regulatory approvals (including the OCC approval). The receipt of such regulatory approvals was a condition to closing.

The details of the ADS transaction made ADS's specific performance demand somewhat problematic. Its contractual counterparties were, in fact, shell acquisition vehicles, not a Blackstone fund. Although the fund guaranteed certain of the buyers' merger agreement obligations, the fund was not

under a direct contractual obligation to use reasonable best efforts to obtain regulatory approvals; that was an obligation of the buyer entities, which had no power to force the Blackstone fund to provide the backstop that the OCC required. In addition, the contract actually provided for specific performance only of certain covenants, which did not include the obligation to use reasonable best efforts to obtain regulatory approvals.

Putting these considerations aside, however (and also putting aside ADS's contention that Blackstone used the OCC's demands as a pretext to escape from the deal because market conditions had deteriorated and financing was more expensive than at the time the deal was signed), this dispute provides some interesting lessons for private equity buyers in mergers and acquisitions in the financial services industry, where regulatory approvals are almost always an important consideration.

With respect to the insurance industry, for example, regulators are often empowered to impose conditions or restrictions on their approvals of acquisitions of insurance companies or other regulated entities in the insurance industry. A regulator could require a private equity buyer to contribute additional capital to the company it is buying or to covenant to contribute capital in the future in order to maintain a specified level of net worth, reserves or capital and surplus of the company. A regulator could also impose restrictions on the operations of the company or its parent beyond the limitations already imposed by statute or regulation, such as limiting the amount of dividends that can be paid or the ability of the acquiror to take on debt or pledge its interest in the company to creditors. If a regulator

is concerned about the potential for jobs leaving the state of domicile of the acquired company, it could impose restrictions on the ability of the acquiror to move the company's operations out of state. A regulator may be more likely to impose conditions on its approval of a sale to a private equity firm or runoff operator, or any other buyer that is not a "repeat player" with other operations over which the regulator has authority, because such buyers may be less susceptible to the regulator's moral suasion to keep the company well capitalized in the future.

It is not always easy to predict, however, when a regulator may impose conditions on an approval. Indeed, in the ADS merger agreement, certain regulatory approvals, such as those of the Federal Deposit Insurance Corporation and the federal antitrust authorities were addressed in some detail. The parties did not similarly address the OCC approval because, according to press reports, they assumed it would be uncontroversial and easily obtained. This omission underscores the importance to a buyer of a heavily regulated entity of making sure to protect itself in an acquisition agreement against the possibility that a regulator will impose burdensome conditions on its approval of the deal.

The protection should be in the form of both an exception to the buyer's covenant to use its efforts (whatever the efforts standard) to obtain regulatory approvals if the regulator imposes materially burdensome conditions, and a further condition to closing that not only must all required approvals be obtained, but that such approvals not be subject to materially burdensome conditions. The wording of this

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ALERT

London Market Association Weighs in on Debt Buy-Backs

Responding to the credit crisis fueled surge in debt buybacks in Europe, the influential London-based Loan Market Association announced in June that it will amend its standard loan agreement forms to include options relating to debt buy-backs by the borrower. In several recent well-publicized transactions, private equity portfolio companies (or their sponsors) have repurchased a portion of their syndicated bank debt at a discount on the secondary market, thus lowering their effective interest costs.

This technique has sparked heated debate in the London banking and financial markets, with legal experts differing as to whether such buy-backs are or should be permitted under existing documentation. The controversy has come to the fore because in the current economic conditions many company loans are trading at a discount in the secondary market, sometimes due to a lender's need for liquidity rather than troubles with the underlying credit. A borrower with available cash, or its private equity sponsor, may find it tempting to take advantage of the discount and reduce its interest costs by buying some of the debt at a bargain price. The non-selling lenders, however, may feel aggrieved if not given the opportunity to participate in the repurchase.

The LMA, whose forms are used worldwide as a starting point for most large, syndicated loans governed by English law, admitted that its current forms do not address borrower buy-backs. While stating that the decision to permit or ban debt buy-backs is a commercial

one, the LMA will suggest provisions for the parties to consider when negotiating a transaction. The LMA also said it believes debt buy-backs should be conducted so that all lenders are treated equally, as that is one of the "fundamental principles of syndicated lending," so practitioners expect some form of open tender to lenders to be part of the new suggestions.

Most existing syndicated loan agreements were negotiated in a stronger market environment and do not contemplate the widespread discounting of syndicated debt that has led to the buy-back phenomenon. One provision in the standard LMA form and thus in most existing agreements that may be applicable, however, is the prohibition on prepayments by the borrower, except on negotiated terms that would normally include a sharing clause so that all lenders would benefit from the prepayment. If the non-selling lenders object to a buy-back, they could seek to characterize it as an effective prepayment under English law which could thus be in breach of the loan documentation. There also may be restrictions in the loan documentation on the borrower's use of its cash for this purpose. Another contentious issue is whether debt held by the borrower or its sponsor can be counted for voting purposes or for acceleration thresholds. These issues are not clear under English law and, if disputes arise, will have to be looked at on a case-by-case basis, including as to whether private equity sponsors or other affiliates of the borrower are caught by the provisions.

Similar issues arise in the U.S.

syndicated loan market, as many existing U.S. credit agreements do not contemplate the possibility of a borrower acquiring its own debt. Some of these issues that arise in both the U.S. and UK include restrictions on assignments; requiring the administrative agents' consent to assign such loans; the pro-rata sharing provisions (whereby the selling lender could be required to share the proceeds of the sale with the other lenders); and possible restrictions on the use of excess cash flow by the borrower.

The LMA proposals are expected to be unveiled later this year, but even in advance of the amendments to the forms, it is likely that borrowers and lender groups negotiating new loan agreements will tackle the question of lender buy-backs in their initial discussions. We would expect that most future English-law syndicated loan agreements will explicitly refer to debt buy-backs and lenders are likely to push for certain conditions, such as following an open tender from the borrower to all lenders. ■

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Tax in a Down Market

A New Market for M&A Brings Some New Tax Issues

Asset Deal vs. Stock Deal

Dealmakers guided by the old maxim that buyers prefer asset sales and sellers prefer stock sales may want to check their compass — bad markets have a way of turning common wisdom on its head.

In buying a business, buyers prefer a high “tax basis” in the assets of the business, including goodwill. Tax basis generally may be amortized over the life of the asset. This reduces the taxable income (and tax) of the business and frees cash that can be used to repay debt, reinvest in the business or pay dividends. Similarly, if an asset (or division) is to be sold, a higher tax basis can mean less taxable gain and more after-tax proceeds.

Buyers Typically Prefer Asset Deals. Most businesses are held by corporations. If the stock of a corporation is purchased, the tax basis in the assets of the corporation are generally not reset as a result of the purchase. By contrast, if the assets of the corporation are purchased, the tax basis of the assets are generally reset to equal their fair market value (based on the purchase price). When values are going up, an asset deal typically results in an “step-up” (increase) in the tax basis of the

business. As a result, in most cases the buyer of a business prefers that the acquisition be structured as an asset deal for tax purposes.

Sellers Typically Prefer Stock Deals but These Are Not Typical Times. For a number of reasons, the seller of a business held in corporate form typically prefers a stock sale to an asset sale. However, different considerations may apply under current law when the seller and target are members of the same U.S. consolidated group. If the group’s tax basis in the stock of the corporate member being sold (the “outside basis”) is roughly equal to the member’s tax basis in the assets of the business (the “inside basis”), the group will generally be indifferent as to whether the transaction is structured as a stock sale or an asset sale for tax purposes.

However, where the outside basis is roughly equal to the inside basis, the selling group is likely to prefer an asset sale over a stock sale in cases where there is a tax loss in the business. This is because it is extremely difficult under current law for a U.S. consolidated group to claim a tax loss upon the sale of the stock of a member of the group. Moreover, if the transaction is structured as an asset sale a portion of the loss may be ordinary rather than capital.

Of course, it is in this very situation that the buyer of a business may prefer the transaction be structured as a stock purchase so that it has some ability to access the historic and higher tax basis. Thus, contrary to the assumption made when values have been rising, in the current market it is important to keep in mind that the buyer may actually prefer a stock sale and a selling consolidated group may prefer an asset sale.

Change in Law Expected Soon. It is expected that by the end of the year (and likely sooner) the IRS will finalize a proposed set of rules that would significantly liberalize the ability of a selling consolidated group to claim a tax loss on the sale of the stock of a

member of the group. While this is good news for selling consolidated groups, the new rules may complicate things for buyers and transactions with consolidated groups in general. Under the proposed rules, if a loss is permitted on the sale of stock of a member, the member would be required (in certain limited cases) to reduce its tax basis in the assets of the business or reduce certain other favorable tax attributes.

The proposed regulations are spectacularly complicated and extremely fact intensive (so much so that some have questioned whether they will be administrable). As a result, in many cases it may be difficult for buyers (or selling consolidated groups) to know with complete confidence whether the selling group is permitted to claim a loss under the proposed rules or whether the proposed rules will require a reduction in the member’s inside tax basis or tax attributes. Moreover, even post-closing IRS adjustments or challenges to the tax returns of the member for taxable years through the closing date can impact the analysis.

Fortunately, the proposed regulations allow the selling consolidated group to elect to forego claiming a loss upon the sale of stock of a member, in which case the member’s tax basis and tax attributes would generally be preserved. Absent a change in the proposed regulations, we expect that buyers from a consolidated group will begin requiring the selling consolidated group to make such an election (including on a protective basis). Although the IRS has announced that the rules (including the rules requiring basis reduction) generally will not apply to the sale of a member pursuant to binding agreement in effect prior to the date the proposed regulations are finalized, we have already begun to see covenants in acquisition agreements requiring such an election.

...[C]ontrary to the assumption made when values have been rising, in the current market it is important to keep in mind that the buyer may actually prefer a stock sale and a selling consolidated group may prefer an asset sale.

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Avoiding Becoming an Inadvertent Public Company: SEC Grants Relief for Private Company Options

One of the advantages of private ownership by a private equity firm is relief from Sarbanes-Oxley and from reporting and other obligations applicable to public companies. However, following the transaction, management and other employees need to be provided with meaningful equity incentives that motivate strong company performance.

A private company that grants equity incentives deeply into its organization can inadvertently find itself subject to the very requirements it intends to be free of. This is so under the “500-person” rule of Section 12(g) of the Securities Exchange Act of 1934, which causes an unlisted issuer to be subject to Sarbanes-Oxley and public company disclosure and other requirements if more than 500 holders own a class of equity security, including compensatory stock options. A new rule adopted by the SEC addresses this issue and grants helpful relief (subject to conditions) to these issuers.

Background

Private companies are generally not subject to public-company registration and disclosure requirements and compliance with Sarbanes-Oxley. As a result, they generally benefit from the following:

- *No Ongoing Disclosure Obligations.* Unless they have agreed to do so voluntarily (typically in connection with issuance of high yield debt), private companies are not required to report financial information on Forms 10-K and 10-Q and other issuer developments on Form 8-K under the Exchange Act. Private companies are also exempt from the onerous proxy and tender offer rules and from restrictions on selective disclosure.
- *No Sarbanes-Oxley Compliance.* A private company is not subject to

Sarbanes-Oxley’s independence requirements for audit committees and outside auditors. A private company is also not subject to Sarbanes-Oxley’s (1) restrictions of extensions of credit to officers and directors (which, in the private company context, are often used in connection with share purchases), (2) “up the ladder” reporting by legal advisors or (3) bonus disgorgement rules in the case of financial misstatements.

- *No Short-Swing Profit Disgorgement.* Under Section 16 of the Exchange Act, directors, officers and 10% owners of a public company are required to report their transactions in issuer securities and to disgorge “short-swing” profits (*i.e.*, profits from purchases and sales of issuer equity securities and derivative securities within a six month period). Private companies avoid these reporting requirements and the risk of profit disgorgement.

However, if the private company has more than 500 investors holding a class of equity security and more than \$10 million in assets at the end of any fiscal year, these obligations kick in. Because stock options are considered a separate class of equity security for purposes of the Exchange Act, an issuer with more than 500 option holders and sufficient assets would have to register its options under the Exchange Act and would become subject to the foregoing obligations.

In some going-private transactions, relief from the public company disclosure requirements may be a lesser concern because the issuer may be required to file Exchange Act reports on a “voluntary” basis as a result of covenants in its high-yield debt. A voluntary filer will, however, generally be subject to some but not all of the audit function requirements (in

particular, a voluntary filer will be subject to the outside auditor independence rules but will not be subject to the audit committee independence rules) and will not be subject to the proxy and short-swing profit rules or the prohibition on extension of credit to officers and directors.

Prior to 2007, the SEC’s primary response to this issue had been through no-action relief exempting companies with more than 500 option holders from Exchange Act registration. The no-action process was lengthy and costly, and companies requesting relief were typically required to agree to numerous conditions, including limitations on the terms of the options, continuous disclosure obligations to option holders and a commitment to eventually register the underlying shares.

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In adopting Rule 12h-1(f), the SEC’s expressed intention was to clarify and make routine the basis for an exemption [from reporting obligations for private companies] to facilitate a company’s use of compensatory stock options, while at the same time assuring appropriate investor protections for option holders.

Avoiding Becoming an Inadvertent Public Company (cont. from page 17)

In December 2007, the SEC adopted a rule that crafts an exemption from the registration requirements specifically for non-reporting issuers. This new rule, Rule 12h-1(f), eliminates the need to seek future no-action relief on a case-by-case basis. The rule is significant because it further liberalizes the prior exemptive relief and eliminates the delay and expense associated with the no-action letter process. Presumably, the SEC also saw the writing on the wall — that, as going-private transactions become larger and larger, the requests for individualized no-action relief would likely become more numerous and more of a drain on SEC resources, in particular in times like the present, when the IPO market has slowed.

The Exemption

In adopting Rule 12h-1(f), the SEC's expressed intention was to clarify and make routine the basis for an exemption to facilitate a company's use of compensatory stock options, while at the same time assuring appropriate investor protections for option holders. There are

three principal components of the rule: first, it defines the group of individuals who may receive options; second, it imposes transferability restrictions; and third, it imposes information requirements.

Eligible Option Holders

The eligible option plan participants are the same as those permitted under Securities Act Rule 701(c). To wit, the exemption is available only for compensatory stock options issued under written compensatory stock option plans. Those plans must be limited to employees, directors, and individual consultants and advisors of the issuer, its parents, and majority-owned subsidiaries of the issuer or its parents. The options may also be held by the eligible option holders' family members who acquire the securities through gifts or domestic relations orders.

Transferability Restrictions

The stock options and, prior to exercise, the shares to be received, generally cannot be transferred directly or indirectly (including by pledging, hypothecating, or otherwise transferring the options or underlying shares, or establishing a short position or through establishment of a put or a call right). The purpose of these restrictions is to inhibit the development of a trading market for the options and the underlying shares while the issuer is relying on the exemption. These restrictions no longer apply when the issuer becomes subject to Exchange Act reporting requirements or ceases to rely on the exception, or when the options are exercised. Limited exceptions to this restriction exist for transfers to family members by gift or pursuant to domestic relations orders, or on death or disability. Transfers back to the issuer are also

permitted as are transfers in connection with a change of control or other acquisition transaction involving the issuer.

Fortunately, these transfer and repurchase restrictions do not apply to the shares received on exercise of the options. Accordingly, normal contractual call and put features contained in stockholders' agreements are not affected by the rule.

Required Information

Every six months, the issuer must provide option holders with risk factors and financial information similar to the requirements under Securities Act Rule 701. The financial statements supplied must be no more than 180 days old. Provision of the required disclosures may be conditioned on the option holder agreeing to maintain the confidentiality of the information. This is a significant difference from the general rules applicable for offerings below the 500-person threshold, which require this information to be provided to an option holder only within a reasonable period of time prior to the exercise of the option. However, this is also a significant liberalization of the prior no-action relief, which imposed full public company-like disclosure requirements. After the stock options are exercised, the issuer no longer has to provide any information to shareholders under the new rule.

Documentation Matters

The rule requires that these limitations and conditions be included in one or more enforceable written agreements, such as the written stock option plans or the individual written option agreements, or in the issuer's by-laws or certificate of incorporation. It is not sufficient for the rule to be satisfied in practice.

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...[T]he new rule is good news for large, private companies that award stock options to their employees. Issuers no longer have to obtain individual no-action relief and can instead rely on the final rule in deciding how deeply to grant equity into their ranks.

Avoiding Becoming an Inadvertent Public Company (cont. from page 18)

Transition Matters

If an issuer with \$10 million in assets but fewer than 500 option holders passes the 500-person threshold, it will have to be in compliance with the new rule by the end of its fiscal year to be eligible for the exemption. This means that if its existing employee stock option plans do not already contain the restrictions and information provisions required by the rule, they must be amended to comply. Ideally, issuers who anticipate having more than 500 option holders should design and implement compensation programs and employee stock option plans with the rule's requirements in mind. Advance planning will avoid the additional costs associated with later amending plans to meet requirements for exemption eligibility.

The Exemption Applies to Options Only

The 500-person rule applies separately to the underlying shares received on exercise of the options, and there is no exemption from Section 12(g) for having more than 500 shareholders. If sufficient numbers of employees exercise their options, the issuer will become subject to the Exchange Act.

Final Points

Since the exemption is limited to issuers that are not subject to Exchange Act reporting requirements, the exemption expires once the issuer becomes a reporting company (a separate exemption from Exchange Act registration is available for options granted by public companies). Additionally, as long as the securities underlying the stock options are all of the same class of securities, the exemption applies on a combined basis to all compensatory stock options meeting the conditions of the plan. This rule applies

even if the options are issued under different plans and have different strike prices, grant dates, vesting schedules and other terms. The exemption, however, does not extend to other rights issued in connection with the compensatory stock options, such as stock appreciation rights or phantom stock units.

Overall, the new rule is good news for large, private companies that award stock options to their employees. Issuers no longer have to obtain individual no-action relief and can instead rely on the final rule in deciding how deeply to grant equity into their ranks. ■

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How to Talk About Research You Haven't Read (cont. from page 4)

- *Private to public deals represented only 6.7% of the transactions reviewed, or 28% in terms of the dollar value of the firms acquired.*
- Private equity transactions remain primarily based in North America and Europe. *Transactions based outside of North America and Western Europe accounted for only 12% of global LBO transactions (9% in value) from 2001 to 2007.*
- *The most common path to exit involves sales to a trade buyer (39%), followed by secondary buyouts (24%) and IPOs (13%).* The study confirms the widespread perception that secondary buyouts have increased in relative importance as IPO exits decrease.
- Less obviously, *buyouts have a lower average default rate than U.S. corporate bond issuers*, particularly among high yield bond issuers. Nonetheless, 6% of private equity transactions end in bankruptcy or a financial restructuring.
- Private equity investors are significantly more likely to be long-term investors than is often surmised by industry opponents. *Fully 58% of private equity investors stay on for more than five years. The study also found that quick flips of less than 24 months are on the decline and accounted for only 12% of the sample.*

Long-run Investment Study

This study also provides additional data for the debate on whether private equity is better at focusing on long-term investment and innovation than public companies which are often accused of focusing on quarterly earnings. In order to assess the effect of private equity on long-term investment, the study looked at the patenting behavior of almost 500

private equity-backed firms worldwide. Among the key findings from this analysis were that:

- *post-buyout firms pursue more economically valuable inventions and maintain comparable levels of cutting edge research;*
- *innovation becomes more targeted following a private equity investment; and*
- *firms tend to focus on core technologies linked to their historic focus after a buyout.*

Employment Study

Among the most eagerly anticipated results were those concerning the effect on employment of private equity transactions in the United States between 1980 and 2005. The study employed U.S. census data to track employment at virtually all private equity-backed companies in the U.S. for five years before and after the private equity transactions and compared this data to that of their peer companies who were not backed by private equity. In a blow to both opponents and proponents of private equity, the study concluded that the effect of the industry on jobs was nearly neutral, specifically:

- Companies that become *buyout targets shed approximately 4% more of their work force than their peers in the two years before they are sold*, probably because the company is struggling or preparing for a sale.
- *In the first two years following a buyout, targets cut, on average, 7% more of their workforce than their public peers. However, at the same time, the targets are also, on average, adding new positions in new locations faster than their peers (15% for private equity-backed*

companies versus 9% for their public peers).

- In the manufacturing sector (accounting for about 25% of all private equity transactions since 1980), there was virtually no difference in the rate of employment growth between private equity-backed companies and public companies.
- In sectors other than manufacturing, *the growth of the target's workforce tracks that of its peers within four or five years of the buyout.*

Corporate Governance Study

The final study looked at changes in board composition in over 140 private equity-backed public to private deals in the United Kingdom between 1998 and 2003. The key findings were that:

- the number and ages of board members tends to decrease significantly, as outside directors are replaced by younger private equity sponsors;
- the participation of private equity representatives on boards appears to increase in proportion to the complexity and anticipated challenges of the transaction, for example, when extra management support or monitoring is needed; and
- in club deals, the proportion of private equity representatives on the board is larger to permit each private equity firm to have a representative.

Case Studies

The empirical analysis of transaction data is complemented by a detailed review of six private equity transactions in Germany, the United Kingdom, China and India.

The case studies round out the large

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How to Talk About Research You Haven't Read (cont. from page 20)

sample analysis and demonstrate in more specific terms how varied the face of private equity has become across the globe. To their credit, they each have a distinct focus that addresses key issues in the jurisdictions concerned. Hence, the case study of the Messer Griesheim deal in Germany provides a key example of the interplay between family owners, industrial companies and private equity owners. In the United Kingdom, the case study of the New Look transaction includes a detailed comparison of the way in which corporate governance shifts in a public to private deal. Similarly, the case studies of the four emerging market deals in China and India highlight “growth capital investments” in rapidly expanding markets.

Collectively, the case studies also pick up on a number of common themes borne out by the larger statistical analyses. Among other things, the case studies are in keeping with the report's overall perspective on employment data, which tends to follow a J curve, decreasing immediately prior to and after the acquisition and growing significantly thereafter, particularly as a result of greenfield job creation.

Private Equity Council Report

American Jobs and the Impact of Private Equity Transactions (January 2008)

(www.privateequitycouncil.org)

Background

A considerably more bullish report on the effect of private equity on employment results from the analysis of data from 42 large transactions valued at \$250 million or more between 2002 and 2005. This report was prepared with the support of The Private Equity Council, an advocacy, communications and research organization and resource center

supported by about a dozen leading private equity firms, by Dr. Robert Shapiro, former Under Secretary of Commerce in the Clinton Administration, and Dr. Nam Pham, founder and president of NDP Group, LLC. (Incidentally, the website of The Private Equity Council is an excellent source of links that feature private equity-related research.) It is believed to be the first empirical study based on data provided by private equity firms directly.

The report concludes that “*large private equity transactions produce significantly greater job gains than observed in other companies in the same sectors, especially other large companies.*”

Key Findings

- Over the three year period under review, *the worldwide work force of the 42 firms studied grew by 8.4%.*
- Among a subset of 26 firms that provided U.S. employment data, *job growth in the U.S. was a whopping 13.3% compared to 5.5% for all U.S. businesses and 2.7% for large U.S. businesses.*
- Deals in *the manufacturing sector had the largest relative growth, with the worldwide data reflecting growth of 8.6% and the U.S. data showing more modest growth of 1.4% against U.S. manufacturing job shrinkage of 7.7%. This growth came on the heels of a J curve similar to that identified in the WEF study; worldwide employment at the nine private equity-backed manufacturing firms studied dropped 1.2% in the first year following the acquisition and further declined by 3.2% in the second year before rebounding 9.8% in the third year.* A

similar J curve effect was visible in the five U.S. manufacturing firms for which U.S. employment data was available.

- *Outside the manufacturing industry, the sample showed worldwide job growth of 8.4% and U.S. growth of 14.3% which again contrasted sharply with a 7.4% growth rate by all non-manufacturing U.S. firms.*

European Parliament Report

Private Equity and Leveraged Buyouts (December 2007)

(www.buyoutresearch.org)

Background

Professor Oliver Gottschalg of the HEC School of Management in Paris prepared this report at the request of the European Parliament's Committee on Economic and Monetary Affairs. Professor Gottschalg also serves as an advisor to private equity investors and co-directs the INSEAD Buyout Research Program. The study was based on the analysis of LBO data gathered from a number of business schools, including the proprietary database of HEC-INSEAD, which tracks the terms and performance of more than 5,500 buyout transactions throughout the world. The study is expressly “more concerned with finding the averages than addressing the extremes.” The press widely quoted this study as illustrating that actual results did not “correspond with the stereotype of the industry making its investors extremely rich.”

Private Equity Value Creation

In response to the EU Parliament's request to determine whether private equity fund investors earn higher returns than they would realize in comparable stock market investments, Gottschalg finds that:

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- *private equity funds have, on average, only modestly outperformed comparable investments in a broad public market index by approximately 3% per year;*
- *net of fees, the average performance of private equity investments relative to public markets was -3%; and*
- there is an enormous difference between the top performing funds and the low performing funds; *the best performing funds exceed stock market performance by a factor of 10.*

In analyzing the extent to which leverage is responsible for any incremental gains over the stock market, Gottschalg evaluates the hypothetical performance of buyouts with leverage adjusted to the levels of similarly situated publicly traded firms and concludes that *more than one-third of the performance of successful buyouts is directly attributable to leverage.*

Nonetheless, *leverage is clearly not the sole driver of success*, as demonstrated by models of public market investment vehicles that mimic the operating risk and leverage of buyouts but significantly underperform actual buyouts.

Time Horizons of Private Equity

Based on a review of over 4,701 buyout transactions between 1971 and 2004, the study finds that at *5.3 years, the average duration of a private equity investment is significantly longer than the average length of the commitment of blockholders* in public companies. Quick flips within 24 months are clearly exceptional, occurring in only 16% of the buyouts reviewed.

The author discredits the claim that private equity leaves behind “crippled and anorexic companies struggling for survival” by analyzing the data relating to 500 reverse LBOs (*i.e.*, where sponsors exited through an IPO) in the United

States over a 25 year period. Observing that the *longer term (one to five year) returns to investors on reverse LBOs were consistently higher than comparable investments in non-buyout backed IPOs*, Gottschalg concludes that *private equity generally adds value in the long-term for both acquired entities and the shareholders who invest in reverse IPOs.*

Possible Social Consequences of Restructuring in Private Equity

Responding to the EU Parliament's request to determine what changes private equity triggers in acquired companies, the author reviewed 1,000 case studies of buyouts generated from private equity fund disclosure to investors.

In fact, *a minimum of the deals (9%) were purely driven by restructuring considerations. Fully 91% of all transactions involved growth-oriented changes* such as add-on acquisitions, new marketing, R&D, geographic expansion, new IT systems, JVs or other growth-oriented initiatives and only 54% lead to restructuring oriented changes (*i.e.*, divestitures, lay-offs, cost cutting, closing of non-core units, consolidation of facilities, outsourcing, etc.)

The EU Parliament also asked the author to consider the long-term impact of private equity on the competitiveness of industry sectors. The author concludes that *there is no statistically significant basis for concluding that private equity accelerates restructuring trends in various industry sectors over a 20-year period.*

Conflicts of Interest in Private Equity

The EU also sought to determine whether multiple relationships between given institutions and private equity firms potentially altered investment performance.

In responding, Gottschalg examined

the potential conflict of interest posed by having banks and their affiliates fulfill multiple roles as limited partners, lenders and book managers on 820 reverse IPOs. Here, the only significant effect appeared to be the tendency of banks which were both exit IPO bookrunners and lenders on LBOs sponsored by the same funds to price IPOs higher (and thus reduce investors' first day return). In the author's words, “Our finding would be consistent with the view that *book managers doing a lot of business with a given general partner arrange an IPO with 'less money on the table' for first day returns.*” At the same time, this initial pricing did not appear to affect 6 month, 9 month and 12 month investor returns.

Conclusion

Gottschalg concludes that private equity fills a crucial role in the economy akin to that of early stage venture capital. In the author's own words, *“through long-term controlling investments, private equity firms trigger predominantly growth-oriented changes in the acquired business with a positive impact on their short- and long-term competitiveness.”*

Boston Consulting Group Report

The Advantage of Persistence; How the Best Private-Equity Firms “Beat the Fade” (February 2008)

(www.bcg.com/impact_expertise/publications/publication_list.jsp?pubID=2574)

Background

Released in February 2008, this study is the offspring of a joint research project conducted by the Boston Consulting Group and the IESE Business School of the University of Navarra in Spain. Like Professor Gottschalg's report to the

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European Parliament discussed above, this study also compares the performance of private equity fund investment with public market investments. However, this project goes on to analyze the ability of top performing funds to beat the fade (*i.e.*, avoid the return to average returns which afflicts the majority of public investments.)

The Role of Leverage

The authors conclude that private equity value creation is increasingly less about the leverage and more about operational improvement and profitable growth. Based on a review of 32 European portfolio companies, the study concludes that *more than half of the average IRR was attributable to sales growth and improvement in margins.* In addition, fully 10 percentage points of the average IRR of 48% were due to increases in the valuation multiples. In fact, leverage was responsible for only about 22% (11 percentage points) of the IRR. The study contrasts this analysis against data from the 1980s and 1990s to conclude that “it’s clear that *there has been a long-term historical shift away from leverage toward operational performance as a key source of value.*”

Private Equity versus the Public Markets

The study constructs a model of private equity returns versus public market returns in order to develop a risk-adjusted analysis of private equity returns. In particular it focuses on two negative factors (the risks caused by the increased leverage and lack of liquidity associated with private equity backed firms) and one positive factor (the relative stability of portfolio companies). The model employs cash flow data from a sample of 218 private equity funds which closed between

1979 and 2002. The results of the analysis lead the authors to conclude that *“the returns of private equity are, on average, roughly equivalent to returns from the public capital markets.”*

However, the study goes on to analyze the tendency of public investments to fade toward the market average over time by reviewing the performance of 66 public large-cap mutual funds between 2002 and 2006. This data is then compared to the performance of 75 pairs of top performing funds — first and second funds launched by the same private equity firm — to see if the follow-on funds showed the same tendency to fade after a strong performance by the initial fund. In fact, the top-rated first funds and the follow-on funds both had returns that were about double the sample average. As a result, the authors conclude, *“this suggests that over time, the top private-equity firms consistently outperform both their public-company and private-equity rivals—and, thus, do represent an extremely attractive investment vehicle.”*

Lessons from the Top Private Equity Performers

The study concludes by comparing 20 private equity firms with above-average performance in an attempt to identify the secrets of their success. It asserts that structural factors are relatively unimportant: fund size, deal size, geographic diversification and industry diversification are all poor predictors of performance.

The authors propose that the over-achievers are leveraging off of distinctive organizational capabilities that they identify as:

Networked access: acting as well-connected insiders in the sectors in which they operate.

Domain expertise: highly specialized knowledge — the more a firm is focused on a particular type of deal or deals in a particular sector, the faster it moves up the experience curve and the faster it can build an advantage over less focused rivals.

Operational improvement: the capacity to turn around an operation and increased reliance on talented individuals with a background in consulting and operational management.

British Private Equity and Venture Capital Association Report:

The Economic Impact of Private Equity in the UK in 2007 (February 2008)
(www.bvca.co.uk)

Background

The ninth annual study of the British Private Equity and Venture Capital Association (BVCA) is based on a random sample of UK businesses that have, at some time, received private equity investment. The BVCA engaged a consulting firm to contact over 6,000 persons and analyzed the results of the 1,013 respondents.

Private Equity and Job Creation

The study found that between 2002 and 2007, *UK-based private equity companies increased their worldwide staffing by an average of 8% per annum, far exceeding the growth rates of the FTSE 100 companies which came in at 0.4%.*

Private Equity and the UK Economy

The survey also demonstrated *annual sales growth rates of private equity-backed companies at 8% per year, which was markedly better than that of the FTSE 100 companies at 6%.*

The BVCA estimates the collective UK

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How to Talk About Research You Haven't Read (cont. from page 23)

tax bill of various private equity participants to conclude that *nearly 35 billion pounds (approximately \$69 billion) flowed into Her Majesty's coffers from private equity firms and their portfolio companies.*

The Added Value of Private Equity

This growth appears also to have inspired confidence among the management of the various portfolio companies, 75% of whom thought that an LBO had had a positive or very positive impact on management and 68% of whom believed that it had given them more freedom to innovate.

Ernst & Young's Annual Review of Private Equity Exits

How do private equity investors create value? A global study of 2007 exits. (July 2008)
(www.ey.com/global/content.nsf/International/Transactions_-_Private_equity_study_2008)

In July, Ernst & Young published the results of its annual study of the 100 largest private equity exits in the preceding year. The survey sample included 53 deals in Europe, 44 in North America and 3 in Australia and Asia. Deals were selected for review based on the enterprise value at the time of the investment, which ranged from \$360 million to \$5 billion. Growth rates were calculated from entry to exit, which occurred on average three and a half years after the initial investment. The data for the study was taken from public information and, in the case of 70% of the deals selected, detailed interviews with the private equity investors behind the deals.

Although E&Y's review of 2007 exit data effectively underlines how much difference a year makes, its key findings also illustrate a value creation model that should be well-positioned to exploit opportunities in tougher times. In particular, the study demonstrated that:

- *The largest private equity exits had enterprise values with a compound annual growth rate (EV CAGR) of 24%, or double the 12% EV CAGR of the public company benchmark.* Within the sample, deals initially valued between \$500 million and \$1 billion grew the fastest, with a EV CAGR of 30%, while deals in excess of \$1 billion grew more modestly with a 21% EV CAGR.
- The best exits belonged to private company acquisitions, which showed annual enterprise value growth of 32%. By comparison, exits from going private transactions show significantly lower growth, with an EV CAGR of 17%.
- A surprisingly large percentage of the leading private equity exits in 2007

originated from secondary buyouts (32% versus 19% for going private deals). With exits from secondary deals showing an impressive average enterprise value growth of 27%, E&Y concludes that *"secondary buyouts do well in the hands of a second private equity owner."*

The study also identified common denominators in the private equity business models behind the most successful exits. In particular, it focused on proactive buying, aligned incentives, strong management, an aggressive business plan, business improvement and growth as the most important drivers of value. E&Y concludes that "more than half of all multiple growth charted for the top exits was attributable to successful strategies implemented under private equity ownership."

Pulling it all Together

Although the studies took different approaches, analyzed very different sets and types of data, and displayed different degrees of academic and statistical rigor, we were impressed by the degree to which they complement each other. For example, each of the following themes emerges in two or more of the reports:

- on average, private equity investments may not outperform public market investments, but the top performing funds have consistently been able to outperform the market;
- employment growth at private equity-backed firms appears to follow a J curve, decreasing in the years immediately prior to and after an acquisition and growing significantly thereafter;
- the "strip and flip" approach is a

Private equity...researchers are drawing conclusions that directly contradict key tenants of private equity's critics, such as the "strip and flip" myth. In other cases, such as the mixed message provided by employment data, the research tells a more textured and complex story than private equity's most enthusiastic proponents might have hoped.

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caricature, with the vast majority of private equity investors staying at least five years and adding significant value; and

- leverage is not the only, or even the most important, driver of success.

Since we promised to help our readers put the foregoing research in the context of the “collective library” of private equity research (without forcing them to read it), we would be remiss if we did not point out that there are reports that strike a distinctly different tone. Among the mostly widely discussed has been the April 2007, “Behind the Buyouts” report issued by the Service Employees International Union (SEIU) in conjunction with the launch of a website aimed at “exposing” the private equity industry last year. In explaining the approach of the report,

which examines five private equity firms and five transactions, the authors suggest that the “lack of public information available about private equity precludes a full, comprehensive analysis of [the industry]”. The report also questions the job creation data reported in then current literature and questions its “accuracy and reliability.” (The full report is available at www.behindthebuyouts.org).

Private equity research is now drawing a critical mass of talented academics and researchers who have found a plethora of valuable information about private equity transactions to be analyzed and studied.

In many cases, these researchers are drawing conclusions that directly contradict key tenants of private equity’s critics, such as the “strip and flip” myth. In other cases, such as the mixed message provided by employment data, the

research tells a more textured and complex story than private equity’s most enthusiastic proponents might have hoped. In all cases, however, this research should contribute significantly to improving what one report’s author has referred to as the “low ratio of facts to opinion” that has heretofore hampered an analysis of the role of private equity in the global economy. Thoughtful industry participants and observers should stay tuned as the collective library of private equity research grows, being always mindful of the message, the messenger and the methodology. ■

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Go-Shops vs. No-Shops in Private Equity Deals (cont. from page 8)

On the back-end, the very end of the time frame under analysis (July/August 2007) is problematic because of rapidly tightening credit, which caused turmoil in many transactions announced during that period. Go-shop deals have become more frequent over time, reaching approximately 50% of transactions by the end of the sample period. Therefore, the credit crisis has had a disproportionate influence on go-shop deals compared to no-shop deals. In order to minimize this effect and focus instead on the question of value extracted by the target board of directors, I end the announcement window at thirty days after deal announcement. Although not all go-shop periods have expired by that time, conversations with practitioners suggest that virtually all of the shopping is completed within thirty days after the

announcement of the deal.

If go-shop clauses are an effective tool for identifying the highest-value buyer and extracting full value from it, then returns to target shareholders should be higher (or at least not lower) in go-shop deals than in the traditional no-shop route. If instead go-shop deals deter potentially higher-value bidders, then target shareholder returns should be lower in the go-shop sample than in the no-shop sample.

I find no meaningful difference in target shareholder returns between no-shop deals and add-on go shop deals but approximately 5% higher abnormal returns in the pure go-shop sample. This difference in portfolio CARs between the pure go-shops and all other deals is statistically significant at 90% confidence (t -statistic = 1.69). The evidence cuts against the conventional wisdom that pure go-shops are particularly suspect (from a target shareholder perspective) because they involve no pre-signing market check. To the contrary, the evidence suggests that there may be something about pure go-shops (but not add-on go-shops) that allows target boards to extract more from a potential acquiror, despite the absence of any competition in the pre-signing process. This finding stands in sharp contrast to the weight of practitioner commentary to date, which generally views the go-shop process as simply “window dressing” and “illusory.”

The question then becomes from where, precisely, does this additional value come. The simple explanation offered by some prior commentators, that go-shops simply reflect sell-side bargaining power, is inconsistent with the distinction reported here between add-on go-shops and pure go-shops. A

more subtle explanation appears from a close review of the proxy statements in the pure go-shop deals. On the sell-side, the proxy statements frequently document the seller’s interest in exclusivity as a means of minimizing disruption, as well as the benefits of the “bird in hand” that arises from a go-shop process. On the buy-side, the proxy statements frequently document the initial bidder’s willingness to pay more in order to maintain exclusivity in the deal. The evidence suggests that the economic value of these benefits might translate into approximately 5% higher returns for target shareholders.

* * *

The narrow (doctrinal) implication of these findings is that go-shop provisions, appropriately structured, can satisfy a target board’s Revlon duties. The broader (transactional) implication is that go-shop provisions can be a “better mousetrap” in deal structuring — a “win-win” for both buyer and seller. This conclusion would be consistent with the increasing use of go-shops over the past two years that I find in my sample. The final (policy) implication is that private equity firms are not stealing companies from the public shareholders at low-ball prices through go-shops, as some commentators suggest; rather, the go-shop process induces a full price from the first bidder, which is meaningfully shopped post-signing.

While the evidence presented here suggests no reason for categorical skepticism of go-shops, the data does indicate some reason to be wary in the specific context of management buyouts (“MBOs”). Non-MBOs with a pure go-shop clause are jumped 23% of the time,

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Go-Shops vs. No-Shops in Private Equity Deals (cont. from page 26)

while MBO go-shops are never jumped. While the sample is small, this finding is consistent with practitioner impressions that potential bidders are generally unwilling to bid when management has publicly signed on with a preferred buyout partner.

Taken as a whole, these findings have implications for how sell-side boards should structure a meaningful go-shop process, and where the Delaware courts should focus their attention in determining whether a particular go-shop satisfies the selling board's Revlon duties. To date, practitioners and courts have focused on the length of the go-

shop window and the magnitude of the breakup fee in assessing the viability of the go-shop process. The analysis presented here suggests additional features that boards should negotiate for and courts should look for, particularly in the context of MBOs: bifurcated breakup fees, no contractual match right or (even better) no ability to participate in the post-signing auction, a contractual commitment for the initial bidder to sell in to any higher offer that emerges during the go-shop period, and ex ante inducement fees for subsequent bidders, among other deal features. This proposal tracks the Delaware courts'

general approach to conflict transactions, which begins with substantive fairness review but gives up fairness review if appropriate procedural protections are in place. ■

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Tax in a Down Market (cont. from page 16)

Separately, Treasury officials have stated that they are working on guidance that would expand the circumstances in which a stock sale or stock distribution may be treated as an asset sale for tax purposes. This would obviously be welcome news for buyers and sellers alike.

NOLs

Dealmakers looking for some consolations in the current economy may want to focus on the "net operating losses" (NOLs) of potential target companies. The tax code has a number of rules that limit the ability of a corporation to use an NOL following an "ownership change" of the company (which typically requires a more than 50% change in ownership). As many people know, in such a case the basic rule is that the company is limited to using only a portion of its NOL each year equal to the adjusted federal long-term rate (generally around 5%) multiplied by the equity value of the company after the ownership change. However, many people forget that in 2003

the IRS liberalized the ability of a corporation to use its NOL during the five year period following the ownership change. Whether a corporation is able to take advantage of the liberalized rules is complicated and depends on the built-in gain in the corporations assets. However, many buyers have been pleasantly surprised once the analysis has been done.

AHYDO

On August 8th the IRS ruled that it would not treat certain debt obligations as subject to the "AHYDO" rules in certain cases where the credit crisis may have created unexpected OID in the obligation. When the "applicable high yield debt obligation" (AHYDO) rules apply to a debt obligation, the deduction for a portion of the OID (original issue discount) under the obligation may be deferred until paid and a portion may be permanently disallowed. The guidance applies in two basic cases. The first is where a corporation issues an obligation pursuant to a financing

commitment obtained prior to January 1, 2009 and the obligation would not be subject to the AHYDO rules if the "issue price" were equal to the net proceeds received. One would typically expect that the issue price in such a case would equal the net proceeds received but the ruling observes that OID may arise if the initial purchaser of the debt sells a substantial amount of the debt at a discount to third parties in its capacity as an underwriter (within the meaning of the tax rules). The ruling also applies in certain cases where a bridge (or similar) financing is converted into permanent financing. ■

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Conditions to Regulatory Approvals: Lessons from ADS (cont. from page 14)

exception and condition can take various forms, and is often subject to heavy negotiation. Sometimes the phrase “materially burdensome condition” is used, often with further definition of conditions to approval that would violate this standard. A buyer may ask for a more subjective standard such as “any condition that would materially impair the benefit of the transaction expected to be enjoyed by the buyer” or “any condition not reasonably acceptable to the buyer” and a seller may push for a higher standard such as “a condition that would cause a material adverse effect on the buyer.” Of course, if a financial sponsor is concerned about specific conditions that it is unwilling to satisfy, it should try to expressly include those in the covenant exception and closing

condition rather than rely on general language.

Beyond negotiating a suitable exception for burdensome conditions, a buyer should also pay close attention to its covenant with respect to regulatory approvals more generally. The points of negotiation with respect to this covenant may involve whether the buyer must share all materials and correspondence submitted to the regulator with the seller or allow the seller to participate in (or at least receive notification of) all discussions with the regulator. Particularly with private equity buyers, there may be an attempt to limit the information about the buyer (or its controlling persons) that must be provided to the regulator.

There also may be negotiation of the level of efforts that the buyer is required to exercise to obtain regulatory approval. The Blackstone acquisition entities are required by the ADS merger agreement to expend “reasonable best efforts” to obtain regulatory approval. The other commonly used formulations are “commercially reasonable efforts,” often thought to be a lower standard than reasonable best efforts, and “best efforts,” thought to be a higher standard. The truth is there is very little case law that is helpful in definitively interpreting the meaning of these phrases relative to one another, so a private equity buyer should not take much comfort from a supposedly lower form of efforts standard and instead, as suggested above, should rely on specific carve-outs from the covenant standard to protect itself against unwanted obligations.

As the ADS dispute demonstrates, a seller may have difficulty in proving that its contractual counterparty failed to satisfy its obligation to use the applicable

level of “efforts” to obtain regulatory approvals if the actions needed to be taken to secure the approvals are actions of a private equity fund or sponsor which is not party to the acquisition agreements, rather than the buyer entity. As a result, sellers may not be able to collect reverse breakup fees where the termination provision of the acquisition agreement requires a breach by the buyer in order for the fee to be payable. In the wake of the ADS case, it is possible that sellers will seek a direct covenant from the private equity fund with respect to regulatory matters or to introduce an additional trigger that requires a reverse termination fee to be paid where regulatory approvals are not obtained even in the absence of a breach, possible developments that we would expect to be resisted.

* * *

The ADS litigation, which is pending, may yield further lessons for private equity sponsors if it is finally adjudicated. But in an environment in which private equity investment in the financial sector is increasing, the ADS dispute serves as a cautionary tale for would be private equity investors as to the importance of a well crafted set of contractual covenants and conditions with regard to regulatory matters. ■

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