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Everything Old Is New Again: PIPEs Go Up-Market

Although PIPEs—private investments in public equity—have long had a place in the private equity toolkit, the tool had, for most PE firms, become rather rusty in the context of the strong acquisition and financing markets of recent years. Indeed, the coercive nature of certain "toxic" PIPE structures that were common in the early part of this decade had until recently led some investors to consider the investment structure, as a whole, somewhat less than fully respectable.

That changed in 2008. Any suggestion that PIPEs were somehow "downmarket" was belied by last year's series of multi-billion-dollar deals involving not only leading private equity firms but some of the country's largest financial institutions and most well-known public companies. Notable transactions included Warburg Pincus's investment in MBIA, TPG Capital's investment in Washington Mutual, Corsair's investment in National City Corp, Carlyle's investment in Boston Private Financial, Berkshire Hathaway's investment in Goldman Sachs and Leonard Green's investment in Whole Foods. Even the U.S. government's investments in AIG, Citigroup, Bank of America and a host of other financial institutions were essentially PIPE transactions.

The recent resurgence of PIPE deals resulted from a number of factors, including unprecedented funding requirements of large financial institutions, a scarcity of other sources of capital, a desire for greater speed and certainty than typically available in a take-private transaction, and regulatory

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Letter from the Editor

The private equity community is hardly alone in being challenged by current economic realities. And, to be truthful, it is probably, as an asset class, among the most able to weather the economic storm.

But no one will argue that the role of private equity in the business landscape is the same as it was a few short (or long) years ago. In this issue, we highlight some of the techniques that private equity can use to invest in the current environment and explain why those investments might just work. On the cover, we remind readers (to borrow from Peter Allen) that "Everything Old Is New Again" and provide a primer on structuring PIPEs transactions. In "Bridging the Gap," we explain that in a world without many financing options, it makes more sense than it once did to use earnouts, seller financing and rollover equity to bridge financing and valuation gaps between sellers and buyers.

A few years ago, limited partner defaults were of concern only to compulsive lawyers drafting the technical sections of fund partnership agreement. Today, the risk of limited partner defaults is on everyone's mind and funds are grateful that their lawyers anticipated today's reality. In our article entitled "Limited Partner Defaults: The Improbable Becomes Reality" we explore how general partners can sensibly manage defaults and potential defaults by their limited partners to mitigate their impact on the rest of the fund. On a more positive note, we also report on continued growth in 2008 for emerging market funds and on some of the challenges for sponsors structuring those funds.

Infrastructure investing has been a part of the private equity menu for many years, but, with the passage of the federal stimulus package, the debate over private funding for public projects has taken center stage. An ad hoc group of private equity professionals, bankers and lawyers has been organized to focus attention on the role to be played by private capital in the development of public infrastructure. In our Guest Column, Barry Gold, Managing Director of the infrastructure investment group at Carlyle, is interviewed by another participant in the ad hoc group—our partner, Ivan Mattei—about "privatizing" public infrastructure.

For those of you who still manage to maintain a "glass half full" world view, we do our best to help you with that perspective. We provide some updates on recent legislation providing tax relief for portfolio companies deleveraging or modifying debt and on final regulations providing comfort that the new Exon Florio regime will not be as stringent for private equity as initially proposed.

While the financing markets are in their current state, we urge you to remember that the devil is in the details. We provide guidance in "Deconstructing Equal and Ratable Security Clauses" on how to add new secured debt without refinancing existing bonds, while reminding borrowers in "Disruptions in the LIBOR Market: The Boilerplate Is Broken" to watch out for changes to boilerplate governing standard yield protection and increased cost provisions that may prove to be expensive.

We hope we have managed to update you on some recent developments in private equity and have given you some new thoughts on how to deal with the current environment. If there is something you'd like discussed in a future issue, please let us know.

Franci J. Blassberg
Editor-in-Chief

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GUEST COLUMN

A Discussion with Barry Gold of the Carlyle Group About Infrastructure Financing

The passage of the federal stimulus package has reinvigorated debate over the funding of public infrastructure projects in the United States. An ad hoc group of private equity professionals, bankers and lawyers has been working to focus attention on the important role to be played by private capital in the development of public infrastructure.[1] On February 25, 2009, Barry Gold, Managing Director of the infrastructure investment group at The Carlyle Group and a leader in the field of private investment in public infrastructure, sat down with Ivan Mattei to discuss the activities of the ad hoc group and Carlyle's views on the opportunities and challenges facing infrastructure funds in the current market.

Carlyle has been a leading participant in the ad hoc group that has been seeking to promote awareness among policy makers and opinion leaders of the potential benefits of private investment in infrastructure. Why is such an effort necessary and what are the group's goals?

The heavy legislative calendar (not just the stimulus package, but also the anticipated legislation for the creation of a National Infrastructure Bank and, later in the year, transportation reauthorization)[2] creates an opportunity for Congress and the Administration to make significant changes in the way U.S. infrastructure is funded, maintained, and operated.

At this moment of crisis, there are multiple competing and worthy ways to spend every available dollar of federal funding. Straight government funding of infrastructure procured under the traditional model will simply not be sufficient to meet the country's needs.

At the same time, there is perhaps $180 billion of available private capital that can be used to build, maintain, and operate infrastructure projects and leverage capital available from government sources. If these private funds are leveraged at a modest 60:40 debt-to-equity ratio, that's $450 billion of total investment. The U.S. Department of Transportation has estimated that every $1 billion of infrastructure investment will create and support 34,800 jobs for one year. If you take the $450 billion of potential private investment and deploy it over 10 years, that implies the creation of over 1.5 million jobs each lasting for a decade. If this capital is deployed more quickly, it would pack a correspondingly greater punch in a shorter period. There is concern in many corners of our market that Congress is not sufficiently focused on the importance of private capital as a source of funding for infrastructure projects.

Timing is also critical because much of this private capital could be redeployed, perhaps to other countries or sectors, if not put to work in the U.S. within a reasonable period of time.

Hence, the limited goal of our "ad hoc" infrastructure group has been to make sure that policy makers are aware of what the private sector has to offer, in hopes that the current and coming legislation in this area will carve out a proper role for private capital.

Previous administrations and various states have promoted the concept of "privatizing" public infrastructure. But there remains much skepticism about outsourcing public infrastructure in many quarters (heightened, perhaps, by the perceived failings of the private sector in the current credit crunch). How do you respond to the skeptics?

The issue is not really whether we should "outsource" construction of our national infrastructure. In fact, under the traditional model of infrastructure procurement, much if not most of the design and construction work is already contracted out to the private sector, at least on projects of any real significance. The same is true for major

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[1] *The group includes, among others, Abertis, Barclays Capital, Carlyle Infrastructure Partners, Citi Infrastructure Investors, Credit Suisse, Debevoise & Plimpton LLP, Deutsche Bank RREEF, Merrill Lynch, Morgan Stanley, RBC Capital Markets, Scotia Capital and UBS.*

[2] *Federal funds for surface transportation infrastructure have traditionally been allocated through multi-year authorization bills, reflecting the long lead times necessary to bring new projects on line. These bills have also tended to be the principal legislative vehicle for the establishment of U.S. federal transportation policy, whether by setting spending priorities, promulgating safety standards, establishing pilot programs or adjusting the regulatory framework. The current transportation bill covers the five year period 2005-2009 and is due for "reauthorization" by year-end. One specific innovation discussed in recent years, and endorsed by President Obama when he was a Senator, is the creation of a National Infrastructure Bank that would be capitalized and operated by the federal government. Its mission would be to provide long-term debt financing for U.S. infrastructure projects; most likely in combination with private debt or equity capital.*

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Guest Column: A Discussion with Barry Gold (cont. from page 3)

refurbishment and expansions of existing infrastructure. The real issue is how to partner with the private sector in the most effective and efficient way possible.

Failing to maintain in good repair existing infrastructure in the U.S. is almost as big a problem as failing to build new capacity. This is one of the key areas where current government practices fall short of world class standards. Under the traditional procurement model, state and local governments contract with the private sector for construction of our public infrastructure, but then retain responsibility for operation and routine maintenance. Because the party that builds the infrastructure does not have to live with the long term consequences of its work (beyond what is typically a relatively short warranty period), the results are predictably different from what you would get if responsibility for construction, operation and maintenance were not separated.

Under a well-structured long term public-private partnership, the process of negotiating, pricing and awarding the contract forces the parties (both public and private) to consider not just the up-front construction costs, but also the "life-cycle" costs of the infrastructure in question. This makes it far less likely that infrastructure will be built in a way that saddles future administrations and taxpayers with unfunded and unmanageable maintenance obligations. That's what we have done in the past and that's why much of our infrastructure is in such a state of disrepair.

Another frequent criticism or concern is that public-private partnerships (P3s) have the effect of placing critical infrastructure in the hands of unaccountable private parties.

This is another place where the issue is one of structuring P3 contracts wisely, rather than whether to have P3s at all. A well-structured P3 transaction is all about accountability. The private partner in such a transaction is obligated to comply with extremely detailed operating standards. The partnering government agency, in turn, is given far reaching power to examine, verify compliance, and work together as a partner to find solutions to benefit the project. Failure to comply with mandated standards can result in fines and penalties. In a worst case scenario, failure to operate the asset to world class standards can result in termination of the P3 contract and forfeiture by the breaching party of some or all of its investment in the project.

Consider the alternative. What happens when a government agency fails to operate and maintain critical infrastructure to a world class standard? That happens every day in virtually every state. There is no mechanism, short of the relatively blunt instrument of the ballot box, to hold anyone accountable in such cases.

One obvious difference between the United States and many other countries where public-private partnerships have been used to good effect is the fact that we live in a federal system and most infrastructure procurement occurs at the state and local level, even when it is funded with federal dollars. In such a system, what role can the federal government play beyond providing infrastructure funding to the states.

One of the key things the federal government can do is to promote best practices at the state level. One good first step would be to establish an office within the federal government (perhaps at USDOT) to help promote and coordinate public-private partnerships at the state level.

The federal government can also help by continuing and expanding initiatives such as interstate tolling and the pilot program for P3s involving airports.

Certain debt financing mechanisms dependent on federal law, such as tax-exempt private activity bonds and TIFIA funding, should be expanded.

Even if Congress were to act on all these ideas, there would most likely still be a government funding deficit. What should states be doing?

Since there will not be public funds sufficient to pay for everything on a given state's infrastructure "wish list," bifurcating that list becomes critical. Some infrastructure projects may not be attractive to the private sector even though they offer a high social rate of return on invested capital. Those projects should be moved to the head of the queue for funding through traditional procurement. At the same time, projects which are most compatible with the P3 model should be placed on a fast track for procurement under that model.

In order to be able to follow such a "dual track," of course, the states must enact a viable statutory or regulatory framework for P3 procurement. That is where the federal government can help with mechanisms to develop and promote adoption of best practices.

Are you optimistic about the prospects for successful innovation at the state and federal level and for the future of private capital in public infrastructure?

Yes, if only because it is hard to imagine how we can meet our enormous and increasing infrastructure needs under the traditional procurement method. But there will be "potholes" along the way. One concern—and this is one of the reasons why we chose to participate in the ad hoc infrastructure working group—is that federal spending in this area could crowd out private capital as opposed to leveraging it. This could happen if federal funds are used to preempt substantially all of the projects that would be most attractive to the private sector. Such an outcome could have the effect of "cleaning out" the pipeline of viable deals for an extended period of time, during which the available private capital will be redeployed to other investment opportunities. That is one reason why it is important for states to pursue dual track policies of the type I mentioned previously. ■

Limited Partner Defaults: The Improbable Becomes Reality

Less than a year ago, most private equity fund managers thought of defaults on private equity fund commitments as a theoretical possibility, at best worthy of the attention of their most compulsive professional acquaintance—their fund lawyer. As a result, few thought twice about the provisions in their partnership agreement meant to protect the fund against the failure of a limited partner to contribute its commitments when called, and rightly so. Current market conditions have rescued these default provisions from obscurity, however, as the threat of limited partner defaults has become a more realistic concern, capturing the attention of fund managers—as well as their lawyers.

While the number of publicly reported significant defaults (or threatened defaults) by limited partners in major private equity funds has been limited to date, there is reason to believe that liquidity concerns will continue to challenge fund managers for at least the near future. Indeed, certain of the very largest funds have made efforts to reduce their size, with Permira's and TPG's probably the most widely reported of these recent efforts to address strains on limited partner liquidity.[1]

In early December 2008, UK-based Permira became the first major private equity firm to tackle the issue of potential limited partner defaults. According to press reports, a large public fund of funds investor affiliated with Permira was poised to default as a result of over-commitment issues throughout the investor's portfolio. In an effort to avoid a default on a future capital call, Permira offered all of its limited partners a one-time option to reduce their commitments by up to 40%, with an overall maximum fund level reduction of 35% (at the time, the fund was about 50% invested). Electing limited partners would not be required to fund future calls for new investments, but would still be required to pay management fees and expenses as if they had not made the election. Reducing limited partners were required to agree to a forfeiture of 25% of future fund distributions (the forfeited amounts to be shared among the non-reducing limited partners) and would not be permitted to participate in future votes. Significantly then, it appears the limited partners who accepted this offer were by its terms subject to essentially the same remedies they would have faced as defaulting investors, though the offer relieved them of the stigma associated with default. Press reports indicate that elections by 18 investors, representing a 13% reduction of fund commitments, were made and that over 90% of the limited partners approved the amendment to permit the reduction. It is not known whether any limited partners agreed to increase their commitments to make up the reduction.

Not long after the Permira offer was reported, U.S.-based TPG similarly took steps to address the stress of challenging market conditions by offering its limited partners the option to reduce their commitments by up to 10%. In the case of TPG, management fees would be waived on 10% of commitments for limited partners not electing to reduce their commitments (or in the case of a limited partner electing to reduce its commitment by less than 10%, on the portion not reduced). In addition, near-term contribution obligations were clarified, with the general partner undertaking not to call more than 30% of commitments in 2009 (the 30% limitation can be waived with the consent of the limited partner advisory committee). Press reports indicate that investors took up less than half of the offered 10% reduction in commitments.

In the current environment, it may be prudent even for fund managers not experiencing funding issues or other similar pressures to give some thought as to what actions can be taken in the event of a default or potential default by its limited partners. Of course, default terms for each fund partnership agreement are different, and each situation will likely involve unique and complex factual issues, so fund counsel should be consulted immediately in the event of any funding-related issue.[2]

What Should the General Partner Do If a Limited Partner Does Not Fund (or indicates That It Plans Not to Fund) a Drawdown?

While Permira and TPG provide examples of some of the steps fund managers have taken in anticipation of the impact of limited partner liquidity constraints on future capital calls, if there is an actual or potential default relating to a pending investment, the fund manager must focus first on how to cover the missed contribution to close the investment and then on how to treat the limited partner that did not fund. In addition, the fund manager will want to think about how (and whether) to replace the limited partner's remaining unfunded commitment.

Covering the Shortfall

Most partnership agreements permit the defaulted amount to be called from the other

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1 *While the Permira and TPG efforts were widely reported by the press, it is not clear whether all of the details were reported correctly or whether additional steps have since been taken.*

2 *This article focuses generally on Delaware limited partnerships and notes where English law takes a slightly different approach. As a general matter, Cayman Islands, which has limited case law in this area, would likely follow an English law approach.*

Limited Partner Defaults: The Improbable Becomes Reality (cont. from page 5)

limited partners, without increasing their aggregate capital commitment to the fund. However, depending on the timing of a default, it may be impossible to call additional funds from other limited partners before the closing of the relevant portfolio investment is scheduled to occur. In addition, some funds impose caps on the replacement amounts that can be called from the non-defaulting limited partners; if the amount required would exceed the cap, it will be necessary to raise capital, perhaps either by seeking a waiver to the cap or identifying a co-investor to fund the acquisition.

The following are some of the actions a fund manager will want to consider if it faces, or is concerned that it may face, the need to cover missed contributions.

- *Draw Down Early.* Consider setting drawdown dates sufficiently far in advance of a closing to avoid risk of shortfalls due to default; the extra time can be used to issue a new capital call to fund the defaulted amount.
- *Draw Down More than Required.* Some general partners routinely overcall to cover unforeseen contingencies at closing, including late limited partner contributions. The overcalled amounts not otherwise used are then returned if there is no default.
- *Borrow the Defaulted Amount.* Some fund partnership agreements permit short-term borrowing to bridge the defaulted amount, whether from a third party or a general partner affiliate. In the absence of an existing subscription-backed credit facility, timing considerations may make borrowing from a third party lender impractical.
- *Late-Funding Limited Partners.* In some cases a limited partner may indicate that it plans to fund, but that it is unable to do so by the drawdown date. It may be possible to apply overcalled amounts from the other limited partners to cover the late contribution. Depending on the length of delay, it may be appropriate to require the late-funding limited partner to pay interest on its contribution (similar to investors admitted to a fund after the initial closing). If the delay persists, the general partner may have to take more drastic steps.
- *Offset Distributable Amounts.* If the fund is set to distribute amounts related to other investments, it may be possible to offset amounts distributable to cover the defaulted amount.

Remedies on Default

Most fund partnership agreements provide the general partner with a wide range of remedies in the event a limited partner is in default, with the general partner usually permitted to select among and apply any or all of the remedies in its sole discretion. These rights typically include a forfeiture by the defaulting limited partner of 25% to 50% or more of its interests in the fund.

If a limited partner defaults, the size of the fund may be reduced by the amount of the defaulting limited partner's unfunded commitment. The reduction may impact the number of investments the fund is ultimately able to complete, as well as reduce the management fee. (The other limited partners are in almost all cases not required to fund the defaulting limited partner's management fee; the defaulting limited partner might still be required to pay the management fee out of any forfeited portion of its interest, which would likely delay payment until the fund has distributable income.) If permitted under the fund partnership agreement, the general partner may want to pursue replacing the unfunded commitment, either from the existing limited partners or from interested third parties.

In the event a limited partner does not fund, the general partner will have to carefully consider the steps to be taken and whether the limited partner should be declared in default. The general partner of a Delaware limited partnership owes duties of loyalty and care. Although these duties may be limited contractually in the partnership agreement, at a minimum the general partner must act in good faith and deal fairly with the fund. The standard is somewhat higher under English and Cayman Island laws, which require the general partner to act in utmost good faith towards its limited partners. These standards may require the general partner to consider a number of factors, including whether it is in the fund's best interest to declare the default, whether the non-defaulting limited partners have an interest in any amounts forfeited by the defaulting limited partner, whether defaulting limited partners must be treated equally, and so forth.

In addition, the general partner must consider that any course of action it takes against the first defaulting limited partner may limit its ability to take a different course of action against similarly situated later-defaulting limited partners. This can be particularly tricky when, as is often the case, the fund consists of multiple parallel vehicles in different jurisdictions with different legal standards. Actions taken in one parallel vehicle might affect the remedies available in other jurisdictions. Also, "most favored nations" rights might limit the extent to which defaulting limited partners may be treated differently. It is also possible that any disclosure or other communications with the limited partners on this issue may restrict future courses of action; for example, if the general partner has indicated that it will take a hard line on

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Stimulus Legislation Provides Some Good News for Portfolio Companies

Not all tax news coming out of Washington has been unfavorable for private equity. The recently enacted stimulus legislation generally permits portfolio companies to deleverage (or modify their publicly traded debt) without triggering immediate taxable income.

In recent months, the deep discounts at which bonds and bank debt have been trading and the difficulty of meeting various financial covenants have caused many companies to consider repurchasing, or modifying the terms of, their debt. However, prior to the stimulus legislation some companies had been deterred by concerns about creating taxable cancellation of debt (COD) income. For example, although this may seem counter-intuitive, a typical interest rate bump made in connection with a bank debt covenant waiver could create COD concerns if the debt were to fit the very broad tax definition of "publicly traded" debt.

The American Recovery and Reinvestment Tax Act of 2009 (the Act), enacted on February 17, 2009 as part of the stimulus package, includes provisions which (1) allow companies that recognize COD income in 2009 and 2010 from the repurchase (or modification) of their outstanding debt to include that income over a five-year period beginning in 2014 and (2) turn off the so-called "AHYDO" (or "applicable high yield debt obligation") rules in a narrow but important circumstance. As a result, companies are generally permitted to deleverage (or modify their outstanding publicly traded debt) without triggering immediate taxable income. Under prior law, this result generally could have been achieved only through filing for bankruptcy or to the extent the company was insolvent (or if the underlying modification was not considered "significant" for tax purposes).

Background

Retirement at a Discount. If a company retires its outstanding debt for an amount less than the issue price of the debt, the company generally recognizes COD income equal to the difference. For example, if a company has $100 of debt outstanding and repurchases the debt for $60, the company generally recognizes $40 of COD income at the time of the retirement.

Related Party Purchases. Similarly, if a company has debt outstanding and a person "related" to the company acquires the debt for less than the issue price of the debt, the company is deemed to have COD income equal to the difference between the issue price and purchase price, and the debt is deemed to have been reissued for an amount equal to the purchase price. For example, if a corporation has $100 of debt outstanding and a related person (including, in some instances, a private equity fund that controls the company) purchases the debt for $60, (1) the corporation has $40 of COD income and (2) the debt is treated as having been reissued for $60. Since the $60 issue price of the new debt is less than its $100 face amount, the deemed new debt is treated as having $40 of "original issue discount" (OID), which is amortized (as interest deductions for the issuer and interest income for the holder) over the remaining term of the debt. If the remaining term of the debt exceeds five years, the AHYDO rules may severely limit the ability of the corporation to deduct the OID. In such a case, the corporation is required to recognize the $40 of COD income even though the $40 of corresponding OID deductions are disallowed. If the OID is deductible, the issuer may still have a timing disadvantage: the COD income is includible in the year of the repurchase and may trigger an immediate tax liability, while the benefit of the corresponding amount of OID deductions may be realized only over the course of several years, depending on the remaining term of the debt.

Modifications. If there is a significant modification (*e.g.*, a typical rate increase agreed to in connection with a covenant waiver) of debt that meets the very broad tax definition of "publicly traded" debt (a term of art that can include debt listed on certain quotation media), the debt is deemed to have been satisfied for the trading price and deemed to have been reissued for the same amount. Thus, if a corporation has $100 face amount of publicly traded debt outstanding and a significant modification is made to the debt while it is trading at $60, (1) the corporation has $40 of COD income and (2) the debt is treated as having been reissued for $60. The same consequences discussed above in "Related Party Purchases" apply. Again, the corporation is required to recognize the $40 of COD income even if the $40 of OID deductions are disallowed.

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Stimulus Legislation (cont. from page 7)

COD Income Relief

Under the Act, a company that recognizes COD income in connection with the "reacquisition" of debt after December 31, 2008, and before January 1, 2011, may elect to include the COD income ratably over a five-year period generally beginning in 2014. The term "reacquisition" is defined broadly to include any acquisition of debt by the company or a related person, including an acquisition of the debt for cash, an exchange of the debt for other debt, a deemed exchange of the debt arising from a significant modification of the debt, an exchange of the debt for equity, a contribution of the debt to capital and a forgiveness of debt. Special rules are provided for COD income recognized by a partnership.

AHYDO Turned Off in Narrow Circumstance for One Year

The Act also generally turns off the AHYDO rules in a narrow but important circumstance. Specifically, the Act provides that the AHYDO rules would not apply to debt issued during the period beginning September 1, 2008 and ending December 31, 2009 in exchange for pre-existing debt (and to debt deemed to have been issued in exchange for pre-existing debt by reason of a "significant modification" of that pre-existing debt) so long as interest deductions on the pre-existing debt are not already limited under the AHYDO rules. However, the AHYDO rules would continue to apply to (1) debt issued for cash or other property (including pre-existing debt the interest on which is already subject to the AHYDO rules), (2) debt deemed to have been issued by reason of a purchase by a related party, and (3) certain debt providing for contingent interest.

As noted above, the acquisition of debt by a related person or the modification of publicly-traded debt can result in both COD income to the issuer and the debt being treated as reissued with additional OID. Under the Act, the deduction for any such additional OID is deferred until the five-year period during which the company is required to recognize the COD income. A practical effect of the Act, from the issuer's perspective, of a significant modification of publicly-traded debt is that the COD income will generally be neutralized by offsetting OID deductions, so long as the original debt instrument was not subject to the AHYDO rules and so long as the modification does not reduce the principal amount of the debt. In contrast, the holder of the modified debt will include the OID income as it accrues over the remaining term of the debt even though the issuer is required to defer the corresponding OID deductions. ■

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Deconstructing Equal and Ratable Security Clauses

Introduction

Ignorance of the intricacies of "equal and ratable" clauses in acquisition candidate's bond indentures was a luxury afforded to private equity players for many years. However, as the private equity community adjusts to working in an environment in which obtaining new debt is—to put it mildly—challenging, structuring around restrictive covenants in existing debt instruments is increasingly critical to making deals work. Negative pledge covenants are among the most common provisions in bond indentures and restrict a borrower from pledging collateral, or otherwise securing, future indebtedness. Negative pledge provisions generally permit the borrower to secure future debt issuances, so long as the existing debt is "equally and ratably" secured.[1] The significance of the "equal and ratable" clause in negative pledge covenants has been spotlighted in recent restructurings and refinancings and as a target of investment grade investors in last year's Credit Roundtable White Paper.

Although many practitioners have grappled with the "equal and ratable" clause and structured transactions around the clause in its many guises, there is little written about the meaning of the "equal and ratable" clause and there is limited case law on the topic. This article is intended to offer concrete guidance on how to effectively deal with adding new secured financing to the capital structure of a company whose debt contains a negative pledge clause.

[1] *A typical negative pledge provision reads as follows: "The Company will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, create, Incur or suffer to exist any Lien (other than Permitted Liens) upon any of its property or assets. . . unless contemporaneously with the Incurrence of such Liens effective provision is made to secure the Indebtedness due under the Indenture and the Notes. . . equally and ratably with the Indebtedness secured by such Lien for so long as such Indebtedness is so secured."*

The Equal and Ratable Clause in Context

The "equal and ratable" clause is designed to provide the borrower with the flexibility to obtain future secured financing, while protecting a creditor's relative claim to the borrower's assets. The clause protects creditors by preventing the borrower from granting new creditors a prior lien on its assets, thereby removing those assets from the pool available to unsecured creditors in the event of the borrower's bankruptcy.

The scope of a negative pledge provision can vary depending on the nature of the transaction and the borrower's business. Some negative pledge provisions are absolute and flatly prohibit the incurrence of any lien to secure indebtedness or other obligations. Such provisions are most restrictive of the borrower's flexibility—both operationally and in their ability to obtain future financing. More commonly, negative pledge provisions contain exceptions that permit the borrower to encumber certain of its assets—"permitted liens"—subject to limitations outlined in the agreement. Sometimes, particularly in older indentures, the negative pledge clause will only limit liens on specified "principal properties" of the borrower—such as the equity interests of its significant subsidiaries or particular manufacturing facilities or real estate.

The "equal and ratable" clause permits the borrower to grant liens beyond the scope of the "permitted liens" so long as the security granted "equally and ratably" secures the debt which benefits from the covenant. The clause maintains the creditors' expectation that only a certain amount of secured debt will be senior to them. If more than the expected amount of debt will be secured, while the liens can be granted to a new creditor, the existing creditors must share an "equal" interest in the collateral, preserving the relative priority of the unsecured creditors' claims to the assets of the borrower.

When a borrower grants the bank the additional collateral required by it to extend the credit and the application of the equal and ratable clause is triggered, typically neither the bank nor the debtor wish to negotiate with the holders of the unsecured notes. So the structuring of an "equal and ratable" security package is left to the debtor, the new creditor and their respective counsel—frequently with limited input from the bond trustee.

Why Get it Right? The Importance of Structuring an Equal and Ratable Security Interest Properly

The consequences of breaching a negative pledge provision help explain the importance of properly structuring an equal and ratable security package.

The negative pledgee's only recourse

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The significance of the "equal and ratable" clause in negative pledge covenants has been spotlighted in recent restructurings and refinancings and as a target of investment grade investors in last year's Credit Roundtable White Paper.

Deconstructing Equal and Ratable Security Clauses (cont. from page 9)

against the debtor that has granted a security interest in violation of the clause is acceleration of the debtor's debt and a claim against the debtor for a breach of contract. The availability of a claim for breach of contract is of dubious value because such a claim does not affect the validity of the security interest granted to the debtor's new creditor. The breach of contract action represents merely an additional unsecured claim of the negative pledgee against the debtor, together with its now-accelerated debt.

Ironically, the new creditor may have a greater incentive to structure properly around a negative pledge clause than the debtor. The creditor who benefits from an improper pledge of collateral is likely to be the target of litigation by the jilted negative pledgee. A number of legal theories are available to permit the negative pledgee to bring action against a new creditor, including tortious interference with contract and the creation of an equitable lien over the collateral in favor of the negative pledgee.

Deconstructing the Meaning of "Equal and Ratable"

Several facets of a security arrangement can be impacted by the "equal and ratable" clause. Although the identity of the assets subject to pledge is the most central feature of a security package, any security arrangement must also contain rules for making decisions regarding dispositions and uses of the collateral, distributions of proceeds in respect of the collateral and other matters. "Equal and ratable" clauses typically do not limit the application of the "equal and ratable" clause to the question of what assets are pledged and are purposely drafted quite broadly. In structuring an "equal and ratable" security package, it is, therefore, essential to examine all of the aspects of the security arrangement that can be impacted by the clause. There are four central elements discussed below: the rank of the security interest, application of proceeds, the nature of the assets pledged and control over the collateral.

Rank of Security Interest

To satisfy the "equal and ratable" requirement, the lien securing the new and existing debt must be of the same rank. Debt obligations, as well as the liens that secure them, are often ranked in order of seniority; senior debt ranks higher than subordinated debt; first lien debt ranks higher than second lien debt. Rank of debt and the lien securing the debt will dictate its treatment in the issuer's bankruptcy. A lien granted to a subsequent creditor cannot be senior in rank to that of the creditor that benefits from the negative pledge covenant.

Application of Proceeds

Proceeds of the shared collateral must be shared equally and ratably between the new secured lender and the negative pledgee following enforcement. Like equality of legal rank, this principle is clearly at the heart of the equal and ratable clause. The negative pledgee must appear in the same level of the distribution waterfall as the new secured creditor in the event of a foreclosure or other realization upon the relevant collateral.

Moreover, many transactions that implement "equal and ratable" security packages require that proceeds of collateral be distributed ratably between the new creditors and the existing noteholders in proportion to the outstanding principal amount of their debt, regardless of whether or not that amount is then due and owing. To the extent that the principal amount is not then due, the proceeds are held in escrow by a collateral trustee or agent for the benefit of those creditors. Such an escrow mechanism makes it clearer that the security interest is truly "equal"—otherwise the bondholders, who may not have the capacity to accelerate their debt at the time that the senior creditors take action against the collateral, might not effectively benefit from the lien.

Assets Pledged: Shared Pool v. Separate but Equal

Another issue that debtors confront in structuring an "equal and ratable" security package is whether or not the "equal and ratable" clause requires that the debtor grant the creditors a shared security interest in the same assets, or whether the debtor can safely provide the creditors with separate security interests in different, but equivalent assets.

In the real world, "equal and ratable" security packages are structured to provide a shared security interest in the same pool of assets for both sets of creditors. When new and existing creditors share a lien over the same collateral, however, many issues arise regarding how to structure distributions from, and the creditors' control over, the shared collateral pool. Issues of control raised will be discussed below. Grappling with such control issues seems to be an easy task when compared with the challenges of structuring an "equal and ratable" pledge over separate pools of collateral.

Still, commentators have suggested that it would be possible to satisfy an "equal and ratable" covenant by granting a security interest in separate, but equal pools of assets. Such an approach would avoid the intercreditor issues created by shared pools of collateral, but raises other significant issues, principal among them, the valuation of the assets pledged to each group of creditors and a number of impediments revolving around legal opinion requirements.

Control Over Collateral

The rights of a secured creditor to monitor collateral and to control dispositions of

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Emerging Markets Shine in a Difficult Year

In recent years private equity activity in emerging markets has been attracting growing attention as industry players look beyond developed markets for investment opportunities. This article examines key differences between private equity fund formation in emerging and more developed markets.

Emerging markets were a relative bright spot in a difficult year for private equity, with $66.5 billion raised in 2008 by 210 private equity funds focused on emerging and transforming markets. Notwithstanding the generally bleak state of the financial markets, growth in the medium term seems poised to continue: 74% of investors surveyed in 2008 by the Emerging Markets Private Equity Association (EMPEA), expect to increase their allocations to emerging markets during the next three to five years.

Several metrics testify to this story of growth:

- the number of funds and the volume of capital raised in emerging markets increased every year from 2003 through 2008;
- the total amount raised by emerging markets funds increased from $3.5 billion in 2003 to $66.5 billion in 2008—an increase of 1900%; and
- the average size of emerging markets funds increased from approximately $182 million in 2003 to approximately $400 million in 2008.

What enabled emerging markets funds to defy the gravitational forces that pulled much of the rest of the private equity market to ground in 2008? Investor interest has increased in part due to the perception that investment incentives in many emerging markets have improved, while investment risks traditionally associated with emerging markets have diminished or become more manageable.

Indeed, many investment risks commonly associated with funds in more developed markets, such as strong competition, excess leverage, more sponsor-friendly fund terms, high entry prices and slow economic growth, are absent or less prominent in emerging markets funds.

The changing risk/reward calculus has resulted in an expansion and diversification of the investor base for emerging markets private equity. Previously dominated by multilateral development agencies such as the European Bank for Reconstruction and Development, the International Finance Corporation and the World Bank, the investor base for emerging markets funds now looks increasingly like that of other classes of funds and includes public and private pension plans, foundations and funds of funds.

The legal and regulatory issues associated with organizing an emerging markets fund and the contours of negotiations with investors bear many similarities to developed markets funds, but nevertheless pose some distinctive challenges. The remainder of this article examines the principal differences in the structures, due diligence process and key terms applicable to funds in emerging and developed markets.

Structure: Jurisdiction

The choice of jurisdiction and legal structure for an emerging markets private equity fund depends on a number of factors similar to those considered when structuring a fund that invests in developed markets. A fund sponsor will take into account the target jurisdiction or jurisdictions where the fund will invest, the anticipated composition of the investor base, and the sophistication of the legal and administrative service industries in the jurisdictions under consideration. Tax considerations are a primary driving force in the structuring process, as the structure should minimize the incidence of taxation on the fund's portfolio companies and avoid introducing additional levels of taxation in connection with repatriating proceeds from portfolio companies (*e.g.*, withholding taxes on distributions from portfolio companies or taxes on intermediate vehicles in the fund or portfolio company acquisition structure). Accordingly, sponsors and their advisors consider the domestic tax laws and relevant tax treaties of the fund's jurisdiction and the jurisdictions where the fund will invest. In emerging markets funds, it is often the case that the fund is organized in a tax-efficient jurisdiction (*e.g.*, the Cayman Islands) and

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Emerging Markets	
Investment Incentives	**Investment Risks**
Superior Risk-Adjusted Returns	Investors Inexperienced in Evaluating Opportunities
Portfolio Diversification	
Increase in Quality of Fund Managers	Limited Number of High Quality Managers
Improving Political and Economic Conditions	Continued Political and Economic Risks
Increase in Experienced Management	Limited Management Talent
Increase in Liquidity	Concerns About Exit Opportunities

Emerging Markets Shine in a Difficult Year (cont. from page 11)

thus much of the tax planning relates to the structure below the fund through which the fund acquires a portfolio company.

Structure: Vehicle

The majority of emerging markets funds are organized as limited partnerships, with an entity controlled by the sponsor acting as the general partner and third-party investors subscribing for interests as limited partners. However, alternate structures are used for funds investing in certain regions. For example, funds investing in India are often organized under Mauritius law and structured as limited liability companies with limited life because neither Mauritius nor Indian law recognizes limited partnerships. In addition, India-resident investors generally avoid investing directly in limited partnership vehicles due to a concern that an Indian court would treat the limited partnership as a general partnership and treat an Indian investor as liable for the unsatisfied obligations of the limited partnership.

Structure: Joint Ventures

Many emerging markets funds are sponsored by joint ventures established by two partners. Typically, one joint venture partner is a local group with a relationship network, a track record in the target jurisdiction and access to proprietary deal flow, and the second joint venture partner is an institution with a well-known international brand and experience operating private equity funds with a solid institutional investor base. A joint venture structure, either at the fund level or the portfolio company level, may also be necessary for investments in restricted industries in certain jurisdictions. For example, foreign ownership restrictions on telecommunications companies in India or natural resources in Russia may mandate minimum local ownership levels or prohibit investment by foreign investors without a local partner. A joint venture with a reputable local partner may also enable western investment firms to reduce political risk and access valuable country-specific experience concerning governmental policies, local business practices and operational and employment conditions.

In addition to the potential benefits, however, a fund sponsored by a joint venture presents a number of risks and potential conflicts of interest that joint venture partners need to manage. The joint venture partners must agree on key economic issues, including the allocation of carried interest and the sharing of advisory or management fees between the partners. Venture partners also must agree on key governance issues, including the process for making decisions involving the fund and the joint venture, such as investments in or divestments of portfolio companies. In addition, the partners will need to address the possibility that their goals and expectations may diverge, either at the outset of the relationship or as the relationship develops.

Process: Due Diligence

Investors in private equity funds focused on any jurisdiction conduct some level of due diligence prior to committing to invest in a fund. Investors typically, however, conduct more extensive due diligence when investing in emerging markets, often because investors are not as experienced with investing in these markets and are therefore less familiar with the relevant legal, regulatory and tax considerations. Investors in emerging markets funds may particularly scrutinize the anticipated structures to be used for the funds' investments and the potential legal consequences of an indirect investment in a jurisdiction, including the possibility that a jurisdiction where the fund will invest may not respect the limited liability afforded to fund investors.

Investors often seek comfort with respect to tax issues, including confirmation that, as a result of investing in the fund, the investor will not be subject to tax in the jurisdiction where the fund is organized or where the fund invests, and that the fund's investments will be structured to minimize tax. While this process is similar to the diligence conducted by investors in developed markets, the analysis can become complex for funds investing in multiple jurisdictions—such as pan-Asia or pan-Africa funds—and in some cases may involve novel questions of law.

Terms: Distributions

The standard distribution waterfall in U.S. fund agreements distributes carried interest on a "realized deals to date" basis. In a realized deals waterfall, while investment gains and losses are netted across the fund's portfolio, the fund may distribute carried interest in respect of a realized investment once the fund has returned to investors all capital contributions in respect of the investment, any previously realized investments, related fees and expenses, and a preferred return. The distribution waterfall in the significant majority of emerging markets funds, however (commonly referred to as a "return all capital" waterfall), does not permit the fund to distribute carried interest until the fund has returned to investors all capital contributions made during the life of the fund, whether those capital contributions were made to fund investments that have been realized or investments that continue to be held by the fund. Some emerging markets funds have a distribution waterfall that is even more investor-friendly (referred to as a "return all commitments" waterfall), which requires the fund to return all capital commitments during the fund's investment period (whether or not actually drawn) prior to distributing carried interest. This difference is due in part to the perception that emerging markets assets are more volatile, and that therefore there is an increased risk that a fund may dispose of one or more portfolio investments at a gain followed by the realization of a loss, resulting in an overdistribution of carried interest to the fund sponsor.

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Disruptions in the LIBOR Market:

Borrowers Beware When the Boilerplate Is Broken

Most of our readers—even those borrowers who are occasionally involved in negotiating credit agreements—are probably unfamiliar with how the standard yield protection and increased cost provisions operate in bank credit agreements. In recent years these provisions would have occupied possibly one line in a term sheet and a few pages of boilerplate in the definitive documents, meriting virtually no attention in the negotiation process.

Then came the financial meltdown of 2008. As a number of banks and financial institutions discovered that they were unable to obtain dollar funds in the inter-bank market at the LIBOR "screen rate," borrowers suddenly faced demands to revisit boilerplate provisions related to the calculation of LIBOR interest rates which have been standard and virtually untouched in credit agreements for years.

The screen rate, published daily by Reuters based on information provided to it by the British Bankers Association, represents the average cost of obtaining deposits in the inter-bank market by a representative sample of sixteen banks on that day as reported by the association and is the most common measure of LIBOR (the London Inter-Bank Offered Rate) used in credit agreements worldwide. The most commonly reported explanation for the disconnect between the screen rate and available dollar funding was suspected under-reporting by banks in the sample group of their cost of funds out of a fear that reporting higher costs would betray relative weakness and difficulty in obtaining credit. Non-U.S. banks, having no U.S. dollar deposit base as an alternative source of funds, rely heavily for funding of U.S. dollar loans on the inter-bank loan market and were particularly hard hit.

Although the boilerplate intended to deal with this type of market disruption event in the typical U.S. credit agreement provides relief where a majority of the banks are unable to obtain funding at the LIBOR screen rate, the relief is typically limited to giving the lenders the right to switch from LIBOR pricing to "prime rate" pricing. The prime rate is an interest rate maintained by most U.S. banks which is supposed to reflect the interest rate they are then charging on loans to their preferred customers and which can theoretically fluctuate on a daily basis in accordance with market conditions. However, this is often not a helpful option for foreign banks who typically do not maintain a prime rate for U.S. dollar borrowings. Nor would foreign banks necessarily have access to funds from the Fed's discount window (the prime rate being most typically linked to the cost of borrowing from the Fed). This problem was aggravated in late 2008 when decisions of the U.S. Federal Reserve Board had the effect of reducing the prime rate of most U.S. banks to a level that was roughly equivalent to the LIBOR screen rate.[1]

Their inability to obtain dollar funds in the interbank market at the LIBOR screen rate was not troubling to many of the specialized funds and non-traditional lenders who have dominated the syndicated loan market in recent years because they do not look to match fund their U.S. dollar LIBOR loan portfolio as the interest rate changes over time. However, for the more traditional bank lenders, who are the few remaining sources of debt financing in the current environment, this inability is more problematic. This is particularly the case where, as is now much more common, the lender is expecting to retain a significant hold position in the loan for an extended period of time.

As a result, a number of lenders, burned by their inability to maintain the funding of their LIBOR priced loans at rates assumed to be available to them under existing agreements, insisted on reopening the standard boilerplate provisions in

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As a number of banks and financial institutions discovered that they were unable to obtain dollar funds in the inter-bank market at the LIBOR "screen rate," borrowers suddenly faced demands to revisit boilerplate provisions related to the calculation of LIBOR interest rates which have been standard and virtually untouched in credit agreements for years.

1 *Due to market constraints, in practice U.S. banks don't really have much flexibility to manage their prime rates in line with short term changes in financial market conditions. As a reflection of this reality, and in order to deal with the fact that LIBOR has not always kept pace with the recent downward movement of the federal funds rate, lenders in a number of recent transactions have required that the credit agreement definition of the "prime rate" be adjusted so that it can never be lower than the equivalent LIBOR rate plus 100 basis points (historically that being the typical spread between LIBOR and prime).*

Disruptions in the LIBOR Market (cont. from page 13)

negotiating new deals. The goal is to rework the relevant provisions to make them more like the market disruption event provisions common to the European bank market which, when a negotiated percentage of the lenders in a bank syndicate are having difficulty funding at the LIBOR screen rate, assure virtually each lender that it will have the right to be compensated in full for the cost of making or maintaining LIBOR priced loans.[2]

This is an unfortunate development for borrowers. Among the consequences for borrowers are:

- Long and painful negotiations will be common until the market resettles in this area, because the issues are relatively arcane and the typical deal negotiators have little experience dealing with them.
- As the applicable standards will inevitably require a relatively high degree of subjectivity, acceptance by the borrower requires an element of trust that is not always there. When yield protection provisions were first introduced and before they became part of the boilerplate, borrowers routinely complained about their lack of transparency and the possibility that they could be invoked selectively and in a discriminatory manner.
- Inasmuch as virtually all fixed-to-floating rate swaps are tied to the LIBOR screen rate, the effectiveness of any interest rate hedging strategy may be jeopardized. The importance of this issue is greatest where the financing needs to be structured with a relatively high percentage of the floating rate credit agreement debt swapped to a fixed rate.
- A borrower's degree of comfort with broader and more subjective market disruption event protections is likely to vary in direct proportion to the strength of its relationship with the particular lender. The more liberal protections of this type could lead to heightened concern and scrutiny by borrowers of proposed secondary transfers by lenders (and the credit agreement provisions regulating them).
- If the need to seek *ad hoc* LIBOR pricing adjustments occurs other than on an extraordinary basis, the process of administering these provisions could easily become unmanageable for both the borrower and the lender representatives responsible for managing the credit agreement.
- The principal device in credit agreements designed to protect borrowers from lenders who abuse these types of yield protection provisions (the "yank-a-bank" clause) is not likely to work very effectively in the current environment. This clause gives the borrower the right to replace an existing lender exercising these protective provisions with a new lender of the borrower's choosing if the replacement lender purchases the loans of the existing lender at par; a right that might not be very meaningful in current depressed market conditions.

These concerns have led to consideration of alternatives to full scale cost of funds protections, or measures to mitigate their impact. Alternatives that have been considered include:

- In lieu of explicitly assuring each bank that it will receive its cost of funds if greater than LIBOR, structuring a more objective alternative under which a specified "disruption" margin is added to the LIBOR screen rate upon the occurrence of certain recognized signs of distress in the credit markets. One approach would trigger the addition of this margin if the spread between three month LIBOR and the three month U.S. treasury bill rates (the "TED spread") exceeds a specified number of basis points.
- Replace the LIBOR base rate entirely with a base rate tied to the average cost of funds for the entire lending syndicate in the loan facility (eliminating, for purposes of calculating this average, the highest and lowest quotes).
- Impose as prerequisites to the right to obtain cost of funds compensation minimum thresholds in terms of either the percentage of the loans held by lenders seeking compensation and/or the number of basis points by which a lender's actual cost of funds exceeds the applicable LIBOR screen rate.
- Where the credit agreement requires a certain amount of interest rate hedging, provide covenant relief for any interest/debt service coverage test if the invocation of the market disruption provisions (and the resulting unhedged interest expense) is the cause of the covenant violation.

The high degree of liquidity in the credit markets in recent years had made these provisions largely irrelevant. However, as long as those markets continue to be weak, one is likely to see greater attention to potential renegotiation of these kinds of boilerplate provisions as more buy and hold investors populate the lender side of credit agreements. ■

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[2] *While these kinds of LIBOR market disruption fallback provisions have for some time been a standard feature of European credit agreements, they have almost never been invoked. In the current environment, borrowers fear that this practice of forbearance will end.*

Bridging the Gap:

How to Get Deals Done in an Unsettled Market

The terms "earnouts" and "seller financing" were not part of the private equity deal lexicon during the days of ample capital and strong equity markets. These days, however, they, along with rollover equity, have become increasingly effective tools for bridging financing and valuation gaps between sellers and buyers. For both deal veterans who need a refresher course, and for those who are newer to the deal environment, this article will discuss how earnouts, seller financing and rollover equity can be used, either alone or in tandem, to get deals done in a less than settled marketplace. While these tools are more frequently used in private company acquisitions, they can also be adapted to public company transactions.

Earnouts

Overview

If a buyer and seller cannot agree on the valuation of a target company because their respective estimates of its future earning potential differ, an earnout can often bridge the gap by making a portion of the purchase price contingent on the target company's achievement of defined objectives. If a private equity buyer intends to retain a company's management stockholders, an earnout will not only help address the valuation gap but will also serve as an additional incentive for the management team to enhance the company's value post-acquisition. In addition, earnouts reduce the amount of consideration required at closing and thus minimize and may even eliminate the need for third-party financing.

Not every proposed acquisition with a pricing gap is ripe for an earnout. For example, where a target company has stagnated or underperformed prior to the acquisition and a private equity buyer intends to introduce new management, business strategies or operational improvements, the buyer may be disinclined to share the potential value associated with such changes with the sellers. More generally, if the seller will not remain involved in the business post-closing, the buyer may find it unpalatable to share future increases in the value of the company with a party that did not actively contribute to its growth.

While an earnout can be an effective way to get a deal across the finish line, both buyer and seller will need to make some sacrifices. The buyer will likely be required to give up some control over the company post-closing because the seller will insist on regulating the operation of the business through restrictive covenants or veto rights to protect its earnout potential. The seller will need to forego a portion of what it may deem to be a fair price at closing and settle instead for the opportunity to be compensated later if the business performs well. Both parties will have to endure the added complexity and negotiation that inevitably accompanies an earnout structure and the potential prospect of a protracted post-closing dispute over whether and to what extent earnout payments are due.

The parties should also think ahead to the likely context in which the ultimate earnout determination will be made. For instance, if management stockholders are retained post-closing with the expectation that the earnout will be paid, will it make sense for the buyer to risk a fractious dispute with management over whether milestones were achieved? In such a case, to mollify management and keep them at the company beyond the earnout period, the buyer may be pressed to pay out some or all of the earnout. Indeed, there is an old saying that "an earnout is seldom earned but always paid."

Structuring Considerations

If the parties do decide to move forward with an earnout, threshold structuring issues include the specific earnout criteria measurement and the time period over which the measurement will take place. Gross revenues, net profits and EBITDA are common metrics, but a private equity buyer might instead condition payment on achieving a specified IRR within a specified term after its investment. Sellers typically prefer top line metrics because they are less prone to manipulation, while buyers prefer bottom line measures because they more accurately reflect value. In any event, the parties will likely need to agree on parameters to prevent the buyer (or management, if applicable) from taking actions to skew results (*e.g.*, inflating expenses or deferring revenue).

The duration of an earnout is typically one to three years. A buyer might prefer a shorter earnout period to avoid long-term constraints on its operation of the business, but will be wary of the opportunity this creates for mischief by the seller in the pre-closing period (*e.g.*, the seller could postpone receivables until after the closing or buy excess inventory pre-closing). Sellers may argue that it will take several years to achieve their projections and thus that a longer period is appropriate, but should consider whether they really want to remain involved with the business over that period. The parties will also need to determine the consequences of one or more management stockholders leaving the company during the earnout term.

If the buyer will integrate the acquired company into existing businesses, another issue to consider is whether sellers should benefit from such integration (*e.g.*, the opportunity to bundle products and cross sell, cut costs and take advantage of other synergies) or whether instead the earnout metric should focus solely on sales of products and services and related cost structures existing as of the closing. Buyer will argue that sellers should not benefit from any synergies that would not have been realized absent the transaction, but post-acquisition it may be difficult to evaluate the acquired company independent of the buyer's other businesses. For this reason, the negotiation and

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administration of an earnout is much easier if the acquired company is managed by the buyer as a stand-alone business after the closing.

What level of control, if any, should the sellers have over the acquired company after the acquisition? Sellers will want to ensure that the business continues to be operated consistent with past practice, while a buyer will not want a seller interfering with the operation of its newly acquired business, especially if the buyer wants to integrate the target into its other businesses or alter the target's operations. This is a delicate balance and there are varying control protections that sellers obtain in earnout structures, ranging from narrow covenants or veto rights to extensive governance provisions permitting sellers to be involved in the day-to-day operation of the business.

Buyers considering use of an earnout should note that Delaware law's implied covenant of good faith and fair dealing may, regardless of whether sellers have any contractual protections, require that a buyer give the management stockholders "a fair opportunity to operate the company in such a fashion as to maximize the earn-out consideration available under the [acquisition] agreement." In *Horizon Holdings, LLC v. Genmar Holdings, Inc.* (10th Cir. 2004), the court held that this Delaware standard meant that the buyer could not take actions in respect of the acquired company that would interfere with sellers' ability to achieve the earnout (*e.g.*, changing product names and marketing, shifting production priority, discontinuing certain products or shutting down a manufacturing facility), even though the agreement did not expressly provide the sellers with rights with respect to such actions post-closing.

Tax and Accounting Considerations

If the earnout is treated as deferred purchase price—sales proceeds and not compensation for future employment—the earnout payment (aside from an imputed interest component) will generally be taxed at capital gains rates rather than as ordinary income. Capital gains treatment is generally advantageous to individual sellers, but not to the buyer, who prefers compensation treatment, which could make the entire payment deductible by the company. Where management sellers will be working for the buyer post-acquisition, the sellers will want to ensure that the earnout payments are not subject to forfeiture for termination of employment in order to avoid ordinary income treatment. Buyers may resist, both for business reasons and in order to obtain the tax deduction arising from treatment as ordinary income.

Additionally, for U.S. federal income tax purposes, the "installment method" generally applies to gain attributable to earnout payments unless a seller elects out of such treatment in the year in which the acquisition closes. Under the installment method, a seller generally would not recognize the deferred portion of the purchase price unless and until it actually receives the earnout payments. Each seller should carefully consider the pros and cons of installment sale treatment. For example, a seller that holds an installment obligation in excess of $5 million would be subject to an annual interest charge on a portion of its deferred tax liability. On the other hand, electing out of the installment method would require the seller to value the contingent payment right and to recognize up-front taxable income with respect to an amount that it may never receive (with the potential capital loss in a subsequent year not being available for carryback to the year of the sale). Finally, the installment method may not be available at all in certain cases.

The accounting treatment of earnouts was modified at the end of last year to require a "fair value" of cash earnouts. Under FAS 141R, future earnout payments to be made in cash, other than those treated as employee compensation, must be assigned a fair value at the time of closing and fully recognized as a liability at that time. Subsequently, the value of the earnout must be remeasured at each reporting date, and will impact earnings in that period to the extent of any fluctuations in the estimated value. Similarly, earnings will be impacted to the extent of any difference between the estimated value and any actual payment ultimately made. In contrast, under the old accounting regime, an earnout liability was not recognized until the contingency was resolved, and there were not generally any interim impacts on earnings or liabilities.

Some buyers may not like these interim earnout-based adjustments, particularly public company buyers or private equity firms hoping to recapitalize, sell or IPO the target company before the end of the earnout period, and will want to take these issues into account in deciding whether to include an earnout. Also, the buyer will need to think through the implications of the accounting treatment under its debt documents. For example, the additional liability and earnings fluctuations may create issues under the financial covenants.

Parties contemplating an earnout structure should consult with their tax and accounting advisers early in the process.

Dispute Resolution

At the time of the acquisition, the parties should establish and carefully draft clear guidelines for determining if an earnout milestone is achieved. Buyers and sellers should coordinate with their lawyers and accountants to ensure that the documentation accurately reflects their expectations and can withstand potential challenges from a dissatisfied party. The parties should also agree on an appropriate dispute resolution mechanic (*e.g.*, using an independent accounting firm to arbitrate and settle any disputes). Another way to manage

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SEC Weighs in on Approval of Stock Mergers by Written Consent

Certainty of closing has always been an important issue for private equity sponsors involved in public company deals—on the sell side as an aid in extracting maximum value from an acquiror, and on the buy side as a means of ensuring, to the extent possible, that the sponsor gets the benefit of its bargain. While the Delaware Supreme Court's 2003 *Omnicare* decision precluded the use of shareholder lock-ups to create a *fait accompli* for a buyer, it left open a technique, since blessed by the Delaware Chancery Court in a 2008 decision (*Optima Int'l of Miami, Inc. v. WCI Steel*), whereby controlling shareholders could actually consent to a merger—rather than commit to vote for it—shortly after a merger agreement is signed.

A recent Compliance and Disclosure Interpretation (CDI) by the Securities and Exchange Commission's Division of Corporation Finance, however, indicates that this technique cannot be used for a public company if the merger consideration will include stock or other securities instead of only cash.

The SEC has a long-standing policy of allowing the registration of shares to be issued in business combination transactions (such as stock mergers or exchange offers), even where principal stockholders have signed lock-up agreements. Although the SEC views the signing of the lock-up as an investment decision being made without the benefit of an effective Form S-4 registration statement and final prospectus, recognizing the "legitimate business reasons" for lock-ups, it has not asserted that lock-ups somehow constitute an unregistered public offering, or that they are a private offering that precludes subsequent registration of the shares to be issued to the public in the business combination transaction—as long as certain requirements are met:

- the lock-up agreements involve only executive officers, directors, affiliates, founders and their family members, and holders of 5% or more of the voting equity securities of the company being acquired;
- the persons signing the lock-up agreement collectively own less than 100% of the voting equity of the target company; and
- votes will be solicited from shareholders of the target who have not signed the agreements and would be ineligible to purchase in a private offering.

The new CDI, however, adds an additional requirement. If the persons entering into lock-up agreements also deliver written consents approving the business combination, the SEC staff will not allow the subsequent registration of the securities to be issued in the transaction on Form S-4 for any shareholders. The theory is that, in such a case, offers and sales in connection with the business combination transaction have already been made and completed privately, and, once begun privately, the transaction must end privately. Because a good private placement of business combination securities to public shareholders is a practical impossibility, the CDI eliminates controlling shareholder consents from the deal protection arsenal in public company deals in which securities are used as currency.

The distinction between a shareholder's commitment to vote and a shareholder consent has never been wholly satisfying, but it is one that the SEC apparently embraces, as, so far, has Delaware. ■

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Limited Partner Defaults: The Improbable Becomes Reality (cont. from page 6)

defaults, it may be difficult to later apply a more flexible approach.

A general partner facing a default may want to take into account the following options and considerations:

- *Work Through Alternatives.* It may not be necessary to declare a default while the limited partner is cooperating with the general partner to resolve a liquidity issue or the limited partner is trying to identify a third party or an existing limited partner to assume its interest in the fund.
- *Declare the Limited Partner in Default.* The general partner must usually deliver a default notice before designating the limited partner in default. Even then default is not automatic because the limited partner would typically not be considered in default until it has been given a chance to cure. It is possible, however, that undue delay in issuing a default notice may be considered a waiver and foreclose the general partner from declaring the limited partner in default.
- *Court Enforced Contributions.* In theory, the general partner may be able to convince a court to require a limited partner to honor its capital contribution obligations. Barring that, the general partner should be able to sue for damages. However, general partners have traditionally been reluctant to sue their investors, concerned primarily about the effects any such action might have on future fund raising. It is possible that under certain circumstances a general partner may conclude that its duty to the other limited partners requires it to take action to enforce the terms of the partnership agreement.
- *Enforceability of Default Remedies.* Neither Delaware nor English law is entirely clear as to the enforceability of default remedies. As a matter of general principle, courts in both jurisdictions are reluctant to interfere with the freedom to contract and will not strike out provisions agreed to by sophisticated parties. However, default provisions, which in the closed-end fund arena provide the primary leverage against default, are subject to particular scrutiny in many jurisdictions. In determining whether to apply the remedies in the fund partnership agreement, the general partner should consult with counsel concerning applicable case law in the relevant jurisdictions.

Other Factors to Consider in the Event of Default

There are a number of other possible ancillary consequences of a limited partner default that a fund manager will want to weigh in fashioning a response, including the impact of a default on the following:

- *Existing Subscription-Backed Credit Facilities.* A failure to fund by a limited partner usually requires notice to the lender, even if the limited partner is not declared in default. In addition, a default of a certain size may accelerate outstanding loans or terminate the facility. Lender consent may be required for certain transfers of limited partner interests or amendments to the fund partnership agreement.
- *Insurance Company Renewals.* Most D&O insurance policies are renewed annually and will require the fund to identify any limited partner defaults. It is possible that a default may affect underwriting decisions, including pricing.
- *Audited Financials/Other Reporting Obligations.* The fund may be required to report the default of a limited partner (and the reduction in total fund commitments) on its financial statements. In addition, the fund partnership agreement or side letters may require material changes to be reported.
- *Diversification Limitations.* If the defaulting limited partner's unfunded commitment is not replaced, the reduced total commitments of the fund may affect the size of future investments.
- *ERISA Considerations under the 25% Test.* If the fund limits benefit plan investors to less than 25% to satisfy ERISA, a limited partner default may require a recalculation to confirm that the fund is still in compliance.
- *Voting and Representation on Advisory Committee.* In almost all cases, a limited partner that defaults is no longer entitled to vote on fund matters and can be removed from the Advisory Committee.
- *Limitations in the Event of Limited Partner Bankruptcy.* It is possible that the fund's remedies may be constrained in the event a limited partner declares, or is about to declare, bankruptcy.

* * *

Limited partner defaults, once seen as a remote prospect, are now sufficiently on the radar of many private equity fund managers that they are engaged in contingency planning for this eventuality. The above suggestions address only some of the issues that should be considered in the event of a default or potential default of a limited partner. Each situation will likely have its own unique facts and all actions should be carefully considered with the advice of fund counsel. ■

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ADS v. Blackstone: Strine Endorses Private Equity Cabins

The Delaware Chancery Court's recent decision in the litigation arising out of Blackstone Group's aborted acquisition of Alliance Data Systems provides welcome affirmation for private equity firms that the legal structure of a typical private equity acquisition will be respected by the Delaware courts.

As some readers may recall, Blackstone announced on May 17, 2007 that its private equity fund, Blackstone Capital Partners V, L.P., had agreed to acquire ADS, a credit card service provider. The deal was conditioned on, among other things, receipt of approval from the U.S. Office of the Comptroller of the Currency (the OCC) as the regulator of ADS's credit card bank subsidiary. As a condition of its approval, the OCC sought a $400 million guarantee from the acquiring Blackstone fund of the obligations of the regulated bank subsidiary. Blackstone refused to provide such a guarantee, and each of Blackstone and ADS eventually sent the other a notice purporting to terminate the merger agreement. ADS claimed it was terminating the agreement because Blackstone's breach of the agreement resulted in the failure of the conditions to closing to be satisfied, while Blackstone claimed that the regulatory condition could not be satisfied by the "drop dead" date as a result of the OCC's decision.

As is typical in a private equity acquisition, the Blackstone fund itself was not a party to the merger agreement with ADS. The parties to the merger agreement were shell entities organized solely for the purpose of entering into the transaction, including a holding company called Aladdin Holdco, Inc. and its subsidiary, Aladdin Merger Sub, Inc., which was to be merged into ADS. ADS's sole remedy under the merger agreement for a failure of Blackstone to close the deal was a reverse breakup fee of $170 million payable by Aladdin Holdco. The Blackstone fund entered into a separate limited guarantee, guaranteeing Aladdin Holdco's obligation to pay the reverse breakup fee but not its other covenants.

ADS claimed that the merger entities that were parties to the merger agreement breached the agreement by failing to cause the Blackstone fund to provide the guarantee of ADS' bank subsidiary required by the OCC as a condition for giving its approval of the transaction. ADS pointed to three provisions of the merger agreement to support its claim. First, the buyer entities covenanted to use reasonable best efforts to obtain regulatory approvals necessary for closing. Second, they covenanted to cause Blackstone not to take any action that would prevent or delay the completion of the deal. Third, they represented that they had all power and authority necessary to enter into and consummate the transaction. In his decision issued on January 15, 2009, Vice Chancellor Leo Strine of the Delaware Chancery Court rejected all three of ADS's arguments and ruled in favor of Blackstone's motion to dismiss ADS's claim.

The court rejected ADS's argument that the merger entities' obligation to use reasonable best efforts to obtain approvals created any similar obligation on the part of Blackstone, which was not a party to the agreement. The court also opined that the negative covenant to cause Blackstone not to take any action that would jeopardize the closing of the transaction could not be read to imply a positive covenant to cause Blackstone to take actions required for closing. Finally, the court did not accept that the representation and warranty that the merger entities had the requisite power and authority to consummate the transaction was rendered inaccurate because they lacked the authority to force Blackstone to take actions required for closing. The representation and warranty, according to the court, spoke only to actions to be taken by the merger entities themselves.

Most interesting was the court's firm statements that extrinsic evidence that all parties considered ADS's negotiating counterparty truly to be Blackstone rather than the Aladdin entities could not be considered where the text of the agreement was clear that Blackstone was not a party and had no obligations to ADS under the agreement. In other words, the court endorsed the validity of the private equity acquisition structure in which, absent an express contractual provision to the contrary, a private equity fund and its sponsors will not be held responsible for the contractual obligations of acquisition subsidiaries and portfolio companies. In doing so, the court evidenced its understanding of the necessity of this structure. As Vice Chancellor Strine wrote in his opinion:

> Blackstone's business model is to operate a series of funds, of which [Blackstone Capital Partners V, L.P.] is an example. These funds make money for their owners by investing in operating businesses that are operated through limited liability entities to prevent the under-performance of any single company from harming a fund's investment in other companies. In other words, Blackstone seeks to cabin its risk for any portfolio company by restricting its investment in each company in a disciplined way.

The ADS decision provides reassurance to financial sponsors as to the legal vitality of the typical acquisition structure for a private acquisition structure, one in which private equity funds are responsible only for the obligations they specifically assume under the transaction agreements. ■

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collateral should be considered in evaluating compliance with an "equal and ratable" clause. Issues of control arise whenever creditors share a security interest in the same pool of assets. Typically those issues are resolved through intercreditor agreements that are customized to the circumstances and needs of each of the parties—frequently after intense negotiations. While control is not a concept that one typically considers in the context of evaluating the legal rank or priority of a creditor's claims, the equal and ratable clause is not so limited; the clause demands that the security interest granted to the negative pledgee be "equal." The practitioner should at least ask "how much control over the collateral must be granted to the negative pledgee in order to satisfy the negative pledge provision?"

This question is addressed in a situation wholly unlike that in most intercreditor discussions. The new secured lender will want to have as much control as possible over all decisions regarding the collateral and leave little or no control over the collateral to the noteholders. The bank will want to be able to monitor the collateral, to make decisions regarding releases of the collateral, and to determine when and how to foreclose on the collateral if necessary. The debtor will typically be willing to provide the bank with as much control over the collateral as possible in order to induce the bank to participate in the financing. The debtor may also believe that the bank will be more responsive to requests for releases of collateral and other matters. For these reasons, the new creditors and the debtor—the parties who are most actively involved in structuring the "equal and ratable" security package—will have a strong incentive to limit the negative pledgee's control over the collateral. The noteholders' role is generally more passive—they accept the security interest on the bank's coat tails and the control rights that the bank and the debtor determine are necessary to satisfy the strictures of the equal and ratable clause.

Three basic elements of control are frequently considered in this context: first, the right of the negative pledgee to commence enforcement actions; second, their ability to participate in decision-making regarding enforcement proceedings with respect to collateral; and third, their ability to consent to, or prevent, the release of their shared liens over collateral following default. Many "equal and ratable" security packages grant the negative pledgee a minimum set of control rights, while reserving most decisions regarding the collateral to the bank's collateral agent—but treatment of such "control" issues can vary widely, as described below.

Commencement of Enforcement Proceedings

The "equal and ratable" requirement should be considered with respect to the trigger for enforcement proceedings. The trigger events permitting the commencement of enforcement proceedings is frequently the same for both the bank lenders and the note-holders. This approach is not universal, however — an event of default under the bond indenture does not always trigger a right to proceed against the collateral in the absence of a bank default.

Dispositions of Collateral and Method of Enforcement

In some cases, decisions regarding dispositions of collateral after commencement of enforcement proceedings are to be made by a vote of all of the secured creditors, in which each creditor receives a vote for every dollar owed to it. This "democratic approach" has been accepted by some practitioners as satisfying the negative pledge clause's demand for "equality," in that the process treats each creditor on equal terms. In practice, however, it should be noted that this approach effectively disenfranchises the negative pledgee, since the amount of its debt is frequently less than that of the new secured creditor, who will be able to outvote the negative pledgee. Practitioners intent on satisfying the equal and ratable clause have focused on the equality of the decision-making process, not the equality of the outcome.

Most "equal and ratable" security packages reserve considerable control to the bank group, however, rather than adopting the pure democratic approach. Before the occurrence of a default, the bank agent on behalf of the bank group typically is permitted to maintain sole control regarding dispositions of collateral and has the exclusive right to inspect and oversee the collateral. In many instances, even following a trigger event, the bank agent retains sole control over the enforcement proceedings and dispositions of the collateral.

In other examples, while the collateral agent for the banks is generally permitted to control decisions regarding enforcement, that control can be assumed by the majority of the creditors, including the bondholders, if the majority of creditors request. The possibility of such a "democratic override" of the bank agent's control arguably enhances the likelihood that the control rights granted bondholders are "equal" to those of the bank lenders.

Alternative structures, in which each secured party is given a single vote or a veto right, would also seem to satisfy the negative pledge clause's demand for equality. Such structures are not seen in practice, however. The explanation for this fact is likely the simplest one—such structures give the negative pledgee more power and secured lenders do not want to have to give

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Final Exon-Florio Regulations: What They Mean for Private Equity

The private equity community has not been getting much good news from Washington, but the recently released final Exon-Florio regulations provide some comfort for sponsors concerned that the overly-broad proposed regulations might have created unnecessary impediments to transactions. In our article, "How the New Exon-Florio Rules Affect Private Equity" in the Spring 2008 *Debevoise & Plimpton Private Equity Report*, we noted that the regulations proposed by Treasury to implement the Foreign Investment and National Security Act of 2007 (FINSA), which amended Exon-Florio, raised a number of questions and ambiguities for private equity funds that are organized offshore or have a significant percentage of foreign limited partners. The final regulations, which became effective on December 22, 2008, provide some helpful answers, although Exon-Florio will still be on the deal checklist for many private equity firms.

Exon-Florio Recap

Exon-Florio authorizes the President of the United States to suspend, prohibit or require the unwinding of any transaction by or with a foreign person that could result in foreign control of a U.S. business, if the President concludes that (1) the foreign interest exercising control might take action that threatens to impair U.S. national security and (2) other laws do not provide adequate protection. Parties to a transaction who are concerned that their transaction may raise national security concerns and who do not want to live with the threat that the President could order the transaction unwound may request a pre-closing review by the Committee on Foreign Investment in the United States (CFIUS). CFIUS also may initiate a review of a transaction on its own. If CFIUS concludes a review without taking further action, the parties can proceed without fear of Presidential interference (subject to CFIUS' ability to reopen a review if any party submitted false or misleading material information to it).

When Is a Private Equity Fund "Foreign?"

The final regulations provide some relief to private equity funds by changing the proposed definition of "foreign entity" so that it now includes only entities organized outside of the United States whose principal place of business is outside of the United States or whose equity securities are primarily traded on one or more foreign exchanges.[1] Accordingly, even a Cayman Islands fund (other than a fund listed abroad) will not be foreign if its principal place of business is in the United States. One potential complication is that the term "principal place of business" is not defined or explained, and this formulation may give pause to funds that maintain, for tax reasons, that they are not engaged in a trade or business in the United States. The revised definition also provides that even if a foreign-organized fund is listed or has its principal place of business abroad, it nevertheless will not be considered foreign if it can demonstrate that a majority of its equity interests are ultimately owned by U.S. nationals.[2]

A U.S.-based private equity fund may also be "foreign" if it is controlled by a foreign national, foreign government or foreign entity. The test of "control" is one of facts and circumstances. In general, a fund's general partner and manager should be deemed to control the fund, but if foreign limited partners are entitled to minority protections (other than those specified in a safe-harbor provision of the regulations), the fund could be deemed foreign. One minority protection that is relatively common but which is not on the safe-harbor list is the right to remove the general partner upon a specified vote of limited partners. However, even where the limited partners have such a right and foreign limited partners could control the vote, the final regulations suggest that if limited partner interests are widely dispersed and foreign limited partners are unrelated and have not agreed to act in concert, CFIUS would not be likely to find foreign control. By contrast, veto rights (other than those specified in the safe-

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In light of FINSA and the final regulations, private equity funds will want to pay more attention to Exon-Florio. Uncertainty about the applicability of the law, as well as the current political climate, will likely lead to more CFIUS filings than in the past.

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1 *Under the proposed rules, a foreign entity would have included any fund organized in an offshore jurisdiction by a U.S. private equity sponsor if 50% or more of the fund's partnership interests were held, directly or indirectly, by foreign nationals, notwithstanding that the fund's general partner and manager were U.S. persons.*

2 *Although the final regulations are very corporation-centric and therefore do not provide much guidance about how partnerships will be treated, we believe that partners will be viewed as holding "equity interests" in proportion to their capital commitments.*

Final Exon-Florio Regulations: What They Mean for Private Equity (cont. from page 21)

harbor provision) that can be exercised by individual foreign limited partners could be troublesome.

The final regulations do not make clear the extent to which CFIUS will look up, or require filers to look up, the chain of control or ownership, although it is clear that CFIUS has leeway to do so. Accordingly, it will be important when structuring a fund that the sponsor pay attention to the nationality of its prospective limited partners and their ultimate controlling persons as well as to any relationships among limited partners, including agreements to vote in concert, that may influence the analysis of whether the fund is foreign-controlled.

Club Deals

Private equity firms considering participation in a club deal with a foreign partner should keep in mind that (1) more than one equity holder can be in control at the same time—the influence over investment and management decisions likely to be shared by foreign and U.S. investors in a 50/50 club deal will be deemed control by each; and (2) even where a club has three or more members, a foreign minority holder may be deemed to have control if it can determine or veto decisions regarding important matters (other than those specified in the safe-harbor provision).

Sovereign Wealth Funds

Past investments by sovereign wealth funds in private equity sponsors (as opposed to funds) often relied on an exemption for acquisitions of 10% or less of a sponsor's voting securities made solely for the purpose of investment. That exemption has been preserved, although the final regulations require that to qualify for the exemption the investment be solely for the purpose of "passive" investment and make clear that an investment that is accompanied by a right to appoint a director is not passive. (Flunking the test of passivity only renders the investment ineligible for the 10% exemption; the investor still may not be considered to have control, depending on all of the facts and circumstances.)

In light of FINSA and the final regulations, private equity funds will want to pay more attention to Exon-Florio. Uncertainty about the applicability of the law, as well as the current political climate, will likely lead to more CFIUS filings than in the past. Sponsors of funds in formation who think that they will face the Exon-Florio filing question—given their investment strategy and the potential make-up of their limited partners—should make sure that they have the ability to elicit from their limited partners the information required to make determinations about foreign status. ■

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Duties of Directors of Distressed Companies: Avoiding an Intrinsic Fairness Review

When times are good, the goal of private equity professionals serving as directors of portfolio companies is relatively straightforward—maximization of value for the corporation's shareholders. Moreover, the interests of the two constituencies that the private equity professional serves—his private equity firm employer and the portfolio company's shareholders—are typically aligned as the private equity firm is usually the portfolio company's largest shareholder. When a portfolio company becomes insolvent, however, the private equity professional serving on its board is confronted with a significantly more complex situation and the legal standard by which his actions are judged may be materially more demanding. Private equity professionals serving as directors of portfolio companies during the current economic downturn should therefore understand the duties they owe to the stakeholders in the corporations they serve and the impact of the corporation's financial condition on these obligations.

First, a quick recap on the topic from the last issue of the *Debevoise & Plimpton Private Equity Report,* "Alert: Duties of Directors of Distressed Companies—An Update and Refresher." Directors typically owe the corporation and its shareholders a duty of care and a duty of loyalty. The duty of care requires that directors exercise the degree of care that an ordinary and prudent person would use in similar circumstances. The duty of loyalty requires that directors act in good faith in the best interests of the corporation and its shareholders and that they not engage in self-dealing. Challenges to directors' decisions are generally difficult to sustain because of the protection afforded to directors by the "business judgment rule." So long as directors are not "interested" in the matter before them, they benefit from the presumption that they acted on an informed basis, in good faith and in the honest belief that their decision was in the best interest of the corporation.

But the business judgment rule does not apply where it can be shown that the directors were either interested in a transaction or lacked independence. In these cases, the burden of proof shifts to the directors to show the "entire fairness" or "intrinsic fairness" of the transaction—that the actions of the board were both procedurally and substantively fair. A court's determination as to whether to apply the intrinsic fairness test, given the higher standard to which this test subjects a director's conduct, may dictate the outcome of a challenge to a board's decision and, at the very least, whether the challenge will survive a summary judgment motion.

When Is a Director Interested or Not Independent?

The burden of proving the intrinsic fairness of a transaction will only shift to the directors if facts can be pleaded that show that either a majority of the directors were interested in the matter before the board or a third party controlled the board as a whole so as to infect the board's decision.

Courts have found that a director may be "interested" in a transaction if he stands on both sides of the transaction or expects to derive a financial benefit from the transaction. To render a director interested, a financial benefit must be (1) personal to the director, rather than a benefit that also devolves upon the corporation or all shareholders generally, and (2) substantial enough, based on the director's individual economic circumstances, to make it improbable that the director could perform his fiduciary duties without being influenced by the benefit.

To be "independent," the director's decision must be based on the merits of the transaction rather than extraneous factors. This determination is typically based on a fact-specific and subjective analysis of

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Private equity professionals serving as directors of portfolio companies during the current economic downturn should therefore understand the duties they owe to the stakeholders in the corporations they serve and the impact of the corporation's financial condition on these obligations.

whether the particular director is likely to be dominated by, or otherwise beholden to, a controlling shareholder or other third party. Courts have held that directors lacked independence in a variety of different situations, including where the director controlled (or was a director of) a party providing financing to the corporation, was an indirect owner of a party receiving significant fees as part of a transaction, or was a management shareholder and would receive financial benefits upon the completion of a transaction beyond those received by the shareholders generally (*e.g.,* options, severance pay).

In order to ensure that a fiduciary does not unfairly benefit himself or a third party at the expense of the corporation, once it is established that a majority of the directors on the board may be interested or otherwise lack independence, the burden of proof shifts to the directors to show that the transaction was fair, both in terms of process and price.

However, once a corporation becomes insolvent, the directors' fiduciary duties run to an expanded constituency that encompasses not only the corporation and its shareholders but also the corporation's creditors.

What is Intrinsic Fairness?

Courts have held that there are two aspects to the intrinsic fairness test: fair dealing and fair price. Fair dealing focuses on the actual conduct of the directors in effecting the transaction, including how the transaction was initiated, structured and negotiated. This may include a review of the timing of the transaction and the board approval process, who controlled the structuring and negotiation of the transaction and whether all relevant information was disclosed to the board. Fair price relates to the economic and financial terms of the transaction, including a review of the value that an otherwise arm's-length transaction would provide. Courts focus on both elements of the test as part of an integrated analysis of all aspects of the transaction since the question is one of "entire fairness."

What Changes When the Portfolio Company Is Insolvent?

When a corporation is solvent, the directors only owe fiduciary duties to the corporation and its shareholders. Generally, creditors are entitled to only those contractual rights set forth in their financing or other agreements. However, once a corporation becomes insolvent, the directors' fiduciary duties run to an expanded constituency that encompasses not only the corporation and its shareholders but also the corporation's creditors. The assumption underlying this expansion is that once a corporation is insolvent, the residual value of the corporation may belong to the corporation's creditors and not its shareholders. This shift can have a significant impact on the application of the intrinsic fairness test, particularly with respect to closely held corporations such as portfolio companies.

When the constituencies to which a director owes duties is expanded, the range of transactions in which a director may be "interested" may also grow. Take, for example, transactions involving a parent and its wholly-owned subsidiary. It is generally settled that a solvent, wholly-owned subsidiary is free to serve the interests of its shareholder parent. Consequently, an employee of the parent may serve on the board of the subsidiary without fear that its relationship with the parent will render him interested. The interests of the parent and the duties of the subsidiary's directors are usually aligned. However, once the subsidiary is insolvent this alignment may no longer exist. The director of the subsidiary is legally obligated to serve the interests of the subsidiary's creditors as well as those of his employer, the parent. As a result, case law suggests that directors of subsidiaries may breach their duty of loyalty if they permit assets—which would otherwise be available to satisfy the claims of the subsidiary's creditors—to be diverted away from the subsidiary for the benefit of the parent.

A private equity sponsor and its portfolio company present very nearly the same situation. A private equity sponsor employee who sits on the board of a solvent portfolio company generally owes fiduciary duties to the sponsor, as the controlling shareholder of the subsidiary, and may therefore approve transactions that are beneficial to the sponsor without concern that his decisions will be reviewed under the intrinsic fairness test, assuming that minority shareholders are treated fairly. However, once the portfolio

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company is insolvent, the director also owes duties to the creditors of the portfolio company, and the director's relationship with the sponsor may render him interested with respect to any transaction benefiting the private equity sponsor even in its capacity as a shareholder.

In fact, in a recent case, the Bankruptcy Court for the District of Delaware found that a Chapter 7 trustee had sufficiently alleged a breach of the duty of loyalty against a private equity sponsor, its counsel and the portfolio company's directors to survive a motion to dismiss. In *In re The Brown Schools, et al.*, the trustee successfully argued that a series of otherwise unsurprising restructuring transactions that preceded the portfolio company's bankruptcy should be evaluated under the intrinsic fairness test because the defendants had engaged in self-dealing. The alleged self-dealing included the payment of certain advisory fees to the private equity sponsor and a grant of junior liens to secure loans the private equity sponsor previously made to the portfolio company. In so holding, the Bankruptcy Court turned what appeared to be a relatively standard duty of care case (reviewed under the deferential business judgment standard) into a duty of loyalty case (reviewed under the more rigorous intrinsic fairness standard). It is important to note that in rendering the Brown Schools decision, the Bankruptcy Court was required to accept the trustee's factual allegations as true and was precluded from considering defenses that the defendants might assert. However, the decision is nonetheless cause for caution.

What Should Directors Do?

Given that an increasing number of corporations are or may be facing insolvency, what should directors do? The primary goal for the directors of any corporation should be the preservation of the protection afforded by the business judgment rule. To achieve this, a private equity sponsor should consider ensuring that at least two independent and disinterested directors sit on its portfolio company's board of directors and, in certain circumstances, may even wish to constitute a special committee of disinterested directors to deliberate on matters that raise conflict issues for other directors. Where disinterested directors serve on the portfolio company's board, it is essential that these directors are fully informed concerning the transactions before the board and the private equity sponsor's interests in the transactions and participate meaningfully in the decision-making process. Finally, these actions should be reflected in the records of the board's deliberations.

If the board does not have independent directors, the sponsor and its portfolio company should assume that board decisions impacting the sponsor will be reviewed under the more demanding intrinsic fairness test and consider how best to structure board deliberations in that light. How frequently and when should the board meet? What advisors should be retained? What input—fairness opinions or other independent review and analysis—should be provided by these advisors? What records should be kept of the board's deliberations?

Private equity professionals serving as directors of portfolio companies will want to be mindful that the current downturn may create complexities in fulfilling their legal obligations that are not present in a more favorable economic environment. Generally, the structure of board deliberations should be carefully managed to avert unanticipated challenges to the process and the result. ■

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Debt Exchange Offerings: A Flash in the Pan?

Last September and October, as high-yield bond prices on the secondary markets dropped precipitously, several issuers, including a number of private equity portfolio companies, launched exchange offers designed to lower their financing costs by capitalizing on the discounted pricing. The smoke has now cleared on these exchange offers and, though the results are mixed, the challenging economic environment combined with recent legislation (discussed in the article that begins on page 7) easing the tax burden associated with debt refinancings may lead to an uptick in new exchange offers in the coming months.

In effect these completed exchanges served as synthetic debt repurchases, pursuant to which an issuer offered to replace, for example, a $100 note obligation with a $50 secured loan obligation. However, unlike more straightforward debt repurchases, the exchanges generally did not require any outlay of cash by the issuer. And unlike previous traditional note exchanges, most of these exchanges involved the replacement of unsecured notes with secured debt, rather than new unsecured notes.

While the exchange offers varied significantly, they each offered unsecured bondholders the opportunity to exchange their bonds for first-, second-, third- or even fourth-lien debt. In several offerings, the debt received in the exchanges contained modified maturity dates, additional cash payments or preferred equity, as well as revised interest terms. Most sought to effect the exchanges without consent from the existing senior secured lenders, though several used the exchange to simultaneously obtain consents to amend the indentures governing the notes to be acquired in the exchange.

This article examines the common features and significant differences among the flurry of exchange offers late last year in which notes were exchanged for secured debt, as well as their results and discusses certain

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Company	Old Debt	New Debt	Discount of New Debt	Selected Additional Terms	Results
Realogy Corporation	Unsecured Notes	2nd Lien Debt	55%-65% (depending on note series)	—	Withdrawn after adverse judgment.
Neff Corp.	Unsecured Notes	1st Lien Debt (subordinated to revolver)	55%-60% (depending on note series)	• Senior revolver capacity reduced, interest rate increased. • Stripped covenants from unsecured note indenture.	Majority subscribed.
Harrah's Entertainment, Inc.	Unsecured Notes	2nd Lien Notes	0%-63% (depending on note series)	• Cash payment option provided on limited portion of near-term maturity notes.	Minority of eligible holders of near-term maturity notes subscribed; majority of eligible holders of long-term maturity notes subscribed.
Hovnanian Enterprises, Inc.	Unsecured Notes	3rd Lien Debt	53%-60.5% (depending on note series)	—	Less than 10% of eligible holders subscribed.
Finlay Fine Jewelry Corporation	Unsecured Notes	3rd Lien Notes	0%	• New notes PIK'ed through 2010. • Exchanging noteholders also purchased additional 2nd lien notes.	70% of eligible holders subscribed.
Station Casinos, Inc.	Secured and Unsecured Notes	2nd and 3rd Lien Debt	46%-83% (depending on note series)	—	Withdrawn because of insufficient interest.

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legal considerations associated with these transactions.

The Commercial Equation

The common commercial equation in each of these transactions is the borrower seeks to obtain a reduction in its debt load by offering lenders a stronger security position and other enhancements with respect to the new debt securities, with the net result that post-offering the lender holds debt with a reduced principal amount which, because of its enhanced credit position, should trade at a premium to the exchanged debt.

More specifically, the benefits for the borrower in these exchanges included a variety of reduced principal amounts, longer terms, lower interest rates and modified covenants. One potentially significant offsetting cost, however, has been tax liability for the borrower on cancellation of indebtedness income incurred pursuant to the redemption of the original notes in exchange for new debt with lower par value. As noted above, however, the new stimulus legislation significantly mitigates this tax liability in future exchange offers.

In addition to getting the pricing equation right, at least two significant legal issues need to be evaluated under an issuer's existing financing arrangements before it can proceed with any debt exchange offer.

The benefits received by the lenders exchanging their notes included security, guarantees, and, in a few cases, cash or preferred equity. An exchange is attractive to lenders when the increase in value provided by the security or other enhancements exceeds the diminution in principal amount of the converted notes and other impairments. For example, if an issuer's notes had been trading at 25% of face value and the issuer provides an option to exchange those notes for secured term debt with a face value of 50% of the exchanged notes, the exchange would be attractive to any investor believing that the newly-issued exchanged term debt would trade above 50% of its principal value. This, in turn, will depend not only on how the market values the specific enhancements to be provided in the newly-issued exchange debt, but also on the impact of the borrower's reduced total debt load on the pricing of the exchange debt.

While some issuers, including Neff Corp. and Finlay Fine Jewelry Corporation, succeeded in untying this Gordian knot, for others it proved all but insoluble. For example, Hovnanian Enterprises, Inc. managed to complete its exchange offer but participation included only notes totaling $71 million, or significantly less than 10% of the notes eligible for exchange, suggesting that the added security did not sufficiently compensate noteholders for the diminution in face value. Another exchange offer, from Station Casinos, Inc., was withdrawn because of insufficient interest. The table on page 23 summarizes the principal terms of several of these recent exchange offers.

Legal Hurdles

In addition to getting the pricing equation right, at least two significant legal issues need to be evaluated under an issuer's existing financing arrangements before it can proceed with any debt exchange offer. First, the issuer needs the capacity to issue new, usually secured, debt and, second, the issuer must have the right to redeem or prepay the existing notes subject to the exchange.

Additional Debt Capacity

In many of the recent exchange offerings, including those by Realogy Corporation, Neff Corp., Finlay Fine Jewelry Corporation and Harrah's Entertainment, Inc., the capacity to issue new, secured debt existed in the senior secured credit facilities through incremental or "accordion" features whereby the issuers have the right to incur indebtedness up to a fixed amount. Accordions generally permit increased indebtedness under the same terms of the original facility or terms that are no less advantageous to the original lenders with respect to subordination, security and maturity.

To maximize exchange benefit while complying with these accordion caps, some issuers structured their exchange offers to apply only to certain classes of notes and often limited the exchange amounts within such classes. For example, in the Realogy Corporation exchange offer, of the maximum $500 million in new exchange issuance, priority was given to subordinated noteholders, then to senior noteholders, while PIK-toggle holders were able to participate only to the extent that the exchange was not fully subscribed by the subordinated and senior cash-pay noteholders. Because the value of these various instruments was potentially diminished by the new—and newly-secured—debt being issued in the exchange offer, this tiering led to considerable discontent among those noteholders whose participation in the exchange was limited.

As a result, certain holders of PIK-toggle notes issued by Realogy Corporation

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brought suit in Delaware Chancery Court to enjoin the exchange offer because of what they considered to be unfair treatment. One of the arguments raised by the Realogy Corporation plaintiffs was that the "accordion" provisions in Realogy's senior credit facility only permitted Realogy to issue new debt in exchange for cash proceeds and thus did not permit Realogy to issue new senior secured term loans in exchange for tendered notes. The Court rejected the plaintiffs' arguments, referring to them as "hyper-technical," thereby providing some comfort that exchange offers of the type initiated by Realogy can be issued under similar accordion provisions of other senior credit agreements. It should be noted, however, that a different court might reach a different decision and that differences in the specific language in the "accordion" terms might lead to different results.

In addition to "accordion" features, senior debt facilities generally include additional baskets that may be tapped to permit the issuance of new indebtedness, including general indebtedness baskets, though such baskets are likely to be smaller than available "accordions."

Right to Redeem

The second principal legal hurdle is an issuer's ability under its existing financing facilities to redeem or prepay the exchange notes in question. Generally, senior secured loan agreements have provisions limiting the redemption or prepayment of junior and/or unsecured facilities; however there are often exceptions to these limitations including if the notes in question are being redeemed in connection with a refinancing. The reasoning behind this exception is that a refinancing should not disadvantage senior or secured lenders provided that the refinancing meets several criteria. These criteria vary among different facilities but generally require that the new debt be of no greater principal amount, no earlier maturity, or no higher priority than the prior debt and benefit from no increase in guarantees or security.

The limitation on a grant of new security in a permitted refinancing was also challenged by the plaintiffs in the Realogy Corporation litigation, and the court ruled in their favor, enjoining the exchange offer. The court found that the grant of a second-lien security interest in the new indebtedness to be issued in the exchange violated the restrictions on permitted refinancing because the existing notes being exchanged were not secured. The decision was a highly technical one however, based largely on the interplay between the applicable indenture and the precise language of Realogy's senior secured facility, and could well have come out differently had the senior credit agreement first been amended to avoid this interplay. This is important because first-lien lenders like Realogy's senior lenders may be favorably disposed to cooperate in making such amendments in these circumstances since an exchange would reduce the debt-load of the borrower to the senior lender's advantage without directly impairing its priority on the security.

In a similar challenge to the ability of an issuer to replace unsecured notes with secured indebtedness filed shortly before the Realogy decision, second-lien lenders to Neff Corp. challenged Neff Corp.'s exchange offer on similar grounds, seeking a preliminary injunction from the Supreme Court of the State of New York. The request for a preliminary injunction was withdrawn, however, without a ruling. The Neff Corp. exchange proceeded to a successful conclusion, though the litigation remains pending with the plaintiffs seeking compensatory damages.

Additional Legal Considerations

In addition to the principal hurdles discussed above, these exchange offers have also raised other legal questions which remain unanswered and could ultimately pose challenges to similar future exchanges. One question is fraudulent conveyance: if the borrower was insolvent at the time of an exchange issuance, there is an argument that, if the new debt was more valuable than the old, it would be considered a fraudulent conveyance to the exchanging debtholders. Another concern is coercion and discrimination: in those exchanges in which the offer is combined with amendments to existing indentures, lenders may be coerced into participating in the exchange by the potentially changed terms of their indentures.

* * *

Any exchange offer will float or founder first and foremost on its commercial terms. That said, the dual issues of debt capacity and redemption and repayment right constitute important obstacles to be carefully navigated by prospective borrowers seeking to offer secured debt in exchange for existing notes. After the rash of exchange offers in late 2008, it appeared briefly as if the risks and challenges posed by such transactions was discouraging new transactions, but, as we go to press, at least two new exchange offers are on the market. Both Freescale Semiconductor and AbitibiBowater are offering to exchange unsecured notes for secured debt and interim results from both offers indicate significant interest from the eligible noteholders. Given the continuing weakness in the credit markets, the complexity of many capital structures and the recent tax changes relating to the cancellation of indebtedness income referred to above, it appears that debt exchanges will remain a valuable tool for borrowers to reduce their leverage. ■

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restrictions that made control investments by private equity firms in financial institutions either difficult or impossible. It seems likely that these factors will remain present in 2009 and perhaps beyond, and that we will continue to see large-scale PIPE transactions involving a broad array of private equity firms.

The structuring of PIPE transactions, particularly in financial institutions, involves numerous interrelated business, legal and tax issues. Key considerations include the following:

Dealing with Investment Consortia

The largest PIPE transactions in 2008 involved multiple investors joining together to invest in distressed financial institutions. Most often, the transaction was led by a private equity or hedge fund firm, who took the lead in performing due diligence and negotiating the basic contracts, with the transaction then being opened up to certain of the issuer's existing institutional shareholders. For example, TPG Capital's approximately $2 billion investment in Washington Mutual was accompanied by an additional $5 billion investment from a group of Washington Mutual's largest institutional shareholders. The anchor investor may receive greater governance rights and better economic terms, but its investment may also be subject to tighter transfer and standstill restrictions.

Alternatively, PIPE transactions can be accompanied by a parallel public shareholder rights offering underwritten by the anchor investor. For example, as part of Warburg Pincus's initial investment in MBIA, Warburg agreed to purchase $500 million worth of common stock and to backstop a rights offering of an additional $500 million in return for warrants. Similarly, J.C. Flowers's investment in MF Global involved the purchase of $150 million worth of convertible preferred securities and the backstop of a parallel public offering (or private placements) of up to an additional $150 million of similar securities in return for a cash commitment fee. While backstopped offerings give the issuer assurance that it will meet its capital raising goals, PIPE issuers should consider the implications of an unsuccessful public offering as well as the additional time required to complete the transaction.

Type of Security

PIPE transactions can involve a variety of securities, including straight common, preferred (convertible or non-convertible), convertible debt or a combination of the foregoing. Investors sometimes get equity kickers in the form of warrants in addition to their primary security. Although less common than warrants, investors sometimes receive call options for an incremental investment within a specified period of time. As discussed further below, in some cases, the security is economically equivalent to common stock but initially takes the form of preferred stock in order to bridge regulatory or shareholder approval requirements.

If the PIPE security is a true preferred stock, a key consideration for the investor will be the terms of the dividend. In addition to the coupon itself, the parties must agree on the length of the no-call period, whether or not the dividend is cumulative and whether accumulated dividends compound. While a non-cumulative dividend clearly puts the investor at economic risk, since under Delaware law an issuer has no duty to pay preferred dividends even if it otherwise has the funds available, dividends on preferred instruments issued by banks and other financial institutions to date have more often than not been non-cumulative. The belief that a bank will totally eliminate dividends on its common stock only as a last resort has often been sufficient to induce PIPE investors to accept non-cumulative dividends, since the issuer cannot pay even a penny dividend on its common stock without having paid its preferred dividends in full.

In most cases, the preferred security will not have a fixed redemption date or be redeemable at the option of the holder. Financial institution issuers are often engaging in PIPE transactions against the backdrop of capital reviews by ratings agencies or regulatory assessment of risk-based capital and the issuer generally will not be able to treat the investment as equity for accounting purposes or get its desired ratings and capital treatment if the redemption decision is in the hands of the holder. Even where redemption is solely at the option of the issuer, ratings agencies will often insist that the issuer enter into capital replacement covenants that prohibit redemption except in connection with a concurrent issuance of new equity.

Dealing with Shareholder and Regulatory Approval Requirements

Assuming the issuer has sufficient authorized capital stock and, in the case of preferred stock, the issuer's board has blank-check authority, the most likely requirements for shareholder approval will come from the rules of the stock exchange on which the issuer's securities are listed. If the investment involves the issuance of more than 20% of the issuer's outstanding common stock—either directly or on an as-converted basis—the issuer will need to obtain the approval of its shareholders under NYSE and NASDAQ listing rules. Investors need to bear in mind that the 20% limit is measured off of the number of shares outstanding prior to the new investment, and hence the limit on a pro forma basis is only 16 2/3%.

The foregoing threshold is significantly

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reduced if the PIPE investor is already a "substantial security holder," in which case any issuance greater than 1% (or, if the sale is for cash and the price is at least the greater of the stock's book and market value, 5%) requires shareholder approval. While private equity firms usually will not have an existing equity interest in the PIPE issuer, this restriction could still apply to their transactions if a coinvesting institutional buyer is a substantial security holder. Issuers and investors must also consider whether the transaction would result in a "change of control," which triggers the requirement for shareholder approval under the NYSE listing rules even if the foregoing objective thresholds are not exceeded.

In addition to the potential need to obtain shareholder approval, investments in many types of financial institutions require prior regulatory approval at even lower investment thresholds. For example, in most states an investment of more than 10% of the voting stock of an insurance company requires prior approval, as does an investment of more than 10% in an entity regulated by the UK Financial Services Authority.

The need for such approvals is often in conflict with the issuer's desire to obtain funding quickly and unconditionally. While it is possible to seek from the applicable exchange an exemption from the shareholder approval requirement on grounds of financial distress, that is a step that—at least until recently—most issuers have been highly reluctant to take. Instead, the conflict is often addressed by structuring the investment as a preferred stock that becomes convertible only once the requisite regulatory and shareholder approvals are obtained.

The parties to such transaction have agreed to a variety of mechanisms designed both to incentivize the issuer (and its shareholders) to obtain the approval and to protect the investor in the event that the approval is delayed or ultimately not forthcoming. These include increasing the dividend rate and/or decreasing the conversion price of the preferred shares, decreasing the exercise price of issued warrants, triggering a cash payment obligation from the issuer to the investor and providing the holders of the preferred stock with special consent rights to significant transactions. In some transactions, if approval is never obtained and the preferred security cannot be converted into common shares, the security can become mandatorily redeemable at a price that provides the investor the same return it would have had if it had converted into common shares and sold those shares at the prevailing market price on the date of redemption.

At the same time, the parties must take care to ensure that the economic consequences of the failure to obtain shareholder approval are not deemed to be coercive of the shareholder vote. There is little interpretive guidance regarding what the exchanges will view as coercive or impermissible. However, so long as the revised terms of the security are no more favorable to the holder than the market price of a deeply subordinated non-convertible instrument, the risk that the terms would be found to be coercive should be limited, particularly if the need for funding is real and the issuer has no better alternatives available to it. In addition, issuers often review transactions with the appropriate division of the applicable exchange prior to signing, and investors typically require that the closing is conditioned upon the issuer having been advised by the applicable exchange that the underlying shares of common will be listed.

Closing Conditions

Even where it is possible to structure around regulatory or shareholder approvals, the need to obtain antitrust clearance or contractual consents can cause a delay between the signing of the PIPE commitment and closing. Where the financing is needed to avoid a credit downgrade or other adverse business consequences, it is obviously important to the issuer to limit the risk that closing would not occur. As a result, some distressed issuers may be able to avoid a "material adverse change" condition or need to bring down representations, although it is almost always the case that funding would continue to be conditioned on the accuracy of the representations as of the date they were originally made.

On the other hand, where the size of the PIPE investment is sufficiently large that the investor may be deemed to be in control of the issuer, the parties have to consider whether the issuer needs to have a fiduciary out. For example, in the case of Thomas H. Lee Partners' and Goldman Sachs's investment in Moneygram, which ultimately represented approximately 79% of the company's voting power, Moneygram was granted a one-month "go-shop" period during which it was free to actively solicit alternative transaction proposals and given the right to terminate the original transaction, in exchange for a 2% termination fee, if a superior deal was struck.

Although the Moneygram PIPE is notable for its majority equity stake, compressed timeline and the pre-signing exclusivity arrangement with THL and Goldman, it is not *sui generis*. It is often the case that PIPE issuers have no ability to shop the deal prior to signing because of the urgency of their capital needs and, if the equity stake is sufficiently high, the issuer might still require a fiduciary out to fulfill its Revlon duties. A number of PIPE transactions for significant minority stakes have included fiduciary outs. For example, in One Equity Partners' investment for

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approximately 34% of X-Rite's common stock, X-Rite was prohibited from actively soliciting transaction proposals but could entertain unsolicited proposals and, subject to the payment of a 3% fee, terminate its agreement with One Equity in favor of a superior deal.

Price Protection

Perhaps the most heavily negotiated issue in recent large PIPE transactions has been the extent to which the investor will be protected if the target company issues new capital on more favorable terms following the closing of the investment. In 2008, PIPE investors were quite successful in achieving such protection, generally lasting for up to 2 years following closing.

Price protection typically covers issuances of common stock or common-linked securities for an implied price per common share less than granted to the investor. Aside from being time limited, protection against offending issuances is sometimes subject to a minimum threshold (for example, $300 million in the case of National City Corporation) and often excludes certain anticipated issuances (for example, pursuant to compensation plans or concurrent offerings/placements prior to closing). In addition to new share issuances, price protection has been applied to change of control transactions and liquidations where the implied value of the common stock falls below the price granted to the investors.

The potential benefit of such provisions was made clear in the case of Corsair's investment in National City Corporation. There, Corsair invested $785 million in a NCC convertible preferred instrument having a conversion price of $5.00 and received warrants exercisable to purchase 39,250,000 additional shares of common at an exercise price of $7.10. Corsair's investment was protected against change of control transactions where the implied value of NCC's common stock was less than $5.00. Upon a change of control, Corsair was entitled (1) to receive additional NCC common stock valued at an amount equal to the percentage difference between $5.00 and the greater of $2.50 or the implied issue price multiplied by the aggregate purchase price paid for the convertible preferred (and any shares of common stock purchased via exercise of the warrant), grossed-up to compensate it for any diminution in value resulting from such payment and (2) to cause NCC to purchase its warrant, in cash or common stock at the election of NCC, for the higher of its fair market value or its option value using a Black-Scholes methodology. If Corsair chose not to exercise its put right with respect to the warrant, the exercise price of the warrant would be reduced to the implied issue price in the change of control, subject to the $2.50 floor.

Less than six months after Corsair's investment, NCC was sold to PNC Financial Services Group in a stock-for-stock deal having a conversion price that valued the NCC common at $2.23 per share. Without the price protection, the sale would have resulted in Corsair owning approximately $350 million worth of PNC common stock, plus warrants to purchase approximately 1.5 million shares of PNC common at a substantial premium. With the price protection, though, Corsair received approximately $740 million worth of PNC common shares plus $240 million in cash in exchange for its warrant.

On the other hand, regulators and ratings agencies have become increasingly skeptical of price protection covenants. In a number of instances, the Federal Reserve has required modifications to price protection covenants in order to allow bank issuers to treat the investment as Tier 1 capital, and rating agencies often give the issuer a lower level of equity credit for investments that are accompanied by strong price protections. The concern in each case is that these provisions will make issuers more reluctant to raise additional equity in circumstances where the protection would be triggered

Governance

PIPE transactions are typically structured as minority investments and the investor does not get nearly the same degree of control that a private equity sponsor is accustomed to receiving in a leveraged buy-out transaction. Nevertheless, as the size of PIPE transactions has grown in recent years, so to has the lead investor's governance rights.

In most cases, an equity stake of around 10% is required to gain the right to designate board members. Above 10%, the number of designees depends upon the specifics of each transaction, the envisioned relationship between the investor and the issuer and in many cases regulatory considerations. For example, Leonard Green's 17% stake in Whole Foods garnered the right to designate two directors to Whole Foods' ten member board; while for a 19% stake in BPF, Carlyle received the right to designate only one director to BPF's 13 member board. The PIPE investor's right to continue to designate representatives to the issuer's board following the initial issuance is typically contingent upon the size of its ownership stake, measured as a percentage of the outstanding equity or as a percentage of the initial purchase. The committee membership of board designees is also subject to negotiation. Typically, where the investor has the right to designate one representative, the representative is afforded the right to sit on a specified committee and granted observer rights for other committees. As the number of investor designees increases, investor designees are typically afforded proportional representation on all committees, subject to applicable legal and governance requirements.

Although terms of the convertible

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preferred stock used in a PIPE transaction will typically provide class voting rights on limited matters, investors do not typically have contractual veto or consent rights. Nonetheless, depending on the leverage of the parties and the size of the equity stake involved, it may be possible for investors to gain veto rights over certain actions. For example, in One Equity Partners' investment for approximately 34% of X-Rite's common stock, aside from board and committee rights proportionate to its equity ownership, One Equity also negotiated for prior approval rights over (1) acquisitions exceeding a specified aggregate amount, (2) issuances of new shares, (3) entrance into new lines of business, (4) incurrence of debt over specified levels, (5) transactions with executive officers, directors or substantial security holders, and (6) increases to the size of X-Rite's board.

Standstill and Transfer Restrictions

As PIPE investors have sought greater equity stakes in the issuer, standstill provisions restricting additional share accumulations and "hostile" actions by the investor have become routine. The standstill period typically terminates when the investor owns less than a specified percentage (usually 5%) of the outstanding common stock or voting power of the issuer. In some transactions, including MF Global and Boston Private Financial, the duration of the standstill period was also subject to a fixed time limit, such as 3-5 years after the investment date. The standstill would also typically terminate upon certain extraordinary occurrences (*e.g.*, board approval of a change of control transaction, board recommendation of a tender offer or exchange offer or a significant change to the composition of the issuer's board). All standstill provisions cap the investor's acquisitions at some level above the percentage ownership upon the closing of the PIPE transaction. In transactions involving financial institution issuers, the cap could also be tied to regulatory "control" thresholds. Most standstills also restrict a standard slate of other actions by the investor, including proposals for fundamental transactions, solicitation of proxies or attempts to influence or control management (other than through its director designees).

Given their longer-term investment horizon, private equity sponsors often trade liquidity for increased governance rights and better terms. Most, if not all, PIPE transactions involving private equity investors are structured as issuances of unregistered securities with trailing registration rights. A separate registration rights agreement typically requires the issuer to meet a specified timetable for an effective shelf registration and grants the investor additional, but limited, demand and piggy-back registration rights. In addition to this structural limitation, PIPEs involving private equity investors typically prescribe additional transfer restrictions. These transfer restrictions generally include a lock-up period (typically 1 to 3 years, averaging 18 months) during which no issued shares can be transferred other than to specified permitted transferees, generally including affiliates, limited partners or shareholders. After the lock-up period, transfers generally continue to be subject to distribution limitations, such as caps on the amount transferred in any single transaction or over specified intervals, and the investor often continues to be subject to limitations on transfers to competitors of the issuer or persons who already hold (or in some case who would hold following the transfer) more than a specified percentage of the issuer's common stock.

Tax Issues

The form of a PIPE transaction can have a material impact on the after-tax returns of the partners of the private equity fund holding the investment. For example, if a PIPE is structured as debt, the coupon will be treated as interest income that is tax exempt to both non-U.S. partners and tax-exempt partners but subject to a 35% tax rate in the hands of a U.S. individual (such as the individuals receiving the carried interest). By contrast, if a PIPE is structured as preferred stock, the coupon will typically be treated as a dividend that is tax-free to any tax-exempt partners, subject to a 30% withholding tax in the case of most non-U.S. partners and eligible for the 15% tax rate in the hands of a U.S. individual. Similarly, in many cases the coupon will accumulate, or PIK, rather than be paid in cash. If the PIPE is structured as debt, the PIK interest will give rise to current income to the fund (and, in particular, any U.S. individual partners). By contrast, if the PIPE is structured as a preferred stock, it is usually possible to structure the terms of the preferred so that any PIK dividends are not currently taxable.

* * *

As debt financing markets continue to experience turmoil and public companies remain in need of fresh capital, we expect private equity firms to be presented with a wealth of PIPE investment opportunities in 2009. While that availability coupled with the scarcity of more traditional investment opportunities may make PIPE transactions appear increasingly attractive to a wide range of private equity firms, the success of such investments will require both financial discipline and a high level of attention to contractual terms. As was demonstrated by several high-profile transactions in 2008, particularly given volatile markets and uncertain capital requirements, the strength of the investor's contractual protections can be the difference between a successful investment and a failure that is both quick and public. ■

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Deconstructing Equal and Ratable Security Clauses (cont. from page 20)

the negative pledgee more power than is necessary to satisfy the strictures of the negative pledge clause.

Releases of Collateral

In equal and ratable security transactions, decisions regarding the release of collateral are generally left in the hands of the bank agent. The fact that the language of many indentures requires the grant of an equal and ratable pledge only "for so long as" the triggering debt is secured supports this allocation of power. A more fundamental concern that counsel frequently address is whether or not the bank agent can unilaterally release an interest in collateral at a time when the bondholders' debt is in default. Faced with this question, many conclude that collateral cannot be unilaterally released without creditor consent when a "triggering event" has occurred—either an acceleration of the bond debt or a bankruptcy event. Whether or not such a triggering event had in fact occurred at the time of the release of collateral by the bank agent was a central issue in the Solutia bankruptcy case last year.

The form of creditor consent to a release of collateral following the occurrence of a triggering event can take different forms as well. Some believe that creditor consent requires a majority vote of all secured creditors—bondholders and bank lenders voting together in a single pool. Others believe that following the occurrence of a triggering event, the representative of each category of secured debt—the bank agent and the noteholder trustee—must each consent to the release.

Structuring in the Context of an Equal and Ratable Clause

Parties faced with an equal and ratable clause have a huge incentive to structure a transaction so that the clause is not triggered. As an initial matter, if possible, any liens granted to the new secured creditor will be limited in scope to fit within the "permitted liens" basket provided in the indenture—or, where the scope of the negative pledge is limited to "principal properties," to assets other than the "principal properties."

In such situations, in addition to careful crafting of the collateral package, parties will frequently adopt express "savings language" in the agreements that create the new security interests. The savings language says, in essence, that to the extent that the liens granted by the new security agreement would give rise to an obligation to grant an "equal and ratable" security interest under the bond indenture, the grant of the security interest is limited so that it does not do so. The existence of such savings language gives legal comfort to the parties that the new arrangements do not violate the relevant bond indenture. At the same time, the new creditor will need to assure itself that the savings clause does not materially impair its expected security package.

Where the grant of an equal and ratable security interest cannot be avoided, the market has adopted a common solution to the implementation of an "equal and ratable" security package—the collateral trust. In a collateral trust agreement, a single trustee acts on behalf of all of the secured parties—new bank creditors and existing bondholders. A security interest is granted in the borrower's assets for the benefit of all secured creditors. The collateral trust agreement and the related security documents contain explicit rules regarding the nature of the assets pledged, the distribution of the proceeds and control over dispositions and releases. Some transactions implement an equivalent structure more simply through the bank security agreements—with the collateral agent, rather than a collateral trustee, as the beneficiary of the pledge.

Several examples of collateral trust agreements are available publicly, including those for the Allied Waste transaction, the subject of an SEC exemption order, and Solutia Inc., where the collateral trust arrangement figured in bankruptcy litigation. Those examples and others show how in practice the variety of issues encompassed by the requirement to grant an "equal and ratable" security interest have been addressed. A review of available collateral trust agreements shows that while a broad consensus supports the understanding that "equal and ratable" requires a pledge of equal legal rank over the same pool of collateral, with pro rata distribution of proceeds after default and enforcement, there is more disparity with respect to the control rights granted to the beneficiaries of equal and ratable pledges.

Collateral trust agreements also contain evidence of the lack of certainty regarding the meaning of "equal and ratable." The agreements frequently use the phrase "equal and ratable" to describe the nature of the security interest and the manner of application of proceeds. Many contain express affirmations that the agreement effectuates an "equal and ratable" pledge—with the expectation that the repetition of that mantra will make it so.

In the absence of clear legal precedent explaining what "equal and ratable" means, the market seems to have generally accepted the collateral trust and similar structures as ways to address the various potentially ambiguous interpretations. The absence of case law challenging the transactions in which such structures have been used and the acceptance by indenture trustees of such arrangements is the best vote of approval available. ■

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Emerging Markets Shine in a Difficult Year (cont. from page 12)

The majority of fund agreements in both emerging and developed markets include a clawback provision that requires the carried interest recipient to return any excess carried interest it has received. However, if an emerging markets fund sponsor has distributed carried interest to individual team members, it may be time consuming and costly to seek the return of these distributions, particularly if the individual team members are located in one or more developing jurisdictions where obtaining a judicial remedy may be difficult. As a result, investors often consider a clawback provision to be a less effective form of protection for funds in emerging markets than it is for more traditional funds.

Terms: Management Fee

According to a survey of limited partners conducted by EMPEA in 2008, management fees in emerging markets averaged 1.95% per annum as compared to 1.80% per annum for developed markets. This higher percentage is likely the result of a number of factors, including the relative size and vintage of the average emerging markets fund as compared to the average developed markets fund:

- Emerging markets funds are generally smaller than their western counterparts. Funds with aggregate commitments in excess of $1 billion are still rare, and investors almost always seek tighter limits on emerging markets funds' maximum commitments. Investors generally request lower management fee percentages as the size of a fund increases, based on the argument that the purpose of the management fee is to enable the fund sponsor to pay the costs of managing and operating the fund, and not to be a source of profit in addition to the sponsor's carried interest.
- Unlike their counterparts in developed markets that receive management fees from multiple funds, in many cases across a range of products, many private equity firms in emerging markets are in the early stages of development. In fact, many funds that have come to the market in recent years are "first time funds." Firms sponsoring first time funds often rely on a somewhat higher management fee to pay start-up costs and ongoing business expenses, including salaries and rent.

Terms: Oversight and Transparency

Despite the recent growth in the industry, investors remain sensitive to investment risks traditionally associated with emerging markets private equity, including concerns related to the quality and transparency of emerging markets' legal regimes and business practices. Many investors share a concern that these risks mean that investments in less developed markets are more likely to cause violations of laws, regulations, policies or guidelines applicable to an investor. Investors based in the United States, for example, focus on the measures fund sponsors take to prevent violations of anti-money laundering rules and anti-bribery regulations such as the U.S. Foreign Corrupt Practices Act.

Attention to risk management and internal policy guidelines causes many investors to request rights to receive more detailed information about emerging markets funds and their investments than a fund sponsor investing in developed markets would ordinarily be requested to provide.

Additionally, investors in many emerging markets funds seek enhanced rights to monitor the activity of the sponsor as a means of continuing their due diligence on the fund and the specific market. For example, many emerging markets funds have larger and more active advisory committees with rights that check the authority of the sponsor than would be true of a developed markets fund. An investor may also seek advisory committee (or, in certain circumstances, investment committee) representation to bolster their familiarity with how business is conducted and deals are done in a particular market, particularly if the investor is interested in participating in co-investment opportunities or developing an active direct investment program in the market.

Terms: Co-Investment Rights

Access to co-investment opportunities has become a highly negotiated term in private equity funds across all markets in recent years. Half of the investors surveyed by EMPEA last year have negotiated co-investment rights with fund sponsors, and many of these investors reported that securing co-investment rights is an important factor in their decision to commit to a fund. As noted above, some investors participate in emerging markets funds as part of a plan to expand their overall investment activity in a region, either by becoming active direct investors or in some instances sponsoring their own fund products. Co-investments present investors with the opportunity to learn about direct investment in an emerging market without requiring the investors to have the capacity to conduct full-scale due diligence of the target. In this way, co-investment rights dovetail with the rights to information discussed above in enabling investors to continue to learn about the private equity industry in a specific region.

* * *

While the repercussions of the current dislocations in the global markets for emerging markets private equity remain to be seen, it will be difficult in light of increased financial and political risk to sustain the recent pattern of growth in 2009. Nevertheless, it seems likely that increasing numbers of institutional investors will include emerging markets assets in their portfolios and that sponsors of private equity funds investing in these regions will need to continue to work closely with this expanding investor base. ■

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Bridging the Gap (cont. from page 16)

expectations and avoid unintended consequences is to set a cap and perhaps a floor on the earnout payments.

Other Types of Retained Seller Interests in an Acquired Company

In light of the constraints in today's credit markets, even if a seller and buyer agree on the valuation of the target company, a buyer may not be able to raise sufficient funds to pay that amount using traditional debt financing. In such event, sellers may be able to address the issue either by accepting a note issued by the buyer as partial consideration or by retaining a minority equity interest in the acquired company. Like an earnout, the use of seller paper or rollover equity also keeps sellers "invested" in the acquired company, which can be particularly desirable for a private equity buyer that will rely on management sellers to run the business post-closing.

Seller Financing

A "seller note," *i.e.*, a note issued by the buyer to the seller, will typically bear interest, payable in cash or in kind, at a rate similar to that of a bridge loan or a high yield security. Periodic principal payments are not usually made, but instead are due at maturity (a so-called "bullet" payment).

Seller paper that stretches the purchase price is often unsecured and deeply subordinated to other indebtedness of the acquired company, including any third-party acquisition financing. Payments on the note will usually be tightly restricted, with debt service permitted only for so long as there is no default under the senior debt. While such terms are found in most seller financings, in certain circumstances (*e.g.*, if seller paper represents a significant portion of the purchase price), the debt may more closely resemble third-party financing and sellers may have additional rights, such as free transferability (to provide liquidity), restrictive covenants and cross-acceleration and/or cross-default tied to the senior debt. Sellers may tolerate payment limitations for a period of time, especially where there is an attractive interest rate, but they may require that the buyer or the acquired company agree to substitute alternate financing for the seller paper at a specified future date or press for the inclusion of other mandatory redemption rights (*e.g.*, upon a change of control). Sellers who anticipate that a private equity buyer will resell the acquired company during the term of the seller paper or take the company public may request the right to be prepaid or convert the loan into company stock at that time. A buyer may want the right to convert the loan into company stock if it is not able to arrange for substitute financing within a required time period. Sellers may seek the ability to freely transfer the loan to a third party in order to convert it into cash, but a buyer should resist, particularly if seller is also requesting registration rights or if the buyer wishes to offset indemnity claims against payments on the note.

Depending on the structure of the transaction and the characteristics of the seller note, this form of consideration may also provide a seller with installment method treatment for tax purposes and thus the advantage of deferring gain with respect to the portion of the purchase price represented by the note, subject to certain applicable tax limitations.

Rollover Equity

Instead of seller paper, the parties may prefer to use target company stock (or the stock of an upper level holding company) as part of the consideration. This structure could be preferable to a private equity buyer if it wants to reduce overall target company indebtedness. However, a seller should be aware that the equity interests likely will be subject to significant transfer restrictions generally limiting its ability to sell the shares to a third party other than in connection with a sale by the private equity buyer or after an IPO.

Rollover equity can take different forms, ranging from common stock with few rights to preferred stock with a special dividend rate and perhaps mandatory redemption provisions. Where a seller's equity stake in the acquired company is substantial (at least 10-15%), a seller may obtain governance rights such as one or more board seats or veto rights with respect to extraordinary transactions.

When rollover equity takes the form of buyer's stock, tax structuring often becomes crucial. Unless the transaction qualifies for tax-free reorganization treatment, the sellers generally will be subject to tax on the shares they receive even though these shares may be illiquid or subject to transfer restrictions, and taxable gain triggered by the receipt of such consideration would not be eligible for deferral under the installment method. The sellers may insist on a structure that qualifies for tax-free treatment, but this may run counter to the buyer's tax objectives (*e.g.*, the desire to obtain a step-up in basis). If tax-free treatment is not available, tensions may arise when the parties attempt to agree on a value for the buyer's stock for tax reporting purposes, which is desirable to ensure that each side reports the transaction consistently. Sellers may push for a low valuation, but that may not be attractive to the buyer for a variety of reasons, including because the buyer has used or plans to use its stock as currency in other transactions or to compensate management.

* * *

In today's challenging deal market, finding alternatives to easy financing and crisp valuations has never been more important. Through the creative, careful and constructive use of tools such as earnouts, seller financing and rollover equity, deal makers should be able to navigate the complications inherent in using these techniques and still get deals done. ■

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