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Reluctant Matchmaker: The FDIC's Policy on Failed Bank Acquisitions — Friendly Enough for Private Equity?

Introduction

It should be a match made in heaven. The banking sector and private equity would seem, in at least one important respect, to be perfect partners: the former an industry desperate for new capital and the latter flush with capital and short of opportunities to deploy it. And the Federal Deposit Insurance Corp. ("FDIC"), in extending to private equity investors in a small handful of deals the benefit of relatively generous loss-sharing arrangements (pursuant to which the FDIC assumes losses on a specified level of a failed financial institution's loan portfolio), has shown some willingness to encourage this incipient romance. As a result, after the FDIC's July proposed policy statement regarding private equity investment in failed banks was widely criticized as effectively precluding such investment, private equity firms waited to see if the mounting problems in the banking sector and their numerous comments to the July proposal would have an effect.

The FDIC's Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Policy Statement"), released on August 26th, contained some good news for private equity firms. The Policy Statement retreats from several of the most problematic aspects of the July proposal, although it continues to have potentially expansive reach. The Policy Statement's modest good news is coupled with the FDIC's continued willingness to improve the economics for all acquirers of failed banks. In many recent

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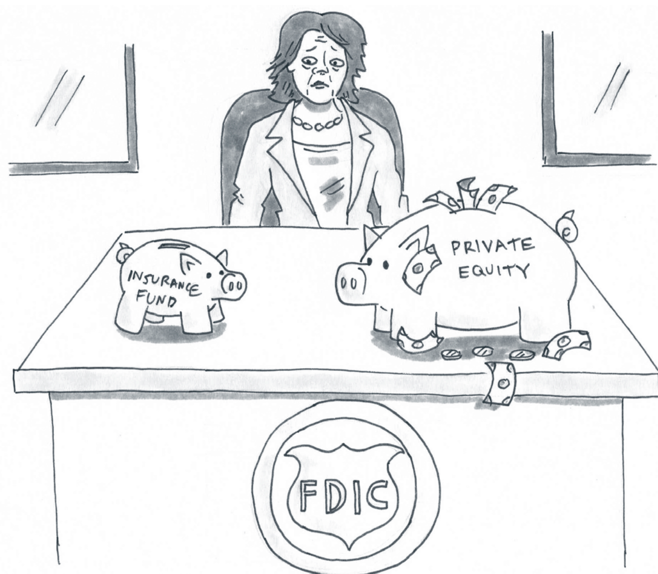

"Which would you bank on?"

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Letter from the Editor

Is it just our imagination, or is the pulse of the private equity community resuscitating? We certainly don't mean to suggest that deal activity is booming or that fundraising is back on track, but we (like many others in the private equity world) see a glimmer of revival. The combination of the number of sell-side assignments, the inflows of capital to high-yield funds, limited partners' lessened concern about potential capital calls and the private equity community's interest in pursuing transactions suggests that the summer doldrums may have ended early this year.

But, the environment has clearly changed. Given the pace of regulatory action, the continued reluctance of banks to provide leverage and the constant uncertainty about valuations, understanding the legal developments and risks of private equity investing and fundraising has never been more important.

In this issue, we highlight a number of areas where the rules of the road have changed. On the cover, we discuss the FDIC's recently released Final Statement of Policy on Failed Bank Acquisitions and focus on both the good and bad news for private investors interested in investing in troubled banks or thrifts. We also tackle one of the most mind-boggling regulations we've seen in a long time in our article entitled "How Green is your Portfolio — Implications of the UK Carbon Reduction Commitment for Private Equity." In that article, we caution private equity investors whose portfolio companies have UK operations that the UK government is serious about carbon reduction and is willing to publicize the energy utilization of private equity organizations and their portfolio companies on its own sort of league table.

If the recent report from the Institutional Limited Partners Association is any indication, governments are not the only ones interested in being agents for change in the private equity environment. In our Alert, Michael Harrell suggests that ILPA's proposed "prefered terms" for private equity go beyond a mere LP "wishlist," and appear to be an attempt to move the market with respect to key economic terms — including carried interest distributions, clawback reserves and calculations and fee sharing — to be more LP friendly.

In our Guest Column, Calvin Reno of Arthur J. Gallagher & Co. shares his thoughts on the current market for management liability insurance and the issues to keep in mind when renewing or structuring comprehensive management liability coverage.

Elsewhere, we highlight some issues that will impact the ability to finance deals in the future, including the way in which changes in GAAP will impact leveraged loan covenants. We also explain that the treatment of mezzanine lenders in recent UK restructurings may impact the future availability and terms of mezzanine financing. The UK restructuring environment is also the topic of one of our Alerts, and we provide a short primer on ways in which the UK restructuring environment is coming to resemble the approach to U.S. bankruptcy.

Franci J. Blassberg
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Rewinding the Clock:

The Impact of Changes to GAAP on Leveraged Loan Covenants[1]

In our last issue, the Guest Column focused on the new M&A accounting standards and their impact on private equity transactions. In this article, we focus on how recent changes to generally accepted accounting principles affect acquisition loan agreements.

If a well-drafted set of leveraged loan financial covenants possess the intricate logic and precision of a Swiss timepiece, their internal mechanism is driven not by a handcrafted or quartz movement, but by generally accepted accounting principles. We are sure it comes as no surprise that the gnomes responsible for crafting these provisions are focused on recent changes in GAAP and their impact on covenant packages. In this credit environment, however, even the most benign tinkering with well-established designs for covenant packages to adjust for reductions in headroom brought about by changes in GAAP are apt to attract more than their fair share of attention.

This article focuses on a number of recent changes in GAAP and their implications for leverage loan covenants, including the application of fair value accounting to outstanding debt instruments, accounting for minority interests, and changes in acquisition-related accounting principles. The thoughtful borrower will soon recognize that dusting off covenants from before the credit crunch for new transactions will not work because not only have the markets changed but so has GAAP. These changes also highlight the benefits of measuring financial covenants in a loan agreement under GAAP as in effect on the date a credit agreement was entered into (affectionately known as "frozen GAAP") as opposed to GAAP as in effect from time to time even though this requires a borrower to keep a separate set of books which can be costly and cumbersome.

FAS 159

Under FAS 159 (effective for years beginning after November 15, 2007), a borrower may, when it enters into a Credit Agreement, choose to apply the fair value option as to that debt.[2] As a result, the value of its liability would be written down from time to time to the extent the debt trades at a discount (and subsequently written up if and when the debt trades back up). This has two consequences. First, the write-down would create non-cash income and the subsequent write-up would create a non-cash loss. Such income (or loss) may or may not impact the Consolidated EBITDA calculation depending on whether or not Consolidated EBITDA excludes non-cash gains or losses (in any event it may be useful to specifically identify such income or loss as a Consolidated EBITDA add-back). Second, the borrower's outstanding debt (*i.e.* the denominator of the leverage ratio) would be reduced to the extent debt trades at a discount, which would result in a boost to its leverage ratio. This would provide a benefit for borrowers whose debt trades at a discount. That being said, the FAS 159 option is irrevocable, and subsequent adjustments to the value of the debt if and when it trades back up would impact both the financial covenants and the earnings per share of the borrower in the relevant periods.[3] Borrowers may not like the resulting volatility.

Lenders who do not want their borrowers to take advantage of this option would need to provide in the relevant Credit Agreement that financial covenants will be calculated in accordance with GAAP without giving effect to any election under FAS 159. It remains to be seen whether or not such a provision will become market practice.

FAS 160

FAS 160 (effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008) changes the method for reporting the share of the net income (or loss) of a borrower's

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1 *The author would like to thank Jillian Griffiths and Jason Waldie from PricewaterhouseCoopers for their helpful comments and suggestions on earlier drafts of this article.*

2 *Credit Agreements existing at the time FAS 159 came into effect were subject to transition rules that permitted borrowers a one-time option to apply fair value accounting to such agreements.*

3 *FAS 159 also requires that debt issuance costs be expensed immediately as opposed to being recorded as a deferred charge and amortized over time. Because this would be an interest expense, it does not impact Consolidated EBITDA but it impacts reported earnings.*

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Rewinding the Clock (cont. from page 3)

less than wholly owned but consolidated subsidiaries that is attributable to third-party interests in such subsidiaries (*i.e.* "minority interests").

Prior to the entry into effect of FAS 160, the "consolidated net income" of a borrower was a number determined after deducting the net income (or adding the net loss) attributable to minority interests. Credit Agreements often added back minority interest expenses for the purpose of calculating the borrower's Consolidated EBITDA on the theory that income from consolidated but less than wholly-owned subsidiaries was available to service the debt of the borrower.

Under FAS 160, the share of consolidated income (or loss) attributable to minority interests will now be reported as "net income (or loss) attributable to non-controlling interests in less-than-wholly owned subsidiaries" on the consolidated income statement of a borrower. More importantly, borrowers will now report two measures of their consolidated net income. The first consolidated net income number represents the entire net income of the consolidated group including the portion of such income attributable to minority interests in controlled but less than wholly owned subsidiaries. The financial statements are then required to separately identify the net income (or loss) attributable to the parent company and the net income (or loss) attributable to non-controlling interests in less-than-wholly owned subsidiaries.

Under FAS 141R, most M&A deal-related costs and expenses, including legal, banking, accounting due diligence and other advisory fees (such as the deal fee paid to a private equity sponsor at the closing of a transaction) will be expensed as incurred. This is a change from the previous rules which permitted many of those costs and expenses to be capitalized.

Because borrowers will now report two measures of their consolidated net income, borrowers and their lenders may want to be specific as to whether the term "consolidated net income" used in the financial covenants refers to a number that (1) includes net income or loss attributable to non-controlling interests in less-than-wholly owned subsidiaries or (2) only includes the net income or loss attributable to the parent company (as was the case before FAS 160). If a Credit Agreement follows the first approach, it is no longer necessary (or appropriate) to add back "net income attributable to non-controlling interests in less-than-wholly owned subsidiaries" for purposes of calculating Consolidated EBITDA.

FAS 141R

Like FAS 160, FAS 141R is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. It applies to all transactions or other events in which an entity obtains control of one or more businesses. Below is an overview of some of the new FAS 141R accounting rules that are relevant to the calculation of financial covenants.

Acquisition-Related Costs and Deal Expenses

Under FAS 141R, most M&A deal-related costs and expenses, including legal, banking, accounting due diligence and other advisory fees (such as the deal fee paid to a private equity sponsor at the closing of a transaction) will be expensed as incurred. This is a change from the previous rules which permitted many of those costs and expenses to be capitalized. The fact that more costs are required to be expensed will reduce the Borrower's "consolidated net income" and hence its Consolidated EBITDA, unless M&A deal-related costs and expenses are specifically added back to "consolidated net income" for purposes of calculating Consolidated EBITDA. While such an add-back was not uncommon under the previous rule for those costs and expenses that borrowers were not permitted to capitalize, FAS 141R creates additional pressure to make sure the add-back is complete, especially if it is subject to a cap. In addition, in Credit Agreements entered into to finance a specific acquisition, the parties will need to determine whether the add-back is limited to the costs and expenses of the acquisition so financed or also applies to the costs and expenses of any future permitted acquisition.

Restructuring Costs

Under FAS 141R, subject to various limitations, restructuring costs generally will be expensed when and as incurred, *i.e.,* potentially over several reporting periods. This is a change from the previous rules which permitted an acquirer to capitalize certain restructuring costs and accrue a liability on the closing date for other anticipated restructuring

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How Green Is Your Portfolio? — Implications of the UK Carbon Reduction Commitment for Private Equity

As the U.S. Congress considers whether to pass legislation curbing emissions of carbon dioxide and other greenhouse gases linked to global climate change, the UK's Labour government has already made its position clear with proposed emissions legislation that, if adopted in its current form, will have broad and potentially costly consequences for private equity funds and their general partners and investment managers.

Two of the most controversial features of the legislation – its imposition of group-level liability and its extra-territorial reach — will be of particular concern to private equity sponsors, as will its price tag, estimated at £830 million for the private equity industry in its initial year. First, one or more UK companies controlled by a common parent, will be grouped together under the scheme with their parent entity(ies) and treated as a single organization with primary responsibility for compliance by each member of the organization resting with the ultimate parent. Second, the ultimate parent will bear such responsibility even when it is not located in the UK. The result: private equity funds organized outside of the UK and potentially their general partners and managers will have direct responsibility – and potential civil and criminal liability – for compliance with the legislation by their UK portfolio companies.

The legislative scheme, known as the "Carbon Reduction Commitment" or "CRC," regulates large non-energy intensive businesses and public sector organizations and is scheduled to come into effect on April 1, 2010. The third round of public consultation on the CRC Order was completed in June of this year, with comments and responses on the draft legislation received on or before June 4. These responses will be considered by the government, which intends to publish a response to the consultation and publish an updated version of the CRC Order. The revised CRC Order will then be sent to Parliament for approval, and will be debated and if necessary amended before becoming law.

While private equity and other affected industry trade associations have been lobbying hard to give the legislation a more industry friendly caste – in the case of private equity, to cut off its application above the portfolio company level – so far there has been little indication of receptivity to these efforts.

How Will It Work?

The CRC will apply to indirect CO2 emissions attributable to the generation of grid electricity and direct CO2 emissions from supplied gas and fuels used by participants in the UK There are two key elements of the CRC Order – a requirement to obtain CO_2 emission "allowances" and an end-of-year ranking and bonus/penalty scheme.

First, the CRC Order will create a "cap and trade" emissions trading scheme in respect of such CO_2 emissions, pursuant to which participants will purchase "allowances" at the beginning of each year (one "allowance" representing the right to emit one ton of CO_2) and, at the end of that year, each participant will be required to surrender allowances equal to the amount of CO_2 emitted by that organization during that year.

During the introductory phase of the CRC (from April 2010 to March 2013) allowances will be sold by the government at a fixed price, expected to be £12 per allowance, with the first sale taking place in April 2011. The government will sell an unlimited number of allowances during this phase and trading in allowances will not be permitted. After March 2013, the number of allowances available for sale will be capped by the government and sold at annual auctions, with purchased allowances being freely tradable by participating organizations.

Second, at the end of each reporting year, a "performance league table" will be produced, ranking each participant based on the emissions reduction performance of all companies in their organization as described below. The rankings are done for all participants in the CRC and are not segregated by industry. Bonuses or penalties

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While private equity and other affected industry trade associations have been lobbying hard to give the legislation a more industry friendly caste – in the case of private equity, to cut off its application above the portfolio company level – so far there has been little indication of receptivity to these efforts.

How Green is Your Portfolio? (cont. from page 5)

will be paid to or incurred by each participant relative to their league table position. And, of course, no company will want to find itself at the top of the penalty table, which there are indications is intended to be used to embarrass participants into better performance. In calculating performance, the UK Environment Agency (the "EA") will not only look at whether a participant has reduced its absolute emissions from the previous period, but will also take into account a participant's growth over the year (and hence its generation of higher emissions) by looking at the relative intensity of its emissions. These metrics are fairly complex and beyond the scope of this article.

The CRC Order will empower the EA to censor publicly and impose fines on organizations that fail to comply with the CRC. The draft CRC Order also includes criminal offenses (punishable by imprisonment for up to three years or an unlimited fine) for knowingly or recklessly providing false information, for attempting to mislead or deceive the CRC administrators or for failing to comply or co-operate with enforcement actions.

According to the CRC Order, the ultimate parent organization of a corporate group will be primarily responsible for its UK subsidiaries and will be required to participate in the CRC on behalf of the group, regardless of its location or legal form, even when it is a foreign general or limited partnership. ...The CRC Order imposes joint and several liability on the ultimate parent, the relevant UK organizations and any intermediate holding entities, even if such ultimate and intermediate parent entities are not located in the UK.

Which Organizations Will the CRC Effect?

A UK organization will be required to participate in the CRC if it consumed over 6,000 megawatt ("MWh") hours of electricity from at least one half hourly meter (a type of electricity meter commonly used by UK businesses) within the UK during the relevant "qualifying period," the first such period being from January 1, 2008 to December 31, 2008. This roughly equates to an annual electricity bill of $850,000. Groups of companies will be treated as one organization, with aggregate electricity use being taken into account when applying the above test.

According to the CRC Order, the ultimate parent organization of a corporate group will be primarily responsible for its UK subsidiaries and will be required to participate in the CRC on behalf of the group, regardless of its location or legal form, even when it is a foreign general or limited partnership. Where a parent organization is based outside of the UK, it will be required to nominate one of its UK subsidiaries or a UK agent to act as "primary member" that will be primarily responsible for compliance on behalf of the group.

The CRC Order imposes joint and several liability on the ultimate parent, the relevant UK organizations and any intermediate holding entities, even if such ultimate and intermediate parent entities are not located in the UK. The purported extraterritorial application of the CRC Order has attracted objections and questions about its ultimate enforceability in many quarters, not dissimilar from the response of many overseas companies to broad assertions of extraterritorial jurisdiction by U.S. regulatory authorities in the securities and other areas. But as a practical matter, the EA would be more likely in the first instance to initiate enforcement proceedings against the nominated UK primary member, and then against the UK-based operations, even though the ultimate non UK parent undertaking would be the "participant" for the purposes of the CRC.

Groups will be determined based on their structure as at the end of the relevant qualifying period. The CRC Order adopts the definitions of "parent undertaking" and "subsidiary undertaking" set out in the UK Companies Act 2006 in order to identify the ultimate parent organization. An ultimate parent organization will therefore be responsible for any UK company, partnership or unincorporated association:

(1) in which it (directly or indirectly) holds or controls a majority of the voting rights;

(2) of which it (or any of its subsidiaries or any person acting on its behalf) is a member and has a right to appoint or

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GUEST COLUMN

Shelter from the Storm:

A Discussion with Calvin Reno of Arthur J. Gallagher & Co. About Management Liability Insurance

Private equity professionals and directors and officers of portfolio companies may face increased litigation and regulatory risk in the current economic environment and should expect difficult negotiations on their next renewal in an insurance market that has been roiled by the financial crisis. To help our readers navigate the insurance landscape, on August 20th, 2009, Calvin C. Reno, Global Managing Director of the Management Liability Division of Arthur J. Gallagher & Co., sat down with Heidi Lawson to share his insights on the current insurance market, claims trends, renewal strategies, and issues to consider in structuring comprehensive management liability insurance.[1]

People often get confused about the differences between directors and officers insurance ("D&O") and fund liability policies such as general partners liability insurance ("GPL"). What are the basic features?

D&O coverage is much narrower than GPL coverage. Portfolio companies purchase D&O policies which cover individuals solely in their capacity as a director or officer of the portfolio company. GPL policies are purchased by fund managers. They provide coverage at the portfolio company level like D&O policies, but also cover private equity professionals in their capacity as a director, officer or manager of the other entities within the private equity fund complex, including general partners, investment managers, and other intermediate group companies. Both D&O and GPL policies cover liabilities such as breach of fiduciary duty, securities claims, and regulatory investigations. However, GPL polices can be further broadened to cover liabilities arising out of failure to provide professional services, controlling person liability, selling shareholder liability, and fund mismanagement.

Ideally, the D&O and GPL policy wording should be coordinated to provide seamless coverage for the broad range of exposures a principal or manager may face. Because D&O and GPL policies typically provide overlapping coverage at the portfolio company level for private equity professionals who sit on portfolio company boards, it is important to structure the policies so that the portfolio company D&O coverage pays first and must be exhausted before payment is required under the GPL policy. This keeps powder dry under the GPL policy to cover claims at the fund level.

When thinking about purchasing D&O and GPL coverage what are the biggest issues management should be concerned with?

Management should focus on indemnification, scope and quality of coverage, and the quality of their insurer.

An individual's primary source of protection is indemnification. There should be a written arrangement with the relevant entity to defend and indemnify that individual in an investigation or lawsuit. The biggest mistake management makes is focusing on insurance first and indemnification second. Managers and directors can find themselves without a right of recovery either under their indemnification arrangements or against the insurer because the company's indemnification obligation is unclear. This often occurs in those non-U.S. jurisdictions where the law relating to indemnification is undeveloped. Also, individuals may find their recovery is limited because the relevant entity lacked assets adequate to fund its indemnification obligations. For a variety of reasons, it may be difficult to use insurance

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Both D&O and GPL policies cover liabilities such as breach of fiduciary duty, securities claims, and regulatory investigations. However, GPL polices can be further broadened to cover liabilities arising out of failure to provide professional services, controlling person liability, selling shareholder liability, and fund mismanagement.

1 *For more information on the interaction between management liability insurance coverage and indemnification, see "Best Planning for the Worst: Assuring Insurance Coverage for Private Equity Sponsors and Portfolio Company Directors in Bankruptcy" in the Fall 2008 issue and "D&O Liability, Portfolio Company Directors and Officers May Need Separate Indeminification Agreements" in the Summer 2008 issue of The Debevoise & Plimpton Private Equity Report.*

Shelter from the Storm (cont. from page 7)

to fill gaps created by unclear or inadequate indemnification, particularly outside of the U.S., where Side A coverage (discussed below) may be difficult or impossible to obtain. Private equity managers should seek and encourage portfolio company management to seek counsel's advice to be sure there aren't any unpleasant coverage traps lurking in discontinuities between their indemni-fication and insurance arrangements.

Scope and quality of coverage are extremely important and can be easily overlooked. All D&O and GPL policies are not the same — either in form or content. Every insurance carrier has its own policy form with its own set of terms and conditions. Companies and funds are structured in a variety of different ways and these variations are seldom addressed by a particular insurer's standard form language. Therefore, each policy must be negotiated and tailored to cover an insured's specific exposures.

Finally, if your carrier is unable or unwilling to pay a claim your insurance becomes worthless. Over the past year several carriers have dramatically changed their underwriting guidelines by reducing limits, altering terms, or completely leaving the D&O and GPL market. The carrier you choose must be well capitalized, committed to writing D&O and GPL policies in good and bad markets, and experienced in paying claims.

The number of insurers willing to write D&O and GPL coverage and the amount of capacity they are willing to devote to this line of business has remained relatively stable over the past year....However, there have been substantial premium increases. Premium increases range from 0% to 45%, depending on the risk. We estimate that premiums are increasing an average of 20% and expect this will continue for at least the next twelve months.

Does a global D&O or GPL policy provide coverage for all international entities?

D&O and GPL policies are usually written to cover claims on a worldwide basis; however, laws often prohibit foreign insurers from covering individuals or assets located within a particular country. For example, under Russian law a non-Russian insurer cannot cover individuals or assets located within Russia. D&O and GPL coverage must be provided by a Russian insurer. There are a long list of countries that have similar laws, including Brazil, China, and Mexico. A thorough review of a company's operations and locations is necessary to assess the need for separate D&O or GPL policies in such countries. The wording of these "local policies" should be coordinated with the global D&O or GPL policy to provide seamless coverage in a cross-border investigation or litigation. Because the legal issues are complex when assessing and covering international exposures, we usually recommend that our clients get legal advice to make sure coverage is appropriate.

What is benchmarking and how is it beneficial?

Brokers use benchmarking to compare certain features of an insurance policy (coverage amount or type) to what is perceived to be the industry standard. We start with information from two data providers, Advisen and Tillinghast. Then, we factor in the experience of our own clients; apply certain proprietary loss models, and consider additional information provided to us by insurance carriers. Because it is very hard to find two private equity firms that have similar exposures, the benchmarking data available is limited and weak. As a result, I go a step further and spend a considerable amount of time conducting a detailed risk assessment of the management liability exposure and provide further insight regarding coverage amount and type. This kind of detailed review provides an opportunity for private equity managers to participate in the risk analysis and, as a result, make a better decision on amount and type of coverage.

In light of the current economic environment, have you seen an increase in the number of claims? In what areas of liability are those claims?

The number of claims has been steadily increasing over the past year. The tightening of the credit markets and growing inability of firms to fund their operations and portfolio companies have led to an increase in the number of bankruptcy-related claims. In addition, we are seeing more deal-related claims from failed transactions and claims against fund managers relating to poor performance of funds.

Have you identified any changes in capacity and premiums within the current market?

The number of insurers willing to write D&O and GPL coverage and the amount of capacity they are willing to devote to this line of business has remained relatively stable over the past year as new entrants or

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Unlocking the Purchase Price Adjustment Puzzle

Purchase price adjustments — typically based on some variant of net working capital — are *de rigeur* in acquisition agreements for private companies and corporate carveouts. Buyers want them to police leakage if the target is not completely sealed off and to avoid "surprise" needs to "prime the pump" or otherwise furnish cash so the business can generate the anticipated cash flow. Sellers often want them as well, either so they can assure themselves of the benefit of operations prior to closing or to extract value from various financing opportunities inherent in the business's current assets and liabilities. In addition, such adjustments provide a handy mechanism for allocating a number of more specific economic items — transactions costs, stay bonuses and various tax benefits.

But purchase price adjustments are nasty, intricate things with lots of traps for the unwary and many opportunities for shifting value. These provisions merit early and systematic attention and have a surprising ability to puzzle even veteran negotiators. In this article we review the basics of purchase price adjustments and then look at how two specific and common fact patterns fare in purchase price adjustment negotiations.

The Basics

At first blush, a working capital adjustment is a simple drafting and accounting exercise — determine the amount by which the sum of current assets (typically excluding cash) minus current liabilities is greater or less than a target, and adjust the purchase price accordingly. Sometimes adjustment provisions start with an estimate of the adjustment at closing to get the numbers pretty close when payments are first made and then true up post-closing. Other times, they just do it all post-closing.

But there's a lot going on under the hood. And buyers and sellers are likely to have pretty different perspectives on all that activity. The seller likely wants to keep the exercise as mechanical as possible — its goal is simply to compare closing date net working capital to the target using exactly the same measurement mechanics and metrics. The buyer, however is usually pleased to have a little wiggle room — an opportunity to challenge accounting practices, claim inventory reserves are too low, and argue about revenue recognition. That disparity of views typically leads to a fairly spirited negotiation of provisions through which the seller seeks to protect itself, for example by tethering the adjustment to specific accounting rules or including language allowing for a readjustment of the target if it wants to add new liabilities or actuarial techniques. In essence, the seller wants to make this a "counting" exercise while the buyer is quite content to let it evolve into an "accounting" exercise.

In addition, there are a surprising number of drafting quirks and pitfalls — how to dovetail the adjustment provisions with any indemnification arrangements in the deal; how to specify the exact moment at which working capital is measured so it captures those aspects of the transaction it is intended to capture and no more; how to narrow and streamline the scope of the inevitable arbitration mechanism; how to deal with disagreements over the pre-closing estimate; and many more.

Two Perennial Problems

Two common issues illustrate the power of working capital adjustments as well as the need to assess and frame the issues early in a negotiation. The first concerns accrued taxes and stems from the mildly remarkable fact that our tax colleagues have persuaded the world that under no circumstances should buyers be responsible for income-based taxes attributable to the pre-closing period. Because we generally approach deals with that in mind, we have an urge to strip accrued taxes out of the working capital adjustment — but what exactly does that mean? Clearly it's not enough to take account of them in setting the target and exclude them in the determination of closing date working capital, because that just makes the buyer pay a positive purchase price increase equal to the amount of the tax accrual in the target working capital number. Therefore, the argument goes, accrued taxes should be taken out of the working capital target as well.

But why? If the company accrues $10 million of taxes per quarter and pays estimates quarterly that means it has an average "float" or free financing for taxes of $5 million. If the goal of the purchase price adjustment is to determine the company's average or normative working capital needs, why shouldn't that financing opportunity be taken into account? What is it about the fact that it happens to be a tax liability that leads to a different result?

This is a pretty common debate, and one that can be expanded to other liabilities and to quirkier working capital issues (for example, if the working capital target for some negotiated reason includes projected growth in accounts receivable, there is a strong argument that a tax provision should also be included in the determination for that target). There are a number of ways of thinking about and

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Unlocking the Purchase Price Adjustment Puzzle (cont. from page 9)

negotiating these "tax target" type issues and all of them benefit from an early effort to see if this will be a significant issue in the deal in question and, if so, to characterize and structure the debate in a way that increases the likelihood of prevailing.

The second example arises frequently in the purchase of businesses (such as investment management or personal services businesses) that defer until the end of the year a substantial amount of their compensation expense — usually in the form of bonuses. In such a situation, the seller might well structure the transaction using for target working capital the amount at December 31, which, let's assume, would include as a liability the prior year's $100 million in bonuses. Assuming a debt-free/cash-free structure and a closing date at the end of the first quarter, the buyer could well find itself faced with a $75 million purchase price increase because of the positive working capital adjustment (the prior year's bonus will have been paid and the accrual for the current year would only be $25 million).

The buyer's first reaction is likely to be that it should not have to pay, directly or indirectly, any amount in respect of pre-closing bonus accruals and that the accruals should be yanked out of the target balance sheet to achieve this result (sounds a little like the tax argument). The theory would typically be that these bonuses related to earnings on the seller's watch from which the seller benefited. While that is all true, just about every liability on the closing or the target balance sheet relates to earnings on the seller's watch and therefore this argument can be tough sledding. Moreover, the seller forcefully makes the contrary argument, which is that the free financing inherent in the bonus arrangement is an immutable characteristic of the current asset and liability cycle of the business and is a serious asset that reduces the cash required to generate earnings.

A second way to discuss the issue is not to argue about inclusion of the bonus liability from the start, but rather to assert that that accrual should be included at an average level rather than at that its maximum, December 31 level. This, in our experience, is a not uncommon way of equilibrating working capital issues (and on our facts would reduce the upward purchase price adjustment to $25 million). It effectively concedes the seller's logical point but asserts that the value of the financing opportunity is the average balance, not the minimum balance (which certainly does seem more nearly right).

It's worth noting that there really is not a right or wrong answer to the bonus question — it just depends on where you sit. Seller is saying "you are buying a business that allows you to pay last year's bonus out of next year's income — all you need to do is draw down your revolver at bonus time and then pay it back the next year. That is what I have always done and it is what you will do post-closing." And buyer is saying the reverse: "you got the earnings, you should pay your bonuses and I will pay mine" (although in reality buyer will presumably do exactly what seller says — that is, he will draw down on his revolver to pay the purchase price, pay it back as cash flow comes in and then draw it down again at bonus time).

Once the bonus issue has become part of the working capital debate it becomes, in our experience, difficult to extract it from that debate, and splitting the difference through some form of average working capital target becomes irresistible. A buyer determined to obtain maximum value would therefore be well-advised from the very outset to exclude bonus accruals from the entire working capital mechanism and insist that they should be treated as debt. Sometimes an early assertion of that position will simply carry the day without further explanation. And sometimes it's necessary to argue either that bonus accruals just feel more intimately related to prior earnings than other expenses, or that the ability to so defer compensation may not be an enduring feature of the business model.

Conclusion

A myriad of issues, many quite fact specific, should shape the parties' views of the best way to structure and negotiate a particular purchase price adjustment. The side that masters those issues early and proposes a structure that channels the negotiation in a felicitous direction (from its perspective) can often extract real value from the process. There are, in short, many "right" answers to the issues that arise in the negotiation of working capital adjustments, but, depending where you sit, some are more right than others. ■

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Convergence, Part 2:

Have Strategic Buyers Begun to Replicate PE-Style Management Equity Arrangements?

In the Spring 2009 edition of *The Debevoise & Plimpton Private Equity Report,* we discussed the growing use by strategic buyers of reverse termination fees and suggested that this trend could help private equity bidders in auction settings by eliminating the historical advantage strategic buyers have had with respect to deal certainty. While not yet a trend, we are now observing some examples of strategic buyers utilizing another mainstay of private equity transactions in structuring their acquisitions: management equity incentives at the level of the target (as opposed to at the strategic buyer itself, which is the usual form of equity incentive in strategic deals). Unlike reverse termination fees, however, the use by strategic buyers of the kind of management equity incentives often used by sponsors, could be competitively disadvantageous to PE firms by reducing the historical advantage PE sponsors have had with respect to wooing management of a target with attractive equity arrangements.

Management Equity Arrangements in Private Equity Deals

As our readers know well, management of a target in a typical private equity acquisition usually acquires or retains an equity interest in the target. Management's equity is a "pure play" — that is, because the private equity firm is not combining the target with a larger business venture, the value of the equity relates solely to the target's business and assets. This structure is designed to ensure that the target's management has "skin in the game" and to thereby align management's economic interests with the interests of the investors. To further align management's and investors' interests, management equity programs are designed with a focus on the private equity firm's exit, usually through a private sale or a public offering. For example, vesting conditions, including IRR hurdles, encourage an exit within the private equity firm's investment horizon; transfer restrictions lapse only upon an exit; and other liquidity restrictions prevent an executive from converting equity to cash before the private equity firm does so.

While management equity incentive programs in private equity deals differ widely, they do share some commonalities, including:

- The size of the management equity pool usually falls within a range of 5% to 15% of the equity value of the portfolio company.
- Management typically purchases the target's equity with cash, by "rolling over" stock of the company that they currently own or with other deferred compensation.
- Financial sponsors may also cause the target to help executives finance their investment in the target's equity with loans or loan guarantees especially in non-public companies.
- Target equity that is purchased (using one of the methods mentioned above) is typically fully "vested" when it is acquired.
- In addition to the purchased equity, management may also receive equity awards, such as restricted stock or stock options, that are subject to vesting. Vesting for this "free" equity is typically time-based, or performance-based, or both, and varies widely among PE firms. Common vesting schedules include vesting tied to continued employment for a number of years (typically three to five years) and/or the achievement of performance goals or the attainment of certain rates of return to the private equity sponsor upon an exit event.
- On termination of employment prior to the PE firm's exit, all of an executive's equity is usually subject to repurchase by the company or the financial sponsor. The price paid on exercise of this call right usually depends on the reason for the

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Unlike reverse termination fees...the use by strategic buyers of the kind of management equity incentives often used by sponsors, could be competitively disadvantageous to PE firms by reducing the historical advantage PE sponsors have had with respect to wooing management of a target with attractive equity arrangements.

Convergence, Part 2 (cont. from page 11)

termination, with "good leavers" typically receiving more for their equity than "bad leavers."

Other common features of management equity incentive programs include transfer restrictions (with exceptions for estate planning purposes and exercises of puts and calls), and drag-along or tag-along rights. In addition, management may have limitations on voting and other rights depending on circumstances.

Management Equity Incentives in Strategic Deals

The types of management equity arrangements described above have not been customarily used in strategic deals for a number of reasons.

First, strategic buyers, unlike PE firms, often do not view themselves as buying a management team along with the target business and often have no special need to retain an existing management team. Simply put, they often believe they have the know-how to run the target company as well as or even better than the target's management. Thus, maintaining management may not be an important concern of a strategic buyer.

Second, unlike private equity investors, who typically have an investment horizon of five to seven years, strategic buyers tend to buy targets with the intention of owning the target indefinitely and/or integrating the target into their company group. As a result, an equity package for management that is monetized only upon a liquidity event of the target is of uncertain value to management and can be cumbersome for a strategic buyer to structure.

Third, even in those circumstances where a strategic buyer does wish to retain some or all of a management team, the strategic buyer often has no desire to offer the management team a "pure play" on the target's equity. Often, the buyer intends that the executives of the target provide value to the buyer's business as a whole rather than simply increase the equity value of the target company, and its equity awards are structured accordingly.

Fourth, strategic buyers often have committed credit lines and significant internal cash or stock that they may use as currency in the deal. Strategic buyers therefore do not need to "finance" any portion of the deal with target equity in the way sponsors sometimes do in order to fill out their capital structure and reduce their equity check.

And fifth, strategic buyers have been hesitant to accept the fiduciary duties and other limitations and obligations associated with having a minority investor in one of their subsidiaries. These can be significant and include, for example, limitations on transactions between the parent and the target (because the interests of minority shareholders must be taken into account by the board of the subsidiary); thorny accounting and financing issues relating to non-wholly owned subsidiaries; access to target financial statements by the minority shareholders (including following their termination of employment); and, in some cases, dissenters' and appraisal rights in certain exit transactions.

The... broad distinctions between private equity investors and strategic buyers [regarding management equity] may be blurring as the deal market evolves — in particular to the extent strategic buyers' stock prices continue to decline and their access to liquidity continues to dwindle.

A Blurring of the Lines

These broad distinctions between private equity investors and strategic buyers may be blurring as the deal market evolves — in particular to the extent strategic buyers' stock prices continue to decline and their access to liquidity continues to dwindle. In one recent strategic deal, for example, the key executive of the target company acquired an interest in the target that resembles a management equity incentive program in a private equity deal. The primary reasons for this arrangement were that the executive is expected to be vital to the continued success of the target company and he is not expected to produce much, if any, value for the buyer (other than through the future success of the target). Accordingly, his compensation is linked directly to his performance and the target's equity value. Moreover, perhaps familiar with the attractive incentives that executives have long received from financial sponsors, the executive wanted to receive a private equity-like incentive package.

The principal terms of the arrangement are as follows:

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Recent Developments in the English Restructuring Market May Leave Mezzanine Lenders Out in the Cold

Mezzanine lenders are increasingly finding themselves without a seat at the table in UK restructuring proceedings and with no value for their loans at the end of the process. This trend could chill mezzanine lending in the UK long after the credit markets otherwise begin to thaw.

Before the economic downturn, a UK private equity portfolio company in financial difficulties was often able to agree on an informal restructuring with its lenders rather than enter formal insolvency proceedings. With the recognition by lenders in the current cycle that much of their debt may be written off, even in a consensual deal, formal processes have become more common in the UK. The pre-packaged administration (or "pre-pack") and the scheme of arrangement have been the most controversial, with lower-ranking creditors — both secured and unsecured — not only wiped out, but excluded from the process if the senior debt exceeds the value of the company as a going concern.

Although mezzanine debt holders have been increasingly vocal about how pre-packs and schemes of arrangement disadvantage them, the UK courts have shown little sympathy, with the High Court's recent and much anticipated decision in the *IMO Car Wash* case dealing a further blow to mezzanine lenders. Recognizing how UK insolvency procedures work is important to understanding the mezzanine lenders' mindset.

Pre-Packaged Administration

If a court grants an application for administration of an insolvent company, it appoints an administrator (a licensed insolvency practitioner) whose priority is to rescue the company as a going concern. Only if this aim is not reasonably achievable is the insolvency practitioner able to liquidate the company — either to achieve a better result for the company as a whole than would be likely if the company were wound up without going into administration or to dispose of property for the benefit of one or more secured or preferred creditors.

In a pre-packaged administration, the court-appointed insolvency practitioner works with the directors and some of the creditors of the company (typically the most senior lenders) to arrange implementation of a sale. The sale is often to a new, special-purpose acquisition company controlled by the senior secured lenders and former managers and other security holders of the insolvent company,

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Proposals for Insolvency Law Reform

In June, the UK Insolvency Service published a consultation paper which contains a number of proposals aimed at facilitating corporate rescues and which, if adopted, will align UK practices more closely with those used in the U.S. There are two key proposals.

The first is to extend the moratorium on enforcement of security and commencement and continuation of proceedings which may currently be enjoyed by small companies under a Company Voluntary Arrangement[1] to large and medium companies. If extended, large and medium companies would be able to apply for either (1) an out-of-court 28-day moratorium if an insolvency practitioner will state that the CVA has a reasonable prospect of success and of being approved by 75% in value of the creditors or (2) a three-month court sanctioned moratorium, if, in addition to the statement from the insolvency practitioner, the company is able to satisfy the court that it is unable to or likely to become unable to pay its debts within three months of the hearing and the moratorium is in the best interests of the creditors as a whole. This proposal has been received with interest by practitioners in the English market as the three-month court sanctioned moratorium is similar to a U.S.-style debtor-in-possession proceeding. There is a concern, however, as to whether in practice the CVA process is compatible with the complex finance arrangements that larger companies usually have in place.

The second proposal is to facilitate the provision of rescue finance to companies in administration by introducing legislation to provide super-priority and security rights to lenders of such finance and to override negative pledge clauses, thus introducing the DIP financing concept familiar in the U.S. market to England. This proposal may raise particular concerns among lenders in existing secured transactions whose position could be undermined. There has been speculation that, going forward, lenders may increase their pricing and adjust their risk models to recognize the uncertainty that these proposals introduce. Sponsors, however, may embrace the proposals as it may make it easier for them to improve their negotiating position and rescue a company as a going concern by providing new money which would rank ahead of the claims of the existing secured creditors. ■

[1] *A scheme whereby a company can propose a compromise or other arrangement with its creditors and which is implemented under the supervision of an insolvency practitioner. The arrangement is binding on creditors if the relevant majorities vote in favor of the scheme at properly convened meetings of creditors and shareholders.*

leaving the liabilities in the existing company. This makes a pre-pack attractive to purchasers and those secured creditors whose interests are above water, but very undesirable for more junior secured creditors and unsecured creditors.

Although not a new phenomenon, pre-packs became increasingly attractive in recent months as creditors' exit options became more limited, focusing a spotlight on the fairness of the process. While pre-pack proponents point to the relative speed of the process, maintaining that this results in less value destruction for a distressed company than other restructuring alternatives, critics of the pre-pack technique make a number of arguments:

- The value of the asset may not be fully exploited as the pre-pack is a "done deal" as a result of which other avenues for achieving value are cut off.
- Because standard intercreditor arrangements in the UK market contain enforcement standstills and rights for the security agent to release security, there is no transparency for subordinated secured creditors, who can be excluded from the administration process and left simply with a claim against an insolvent company with no assets.
- Administrators do not have to obtain the approval of the courts or the other creditors (although the right of other creditors to bring an action against the administrator in certain circumstances means that the administrator is likely to obtain legal advice before agreeing to a pre-pack).
- A pre-pack to the former managers of the insolvent company amounts to the creation of a "phoenix" company — an ostensibly new company with the same assets, management and, often, similar name as the former company — a practice which is prohibited under English law.

Although mezzanine debt holders have been increasingly vocal about how pre-packs and schemes of arrangement disadvantage them, the UK courts have shown little sympathy, with the High Court's recent and much anticipated decision in the IMO Car Wash case dealing a further blow to mezzanine lenders.

In an attempt to address some of these concerns, a Statement of Best Practice for Insolvency Practitioners (which includes administrators) was issued in January 2009, focusing on transparency and disclosure. Although not legally binding, an administrator may face regulatory or disciplinary proceedings if the Statement is not followed. Essentially, the Statement requires that the administrator maintain detailed records which demonstrate that it has considered the duties and obligations owed to creditors in the pre-appointment period as well as explain and justify why a pre-pack was undertaken. These guidelines are being monitored by the Insolvency Service, and the House of Commons' Business and Enterprise Committee has indicated that if they do not prove effective, more radical action will be taken.

An English court recently considered the merits of a proposed pre-pack in light of the Statement of Best Practice and held that the court must consider the merits of an intended sale in deciding whether to make an administration order, in particular whether the transaction is in the best interests of the creditors as a whole.[1] In two recent cases arising from the administration of Lehman Brothers International (Europe)[2], however, the decisions reflected the courts' traditional reluctance to interfere in the conduct of an administrator's work or to give special treatment to individual creditors, suggesting that the English courts will continue to give significant deference to administrators decisions in pre-packs.

Schemes of Arrangement

A scheme of arrangement is another method to "cram down" minority creditors. A scheme of arrangement can be used for many purposes under English company law, but in the context of a company facing insolvency, it is a compromise between a company and its members or creditors (or any class of them) for the purpose of avoiding liquidation. If approved by a majority in number who represent at least three-quarters in value of the creditors (or any class of creditors, if relevant) who vote at the meeting to approve the scheme, the scheme binds all of the parties to the scheme. Once agreed, the company's assets

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1 *Kayley Vending Ltd, Re Insolvency Act 1986 [2009] EWHC 904 (Ch).*

2 *RAB Capital Plc and RAB Capital Market (Master) Fund v. Lehman Brothers International (Europe) [2008] EWHC 2335 and Re Lehman Brothers International (Europe) [2008] EWHC 2869 (Ch).*

Whipsaw Claims and Wage and Hour Suits:

Potentially Expensive Employment Liabilities to Watch for in Litigation Diligence

Dealmakers beware: employment practices that may appear to be innocuous can ring up serious damage awards if they involve the failure to fully compensate a whole class of employees over long periods of time. In a number of recent transactions, we have come across two types of claims that fall comfortably within this description: so-called "whipsaw" claims under ERISA and "wage and hour" suits in California. Successful class-based claims in either of these areas can result in liabilities in the tens or even hundreds of millions of dollars, so dealmakers are well advised to include a thorough assessment of such risks in their diligence checklists.

Whipsaw Claims

Whipsaw claims are a potential concern for companies that sponsored cash balance retirement plans at any time prior to the legislative reform in the Pension Protection Act, which became effective on August 17, 2006.[1] The claims arise from a standard feature of cash balance plans giving a participant in the plan the right, upon termination of employment, to a distribution of his or her accrued benefits in the plan.

Under a traditional defined benefit pension plan, benefits are paid periodically after an employee retires, with the size of the payments based on a formula that usually includes factors such as length of service and the employee's salary or wages at the time of retirement. Benefits in cash balance plans, however, are based on the balance of the employee's notional "account" under the plan, which builds up during the employee's tenure. At retirement, a participant can choose to have his or her account paid out in the traditional manner, as annuity or a series of installment payments following retirement, or as a lump-sum payment. He or she may elect to receive such payment immediately after employment ceases, whether in the context of retirement, a voluntary termination or involuntary termination. Employees who took pre-Pension Protection Act lump-sum payouts, however, are in some cases entitled to an amount—known as a "whipsaw" payment—in excess of their account balance calculated as described below. If whipsaw payments were not made to the employee, or were not properly calculated, participants may sue the plan to recover the unpaid amounts. In certain circumstances — where the terms of the plan involved are generous and a substantial number of participants are affected — the resulting liabilities can be substantial.

The Whipsaw Calculation

As noted above, cash balance plans maintain notional accounts for participants. A participant's account balance is equal to the credits made to his or her account by the employer. Employers are required to give two types of periodic credits to participant accounts: fixed contributions for the employee's service during a given period, and "interest" credits, which represent a notional return on the participant's existing account balance during that period. The amounts of credits are calculated in accordance with the rules of the plan. Service credits are typically defined as a percentage of the employee's salary for the given period; interest credits may be based on a fixed rate or tied to other non-discretionary metrics such as, for example, the ten-year treasury rate or the investment return on assets in the pension trust fund.

Under ERISA, employees have a legal right to receive their accrued benefit under a pension plan regardless of the date of, or reason for, their departure. For defined benefit plans, the value of a participant's accrued benefit is required to be calculated by reference to his or her normal retirement date.[2] As a result, payments received by a participant who leaves must equal, at a minimum, the present value of

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…[E]mployment practices [such as so-called whipsaw "claims under ERISA" and "wage and hour" suits in California] that may appear to be innocuous can ring up serious damage awards if they involve the failure to fully compensate a whole class of employees over long periods of time.

1 *After the Pension Protection Act of 2006 was enacted, the IRS issued Notice 2007-06 confirming that lump-sum payouts would not violate ERISA if they were equal to the employee's notional account balance at the time of departure — essentially eliminating the whipsaw payment. This change applies to payouts made after August 17, 2006.*

2 *Despite having readily assessable account balances, which are reminiscent of defined contribution plans, cash balance plans are considered by ERISA to be defined benefit plans.*

Whipsaw Claims and Wage and Hour Suits (cont. from page 15)

the payments that the participant would be entitled to receive at his or her normal retirement date, using a discount rate prescribed by ERISA.

The "whipsaw" problem arises when the present value of the lump sum payment an employee would be entitled to receive at normal retirement exceeds the value of his account balance. This may occur because the courts have determined that a participant's accrued benefit includes not only his or her current account balance, but also the right to receive future interest credits on that account balance, and the interest credit rate under the plan may be greater than the discount rate used to present-value an accrued benefit. A participant who departs from a cash balance plan and takes a lump sum is entitled, in addition to his or her account balance, to the present value of the interest credits that would have been credited to his or her account through normal retirement age. (At termination, employees who don't take lump sums typically cease to receive additional service credits but continue to receive interest credits on their existing balances.) This accrued benefit is considered non-forfeitable, and exists regardless of the reason for the employee's departure.

To illustrate, the present value discount applied to the lump sum payment is required by ERISA to be the 30-year treasury rate. If a plan's established rate of return is also equal to the 30-year treasury rate, then the present value of the future returns under the plan is zero, and the employee is entitled to only her account balance upon departure. However, many cash balance plans provide for a rate of return that is, or is likely to be, higher than the 30-year treasury rate, in which case the employee is entitled receive her account balance at the time of departure plus a whipsaw payment, which together total the present value of her accrued benefit that would be payable at normal retirement age under the plan. The amount of the whipsaw payment is equal to the total of the "interest" credits that would have been made from the date of departure until the employee's normal retirement age, discounted using the prescribed rate. Where the plan provides for a variable rate of return, the calculation necessarily involves estimating future rates. In the context of a whipsaw suit the district court will likely be deciding the proper estimate of the future rates of return.

Most people in the deal business know to avoid the Texas courts but not as many recognize that buying businesses with large numbers of employees in California can impose potentially expensive risks.

Wage and Hour Claims

Most people in the deal business know to avoid the Texas courts but not as many recognize that buying businesses with large numbers of employees in California can impose potentially expensive risks. California's labor law requires strict compliance with the fairly complex rules governing employees' rest and meal breaks, and other circumstances involving unpaid work. Class-action suits based on non-compliance with these rules, known as "wage and hour" suits, have, in many cases, led to very large settlements. These cases received national media attention in 2005 when a jury awarded plaintiffs $172 million in a case against Wal-Mart for failing to provide adequate meal breaks (thus prompting a painful number of "no free lunch in California" headlines).

The question of whether an employer is required to ensure that adequate breaks are being taken — as opposed to merely making them available — is currently pending before the California Supreme Court. The outcome of this case, *Brinker v. Superior Court*,[3] could require large employers to make major enhancements to their policies and compliance procedures.

A ruling in favor of the employers in *Brinker*, however, will not change the fact that in most wage and hour suits the employer bears the burden of proving adequate compliance. To guard against costly litigation, companies must adopt internal policies which reflect current law, monitor their own compliance, and make sure that accurate and thorough records of employee's hours are kept.

The Employer's Obligations

California's labor code requires that employees working more than five hours per day be provided with an uninterrupted 30-minute meal break that is free of any work duties. An employer and employee may waive the meal break by mutual consent only if the total work day is no more than six hours. If an employee works ten hours per day, he or she must receive a second uninterrupted 30-minute break period. This second meal period may be waived by mutual

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3 *80 Cal. Rptr. 3d 781 (2008).*

Good News for Selling Shareholders Worried About Fraudulent Conveyance Risk

Two recent U.S. appellate court decisions suggest that the old real estate adage — Location! Location! Location! — may apply equally to leveraged acquisitions, at least when it comes to insulating such transactions from fraudulent conveyance risk. The decisions by the Sixth and Eighth Circuit Courts of Appeals make clear, in those jurisdictions at least, that payment of deal consideration through a qualifying financial institution protects such payments under Section 546(e) of the U.S. Bankruptcy Code from subsequent challenge as a fraudulent conveyance, even in a private sale transaction.

Well-counseled investors selling shares in a leveraged transaction know well the risk of a later fraudulent conveyance action under Section 548 of the Bankruptcy Code or comparable provisions of state law. Once a company files for bankruptcy protection, the debtor-in-possession may seek recovery of the purchase price of the shares, even years after the closing of the transaction, where the acquired company at the conclusion of the transaction was insolvent, left with an "unreasonably small capital" or intended to incur or believed that it would incur debts beyond its ability to pay.

For some time, investors that sold their equity position through the public markets have often been able to use Section 546(e) of the Bankruptcy Code to fend off such suits. Under Section 546(e), which was enacted "'to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries,'"[1] the debtor-in-possession "may not avoid a transfer that is a...settlement payment...made by or to a...stockbroker, financial institution, financial participant, or securities clearing agency that is made before the commencement of the case." Since Section 546(e) was modified in the 1980's to expand its reach, the courts have regularly held that transfers in publicly-traded securities in the context of a leveraged buyout are protected by the provision.[2]

Until recently, however, it was far from clear that Section 546(e) applied to cash or other consideration received in LBOs involving privately traded securities. In recent months, however, the Sixth Circuit (with jurisdiction over Kentucky, Michigan, Ohio, and Tennessee) and the Eighth Circuit (with jurisdiction over Arkansas, Missouri, Iowa, Nebraska, the Dakotas and Minnesota) have each ruled that Section 546(e) protected sell-side parties who received cash payments through a "financial institution" in connection with an LBO.

In the Sixth Circuit case, *In re QSI Holdings, Inc.*,[3] the court addressed cash payments received as consideration by individual shareholders and employee participants in the company's Employee Stock Ownership Trust, and who, as part of the 1999 merger of Quality Stores, Inc. into Central Tractor Farm and Country, Inc., had received payments through the buyer's exchange agent, HSBC Bank USA.[4] In the Eighth Circuit case, *Contemporary Industries Corp. v. Frost*,[5] the court considered fraudulent conveyance claims against former owners of a privately-held Nevada corporation who had received a $26.5 million payout facilitated by First National Bank of Omaha under an escrow agreement governing a buyout of their equity interest.[6]

In both cases the appellate panels relied on the definition of "settlement payment" set forth in Section 741(8) of Title 11, namely, a payment "commonly used in the securities trade" and held that Congress intended the exemption to reach broadly to include cases such as "a common leveraged buyout involving the merger of nearly equal companies."[7] In so doing, the Sixth and Eighth Circuits rejected or distinguished most of the law developed on this subject in the United States District Courts.

Although the law in this area remains unsettled, with most of the courts of appeals having yet to weigh in, the recent Sixth and Eighth Circuit rulings provide substantial comfort to sell-side parties in those jurisdictions, and suggest that sell-side parties in leveraged transactions nationwide should work with counsel to ensure that payments flow through a qualifying financial institution and thereby arguably fall within Section 546(e) — at least until the Supreme Court of the United States steps in and finally settles the matter. ■

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1 *Kaiser Steel Corp. v. Charles Schwab & Co., Inc., 913 F.2d 846, 848 (10th Cir. 1990) (citing H.R. Rep. No. 420, 97th Cong., 2d Sess 1, reprinted in 1982 U.S. Code Cong. & Admin. News at 583).*

2 *Id.*

3 *2009 WL 1905237 (6th Cir. July 6, 2009*

4 *Id. at *1.*

5 *564 F.3d 981 (8th Cir. 2009).*

6 *Id. at 984.*

7 *2009 WL 1905237*4 (citing and quoting Contemporary Industries, supra).*

Rewinding the Clock (cont. from page 4)

charges. Similar to the discussion of M&A deal costs and expenses above, the increase in the amount of restructuring costs required to be expensed makes it important to review whether or not Credit Agreements permit the relevant restructuring costs to be added back to Consolidated EBITDA. In addition, the add-back to Consolidated EBITDA, if any, would now need to be drafted with sufficient flexibility to be applicable for the periods during which such costs are expensed.

Contingent Consideration and Earn-Outs

Under the previous rules, contingent purchase price payment obligations ("earn-outs") payable in connection with an acquisition were added to the purchase price and therefore did not flow through "consolidated net income." This is no longer the case. Indeed, the new rules require that earn-out payment obligations that are to be paid in cash be recorded as a liability at their fair value on the closing date and marked to adjusted fair value in subsequent reporting periods. This has two consequences. First, changes in the estimated fair value of the earn-out payment obligation will flow through "consolidated net income" (on the date of payment, however, unless there is a need to true up the amount of the earn-out, the payment will not be an expense that flows through consolidated income but rather a payment of a previously recorded liability which is neutral from an income point of view). Borrowers should consider the impact of adjustments to earn-out payment obligations on the calculation of Consolidated EBITDA and whether a specific add-back (for instance as an item resulting from the application of the purchase accounting rules) is appropriate. Second, the treatment of an earn-out payment obligation as a liability increases the amount of debt taken into account in computing the leverage ratio under those Credit Agreements that compute the leverage test by reference to all indebtedness of the borrower that is reported as a liability under GAAP (it is neutral, however, under those Credit Agreements that compute the debt portion of a leverage ratio by taking into account only indebtedness for borrowed money).

Under the previous rules, contingent purchase price payment obligations ("earn-outs") payable in connection with an acquisition were added to the purchase price and therefore did not flow through "consolidated net income." This is no longer the case.

Bargain Purchases

Under the new rules, an acquisition (such as a distressed acquisition) could create a boost to Consolidated EBITDA to the extent the fair value of the acquired assets exceeds the purchase consideration. Indeed, the new rules require the excess of the fair value of the acquired assets over the purchase price to be recognized as a gain in current period's earnings. While Credit Agreements often carve out from the Consolidated EBITDA calculation gain on sales of assets or businesses (other than in the ordinary course of business), it is less frequent to see a carve-out for gains resulting from the acquisition of a business. This may unexpectedly turn one bargain into two for the wise acquirer.

IP R&D

Intellectual property research and development ("IP R&D") that is acquired in an acquisition used to be written off on the day following the completion of such acquisition. It is now recorded as if it had been developed by the acquirer. As a result, the acquirer will at some point, potentially long after the closing of the relevant acquisition, determine whether the acquired IP R&D has value (in which case the acquirer will turn it into an asset) or not (in which case the acquirer will expense it). Expensing the acquired IP R&D would reduce "consolidated net income" and therefore potentially impact the calculation of Consolidated EBITDA. Borrowers may want to specifically identify acquired IP R&D expenses as an item that is added back to Consolidated EBITDA.

* * *

The changes discussed above may or may not impact existing Credit Agreements depending on (1) when the relevant Credit Agreement was entered into and (2) whether it contemplates that financial covenants will be determined based on GAAP as in effect on the date the Credit Agreement was entered into, or GAAP as in effect from time to time. These changes will inform the structuring of covenant packages for newly negotiated Credit Agreements and may also be the impetus for some amendment requests. The thoughtful borrower has already recognized that recycling covenants from before the credit crunch for new transactions will clearly not work as the credit markets revive – not only have those markets changed but so has GAAP. ■

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remove the majority of the board of directors;

(3) over which it has the right to exercise a dominant influence;

(4) over which it (directly or indirectly) has the power to exercise, or actually exercises, dominant influence or control; or

(5) that is managed on a unified basis with such parent undertaking.

Any UK subsidiary that would have qualified for the CRC in its own right (*i.e.*, its UK operations consumed more than the 6,000MWh threshold) will be classed as a "principal subsidiary," and the participating parent undertaking may have additional reporting obligations in respect of that "principal subsidiary."

What Are the Ramifications for Private Equity Sponsors?

The concept of ultimate parent responsibility was incorporated into the CRC Order in order to simplify administration and reporting procedures and to achieve maximum coverage. This reasoning makes sense for large operating companies with numerous integrated operations in the UK, and group reporting may simplify the administrative burden. However, private equity funds usually invest on a short- or medium-term basis in a wide variety of businesses often with little or no integrated operational relationships. Portfolio companies of a private equity fund are not considered a "group" in the conventional sense, and indeed are not usually treated as such for tax purposes.

The government, however, has stated that it will not afford special treatment to private equity funds or venture capital firms. In its March 2008 consultation document, the Department for Environment Food and Rural Affairs confirmed that a specific derogation for private equity and venture capital firms had been investigated, but that it would present "significant legal difficulties" as such firms do not differ structurally or constitutionally from other entities.

More recently, the British Venture Capital Association has advocated, among other things, applying UK generally accepted accounting principles in determining the existence of a group for purposes of the scheme, correctly arguing that such an approach would bring the CRC in line with the standards applied under other regimes such as tax and accounting. Again, however, it is unclear whether this approach will gain any traction.

Unless a workable modification or exemption can be proposed on behalf of the private equity industry and agreed by the UK government, it is likely that private equity firms will have to comply with the CRC, provided that the usage threshold is reached by its UK entities as a whole.

The chart below provides a general summary of the entities that will be included in the operations for which a fund or its general partner or manager will be responsible under the CRC Order.

Within the Fund, Who Is Responsible?

If implemented in its current form, the CRC Order will impose responsibility on the person ultimately controlling the relevant UK operations. In some cases, control may be exercised by one or more individuals, who would not carry liability under the CRC Order as the CRC only applies to "undertakings" (unless of course that individual is guilty of one of the criminal offenses, whether directly or as an officer of a guilty undertaking). Each fund structure will need to be reviewed carefully to identify the ultimate parent in

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Included	Not Included
• UK portfolio company controlled by the fund. • UK operations of non-UK portfolio company controlled by the fund. • UK operations that are "principal subsidiaries," for the entire year even if the portfolio company is acquired at year-end.	• Non-UK portfolio company controlled by the fund with no UK operations. • Non-UK operations of UK portfolio company controlled by the fund. • All operations (UK and non-UK) of companies owned by a "club" of funds so long as no club member has control; note, however, that the ultimate parent controlling an operating company with the requisite UK nexus will be the responsible parent organization for CRC purposes. • Non-control investments. • UK operations that were "principal subsidiaries," for the entire year if such operations were disposed of during such year.

How Green is Your Portfolio? (cont. from page 19)

each case, taking into account all circumstances. Depending on the circumstances and any clarifications that may be made in the final legislation, it is possible that the ultimately responsible participant entity could be the fund itself, its general partner, its manager, or the undertaking that controls the general partner or manager. Much will depend on the specific facts.

There may be special considerations for fund groups where a common parent company owns each fund's general partner or manager, which may then be considered as the responsible person for all of the group funds' UK operations. Moreover, in such a structure, each of the funds across the group and their portfolio companies would be treated as a single organization for purposes of the CRC scheme, creating some potentially thorny cross-fund allocation issues.

In any case, the CRC Order could impose a novel type of liability on the general partner or manager (or its owner) which it typically does not face for other purposes.

...[P]rivate equity funds with UK portfolio companies (including portfolio company subsidiaries) should review their group structure carefully, in order to establish the extent of the group for CRC purposes, and to identify the "ultimate parent" [, and]...private equity funds that had UK portfolio companies in 2008 should, in conjunction with those companies, begin obtaining and measuring energy data to assess whether they will be subject to the CRC.

What to Do Now?

The CRC Order raises a number of issues for action and further consideration. Given the cost of compliance — even of preparing for compliance — and that some uncertainty continues to exist as to the contours of the final legislation, private equity sponsors face a difficult choice as to how much work to do at this stage in preparing for implementation of the scheme. Nevertheless, because there are certain near-term reporting obligations, and because implementation will be a major undertaking, some foundational work and analysis seems prudent at this stage.

Determine Who Is the Parent

As stated above, private equity funds with UK portfolio companies (including portfolio company subsidiaries) should review their group structure carefully, in order to establish the extent of the group for CRC purposes, and to identify the "ultimate parent." Sponsors of multiple funds should consider structuring their ultimate "parent" companies so that no single parent entity controls more than one fund.

Monitor. Private equity funds that had UK portfolio companies in 2008 should, in conjunction with those companies, begin obtaining and measuring energy data to assess whether they will be subject to the CRC. At the very least they will need to complete the qualification packs during September 2009 which the Environmental Agency is requiring be completed prior to the adoption of final CRC legislation. Funds with UK portfolio companies will need to evaluate how they will staff the resources necessary for compliance with the CRC, as well as how they intend to implement their own internal allocation of responsibility, which is discussed briefly below.

Allocate Responsibility

A sponsor may find it prudent to enter into CRC liability sharing arrangements (like tax sharing agreements) with the fund's portfolio companies to address allocation of responsibility between the fund and a UK portfolio company, presumably with the portfolio company shouldering all compliance costs. The fund may also want to consider how misallocations within the group should be handled under such a sharing arrangement. For example, the fund may find it more beneficial for UK portfolio company A to sell its excess emission allowances to UK portfolio company B, rather than sell them on the open market or have UK portfolio company B go to the market for allowances.

In addition, a fund may want to consider how the potential bankruptcy of a UK portfolio company would affect the fund's and the group's allocation of responsibility. A fund may ask a UK portfolio company to pledge its allowances to the fund as a matter of course or require them to transfer allowances to the parent (or the nominated "primary member") in advance of the end of the compliance year.

A fund may also want to consider whether any of the direct or indirect minority owners of a UK portfolio

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How Green is Your Portfolio? (cont. from page 20)

company should share responsibility for certain aspects of compliance with the CRC. For example, if a general partner incurs CRC-related liability for a bankrupt UK portfolio company, the fund may ask for the portfolio company's minority shareholders to carry their share of this liability.

Finally, the sponsor entity with ultimate responsibility under the CRC, should evaluate the proper risk allocation between it and the fund and then determine whether the typical fund indemnification provisions afford sufficient protection without further amendments.

Conducting Due Diligence on New Investments

The potential CRC implications of making new investments in UK companies (and increasing holdings in existing UK companies) will need to be considered carefully and the necessary due diligence undertaken. Once the first trading period begins, the CRC position of a UK target company or an existing subsidiary may be an important factor in assessing the relevant company's value.

Buying and Selling Portfolio Companies with UK Operations

When assessing an acquisition or a sale of a company with UK operations, the parties will want to assess whether deal terms should reflect compliance costs under the CRC.

The CRC has a simple compliance year cut-off provision for principal subsidiaries bought and sold during a year. Responsibility for a participant or principal subsidiary's emissions will transfer to the new owner on purchase of such entity, and the participants affected will be required to inform the EA of such "Designated Changes."

Designated Changes will be deemed to have occurred at the start of the emissions year during which the change to took place. In theory, this will mean that no apportionment of emissions will be required as between the transferor and transferee. For any changes that are not Designated Changes, the seller will be responsible for the target's emissions up to the date of completion of the sale and the purchaser will be responsible for its future emissions and will have to buy additional allowances accordingly.

For example, in the case of the purchase of a "principal subsidiary," a buyer may request a closing adjustment, to be calculated post closing on the basis of assessment of emissions through closing, to cover the cost of any allowances not on the books of the target company. Another alternative would be for the selling fund to transfer certain allowances to the buyer to offset the actual or estimated amount of CO_2 emitted by the UK target up to closing. This may be complicated to calculate, as the acquisition of a "principal subsidiary" by a CRC participant could have a positive effect on the participant's performance in a compliance year (and could therefore increase its recycling payment) if the target company reduces its emissions during that year.

The situation with the buyer and seller's relative performance under the year-end bonus/penalty scheme is even more difficult to address since it is not possible to know, mid-year, how a target (or the organization of which it is or will become a part upon completion of the sale) is performing relative to other participants in the CRC. As bonuses are awarded and penalties incurred relative to a participant's league table position, the financial consequences of selling or purchasing a UK undertaking in terms of the CRC will in part depend on how well all other CRC participants have performed during that year.

There are as many potential solutions to these issues as buyers and sellers have managed to dream up in allocating risks with regard to other types of operational liabilities.

Conclusion

The CRC raises several novel issues for funds by imposing parent company liability, even extra-territorial liability, for funds and sponsors that control UK entities with significant CO_2 emissions. Many of the uncertainties in the law may be addressed as it continues through the legislative process in the UK. For now, an affected fund should give careful consideration to the CRC and its implementation. ■

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Shelter from the Storm (cont. from page 8)

capacity has replaced insurers exiting or reducing their exposure to this market. However, there have been substantial premium increases. Premium increases range from 0% to 45%, depending on the risk. We estimate that premiums are increasing an average of 20% and expect this will continue for at least the next twelve months.

What's driving the premium hikes if it's not a loss of capacity in the market?

Premiums are rising because claims are rising, particularly for financial institutions. The same underwriters who underwrite financial institutions typically underwrite private equity and hedge fund risks as well. Even though the risks are different and not necessarily correlated, the financial crisis has tainted the underwriters' view of the entire market. To help keep premium increases to a minimum, we recommend starting a policy renewal process months in advance. If the underwriters have the opportunity to meet with the fund sponsors or portfolio company to get a more nuanced view of their business and potential exposures, they are likely to become more comfortable with the risk profile. The result will be better policy terms and premiums.

Have you noticed any changes in buying trends in the last 12 months?

We have not seen a meaningful change in the amount of coverage purchased. However, we have seen a shift in buying patterns. Some insureds are buying more specialized D&O insurance referred to as "Side A D&O." Side A D&O covers directors in certain circumstances when a company is unable or unwilling to indemnify. This kind of coverage is particularly critical in a bankruptcy scenario where a company is financially unable to indemnify a director.

What are the common issues to be wary of when reviewing coverage in the context of a potential bankruptcy situation?

Management must ensure the D&O or GPL policy is available for their primary benefit in a bankruptcy. Certain provisions should be requested while the company is still financially viable and not on the eve of a financial meltdown. There are a number of key provisions to consider, including priority of payments, bankruptcy clauses, financial insolvency clauses and insured versus insured exclusions.

In a U.S. bankruptcy, the "automatic stay" prevents claims against the bankruptcy estate, including insurance policies and certain insurance policy proceeds that belong to the estate. However, the automatic stay will not prevent claims against individuals, so management may be left without coverage if the proceeds of the D&O or GPL policy are deemed to belong to the estate. A "priority of payments" provision provides that non-indemnifiable claims by management against the insurance policy have priority over claims by the company. Bankruptcy courts have confirmed that the "priority of payments" provision has the effect of excluding from the bankruptcy estate certain of the proceeds of the policy, thereby conferring management access to those policy proceeds.

You said that priority of payment clauses ensure payment for non-indemnified claims. What about indemnified claims?

That's where the bankruptcy clause comes in. Together with the "priority of payments" provision, the "bankruptcy clause" should ensure that the policy proceeds are available to individuals in all circumstances. A properly drafted "bankruptcy clause" evidences, among other things, a clear intention that the entity's policy is intended to protect and benefit individuals and that, in the event of bankruptcy of the entity, the automatic stay will be lifted to the extent the stay is preventing any individuals from accessing the policy.

You also mentioned financial insolvency clauses and "insured versus insured" exclusions?

Yes. A properly drafted financial insolvency clause enables an individual to access the policy from the first dollar (*i.e.*, eliminating the retention or deductible) in the event that the entity is unable to pay indemnifiable claims of individuals due to its insolvency.

Finally, in a bankruptcy, an "insured versus insured" exclusion is problematic because if a trustee or other party representing the interest of the company (an insured) brings a claim against the directors and officers (also insureds), the exclusion is triggered. Therefore, it is important that the policy include an exception to the normal exclusion to allow coverage for claims brought by a bankruptcy trustee, an examiner, a creditors' committee, and their respective assignees and functional (and, where relevant, foreign) equivalents.

At what point in a potential claim situation should insureds begin talking to our insurers regarding coverage? And to our attorneys regarding coverage?

At any time an insured becomes aware of a claim, or a situation that they believe could give rise to a claim, they should seek the advice of counsel. Depending on the facts and circumstances, it may be best to speak with your counsel and insurance broker first, and then involve the carrier if it is necessary to report the claim or circumstance.

The policy typically requires that the carrier be kept informed and gives the carrier a right of consent with respect to any settlement. Failure to comply could jeopardize the availability of coverage under the policy for the related claim. ■

Convergence, Part 2 (cont. from page 12)

Ownership Interests: The buyer established a limited liability holding company to acquire 100% of the interests of the target company. The limited liability holding company has two classes of interests, one of which — the Class A interests — is wholly owned by the buyer, and represents the bulk of the target's value at the time of the deal. The Class A interests accrue a preferred return of 10%. The second class of interests — the Class B interests — is held 75% by the buyer and 25% by the executive. The executive's Class B Interests are fully vested.

Interests Valuation: The executive paid an appraised fair market value for his interest in part with deferred compensation owed to him by the target company and in part with a loan from the buyer. The loan bears interest at the applicable federal rate, has a maturity of eight years (subject to mandatory pre-payment upon a sale of the interests and certain other customary events) and is secured by the Class B Interests and other assets held by the executive.

Right of First Refusal: The executive is prohibited from disposing of the equity interest without the buyer's consent for six years following the closing of the transaction. Following the sixth anniversary of the closing, the executive may sell the interests subject to a right of first refusal in favor of the buyer. Moreover, except with respect to the transfer of interests to other employees of the buyer or its subsidiaries, the buyer agreed that it will offer the executive the right of first refusal should the buyer seek to transfer an agreed upon portion of its interests.

Put/Call Options: The buyer has a call option, from the fourth anniversary of the closing through the sixth anniversary of the closing, to purchase the executive's interest based on the fair market value of the interest at the time of purchase. For a period of 30 days following each of the sixth, seventh and eight anniversaries of the closing, the executive would have a put option pursuant to which the executive has the right to require the buyer to purchase up to one third of his interests at the then fair market value. For purposes of the put and call, the fair market value will be determined by the mutual agreement of the buyer and the executive or, if the buyer and the executive cannot agree, by an independent appraiser, without taking into account the lack of an active trading public market for the interests, any restrictions on the transfer of such interests, or any minority discount.

Other Terms: The limited liability holding company's operating agreement also provides for customary preemptive rights and tag-along and drag-along provisions and provided for vesting upon agreed upon EBITDA targets.

Some Familiar and Unique Issues

In the process of providing private equity-like arrangements to executives, strategic buyers will need to consider some of the same types of issues faced by financial sponsors in this area, and some additional issues unique to them.

Securities Law Issues: For example, shares granted to management must be registered with the Securities and Exchange Commission (SEC) in accordance with the federal securities laws, unless there is an available exemption from registration. Often, a public company strategic buyer uses equity that is available under its equity incentive plan for its other employees and that it is already registered with the SEC. Or, it may use new shares and simply register them on a Form S-8, an easy, efficient and inexpensive way to register shares used in a public company's equity incentive programs. Form S-8 is not available to private companies, however, such as a target which becomes a subsidiary of a public company buyer. Instead, private companies, as in the case of many PE deals, rely on an exemption from registration, such as Regulation D for accredited investors, or Rule 701 for compensatory equity programs.

Sarbanes-Oxley: The Sarbanes-Oxley Act (SOX) prohibits a public company from extending or "arranging" for the extension of personal loans to any of its directors or Section 16 officers. Unlike PE firms, which are not subject to SOX, public strategic buyers are therefore prohibited from helping (or causing the target to help) any member of the target's management team who is deemed to be "a Section 16 officer" finance his or her investment in the target's equity with loans or loan guarantees. (In the transaction described above, the employee is not a Section 16 officer of the strategic buyer.)

Exchange Issues: By issuing equity in a target which becomes a subsidiary, a public company strategic buyer may also be able to avoid the thorny issue of shareholder approval of any equity arrangements for target's management at the buyer level since major stock exchanges and NASDAQ require shareholder approval of compensatory equity incentive plans by public companies. This may not be an issue if the buyer has a sufficient number of shares to issue under its shareholder-approved plan that it uses for its

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Convergence, Part 2 (cont. from page 23)

employees generally. But, if it has an insufficient number of shares, the buyer would need to either seek shareholder approval or rely on an exemption from shareholder approval — if one is available. These issues are avoided by issuing equity of a non-public subsidiary of a public buyer since private companies are not required to obtain shareholder approval for their equity incentive programs.

Accounting Treatment: Public companies tend to be more concerned than private equity buyers about the impact of acquisitions on their financial statements. In the deal described above, for example, the buyer was interested in devising the management's equity in a manner that did not give rise to profit and loss charges on its income statement following the closing. For this reason, the accountants recommended that the awards should not be subject to a service vesting condition (*i.e.*, continued employment) and great care was taken to design the award so that it "vests" based on financial parameters (in this case, EBITDA targets) rather than continued employment. In addition, because the equity granted to target management is a minority interest, public companies need to be mindful of the accounting impact of granting such equity on both their financial statements and their loan covenants. See "Rewinding the Clock: The Impact of Changes to GAAP on leveraged Loan Covenants," elsewhere in this issue. In contrast, financial sponsors usually impose service vesting conditions on management's equity awards, without regard to the accounting charge.

Public companies tend to be more concerned than private equity buyers about the impact of acquisitions on their financial statements.... [B]ecause the equity granted to target management is a minority interest, public companies need to be mindful of the accounting impact of granting such equity on both their financial statements and their loan covenants.

Tax: A strategic buyer wishing to issue equity of the target to management would also have to address the seemingly ever-present Section 409A of the Internal Revenue Code of 1986, as amended, which imposes strict rules on how and when deferred compensation may be paid. Among other things, Section 409A limits the terms and conditions that may apply to equity awards that are granted in exchange for deferred compensation that is otherwise owed to the executive. In the transaction described above, for example, the executive "bought" his equity interest with deferred compensation that was otherwise to be paid to him in connection with the transaction. As a result, the buyer (and the executive) had to grapple with the terms of the equity award to ensure that payment was made in compliance with Section 409A. As it happened in this transaction, the parties became comfortable relying on a limited exception related to the so-called "short-term deferral" rule. However, Section 409A analyses are highly technical, nuanced and fact-specific.

Conclusion

It is too early to tell whether private equity-like incentive packages will be embraced broadly by strategic buyers, let alone even become a discernable trend. Despite the transaction described above, such arrangements remain rare. Still, if offering private equity-like incentive packages to target's management gives strategic buyers a competitive advantage over private equity bidders and/or helps strategic buyers finance transactions, it would not be surprising to see them offering such packages in the future, opening an additional competitive front for private equity investors. ■

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Recent Developments in the English Restructuring Market (cont. from page 14)

are transferred into a new company.

The company has discretion to determine who will be a party to a proposed scheme, so long as all creditors whose rights will be altered by the proposed scheme are included. Accordingly, English courts have held that a company may exclude creditors if their rights will not be altered by the scheme, either because those rights are left untouched or because the excluded creditors lack an economic interest in the company. Moreover, the company may have latitude to group holders of different securities together as a single class for purposes of a scheme if their rights against the company are similar.

Not surprisingly, lenders are chronically concerned that class determinations may be manipulated to ensure passage of a scheme at the expense of one or more groups of creditors. The introduction of "stretched" senior tranches with relatively thin mezzanine tranches may exacerbate this concern for mezzanine lenders. If secured mezzanine lenders are found to form the same class as secured senior lenders, and the senior tranche is, by value, three times that of the mezzanine tranche, the mezzanine lenders can effectively be dragged along by the senior lenders.

Recent English court decisions have underlined the weak position of mezzanine lenders in restructuring schemes. In *McCarthy & Stone*,[3] which considered a scheme involving an English construction company, the court reaffirmed that when a company's value is less than the outstanding senior debt, the remaining creditors can be excluded from the scheme because they lack an "economic interest" in the company. This led the court to approve a scheme whereby the senior lenders rolled much of their existing loan into the new company, while the mezzanine lenders were forced to write off their loans completely.

The recent decision in *IMO Car Wash*,[4] which involved the English subsidiaries of the biggest carwash business in the world, was the first case in which the English courts addressed the question of whether subordinated lenders have an "economic interest" in a scheme where senior and junior lenders presented competing valuations. In arriving at his decision, the judge accepted the senior lenders' lower valuation of the company on a going concern basis, finding that the mezzanine lenders' higher valuation was based on a statistical analysis of possible outcomes rather than a true estimate of the probable value of the company. He thus held that the holders of IMO's mezzanine debt had no "economic interest" in the company and no right to object to the proposed scheme of arrangement. He also emphasized that in the scheme the senior lenders would effectively receive what they were entitled to under the intercreditor agreement in effect between the parties.

Conclusion

With the current economic downturn pushing more highly-leveraged English companies to consider insolvency, England's insolvency procedures have come under closer scrutiny. Private equity sponsors and investors should be aware that recent developments in English restructuring practice may affect not only existing investments, but the availability and structure of English financing for years to come. ■

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3 *McCarthy & Stone PLC [2009] EWHC 116 (Ch).*

4 *Bluebrook Ltd and IMO (UK) Ltd and Spirecove LTD and Companies Act 2006 [2009] EWHC 2114 (Ch).*

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Whipsaw Claims and Wage and Hour Suits (cont. from page 16)

consent only if the total work period is no more than twelve hours and the employee did not waive the first meal period. California law also requires that employees receive at least one paid ten-minute rest break for every four hours worked, and a proportional break for major fractions thereof.

California's courts have been divided over the question of whether an employer has an obligation to ensure that the required breaks are taking place, or is merely required to make them available. The state agency charged with enforcing state labor laws (the California Division of Labor Standards Enforcement) originally interpreted the labor code as affirmatively requiring employers to ensure that employees are in fact taking the 30-minute meal break. In *Cicairos v. Summit Logistics, Inc.*[4], a California appellate court endorsed this reasoning, finding that it was insufficient for employers to assume break periods were taken: rather, employers had an affirmative duty to ensure workers were relieved of all obligations during rest or meal periods.

More recently, some appellate courts have recognized that it would be impracticable for a large corporation to ensure that every employee took advantage of his breaks each day, finding that an employer's duty is to make the breaks available. In *Brinker*, the case now pending on appeal before the California Supreme Court, restaurant workers claimed they were denied their required meal and rest periods and not compensated for work before and after scheduled shifts, as well as during meal periods. The appeals court ruled in favor of the employers, finding that while employees must have the opportunity to take their statutorily mandated breaks, employers are not required to ensure every break is taken. The court made it clear that employers cannot dissuade, impede, or discourage employees from taking their allotted meal periods. In addition, the court ruled that employers can only be held liable for employees working "off the clock" if the employer knew, or should have known, such work was occurring.

The California Supreme Court granted plaintiff's petition for review in Brinker, signaling that it might not agree with the appeals court's decision. The outcome of this final appeal is not expected until this fall, at the earliest. The California Division of Labor Standards Enforcement withdrew its opinion interpreting labor code to require employers to ensure breaks are taken, endorsing the *Brinker* rationale until the Supreme Court rules. Legal analysts are largely uncertain about how the court is likely to rule.

Strict Compliance and Documentation Are Key

Regardless of the outcome in *Brinker*, employers will continue to face a serious risk of wage and hour litigation in California, which can only be mitigated by adopting and enforcing policies that fully reflect the applicable laws. Not only do the correct policies need to be in place, but training to ensure that employees are aware of those policies, and documenting the company's compliance with its own policies are also critical.

Accurate and thorough documentation is important in wage and hour cases because companies facing these claims will need to prove affirmatively that the required breaks were provided and that workers were properly compensated for the time they actually worked. Courts will assume that if no break was documented, no break was taken. Thus, companies may be liable in wage and hour claims even if they otherwise have the right policies in place, if their record keeping is inadequate.

Documentation can be particularly challenging for operations in which employees are working in the field — and thus may not be able to "punch-in." More sophisticated time-keeping systems, such as those that are accessible by telephone or other electronic devices, may be useful in addressing these problems.

* * *

Whipsaw and wage and hour claims can be very expensive to resolve. Dealmakers contemplating the acquisition of a company with a significant number of employees are well-advised as part of their due diligence investigation to obtain information sufficient to assess whether the potential for such claims exists and, if so, to quantify any potential liability and its impact on valuation and transaction financing. ■

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4 *133 Cal.App.4th 949, 962-63 (2005).*

The FDIC's Policy on Failed Bank Acquisitions (cont. from page 1)

deals, the FDIC has assumed more than 80% of the losses on specified levels of a failed bank's loan portfolio, making many acquisitions highly attractive to prospective buyers.

The less good news is that, as we describe below, the Policy Statement, like the July proposal, continues to set substantive hurdles for private equity, hedge fund and other private capital investors interested in investing in failed banks and falls well short of creating the level playing field for which some had hoped. In addition, despite all the attention being paid to the Policy Statement as we go to press, it is important to keep in mind that it has no impact on the separate qualification standards and regulatory requirements imposed by the Federal Reserve ("Fed") and Office of Thrift Supervision ("OTS") with respect to acquisitions of both healthy and failed banks or thrifts. These requirements are evolving but can be expected to continue to pose additional challenges to private equity acquisitions of U.S. depository institutions. Ultimately, it will be the interplay of the FDIC's requirements, on the one hand, and the Fed or OTS's requirements, on the other hand, that will determine the viability of private equity investment activity in this sector, pointing to the desirability of a coordinated and comprehensive framework adopted by all regulators with respect to investments by private equity firms in failed financial institutions.

The Policy Statement[1]

Scope

By its terms, the Policy Statement applies to "private investors" (1) in any company proposing, directly or indirectly, to assume the deposit liabilities, or both the liabilities and assets, of a failed insured depository institution; and (2) involved in applications for deposit insurance in the case of de novo charters issued in connection with the resolution of a failed insured depository institution.

As worded, the Policy Statement appears to have broad reach. For example, the term "private investor" is not defined and, thus, could potentially extend beyond private equity and hedge funds to include other sources of private capital, potentially even individuals.

The Policy Statement does not apply in the following circumstances:

- Unlike the proposal, the Policy Statement will apply only prospectively and not to acquisitions of failed depository institutions made prior to the adoption of the Policy Statement. This will come as welcome news to the private equity investor syndicates in, for example, Indy Mac and BankUnited; that said, the Policy Statement would appear to apply if either of those banks were to acquire another failed depository institution.
- The Policy Statement will not apply to investors entering into partnerships with bank or thrift holding companies that have "a strong majority interest" in an acquiree depository institution and an established record of successfully operating insured depository institutions. In the Policy Statement, the FDIC "strongly encourages" such partnerships but refrains from defining what constitutes an adequate "strong majority interest" to satisfy this exception. Given their experiences in Washington Mutual and National City, private equity firms will want to look hard at their prospective partner before taking a non-controlling investment in a banking enterprise. But minority investments appear to be the cleanest investment structure under the Policy Statement.
- The Policy Statement generally will not reach investors owning 5% or less of the total voting power of a banking enterprise, provided there is no evidence of concerted action with other investors. Assuming the FDIC does not aggressively apply a "concerted action" approach to negate the benefits of this exception, this provision should be helpful in attracting small investments to plug financing holes in failed bank deals.

The Policy Statement expressly disallows in failed bank deals certain types of structures that private equity firms have favored. The Policy Statement prohibits "complex and functionally opaque ownership structures," including "organizational arrangements involving a

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...[T]he Policy Statement, like the July proposal, continues to set substantive hurdles for private equity, hedge fund and other private capital investors interested in investing in failed banks and falls well short of creating the level playing field for which some had hoped.

1 *For a more detailed description of the Policy Statement, see our Client Alert, dated August 27, 2009.*

single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by a parent fund." The prohibition appears aimed at certain "silo" structures, permitted in the past by the OTS, which seek to expose one investment fund or structure to bank regulatory restrictions but to hold other funds and structures managed by the same private equity firm (and the private equity firms themselves) outside the regulatory reach.

Three elements of the July proposal created the greatest concern: the bank capital levels, the need for private equity funds to serve as an ongoing "source of strength" to the bank, and the ability of the FDIC to use a private equity firm's interests in one banking structure to reimburse the agency for its costs related to the failure of another bank under some level of common ownership....

Key Substantive Provisions

Three elements of the July proposal created the greatest concern: the bank capital levels, the need for private equity funds to serve as an ongoing "source of strength" to the bank, and the ability of the FDIC to use a private equity firm's interests in one banking structure to reimburse the agency for its costs related to the failure of another bank under some level of common ownership (the so-called "cross-support" requirement). The Policy Statement retreats somewhat on the harsher components of these elements in ways that may be helpful to private equity investors, but, as discussed below, certain issues still remain.

Capital Commitment

Under the Policy Statement, an investee depository institution must maintain a minimum ratio of 10% Tier 1 common equity-to-total assets for a period of three years and, thereafter, be "well capitalized" for the remaining period of ownership by the private equity investors. These capital levels generally should be less onerous to private equity investors than what the FDIC proposed in July. The FDIC originally proposed a three-year 15% Tier 1 leverage ratio but also defined the numerator of the ratio to include certain equity interests in addition to common stock. The Policy Statement limits the numerator to straight common equity.

The July proposal contained language that would have required private investors to "agree" to cause an acquired bank to meet its capital requirements and "to immediately facilitate" restoring a bank to the required capital standards. Consistent with the elimination of the "Source of Strength" provisions discussed below, this language has been removed from the Policy Statement.

On paper, these capital requirements appear to put private equity buyers at a competitive disadvantage to strategic buyers, which are not subject to the same requirements. But given that private equity buyers are likely to be at a competitive disadvantage to strategics in the banking sector as a practical matter even without this additional burden, these requirements are likely to be germane most often in transactions in which private equity investors are the sole bidders for a particular target. In these situations, these capital requirements will reduce IRR, and their inclusion in the Policy Statement may ultimately put pressure on the FDIC to accept a lower purchase price for a failed institution so as to enable a private equity investor to model the acquisition consistent with its target returns.

Source of Strength

The FDIC's July proposal would have required investors in certain organizational structures "to commit" to serve as a source of strength and support the depository institutions being acquired. This language arguably could have been read to impose unlimited liability on private equity funds (and conceivably their investors) with respect to the liabilities of an acquired bank and therefore could have been a "showstopper" for private equity investment in failed financial institutions. Happily, the Policy Statement drops this source of strength commitment.

Cross Support

The statutory framework under which the FDIC operates includes a "cross-guarantee" provision that permits the FDIC, under certain circumstances, to use interests in a healthy bank to reimburse itself for funds expended to resolve a commonly controlled failed bank. In the

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July proposal, the FDIC had proposed a very expansive application of this requirement. Basically, the proposal would have required private investors whose investments, individually or collectively, constituted a majority of the direct or indirect investments in more than one bank to commit their investments to the FDIC to reimburse the agency if any of the banks failed. Because of its broad wording, this provision could have put at risk even a 1% private equity investor in multiple banking enterprises.

The Policy Statement scales back to a degree the July proposal's cross-guarantee requirement (which the FDIC has re-labeled as "cross support"). The new cross-support requirement provides that if one or more private investors own at least 80% of multiple insured depository institutions, these investors' interests in commonly owned banks and thrifts would be pledged to the FDIC to cover potential losses sustained by the agency from the failure of any one of these institutions. The mechanics of this pledge are not specified. It is also reasonable to assume, but not entirely clear, that pursuant to the application provisions set forth above, a less than 5% owner in an investee bank would not be subject to the cross-support requirement, at least unless it was clearly acting in concert with more significant investors.

Even as revised, these rules expose any investor holding a differing but greater than 5% ownership percentage interest in two syndicates, each of which owns at least 80% of an insured depository institution, to a disproportionate share of liability with respect to a failure of the insured depository institution owned by the syndicate in which such investor holds a lesser interest. While this potential exposure could be addressed under an indemnity arrangement or the like among members of the syndicate, private equity club deals also may be structured going forward to avoid 80% overlapping ownership with a prior consortium deal.

Other Substantive Provisions

The Policy Statement contains a number of other provisions, which may not be as problematic or noteworthy as the provisions discussed above, but which still may be highly relevant to a potential private equity investor. Of particular relevance here, these provisions:

- Preclude an entity existing in a "bank secrecy jurisdiction" from participating in a failed bank deal unless (1) its parent is subject to comprehensive consolidated supervision as determined by the Fed, and (2) it enters into informational and other commitments with the FDIC. The Policy Statement defines a "bank secrecy jurisdiction" to encompass any country that "applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with U.S. regulatory authorities, or does not provide for a minimum standard of transparency for financial activities." The FDIC does not specify which jurisdictions would fall within this definition and, given the breadth and seeming elasticity of the definition, this language may apply to many countries in which non-U.S. private investment vehicles are frequently organized, such as the Cayman Islands. Subject to tax planning, one way around this limitation may be for well-advised funds to utilize the AIV (Alternate Investment Vehicle) provisions of their limited partnership agreement to form a special purpose vehicle in a jurisdiction that clearly does not constitute a "bank secrecy jurisdiction," such as Delaware.
- Generally preclude a private equity investor from transferring ownership in a banking enterprise for three years. These provisions obviously could negatively impact a fund's ability to generate targeted IRRs by requiring a three-year holding period. The scope of the provision is unclear, and it could also be implicated in the event of a secondary sale of interests in the private equity fund.

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...[E]ven if a group of private equity firms decides to buy a failed bank from the FDIC and meets all of the Policy Statement's guidelines, one or more of the acquirers may still need to undergo a lengthy process with a different federal banking agency to determine if they will need to register, and be subject to supervision and regulation, as bank or thrift holding companies.

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Impact of Separate Regulation by the Fed and OTS

As mentioned above, the Policy Statement does not supplant the qualification standards and regulatory requirements imposed by the Fed and OTS under the Bank Holding Company Act ("BHCA") or Savings and Loan Holding Company Act ("SLHCA"), respectively.

Accordingly, even if a group of private equity firms decides to buy a failed bank from the FDIC and meets all of the Policy Statement's guidelines, one or more of the acquirers may still need to undergo a lengthy process with a different federal banking agency to determine if they will need to register, and be subject to supervision and regulation, as bank or thrift holding companies. Most private equity investors cannot easily satisfy the requirements to become a bank or thrift holding company consistent with their business models and, thus, the imposition of those holding company requirements can be a bar to investment activity in this sector.

In taking its recent actions, the FDIC acknowledged the need for additional capital in the banking system. If anything, that need for capital is expected to increase significantly; some analysts expect another 150 to 200 bank failures this year (on top of the 84 to date).

The BHCA and SLHCA requirements apply to entities that "control" a bank or thrift, respectively. "Control" can be found, under these statutes, if an investor owns or controls, directly or indirectly, 25% or more of the voting securities of a bank or thrift. Control also can be found in numerous other circumstances involving lesser levels of ownership, based on a facts-and-circumstances assessment by the regulatory agencies. For example, in certain situations, the Fed can require an investor owning as little as 10% of the voting securities of a bank to agree to be an entirely "passive" investor to avoid being deemed to be in a "control" position.

Both the Fed and OTS have taken some steps to encourage private equity investment in the banking sector. The Fed, which has consistently been the most tentative in this area, issued its own policy statement in September 2008 to liberalize — to a limited extent — the ability of private equity and other investors to take stakes in banks and bank holding companies without being deemed to "control" such organizations. The Fed's policy statement provides useful guidance and relief, for example, with respect to the extent to which investors may have director interlocks with, make non-voting equity investments in, and communicate with management of banking organizations without becoming subject to the BHCA. For its part, the OTS generally has been more receptive than the Fed (and FDIC) to private equity investors. The OTS has, for example, approved certain "silo" structures and club deals that likely would have raised issues under the Fed's interpretations of the BHCA.

Conclusion

Whether the Policy Statement, in conjunction with the loss-sharing agreements into which the FDIC has entered, encourages significant private investment in failed banks should become evident over the coming months. Over that period, we also may get further clarity on how the FDIC intends to interpret certain of the Policy Statement's ambiguous and expansive provisions.

In taking its recent actions, the FDIC acknowledged the need for additional capital in the banking system. If anything, that need for capital is expected to increase significantly; some analysts expect another 150 to 200 bank failures this year (on top of the 84 to date). If these numbers hold true, the FDIC likely will face significant pressure to reconsider its approach and to be even more accommodating to private equity investors. That step alone may not be sufficient to spur significant private investment in the banking sector, unless the Fed and OTS also are willing to alleviate their respective rules. Encouraging meaningful private equity participation in the banking sector may require the adoption of a coordinated, transparent, and comprehensive framework by federal banking regulators that is more clearly receptive to private equity investment. ■

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ALERT

Institutional Limited Partners Association Releases *Private Equity Principles* Report Listing Private Equity Preferred Terms

On September 8th, the Institutional Limited Partners Association ("ILPA"), a not-for-profit association representing certain institutional private equity investors, released a report titled *Private Equity Principles* (the "IPLA Report"). The ILPA Report describes "preferred" private equity fund terms. The preferred terms, not surprisingly, incorporate many of the pro-investor ("LP") comments that LPs often make to fund sponsors ("GPs") when negotiating the terms of a private equity fund. The ILPA Report, like the "Mercer Report" sponsored by nine state retirement plans in 1996, appears to be an attempt to move the market to terms that the authors believe are more LP-friendly.

In a number of respects, however, the ILPA Report goes beyond being a comprehensive LP "wish list." The report also recommends certain economic and other terms that many LPs rarely request, and that are not standard (*i.e.*, terms that are not "market") for most buyout and venture capital funds.

The preferred terms called for by the ILPA Report include the following:

- carried interest should be distributed to GPs only after all contributed capital plus a preferred return on that capital has been distributed to the investors in the fund (as contrasted with the U.S. standard "deal by deal" waterfall, which allows earlier carried interest distributions);
- funds that do not follow the "all capital first" distribution model, but instead allow for "deal-by-deal" payouts of carried interest, should:
  - establish large reserves if a "clawback" obligation arises,
  - return all management fees and other expenses funded by the LPs through the date an investment is realized (not just a portion of total expenses apportioned to that realized investment), and
  - require joint and several guarantees of any clawback obligation (and not require each carried interest recipient to guarantee only his or her proportionate share of any clawback);
- the GP should make a "substantial" investment in the fund, and that investment should be primarily in cash (whereas use of the management fee offset mechanisms that so many firms have adopted is discouraged);
- any clawback should be calculated on a gross basis (not on an after-tax basis);
- fund partnership agreements should provide for payment of clawback obligations within two years of recognition that a GP has received more than 20% of the cumulative net profits of the fund (rather than requiring payment of clawback amounts only at the end of the term of the fund);
- 100% of any transaction and monitoring fees that are charged by a GP or its affiliates should accrue to the benefit of the fund (and not only the 50% to 80% that is most common today);
- a mere majority-in-interest of the LPs should be able to require suspension or termination of the investment period without cause (and not the supermajority vote that most fund partnership agreements now require);
- indemnification should be capped and limited in other respects (as contrasted with the broader indemnification historically contained in most fund partnership agreements); and
- reporting to the LPs should be substantially beefed up, and should include disclosure of each individual investment professional's share of the carried interest and share of the GP's capital investment in the fund.[1]

In addition to setting forth proposed best practices and a list of preferred fund terms, the ILPA Report includes a number of interesting and detailed suggestions concerning reporting to LPs and the operation of LP advisory committees.

Many of the recommendations contained in the ILPA Report are thoughtful and sensible, and will be seriously considered by GPs. Other recommendations made by the report, including several of those listed above, represent departures from current market terms — in a number of cases from market terms that go back to the beginning of the buyout business in the late 1970s. While market practices can and do change, many of the recommend-ations contained in the ILPA Report will undoubtedly prove controversial and will be resisted by many GPs. ■

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1 *For a discussion of clawbacks and the "all capital first" vs. "deal-by-deal" distribution mechanics discussed in this article, see "Clawbacks: Protecting the Fundamental Business Deal in Private Equity Funds" from the first issue (Fall 2000) of The Debevoise & Plimpton Private Equity Report.*