Debevoise & Plimpton
Private Equity Report

Fall 2009 | Volume 10 | Number 1

The End of Pay to Play? The Proposed SEC Rule Banning Certain Political Contributions

Introduction

The SEC is poised to adopt a rule that while not advanced by the private equity community might nonetheless save some PE professionals some money.

How so? Private equity professionals, like other citizens, are often besieged by requests for political contributions. Under a new rule proposed by the SEC on August 3, 2009 as part of its efforts to address perceived pay to play practices by investment advisors (the "Proposed Rule"), however, private equity sponsors may soon have a new, pithy and disarming response to those irksome dinnertime phone calls seeking political donations: "Sorry, I'd like to help, but the new SEC antifraud rule governing political contributions by investment advisers is so complicated and expansive that I can't afford the legal work to determine if I can make the contribution in the first place."

The Proposed Rule is designed to end perceived "pay to play" practices in the selection process of investment advisers by state and local governments. The Proposed Rule relates to state and local government clients only. It does not apply to federal or non-U.S. governmental clients.

A private fund sponsor will have to comply with the Proposed Rule even if it is not a registered investment adviser: the Proposed Rule applies to both registered investment advisers and advisers that are

CONTINUED ON PAGE 21

© 2009 Marc Tyler Nobleman / www.mtncartoons.com

"I would love to, but I have to check with my corporate counsel first."

What's Inside

3 To Change or Not to Change: Should Sponsors Modify Management Equity Due to the Economic Downturn?

5 GUEST COLUMN State of the Private Equity Secondary Market

7 "Blind Pools"— Another Vision of Investing in Failed Banks

9 Mind the (Funding) Gap: Trouble Ahead for Multiemployer Plans

11 Dealing With Mr. Big: Recent Developments in Transactions Involving Controlling Shareholders

13 UPDATE How Green Is Your Portfolio?

15 Caution Ahead: Rules of the Road for Buying Assets from Distressed Companies

17 ALERT What Really Changed? — The Market Impact of the 2008 Changes to Rule 144

19 ALERT Developments in EU Antitrust Laws — Private Equity Funds May Be Liable for Violations of Portfolio Companies

Letter from the Editor

It is hard to believe that this is the tenth anniversary issue of the *Debevoise & Plimpton Private Equity Report*. In many ways, it seems like just a few short years ago that the dearth of attention and analysis afforded to the private equity community by legal commentators and the financial press prompted us in 1999 to start a quarterly report to advise our clients and friends of topics we thought might be of interest to them. In many other ways, that seems like several generations or business cycles ago. Today the private equity community may be suffering in a number of ways, but hardly from a failure to attract more than its fair share of attention from the popular press, financial press, politicians, regulators, labor, and even the academic community. In the late '90s, private equity was just becoming an accepted asset class; today, while not perhaps at its most popular or profitable moment, it has shown itself to be a formidable factor in the business and investment landscape and to be positioned to accept and help shape the regulatory and structural changes that will undoubtedly emerge in the coming decade.

We still believe we have something unique to offer to our readers: thoughtful and practical guidance on the legal and business issues that impact the way private equity funds are, and will be, raised, committed and turned into successful exits.

In the coming months, one of the themes on everyone's mind is the anticipated regulatory changes expected to impact the industry. On our cover, we report on a proposed SEC rule designed to end perceived pay to play practices in the industry by banning certain political contributions to state and local officials charged with selecting investment advisers. The broad sweep of the proposed rule may warrant a proactive approach by fund managers in reviewing in-house policies with respect to political contributions by employees and may result in some significant consequences, including a ban on routine contributions.

We had hoped to provide an update on the state of proposed regulations from the European Union on Alternative Investment Fund Managers, but have decided that the pace of the competing revised proposals is better suited at this time to a daily rather than a quarterly publication. We expect that the various proposals will emerge into a compromise approach on which we can report in our next issue. It goes without saying, however, that U.S. managers will not welcome the approach the EU will take with respect to non-EU managers.

We report from Europe that U.S. managers would be well-advised to track especially closely antitrust compliance by their portfolio companies in light of a recent decision imposing liability on a parent for the antitrust violations of its wholly-owned subsidiary.

In our Guest Column, Michael Pugatch from HarbourVest, reports on the state of the secondary market for private equity fund interests and puts the notion that 2009 is the "golden age" for secondaries into perspective.

In an article designed for those of you interested in distressed investing, we remind you of the risks involved in purchasing assets from distressed companies, many of which can be avoided through careful structuring and negotiation. We also provide some cautionary advice for those considering investing in businesses with underfunded multiemployer plans, which are often present in distressed businesses with a unionized workforce.

Incentivizing mangers of private equity portfolio companies when their compensation is heavily equity related can create difficult issues in a depressed economy. We analyze the ways modifications to management equity programs can be designed and discuss whether those modifications are in fact appropriate.

As we enter our second decade with the Debevoise and Plimpton Private Equity Report, we would like to thank you for your always thoughtful comments on our articles and would like to encourage you to keep us posted on the ways we can best provide practical guidance to you in the coming years.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of

Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
1 212 909 6000

www.debevoise.com

Washington, D.C.
1 202 383 8000

London
44 20 7786 9000

Paris
33 1 40 73 12 12

Frankfurt
49 69 2097 5000

Moscow
7 495 956 3858

Hong Kong
852 2160 9800

Shanghai
86 21 5047 1800

Franci J. Blassberg
Editor-in-Chief

Stephen R. Hertz
Andrew L. Sommer
Associate Editors

Ann Heilman Murphy
Managing Editor

David H. Schnabel
Cartoon Editor

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

All contents © 2009 Debevoise & Plimpton LLP. All rights reserved.

The Private Equity Practice Group
All lawyers based in New York, except where noted.

Private Equity Funds
Marwan Al-Turki – London
Kenneth J. Berman – Washington, D.C.
Erica Berthou
Jennifer J. Burleigh
Woodrow W. Campbell, Jr.
Sherri G. Caplan
Jane Engelhardt
Michael P. Harrell
Geoffrey Kittredge – London
Anthony McWhirter – London
Marcia L. MacHarg – Frankfurt
Jordan C. Murray
Andrew M. Ostrognai – Hong Kong
David J. Schwartz
Rebecca F. Silberstein

Hedge Funds
Byungkwon Lim
Gary E. Murphy

Mergers & Acquisitions
Andrew L. Bab
E. Raman Bet-Mansour – Paris
Paul S. Bird
Franci J. Blassberg
Richard D. Bohm
Thomas M. Britt III – Hong Kong
Geoffrey P. Burgess – London
Marc Castagnède – Paris
Neil I. Chang – Hong Kong
Margaret A. Davenport
E. Drew Dutton – Paris
Michael J. Gillespie
Gregory V. Gooding
Felicia A. Henderson – Paris
Stephen R. Hertz
David F. Hickok – London
James A. Kiernan III – London
Antoine F. Kirry – Paris
Jonathan E. Levitsky
Guy Lewin-Smith – London
Li Li – Shanghai
Christopher Mullen – London
Dmitri V. Nikiforov – Moscow
Robert F. Quaintance, Jr.
William D. Regner
Kevin A. Rinker
Jeffrey J. Rosen
Jeffrey E. Ross
Kevin M. Schmidt
Thomas Schürrle – Frankfurt
Wendy A. Semel – London
Andrew L. Sommer
Stefan P. Stauder
James C. Swank – Paris
John M. Vasily
Peter Wand – Frankfurt

Leveraged Finance
Katherine Ashton – London
William B. Beekman
David A. Brittenham
Paul D. Brusiloff
Pierre Clermontel – Paris
Alan J. Davies – London

To Change or Not to Change:

Should Sponsors Modify Management Equity Due to the Economic Downturn?

Introduction

Management equity is always at the front and center of any private equity acquisition since it aligns the economic interests of the private equity sponsor and management after closing and rewards management for their commitment to the success of the portfolio company. The effect of the economic downturn on management's expectations with respect to their equity has ranged from modest disruption of this traditional incentive alignment structure at some portfolio companies to complete devastation at others. This article explores how private equity sponsors are dealing with (or not dealing with) the changed financial return expectations of the management of certain portfolio companies.

Background

Nearly all private equity sponsors favor management equity programs consisting of a combination of some form of purchased equity and some form of "free" equity. The purchased equity, often funded from proceeds to management in the transaction or effected through the rollover of existing target equity, is intended to ensure that management's economic fortune is tied to the private equity sponsor's success through the risk of losing capital actually invested. "Free" equity accompanies the purchased equity and is essentially a form of carried interest, providing management with the opportunity to earn a return disproportionate to their cash investment as a reward for providing services to the portfolio company during a successful investment period.

Although this framework is generally consistent across private equity sponsors, there is significant variation from sponsor to sponsor and, sometimes, from deal to deal. For example, the purchased equity may or may not be the same class of equity purchased by the private equity sponsor, or loans to management to purchase equity may be permitted or disfavored. Free equity may consist of appreciation rights (such as options, stock appreciation rights or partnership profits interests) or full-value awards (such as restricted stock or restricted stock units), and may be subject to vesting based on performance or continued service (or both). For performance-vesting awards, goals may be keyed solely to an exit, or to ongoing financial metrics such as EBITDA, or other performance criteria. The effect of a termination of a holder's employment may differ from sponsor to sponsor, and calls on the management holder's equity (and, less often, puts) may or may not be triggered by a termination of employment. Transfer restrictions may lapse on an initial public offering or may continue after the offering until the private equity sponsor has largely exited the investment.

The economic downturn has disrupted the return models with respect to management equity in many deals, in some cases significantly. In particular, some deals that closed at the height of the private equity boom from 2005-2007 are now facing the prospect of, potentially, sharply lower returns than were anticipated at the time of closing. In addition, it is possible to likely that private equity sponsors will be forced to stay invested in certain of their deals for much longer than the normal 5-7 year investment period. The question that follows from this changed landscape—sometimes raised independently by a private equity sponsor and sometimes forced on a sponsor by management—is whether any changes should be made to the management equity program as a result.

Doing Nothing in the Downturn

Of the two alternatives to dealing with management equity in the current economic downturn—doing nothing and doing something—doing nothing has been the most common course to date. The following reasons are typically offered for maintaining the status quo:

- When considering whether to grant new awards, a private equity sponsor may be unwilling to increase the dilution of its interest caused by additional management equity.
- When considering whether to reprice options or otherwise adjust outstanding awards, the private equity sponsor may be concerned with the reaction of limited partners of the fund or, if the portfolio company is public, of the public shareholders.
- The private equity sponsor may not wish to treat management of a portfolio company uniformly with respect to any of

CONTINUED ON PAGE 4

Peter Hockless – London
Alan V. Kartashkin – Moscow
Pierre Maugüé
Margaret M. O'Neill
Nathan Parker – London
A. David Reynolds
Philipp von Holst – Frankfurt

Tax
John Forbes Anderson – London
Eric Bérengier – Paris
Andrew N. Berg
Pierre-Pascal Bruneau – Paris
Gary M. Friedman
Peter A. Furci
Friedrich Hey – Frankfurt
Adele M. Karig
Rafael Kariyev
Vadim Mahmoudov
Matthew D. Saronson – London
David H. Schnabel
Peter F. G. Schuur
Marcus H. Strock
Richard Ward – London

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

Employee Compensation & Benefits
Lawrence K. Cagney
Jonathan F. Lewis
Alicia C. McCarthy
Elizabeth Pagel Serebransky
Charles E. Wachsstock

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

To Change or Not to Change (cont. from page 3)

the possible adjustments, and the prospect of making changes to some, but not all, employees' equity may be sufficiently disruptive that no changes are made. Similarly, some sponsors may be concerned about a domino effect from treating one portfolio company differently from another similarly situated portfolio company, although this has been seen as a lesser concern to date.

- As we have seen over the past year, markets do eventually recover, at least in part, and a private equity sponsor may be unable or unwilling to predict a recovery and may be wary that changes will result in a windfall if the recovery happens sooner, or more robustly, than expected.
- More generally, the private equity sponsor may view management equity changes as fundamentally inconsistent with the message that the private equity fund and management should participate together in both good and bad times.

Doing Something

Sometimes, however, a private equity sponsor views doing nothing as the wrong answer. This view is most often the result of the sponsor having concluded that existing equity held by a management team does not provide a sufficient incentive for the management team to remain focused on increasing the value of the portfolio company and to continue moving (no matter how slowly) toward an exit. In particular, where a sponsor views a management team as fundamentally solid but as having been swept up in the downturn by general market forces, changes to a management equity program may be more readily embraced. Other reasons, such as the costs of replacing a management team, the desire to avoid further deterioration in the portfolio company's business or the need to deal with a management team or individual managers with particular leverage, are also offered as reasons to make changes.

Changes to management equity programs considered by private equity sponsors range from tweaks to radical surgery. Although the following changes are most often considered, the diversity of portfolio companies, sponsors and management teams makes it unlikely that identifiable trends will develop.

- ***New Grants of Free Equity.*** New awards are most common, probably because of their simplicity. Although new awards increase the dilution caused by management equity, the private equity sponsor may feel reasonably comfortable after modeling the dilution and expected return from the old awards and the new awards. Full value awards, such as restricted stock and restricted stock units, are often perceived as a more desirable form of free equity for these new grants—from the sponsor's perspective, because a lower number of full value awards are granted (when compared with stock options), and, from management's perspective, because full value awards continue to have an intrinsic value even if the value of the underlying stock falls after the grant date. Vesting in these new awards need not follow the same vesting principles as the prior awards, and applying performance vesting to a full value award is not uncommon. Requiring an additional cash investment as consideration for these new awards is uncommon.
- ***Repricing of Options.*** Stock options continue to be the most prevalent form of free equity, and sponsors may consider whether to reprice underwater options. For private portfolio companies, a "straight" repricing—that is, the reduction of the exercise price to the new, lower fair market value—is a reasonably straightforward exercise. More complicated repricings, such as a reduction in the number of option shares in addition to a change in the exercise price, may require participant consent and, for a public portfolio company, may require compliance with the SEC's tender offer rules. Public portfolio companies may also need shareholder approval of a repricing under NYSE or Nasdaq corporate governance rules, and institutional shareholder reaction should be considered (even if the private equity sponsor ultimately controls the shareholder vote). In the past, repricings presented significant accounting risk if done incorrectly (which resulted in having to wait six months and one day to effect a repricing); under the current accounting rules, only the incremental cost of a repricing must be reflected in the portfolio company's financial statements, and as a result a repricing can typically be effected without significant accounting complexity or risk.
- ***Resets of Performance Vesting and Related Adjustments.*** For awards subject to performance vesting, sponsors may consider resetting the performance goals to match the new expectations of the portfolio company's performance. For example, if existing EBITDA or cash flow metrics are hopelessly obsolete, the realignment of incentives through new EBITDA or cash flow metrics may make sense. Alternatively, a private equity sponsor may consider adopting completely new performance metrics to match a portfolio company's new outlook—for example, preservation of cash or compliance with debt covenants may, in the near term, be a more compelling performance metric than exit value. The *quid pro quo* for these changes may include re-setting requirements for continued employment, so that the sponsor can be reasonably assured that

CONTINUED ON PAGE 8

GUEST COLUMN

State of the Private Equity Secondary Market

The private equity secondary market has received much attention over the past year. In its simplest form, the secondary market allows institutional or individual investors with existing private equity investments to sell their assets to secondary buyers. A buyer purchases these assets at an agreed upon price, typically representing a discount to current reported net asset value ("NAV"), and then assumes any remaining unfunded obligation associated with the seller's investment.

There are a variety of reasons for selling assets in the secondary market. Recently, these have included a need for liquidity, a desire to reduce future unfunded obligations, or a decision to pare back overall exposure to the private equity asset class. As the global financial crisis took hold in September 2008, many investors who were over-allocated to private equity or who needed immediate liquidity turned to the secondary market.

Over the past year, endowments and publicly-traded private equity funds were among the more active secondary sellers. In a market where financial institutions and corporations had historically been the most active, this represented a dramatic shift in the profile of institutions selling assets. In late 2008, market activity was dominated by endowments that suffered large losses across their public equity and fixed income portfolios. This led to the often-discussed "denominator effect," where an endowment's private equity holdings eclipsed its target allocation because of a shrinking overall asset base, resulting in over-exposure to private equity and forcing some of these institutions to reduce their holdings. Nearly half of the available commitments for sale that HarbourVest evaluated during the fourth quarter of 2008 were held by endowments, which had historically made up only a small fraction of the overall market.

Similarly, during the first half of 2009, nearly one-third of HarbourVest's deal flow came from publicly-traded private equity funds. In the years leading up to the credit crisis, many of these funds had employed an over-commitment strategy, relying on the expectation that a private equity portfolio could "self-fund" by utilizing the recurring distributions from one or more PE sponsors to meet the capital call requirements of other sponsors, which are typically funded over an average of ten years. As a result, these public vehicles would often over-commit their equity base in order to maximize the amount of NAV that was directly exposed to private equity versus cash or other securities reserved for future unfunded obligations. This strategy, like other forms of leverage, can succeed in a rising market with available liquidity. However, as the exit environment deteriorated, the pace of distributions slowed, and access to credit dried up, many public vehicles were forced to sell assets on the secondary market quickly and often at deep discounts to raise cash and meet funding obligations.

The financial crisis also had a marked impact on the behavior of secondary buyers. Secondary firms that had actively acquired assets prior to the crisis began scaling back amid market uncertainty and a view that trailing NAVs were (in many cases) well in excess of declining fair market values. As a consequence, secondary bids for private equity assets fell dramatically and rapidly over the second half of 2008 and first half of 2009. According to secondary market intermediary Cogent Partners, the average median bid as a percentage of NAV fell from over 90% in 2006 and 2007 to approximately 55% in the second half of 2008. Prices dropped even further in the first half of 2009, declining to approximately 36% of NAV.

This dramatic decrease in pricing led to a sharp decline in the number of completed transactions in 2009. While the dollar amount of deals evaluated by HarbourVest through the third quarter was up 15% over the same period in 2008, HarbourVest estimates that the volume of completed deals is down by over 50% from last year. This reflects the material bid-ask spread between buyers and sellers that has persisted through most of the year. Many forced sellers did complete transactions at steep discounts. However, many more potential sellers declined to sell at such distressed prices, electing to hold with a hope that pricing levels would improve.

Another key market theme over the past year has been an increase in the availability of partnership interests that

CONTINUED ON PAGE 6

While 2009 has been referred to by some observers as a "golden age" for secondaries, the level of recent activity for completed deals in the market suggests otherwise.

Guest Column (cont. from page 5)

have called little to no capital. Selling these lightly-funded interests, which are typically 0-20% called, can help investors reduce exposure to private equity and alleviate concerns about their ability to fund future commitments. Given the lack of new deal activity over the last year, many of the underlying investments within these lightly-funded portfolios were made prior to the financial crisis and at relatively high valuations. Accordingly, pricing for these interests has typically been below the average discounts seen in the broader secondary market. In some cases, buyers were offering to assume the remaining unfunded commitments while acquiring the existing NAV for no purchase price. While these opportunities can appear attractive, many traditional secondary investors have avoided them given that largely unfunded positions more closely resemble primary commitments and are often not a core part of their strategies. The buyers have instead been non-traditional, such as insurance companies, pension funds, and even some endowments. These lightly-funded secondaries often provide buyers the opportunity to increase exposure to a particular general partner in their portfolio while decreasing their average cost basis in that partnership.

While 2009 has been referred to by some observers as a “golden age” for secondaries, the level of recent activity for completed deals in the market suggests otherwise. HarbourVest believes that the market will experience an increase in completed transactions within the next several quarters as the bid-ask spread between buyers and sellers begins to narrow. This will be partly driven by renewed buyer confidence as the markets continue to stabilize and visibility on underlying company operating performance improves. A gradual acceptance of market pricing on the part of sellers should also help narrow the gap.

Ultimately, HarbourVest expects that an increase in deal activity by general partners, which in turn leads to more frequent capital calls, could serve as a catalyst for increased secondary market activity. While some investors with larger liquidity issues have sold assets over the past year, many others have held back, as the lack of funding activity has not created immediate liquidity concerns. However, many secondary buyers believe that the inevitable increase in the rate of capital calls from general partners will be the key to unlocking a flood of secondary transactions. ■

Michael J. Pugatch
HarbourVest Partners, LLC

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

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

I would like to receive my reports:

- ❑ **via email**
- ❑ **via email and regular mail**
- ❑ **via regular mail**

Name of Contact ______________________________

Title ______________________________

Company Name ______________________________

Address ______________________________

City ____________________ State or Province __________ Postal Code __________

Country ____________________ E-mail Address ____________________

Telephone ____________________ Direct Dial ____________________

Fax ____________________ Direct Dial Fax ____________________

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

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

"Blind Pools"—
Another Vision of Investing in Failed Banks

Notwithstanding the attractive loss-sharing arrangements that the FDIC has offered to investors in failed banks, private equity investors have continued to struggle with the regulatory hurdles presented in bank acquisition transactions. The latest market innovation to circumvent some of these issues are so-called "blind pools." Blind pools are designed to avoid the principal regulatory hurdles presented by the FDIC Policy Statement on Qualifications for Failed Bank Acquisitions ("FDIC Policy") and the Federal Reserve's "controlling influence" standard under the Bank Holding Company Act ("BHCA").

The "blind pool" phenomenon is relatively new, and, at press time, no transactions had actually been effected using a blind pool structure. However, a number of firms, including Friedman Billings & Ramsey and Goldman Sachs have raised blind pools of approximately $1 billion each to fund the acquisition of failed banks; others reportedly are working on similar funds which would acquire a platform bank to be the vehicle through which failed banks would be "rolled up." The pools themselves are generally structured to limit the participation by institutional investors to 9.9% of the voting common stock issued by the pools and by individuals to 4.9% of such stock. The pools also permit investors to acquire nonvoting stock. Unlike special acquisition companies ("SPACs"), which also have been formed to make failed bank acquisitions, the investors in blind pools do not retain a right to approve any bank acquisitions undertaken by the pool; rather, such decisions are left exclusively to pool management. In addition, unlike many other private equity structures, an investor in a blind pool has no knowledge of the identity of the pool's other investors so there is no risk that they could be acting "in concert."

As described in detail in the Summer 2009 issue of the *Debevoise & Plimpton Private Equity Report*, the FDIC Policy imposes significant regulatory requirements on banking transactions and arguably creates an unequal playing field between private investors, on the one hand, and so-called "strategic investors" (that is, other banking organizations), on the other. Many in the private equity community believe that, notwithstanding the FDIC Policy, which gives lip service to accepting private equity-backed investments in failed banks, the FDIC will approve a private equity bid for a failed bank only when there is no other reasonable alternative. The blind pool structure is designed to avoid direct application of the FDIC Policy and the perceived negative *imprimatur* of private equity investments in banks through the voting stock ownership limitations on the pool's investors, the use of non-voting stock and the non-disclosure of investors' identities to each other.

The Federal Reserve traditionally has taken a conservative stance as to what constitutes a "controlling influence" under the BHCA and, thus, triggers registration as a bank holding company ("BHC") under that Act. A little more than a year ago, the Federal Reserve published a Policy Statement on Equity Investments in Banks and Bank Holding Companies (the "FRB Policy") that many hoped signalled some relaxation in the agency's traditionally strict approach. Indeed, approximately two weeks after publishing the FRB Policy, the Federal Reserve allowed Mitsubishi UFJ to make a 24.9% investment in Morgan Stanley without requiring Mitsubishi to register as a BHC; this approval created expectations that the Federal Reserve might apply the FRB Policy to allow two or more private equity firms to each acquire up to 24.9% of the voting stock of a fund to acquire one or more banks without those firms having to register as BHCs. To date, however, the Federal Reserve has been reluctant to allow such private equity club-like structures, generally because of concerns that private equity firms with significant voting stakes (that is, above 9.9%) may be acting "in concert" in making bank acquisitions and, thus, should have their interests aggregated for purposes of BHC determinations. In addition to such aggregation issues, the lengthy process (often several months or more) the Federal Reserve often undergoes to make a determination about the permissibility of a structure has proven to be a significant obstacle to private equity involvement in bank deals. The blind pools are designed to avoid the Federal Reserve issues that have dogged private equity focused investment in this area by (1) limiting voting stock by investors in the pool to below 9.9% (which is below the level for virtually all bank regulatory filings), (2) avoiding "acting in concert" concerns by leaving decision-making principally in the

CONTINUED ON PAGE 8

Although blind pools represent the latest market innovation to pursue the attractive economics that failed bank acquisitions offer by virtue of the FDIC's loss sharing arrangements, it is not clear whether they create a new investment paradigm or are merely a stop-gap approach....

"Blind Pools" (cont. from page 7)

hands of pool management and (3) generally not permitting pool investors to know the identity of other investors in the pool.

These regulatory benefits of blind pools come with tradeoffs since this structure limits the ongoing involvement of investors in pool management and in the management of the banks acquired by a pool. Investors seeking greater participatory rights may find blind pools less desirable than other structures, such as SPACs, which at least allow shareholders to vote on particular deals. For this reason, if additional regulatory clarity from the Federal Reserve and additional easing of regulatory requirements from the FDIC is forthcoming, blind pools may be attractive only to truly passive investors.

Although blind pools represent the latest market innovation to pursue the attractive economics that failed bank acquisitions offer by virtue of the FDIC's loss sharing arrangements, it is not clear whether they create a new investment paradigm or are merely a stop-gap approach until the Federal Reserve and the FDIC permit more private equity-focused structures to pursue acquisitions in a reasonable, timely manner. Of course, as the policy of the Federal Reserve and the FDIC in this area continues to take shape, the recent re-awakening of the public markets in bank stocks, and the associated impact on valuations, may reduce the attractiveness of some bank deals to PE funds. Still, given the ample supply of failed banks, private investment pools — whether via private equity-focused acquisitions, SPACs, blind pools, or some other market innovation — will likely continue to play a significant role in helping to resolve the banking crisis for the foreseeable future. ■

Satish M. Kini
smkini@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

To Change or Not to Change? (cont. from page 4)

the portfolio company's management team will remain in place.

- ***Cash Awards.*** Some private equity sponsors may wish to provide relief to management but also decide that they are unwilling to tinker with their customary methods of providing management equity. For these sponsors, it may make sense to consider a long-term cash incentive program. If structured correctly, such a program can be self-funding by predicating the awards to management on the direct or indirect generation of cash to pay those awards. Cash awards in the current downturn may also (rightly or wrongly) be perceived by a management team as more valuable than additional equity. These awards would normally be subject to medium-term performance-vesting goals rather than vesting on an exit. With respect to annual bonuses, some private equity sponsors are providing for shorter (*e.g.*, quarterly or semiannual) performance periods so that performance goals can be reexamined and refined over the course of the year in light of ongoing business volatility.

What About Liquidity?

Although the economic downturn has extended the investment horizon for some private equity sponsors in some portfolio companies, discussions about changes to management equity have to date generally not gone so far as to cover the possibility of providing a management team with the opportunity to exit its investment more quickly than the private equity sponsor. Exceptions to this general rule are, and should be, rare—a manager exiting before a sponsor exits (other than in the obvious cases of termination of employment or following an initial public offering) should be viewed as a fundamental change in the private equity model of management equity. In addition, the sponsor runs the potential risk in this situation of appearing to reward failure with liquidity. One example for which an exception may be appropriate is a selling founder nearing retirement age who was never intended to remain with the portfolio company past a normal investment horizon. It is also conceivable that some sponsors could offer partial liquidity outside of a public offering as a reward for satisfying performance goals, although probably not for a portfolio company that is a reasonable candidate for an IPO.

What Next?

It remains to be seen whether an economic recovery reduces the pressure on private equity sponsors to make changes to management equity programs at their portfolio companies. That may be the case, but an economic recovery will also likely lead to a more robust hiring market, which in turn may give members of management more leverage to demand improvements in their position. Additional pressure may also be placed on management equity if the recovery is delayed or in the event of another downturn. ■

Jonathan F. Lewis
jflewis@debevoise.com

Mind the (Funding) Gap: Trouble Ahead for Multiemployer Plans

Introduction

Private equity sponsors investing in industries with union employees covered by multiemployer plans — *i.e.*, pension plans sponsored by unions to which many different employers contribute — should pay special attention over the next several years to the potential liabilities under those plans. A recent report issued by Moody's highlights the financial turmoil surrounding multi-employer plans caused by the economic downturn and other factors. While these plans are generally prevalent only in a narrow slice of industries of the old economy, private equity sponsors investing in these industries should be diligent in ascertaining the full range of effects that these plans could have upon potential targets. These effects, described in this article, include cash costs not fully reflected as liabilities or contingencies in a target's balance sheet (or related foot-notes), credit downgrades and labor unrest.

Brief Overview of Multiemployer Plans

Multiemployer plans (sometimes also referred to as Taft-Hartley plans) are plans formed and sponsored by unions and typically cover employees within a particular industry (such as the construction, trucking and hotel/casino industries). As part of the collective bargaining process, a group of employers agree to make contributions to these plans — a typical contribution formula would be a fixed dollar amount for each hour worked by a union employee covered by the plan. For technical reasons, even before the current economic downturn, these plans were often underfunded because the levels of plan benefits would be increased as the value of the plans' assets increased.

Still, notwithstanding the potential for a contributing employer to bear liability in connection with plan underfunding, these exposures are generally not required under GAAP to be reflected in any way on a contributing employer's financial statements unless and to the extent actually paid, in which case they are run through the employer's statement of cash flows. In that sense, from the perspective of a contributing employer's financial statements, a multiemployer plan is like a 401(k) plan because the cash liability runs through the statement of cash flows, but no liability for underfunding appears on the balance sheet or in the footnotes to the financial statements.

The principal exception to that accounting treatment is if the contributing employer negotiates an exit to its future obligations to contribute to the plan (either in whole or in part). The liability recognized by the employer in this circumstance, known as "withdrawal liability," is assessed by the plan based on a statutory formula and is typically payable in installments over a number of years. When a withdrawal liability is triggered, the liability would be includible both in the statement of cash flows and on the balance sheet.

Prior to the current economic downturn, the economic and non-economic costs of contributing to a multiemployer plan were often relatively stable and not disruptive of the normal operations of a contributing employer (except in the event of the employer's withdrawal, which was rare and usually within the employer's control). But despite the continuing accounting treatment of these exposures under GAAP described above, acquirers and ratings agencies are now focusing more closely on the potential liabilities under these plans in light of the economic downturn, demographic changes and legislative initiatives. In September 2009, Moody's issued a report in which it catalogs the current funded status of multiemployer plans and the expected future pressures under these plans over the next several years. The Moody's report says that, although widespread downgrades of contributing employers are not expected, it is possible that a contributing employer's increased cash obligations under such plans (which Moody's, unlike GAAP, treats as a debt-like adjustment to the employer's financial statements) may increase the employer's risk profile and be a factor in considering a downgrade of it.

Effect of the Economic Downturn and Other Events

Multiemployer plan risk is by no means new, but a number of events over the past

CONTINUED ON PAGE 10

While these plans are generally prevalent only in a narrow slice of industries of the old economy, private equity sponsors investing in these industries should be diligent in ascertaining the full range of effects that these plans could have upon potential targets.

Mind the (Funding) Gap (cont. from page 9)

few years have converged to increase this risk.

- ***Economic Downturn.*** The most important of these events is the economic downturn, which has exacerbated the already significant underfunding of many multiemployer plans. Data collected by Moody's estimates that multiemployer plans were collectively 77% funded in 2007 and are likely to be 56% funded in 2008. (The precise underfunding will not be known until the plans' 2008 annual informational returns become public.) In addition, bankruptcies have operated to reduce the number of contributing employers in industries covered by multiemployer plans. The result of these factors is a declining number of employers having the obligation to fund an increasing liability.
- ***Change in Union Demographics.*** There have also been important changes in union demographics. New entrants in traditionally unionized fields are less likely to have unionized workforces. The Moody's report cites as examples FedEx in transportation and WalMart in supermarkets. As a result, and in combination with population demographics generally, there are a fewer number of active employees in the plan supporting the benefit obligations to a greater number of retired workers in the plan who are living longer. Added to this mix is the potential withdrawal from plans by large, stable contributing employers (UPS being a prominent recent example).
- ***Legislative Initiatives.*** The Pension Protection Act of 2006 (PPA) categorized troubled multiemployer plans into "yellow zone" (badly underfunded) and "red zone" (very badly underfunded) plans. PPA requires that both yellow zone and red zone plans achieve specified funding targets within a 10-15 year period, a change from prior law. Red zone plans must also consider reducing benefits. The likely effect of these rules in most cases is an increase in plan contributions and a freeze or decrease in plan benefits. Subsequent legislation has softened the impact of these rules because of the economic downturn but not eliminated them entirely, and further legislation is possible. Interestingly, this legislation, which is intended to preserve the *status quo* for a plan until a market recovery, may have the effect of masking a plan's true health to potential acquirors.

In any private equity deal in which the target contributes to a multiemployer plan, the potential plan liabilities should be a particular focus of diligence, despite the absence of any liability or contingency for these exposures on the target's GAAP balance sheet.

The combination of these factors seems to spell trouble for employers that contribute to multiemployer plans in the form of the direct cost of increased cash contributions and the indirect costs of decreased benefits, or both. Decreased benefits may create indirect costs as a result, for example, of increased unrest among the union population or by effectively requiring the employer to make up the lost benefits in some other way.

The Moody's report offers as an example the Central States multiemployer plan, which covers the trucking industry. In December 2007, UPS, one of the largest contributors to the Central States plan, successfully negotiated to withdraw from the plan. This withdrawal required UPS to contribute roughly $6 billion to the plan, but, even after the contribution, the plan was estimated to be only 67% funded. Moody's also estimates that, because of the drop in asset values in 2008, the plan's current underfunding may be as much as $25 billion (corresponding to a 44% funding level). In mid-2009, another large contributing employer, YRC Worldwide, negotiated an 18 month funding holiday from the Central States plan because of financial distress. The Moody's report points out that if YRC were to cease contributing to the plan altogether, the remaining contributing employers would be a fraction of the size of UPS and YRC and would be collectively responsible for funding the estimated $25 billion referred to above.

No (Easy) Way Out

There is no easy way for an employer to control these obligations, for three reasons. First, withdrawal requires negotiating with the union. For example, UPS, which withdrew from the Central States plan in 2007, had been trying to do so for years, which reportedly contributed to a 15-day strike in 1997. Second, even where the union approves the withdrawal, the withdrawing employer must pay its allocable share of unfunded benefits in

CONTINUED ON PAGE 18

Dealing With Mr. Big:

Recent Developments in Transactions Involving Controlling Shareholders

Controlling shareholders of public companies contemplating a sale of the company to a third party sometimes favor private equity bidders over their strategic competitors. This is because private equity sponsors typically can be more flexible than strategic buyers in structuring transactions that allow the controlling shareholder to retain an equity stake in the surviving entity or to receive other financial benefits that are not shared with the minority shareholders, such as continuing employment with the surviving entity, stock options and other arrangements.

The Delaware Chancery Court's recent decision in *In re John Q. Hammons Hotels Inc. Shareholder Litigation* (Oct. 2, 2009) provides a road map for parties to structure controlling shareholder sale transactions so that they will be subject to the protections of the business judgment rule, rather than the more rigorous "entire fairness" standard of review. However, the Chancery Court held in *Hammons* that a merger between a controlled company and a third party unaffiliated with the controlling shareholder was subject to the entire fairness test because the controlling shareholder received consideration different from that received by the minority shareholders and because the transaction did not include sufficient procedural protections to protect the minority: namely, in addition to the special committee process typically used in going private transactions, there be a condition to the merger that it be approved by holders of a majority of the outstanding shares held by the minority shareholders.

The Hammons Hotels Sale

Hammons arose out of the 2005 buyout of John Q. Hammons Hotels, Inc. by Jonathan Eilian, an unaffiliated private investor. Under the merger agreement, all holders of the publicly traded Class A common stock received $24 per share in cash (which constituted a substantial premium), and Mr. Hammons, who held a small portion of the Class A common stock and all of the high-voting Class B common stock and controlled approximately 76% of the company's voting power, received in exchange for his Class B shares a small equity interest in the acquiring entity, a preferred interest with a large liquidation preference, a $300 million credit line and certain other assets. The merger agreement was negotiated by an independent and disinterested special committee and included a closing condition requiring that the merger be approved by holders of a majority of the shares held by minority shareholders voting on the merger (which condition was waivable by the special committee).

Plaintiffs, holders of Class A common stock, alleged that Mr. Hammons breached his fiduciary duties as a controlling shareholder by using his controlling position to negotiate benefits for himself that were not shared with the minority shareholders. Plaintiffs also argued that the target's directors breached their fiduciary duties by conducting a deficient process in negotiating and approving the merger.

The Standard of Review: Entire Fairness or Business Judgment

Delaware courts traditionally review mergers in which minority shareholders are cashed out by the controlling shareholder under the entire fairness standard established by the Supreme Court of Delaware in *Kahn v. Lynch Communication Systems, Inc.* (1994). The entire fairness standard is designed to protect minority shareholders from the "inherent coercion" existing where the controlling shareholder stands on both sides of the transaction and negotiates with the target board to buy out the minority. In such a case, the use of a properly functioning and independent special committee, or subjecting the transaction to an informed majority-of-minority vote, will shift the burden of proof to the plaintiff to show that the

CONTINUED ON PAGE 12

The Delaware Chancery Court's recent decision in … *Hammons* … provides a road map for parties to structure controlling shareholder sale transactions so that they will be subject to the protections of the business judgment rule, rather than the more rigorous "entire fairness" standard of review.

Dealing With Mr. Big (cont. from page 11)

transaction was not entirely fair.

In *Hammons,* plaintiffs argued that the merger should be reviewed under the entire fairness standard, regardless of any procedural protections that may have been used, because Mr. Hammons effectively stood on both sides of the transaction. The Delaware Chancery Court disagreed. The court pointed out that the fact that Mr. Hammons retained a small equity interest in the surviving entity and received other consideration not shared with the minority shareholders did not change the fact that the offer to the minority shareholders was made by an unrelated third party, and that Eilian negotiated separately with Mr. Hammons and the special committee representing the minority shareholders. Accordingly, the court concluded that *Lynch* did not mandate that entire fairness automatically apply to the merger.

However, the Delaware Chancery Court declined to review the merger under the business judgment rule. The court reasoned that, even though Mr. Hammons did not stand on both sides of the merger, Mr. Hammons and the minority shareholders were "competing" for portions of the consideration that Eilian was willing to pay to acquire the target, and Mr. Hammons' controlling position enabled him to veto any transaction he did not like. In such a case, the business judgment rule would be the appropriate standard of review if there were "robust procedural protections" in place to ensure that the minority shareholders had sufficient bargaining power and adequate information to decide whether to accept Eilian's offer.

In light of *Hammons*, controlled targets may push hard to include a majority-of-the-minority approval condition in situations where the controlling and minority shareholders are in competition for merger consideration, in order to avoid the application of the entire fairness standard.

According to the court, adequate procedural protections exist if the merger agreement (1) is recommended by an independent and disinterested special committee *and* (2) includes a non-waivable condition that the merger be approved by a majority of all outstanding shares held by the minority shareholders — including those who do not actually vote.

Applying this standard to the procedural protections used in the Hammons Hotels merger agreement, the Delaware Chancery Court found that they were deficient. The fact that the merger agreement gave the special committee the power to waive the minority vote, and required only the vote of a majority of the minority shareholders actually voting on the merger, rather than a majority of the outstanding minority shares, rendered the protections inadequate, even though the merger was in fact approved by holders of a majority of the outstanding minority shares. Accordingly, the court held that the merger should be reviewed under the entire fairness standard.

Implications of *Hammons*

In light of *Hammons*, controlled targets may push hard to include a majority-of-the-minority approval condition in situations where the controlling and minority shareholders are in competition for merger consideration, in order to avoid the application of the entire fairness standard. This could result in lesser deal certainty, especially where the majority stake is concentrated among relatively few shareholders, who may use their potentially blocking position to seek to negotiate improved terms. However, Hammons could provide a bright-line rule for structuring a sale of a company with a controlling shareholder to a third party in a manner that would not subject the transaction to the entire fairness test, if the target follows the proper special committee process and the transaction is conditioned on approval by holders of a majority of the outstanding shares held by the minority.

* * *

The Delaware Chancery Court's decision in *Hammons* has been appealed to the Supreme Court of Delaware. We will continue to monitor the situation and will update you on any important developments. ■

William D. Regner
wdregner@debevoise.com

Dmitriy A. Tartakovskiy
datartak@debevoise.com

UPDATE

How Green Is Your Portfolio?

Private equity funds may be able to breath a small sigh of relief. On October 7, 2009, the UK government published its response to the third and final consultation on the Carbon Reduction Commitment ("CRC") legislation and the outlook for the private equity industry does not look as bleak as first feared. Coming into effect on April 1, 2010, the CRC legislation will regulate large non-energy intensive business and public sector organizations. The October 7th response sets out the UK government's final policy position on the CRC Energy Efficiency Scheme (as it has now been renamed), and explains some significant changes to the scheme to be formally implemented in revised draft legislation before the end of this year.

The prior proposed CRC legislation presented difficulties for private equity funds because UK organizations, controlled by a common parent, were to be grouped together with their parent entities and treated as a single organization. The ultimate parent of the combined organization, including those parent entities based outside of the UK, would bear responsibility for compliance with the legislation by their qualifying UK portfolio companies. Although this is still likely to be the default position, the response indicates that the revised CRC legislation will provide a mechanism by which corporate groups may be split into separate participants for reporting and compliance purposes, which could in many cases allow private equity funds to limit their exposure to the scheme and which should reduce the problems of joint and several liability across a fund's portfolio.

As mentioned in our previous article, all UK organizations (with groups of companies being treated as one organization) that consume more than 6,000 megawatt ("MWh") hours of electricity in a given time period will be required to participate in the scheme. The revised legislation will allow the ultimate parent of an organization to voluntarily select any "Significant Group Undertaking" ("SGU") within its group to be disaggregated from the group and participate separately in the scheme. An SGU (which was referred to as a "principal subsidiary" under the prior proposed legislation) is any UK organization that, in its own right, would qualify for the scheme. As long as the SGU consents to such disaggregation, it will be obliged to participate in the scheme as an entirely separate participant, and, most importantly, its parent company will not be jointly and severally liable for that SGU's compliance with the scheme.

The election to disaggregate one or more SGUs from a corporate group will need to be made at the beginning of the registration process (this period is from April 1, 2010 through September 30, 2010 for the introductory phase of the scheme), at the start of each subsequent phase of the scheme, or when an SGU is purchased by an existing participant. The most important condition for disaggregation appears from the response to be that an SGU cannot be disaggregated if it would result in the remaining group falling below the 6,000MWh participation threshold after disaggregation of the relevant SGU. Even if the proposed changes are implemented in the most private equity friendly manner, the legislation may still be challenging for funds, as each fund will need to identify the participant group for registration purposes and assess where best to disaggregate its portfolio companies.

The response contains only a summary of the main changes to the scheme, and there are, therefore, several uncertainties that will not be resolved until the revised legislation is published. Most importantly the response does not state:

- whether group companies with no emissions can effectively be absolved of joint and several liability by using the disaggregation process; and
- what will happen if a parent company decides to sell part of a disaggregated SGU, where such sale would result in the remaining disaggregated group falling below the 6,000MWh threshold. Will the remaining group be permitted to continue to participate as a separate grouping (even though it no longer meets the threshold for being an SGU), or will it be "re-aggregated" with the ultimate parent entity?

The response also details a number of other important changes to the scheme, including removal of the requirement to purchase allowances for the first compliance year from April 2010 to May 2011. In the first year of the scheme participants will therefore only be obliged to register, report and monitor their CO2 emissions.

We will provide a full update on these and other changes to the scheme once the revised draft legislation is issued. ■

Geoffrey P. Burgess
gpburgess@debevoise.com

Russell D. King
rdking@debevoise.com

Recent and Upcoming Speaking Engagements

October 1, 2009

Satish Kini

Gregory Lyons

"Private Equity Investments in Banks - Hurdles and Opportunities"

Practising Law Institute

New York

October 29, 2009

Andrew Berg

"Tax Strategies for Financially Troubled Businesses and Other Loss Companies"

Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2009

Practising Law Institute

New York

October 29-30, 2009

Franci J. Blassberg, Program Co-Chair

"Negotiating the Acquisition of the Private Company"

"Special Problems when Acquiring Divisions and Subsidiaries"

Twenty-Fifth Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions

ALI-ABA Committee on Continuing Professional Education

Boston

November 3, 2009

Geoffrey Kittredge

"Fund Terms and Conditions in the New World Order PEI and EMPEA"

Geoff Burgess

"Panel Session: Ask the Audience"

The Emerging Markets Private Equity Forum

London

November 8, 2009

Li Li

"Development and Inter-Relation Between RMB and Foreign Currency Funds EMPEA and BPEA"

Second Annual Beijing Global Private Equity Forum

Beijing

November 12, 2009

Sherri Caplan

Richard Hahn

Michael Wiles

Bryan Kaplan

"Private Equity Limited Partners in Bankruptcy: Preparations, Rights and Remedies"

Bankruptcy and Private Equity

Thomson Reuters

Webcast

November 12, 2009

Ken Berman

"Board Considerations in a New Era"

2009 Independent Company Directors Conference

Investment Company Institute and Independent Directors Council

Amelia Island, FL

November 12, 2009

Heidi Lawson

"Risk Management for PRC Companies Going Global"

Asian Business Dialogue on Corporate Governance 2009

Asian Corporate Governance Association

Beijing

November 16-17, 2009

Franci J. Blassberg, Session Chair, Moderator

"Assessing the Current State of the Private Equity Marketplace"

E. Raman Bet-Mansour

"Public Relations, Labour Relations and Lobbying: Managing External Relationships International Bar Association"

Geoffrey Kittredge

"Sponsorless Funds, Purchase and Sale of Funds or Portfolios, and Other Organic Changes at the Fund Level: What Are the Special Issues Presented by a Failed Portfolio?"

Matthew D. Saronson, Session Co-Chair, Co-Moderator

"Developments in Taxation of Private Equity"

International Private Equity Transactions 2009: A Symposium for Leading Private Equity Lawyers

International Bar Association

London

November 19, 2009

David Schnabel

"Tax Strategies for Financially Troubled Businesses and Other Loss Companies"

Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 2009

Practising Law Institute

Chicago

For more information about upcoming events visit www.debevoise.com/newseventspubs/events

Caution Ahead: Rules of the Road for Buying Assets from Distressed Companies

The high profile section 363 sales of GM, Chrysler, and other distressed businesses during the current recession have debunked the myth that the formal bankruptcy process cannot support quick, complex asset sales and convinced the business community that a bankruptcy filing does not necessarily destroy consumer confidence or capsize a carefully deployed sales process.

But even as the section 363 sale takes its star turn, its counterpart, the more familiar out-of-court sale, remains the preferred method (and sometimes the only method) for many distressed asset acquisitions, especially those by private equity funds. Indeed, from the perspective of a private equity sponsor attracted to a particular segment of a business, section 363 sales will not be an option. Those assets will be available only out of court either because their owners do not legally have access to section 363 sales or because the sellers are unwilling to endure bankruptcy for the sake of the sale — particularly if the asset sale is part of an overall out-of-court restructuring in which a consensus to avoid bankruptcy has already been reached or the business to be acquired is a healthy operation within a troubled company. And, many acquisitions go to the courageous: those who wait for the relative safety of a section 363 sale may concede many attractive opportunities.

Out-of-court distressed asset sales sometimes offer advantages over section 363 sales. Out-of-court transactions avoid the considerable — sometimes prohibitive — costs, delays and publicity of a bankruptcy process. The seller's management and the buyer can maintain the type of control of the sales process that in bankruptcy must be shared with creditors and ultimately belongs to the court. Once in a bankruptcy proceeding, two-party negotiations between the buyer and seller may give way to multi-party negotiations, unless the creditors happen to support the transaction or are otherwise disinterested. Finally, out of court, the parties are not bound to section 363's notice and auction requirements. Buyers of distressed assets will thus continue to seek out of court bargains and will need to keep in mind, among others, two risks facing out-of-court buyers of assets of distressed companies: (1) fraudulent conveyance risk and (2) successor liability risk. Fortunately, these risks can often, though not always, be mitigated through careful due diligence and careful deal-making, each of which also contributes to ensuring the economic success of the acquisition.

Fraudulent Conveyance

Buyers may find themselves the unwelcome targets of fraudulent conveyance actions brought by creditors or shareholders of the distressed seller, even years after the deal closes. In particular, buyers need to understand (and factor into their purchase price) the possibility that, if the seller subsequently files for bankruptcy protection, the sale could be attacked — ultimately voided — as a fraudulent conveyance. Fraudulent conveyance claims can be brought under the Bankruptcy Code or state law. Under the Bankruptcy Code, a buyer is exposed to potential fraudulent conveyance claims if the seller files for bankruptcy protection within two years of the transaction. If the claim is brought under state fraudulent conveyance statutes, the look-back period is usually longer. Under New York law, for example, the period is six years.

But what is a fraudulent conveyance? There are two kinds. The first is a sale entered into with the actual intent to hinder, delay or defraud the seller's creditors. While a buyer must take care that no such intentional wrong is being perpetrated by the seller, it is the second, unintentional and subtler form that causes the greater worry for buyers, precisely because it may exist and require remedy even if nothing inappropriate is done. This second kind is the constructive fraudulent conveyance, and it is principally the focus of a buyer's concern in most distressed transactions. A transaction may be found to be a constructive fraudulent conveyance if the seller (1) did not receive "reasonable

CONTINUED ON PAGE 16

... [E]ven as the section 363 sale takes its star turn, its counterpart, the more familiar out-of-court sale, remains the preferred method (and sometimes the only method) for many distressed asset acquisitions, especially those by private equity funds.

equivalent value" and (2) was insolvent at the time (or rendered insolvent as a result) of the transaction, had unreasonably small capital to conduct its business, or intended to incur debts beyond its ability to pay as such debts matured.

If a court finds that an insolvent seller received less than fair consideration, the remedy is to unwind the transaction — which is generally impracticable — or to recover the judicially-determined value of the asset from the buyer, less amounts already paid, which is, to put it mildly, highly undesirable. It is important to remember that the analysis is always done with the benefit of hindsight, when creditors of a now bankrupt seller are looking for additional sources of recovery. Therefore, although fraudulent conveyance claims are rarely litigated (and may often have little merit), they will nonetheless often be asserted against buyers viewed as potential deep-pockets and may have substantial settlement value.

There is no way to eliminate the fraudulent conveyance risk completely. There are steps that can be taken to minimize the risks, and the time for a buyer to start preparing a defense against such risks is during the transaction itself. For example, were the particular assets being purchased aggressively marketed by an independent third-party investment firm? Has there been active bidding in an auction process? Has an independent third-party provided a fairness opinion with respect to the transaction? Will the seller remain solvent after the transaction? In some instances, the buyer may also be able to take comfort from the consent of a third party — a secured lender or a regulator — to the transaction where the consenting party is focused on the adequacy of the consideration paid by the buyer. Of course, some of these approaches are more difficult to implement (but not impossible) when a buyer is purchasing a limited group of assets and assuming a limited group of liabilities from a group of sellers — as the buyer would prefer that the marketing, auction, fairness opinion and lender consent be focused solely on the particular assets the buyer is purchasing (and the particular subsidiaries from which the assets are being purchased).

In the U.S. and in other common law jurisdictions, buyers of assets from a seller cannot be forced to take on the liabilities of that seller. The exceptions to this rule, however, are significant....

Successor Liability

In the U.S. and in other common law jurisdictions, buyers of assets from a seller cannot be forced to take on the liabilities of that seller. The exceptions to this rule, however, are significant, and together amount to the second major risk facing buyers of assets out of court from distressed sellers.

First, when buying an unincorporated division of a distressed company, the parties themselves may divvy up liabilities contractually: some assumed by the buyer, others retained by the seller. The buyer will generally choose to assume some, but not all, supplier and service contracts associated with the acquired assets. The seller, in turn, will desire to retain some contracts to support and operate the unsold portion of its business. Other contracts may need to be partitioned, and still others will be desired by neither party, but assumed or retained as a burden with transaction consideration negotiated accordingly. This division of liabilities should be clear not only on its face but also scrutinized for any possible surprises to the buyer. By assuming contracts, a buyer accepts certain pendant liabilities as well; some are obvious, but others may be dragged in unnoticed unless the buyer carefully examines contract language, preexisting or transaction-triggered breaches, and other statutory and conventional aspects of contracts taken aboard.

Even the most careful due diligence and drafting cannot insulate the buyer from some liabilities, which may flow through the acquisition regardless of contract. For example, federal statutes create exceptions for certain environmental, labor and employment liabilities. Environmental liabilities may be obscure to the buyer, or even unknown to the seller, yet follow the assets and be binding to the buyer. Labor and employment obligations may also follow the asset, notwithstanding contractual language to the contrary. For example, a buyer must take care that it is not acquiring goods produced in violation of the Fair Labor Standards Act. The transaction itself may trigger the "WARN" Act if reductions in workforce are involved. Statutory and judicial exceptions, which vary by state, also exist for products liabilities, which do not fit traditional doctrines of successor liability: for example, under certain circumstances and in some states, an acquirer may be

CONTINUED ON PAGE 20

ALERT

What Really Changed? —

The Market Impact of the 2008 Changes to Rule 144

As we predicted in our Winter 2008 edition of the PER, the changes to Rule 144 adopted almost two years ago were, among other things, likely to change market practices in deals involving the issuance of restricted securities, including offerings of high-yield debt to finance PE transactions. While the freeze in the capital markets in late 2008 and early 2009 inevitably stalled the development of new practices, the impact of the changes to Rule 144 on market practice is now beginning to take shape.

As discussed further below, the changes to Rule 144 have not yet moved the needle for market practices involving issuers of high yield notes who are not already filing periodic reports with the SEC. But they have begun to have an impact on market practices involving issuers who were filing periodic reports with the SEC prior to the offering of the restricted securities.

As a quick refresher, the principal changes to Rule 144 were to:

- reduce to six months from one year the Rule 144(d) holding period for resale of restricted securities of companies subject to the reporting requirements under the Securities Exchange Act of 1934 (note that this does not include so-called "voluntary filers");
- provide that non-affiliates of companies not subject to the above reporting requirements may resell restricted securities of such companies without limitation after a one-year holding period;
- reduce substantially the restrictions under Rule 144 on resales of restricted securities by non-affiliates such that, once the applicable holding period has passed, resales of restricted securities by non-affiliates are generally not subject to other limitations under Rule 144. One important exception applies to resales of restricted securities of reporting issuers, where the issuer must comply with a continuing information requirement for six more months after the initial six-month holding period has passed; and
- permit issuers to remove restricted legends on privately placed securities, as clarified by the SEC in a footnote to the Rule 144 amendment adopting release.

As noted above, almost two years after adoption of the rule changes, there appears to have been little evolution in market practice for registration rights for securities of companies not already filing periodic reports with the SEC, including most issuers of new high-yield notes issued in leveraged acquisition transactions. In these deals, investors are continuing to value SEC registration of the notes in an A/B exchange and the required SEC periodic reports and applicable Sarbanes Oxley compliance resulting from SEC registration. These companies typically continue to be "voluntary filers" after the high-yield notes are registered.

In contrast, investors in privately placed notes issued by companies that are required to file periodic reports with the SEC prior to the offering appear increasingly willing to forego a registration rights agreement. This is presumably because not only are reporting covenants contained in most indentures, but also because the new shorter Rule 144 holding period is about the same duration as the period of time before an A/B exchange offer historically must have been completed under a customary registration rights agreement.

The market is slowly adjusting to the new shorter holding period. For example, in one recent deal, investors in high-yield notes of a reporting issuer insisted on a registration rights agreement, but required the issuer to conduct the A/B exchange offer only if, one year after the issue date, the notes were not freely transferable by non-affiliates or the restricted legend had not been removed from the notes.

In several other recent deals for debt securities of reporting companies, investors did not require a registration rights agreement and instead relied on hard-wiring a legend removal mechanic on the notes to enhance their marketability. In those cases, the issuer implemented procedures proposed in October 2008 by the Securities Industry and Financial Markets Association (SIFMA) and reviewed by The Depository Trust Company for "deemed removal" of restricted legends on securities and change to unrestricted CUSIP numbers. By including the SIFMA proposed language on the face of the notes and appropriate provisions in the related indenture, the restricted legend on the notes is "deemed removed" upon delivery to the indenture trustee of a "certificate of free transferability," a form of which is attached to the indenture. The notes themselves also include a footnote to the CUSIP numbers specifying that these numbers are deemed to change to

CONTINUED ON PAGE 18

The Market Impact of the 2008 Changes to Rule 144 (cont. from page 17)

unrestricted CUSIP numbers upon delivery of the same certificate. Practically speaking, this means that the issuer needs to obtain an unrestricted CUSIP number at the same time that it obtains the Rule 144A and Reg S numbers prior to issuance of the securities. The issuer's failure to comply with these procedures triggers penalty interest that, similar to the registration rights agreement model, accrues as long as the issuer continues to fail to remove the restricted legend from the securities by the agreed date (usually, one year from the initial settlement date). Penalty interest rates vary and can include features such as a step-up or a cap, much as they did under traditional registration rights agreements.

We also understand that the use of registration rights agreements is declining in PIPEs transactions for reasons similar to those that apply to debt securities of reporting companies. One twist in Rule 144, however, applies to former shell companies and has sparked significant discussion. Under Rule 144(i) and several related SEC Compliance & Disclosure Interpretations, restricted securities of a company that at any time previously had been a shell company may be resold under Rule 144 only if the issuer fulfills all of the requirements of Rule 144(i)(2), including that the issuer has filed all Exchange Act reports (other than Form 8-K reports) and other required materials during the preceding 12 months. It is unclear how restricted legends on securities of former shell companies can ever be removed since compliance with reporting requirements is determined at the time of resale.

We will provide appropriate updates on evolving market practices in this area in future editions of the *Private Equity Report.* It remains to be seen if the rule changes will ultimately result in a shift in practice for "quasi-public" issuers who are voluntarily filers and make once routine A/B exchanges a part of history. ■

Peter J. Loughran
pjloughran@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

Mind the (Funding) Gap (cont. from page 10)

connection with the withdrawal upfront which, in the case of many of these plans, could be a substantial amount. For UPS, this amount was $6 billion. Finally, in order to prevent a race to the exits, Federal law also creates an additional type of withdrawal liability when substantially all employers withdraw from the plan at roughly the same time (whether or not in concert with each other). This liability — called "mass withdrawal liability" — essentially allocates the entire underfunding of the multiemployer plan to all employers who withdraw during a roughly two year period. Again, using UPS as an example, if a mass withdrawal were to occur under the Central States plan before 2010, UPS would be deemed to be part of the mass withdrawal and would be allocated its proportionate share of what Moody's believes is likely a $25 billion underfunding — and this contribution would be in addition to the $6 billion UPS already has paid.

Effect on Private Equity

In any private equity deal in which the target contributes to a multiemployer plan, the potential plan liabilities should be a particular focus of diligence, despite the absence of any liability or contingency for these exposures on the target's GAAP balance sheet. For the foreseeable future, it should be assumed that all multi-employer plans are at least "yellow zone" plans; this assumption is not likely to be too far off. More than a few will be "red zone" plans. These liabilities cannot easily be left behind with a seller or otherwise hedged against, and, while it may be possible to self insure these costs by modeling the possible cash contributions to the plan into one's purchase price under a range of "normal" scenarios over the investment period, other risks associated with continuing plan contributions (*e.g.,* the chances of successfully negotiating benefit changes, of labor unrest or of mass withdrawal) are industry risks and will not easily be quantifiable.

In all events, to be clear, (1) owning a strong player in an industry may not be enough to avoid these problems to the extent the strong player's contributions increase due to the missed contributions of competitors who have withdrawn or gone bankrupt, and (2) private equity buyers should be modeling the possible effect of these contingent liabilities on a target's credit ratings despite their absence from a target's financial statement since, unlike under GAAP, these contributions obligation are treated as debt-like obligations by Moody's, and they thus could, in the wrong circumstances, drag down the target's credit rating. ■

Jonathan F. Lewis
jflewis@debevoise.com

Alicia C. McCarthy
acmccarthy@debevoise.com

ALERT

Developments in EU Antitrust Laws — Private Equity Funds May Be Liable for Violations of Portfolio Companies

Recent decisions by the European courts raise the concern that private equity firms may face liability for violations of EU antitrust laws by their portfolio companies. Those decisions hold that parent companies are subject to a rebuttable presumption of liability for violations committed by their wholly-owned (or nearly wholly-owned) subsidiaries. Although these decisions concerned industrial groups, the same rules may be applied to investment entities.

Importance of the Issue

The attribution of liability may have several consequences. First, the parent company and the subsidiary will be held jointly and severally liable. Second, the European Commission's mandatory cap on fines (10% of revenues) will not be based on the revenues of the subsidiary which committed the infringement, but on the *group's* worldwide revenues. Third, although the Commission's guidelines for calculation of a fine for an antitrust infringement are based on the value of sales to which the infringement relates, the Commission may increase the fine based on a group's overall economic strength in order to ensure a sufficiently deterrent effect.

The Akzo and the Elf Aquitaine Case

In the *Akzo* decision of September 10, 2009, the European Court of Justice ("ECJ") confirmed that a parent company is presumed liable for its wholly-owned subsidiary's involvement in a cartel, even if it did not itself take part in the cartel's activities. Just a few weeks later, on September 30, 2009, the European Court of First Instance ("CFI") decided that this presumption also applies to parent companies of almost wholly-owned subsidiaries. The CFI attributed liability to *Elf Aquitaine* for the conduct of its 98 percent-owned subsidiary.

Basic Principles on Attribution of Liability

A parent company may be held jointly and severally liable with its subsidiary, if the latter does not determine its own course of conduct on the market fully independently. The conduct is not independent if (1) the parent has the possibility to exercise decisive influence on the commercial decisions of its subsidiary, and (2) effectively exercises this possibility. The rationale for imposing liability on the parent is that EU antitrust law addresses "undertakings," a term that the EU courts and the Commission interpret as economic units rather than legal entities. An undertaking may therefore be a combination of several individual legal entities, namely parent and subsidiaries. This is different from the U.S. approach, under which a parent is generally not liable for its subsidiary's actions, except where the parent treats the subsidiary as "a mere agency or instrumentality."

For the same reason, although the general rule is that an acquirer is liable for the conduct of a target only from the moment of the aquisition, an acquirer may, in some cases, be attributed full liability for a target's infringement committed before its acquisition of the target. For example, if the target loses its legal personality because its assets have been absorbed, the acquirer may be fully liable under the doctrine of economic continuity.

The burden of proof to establish that a subsidiary did not act autonomously rests with the Commission. However, in the case of 100% (or close-to 100%) ownership, there is a rebuttable presumption that the subsidiary does not act autonomously, and the parent company has to prove the contrary.

The threshold to rebut this presumption is high: To prove "autonomy," *i.e.*, that the subsidiary determines its own course of conduct on the market independently, the parent company needs to show independence not just in the aspects of commercial policy which are directly relevant to the specific case (*e.g.*, distribution strategy and pricing), but more generally as well. According to the ECJ, the Commission may consider also the general relationship between parent and subsidiary, *i.e.*, their economic, organizational and legal links. For example, if the parent and subsidiary share directors or executives, a rebuttal will likely fail. Consequently, cases where the presumption has been rebutted are so far extremely rare.

Investment Entities and Funds

The Commission has applied this concept of parent liability also to investment entities. It has attributed liability to an investment holding company, a turnaround fund and even an investment vehicle held by a private equity consortium. It is important to note that the Commission seems to draw a line between passive financial investors and investors that follow a more hands-on approach, although the ECJ has not yet decided this issue. The

CONTINUED ON PAGE 20

Developments in EU Antitrust Laws (cont. from page 19)

Commission's *Akzo* decision observes that Akzo "is not simply an investment vehicle that merely serves to invest capital in companies whose commercial operation it then leaves to those companies," thus implying that such investment vehicles would not be subject to the presumption of liability. Conversely, attribution of liability may occur if an investor exercises a decisive influence over a portfolio company.

As a consequence, private equity investors that exercise "hands-on" management of portfolio companies active in the EU should scrutinize closely their portfolio companies' activities, considering in particular that:

- Preventing antitrust problems by means of an effective and tested compliance program is always less expensive than managing problems after they arise (and paying fines).
- Exposure to fines may be avoided or reduced by applying for leniency. However, full immunity is only available for the first company involved in an alleged cartel to provide comprehensive information to the antitrust authorities. Again, compliance control is key.
- Internal investigations may shed light on potential antitrust exposure and also help to create a basis for effective cooperation with the antitrust authorities, as is required in order to benefit from leniency programs. ■

Dr. Thomas Schürrle
tschuerrle@debevoise.com

Daniel Wiedmann
dwiedmann@debevoise.com

Buying Assets from Distressed Companies (cont. from page 16)

held liable for injuries caused by prior manufactured products in a line which the acquirer continues to manufacture. Avoiding such liability is not always possible and requires careful structuring even when it is possible.

Certain additional creditors' claims also may follow the business operation, sometimes without the awareness of the buyer (or even the seller): materialmen's and mechanics' liens, and oil, gas and agricultural liens each have special rules which make their disclaimer by the buyer, if possible at all, a matter requiring discovery, express treatment and other special provisions, usually including notice to the potential claimant. Also, a few states have not yet eliminated their bulk transfer laws. In such states, an asset sale may constitute a bulk transfer if it involves the sale of a substantial portion of the seller's inventory outside the ordinary course of business, in which case notice of the asset sale must be given to the seller's creditors. Finally, most states impose successor liability on the buyer if the transaction is deemed to create a "mere continuation" of the acquired business or if the transaction is considered a "*de facto* merger." A forewarned buyer should carefully consider a distressed asset sale with these attributes, and should explore alternatives.

These risks can be ameliorated through contractual covenants, closing conditions, indemnification, escrow or holdback provisions. For example, a general indemnity together with particular indemnities for pending or threatened litigation and environmental conditions or violations may be appropriate. However, the value of such contractual protection must be weighed carefully, as these types of provisions may not have much teeth against a distressed seller on the verge of a bankruptcy filing. Distressed acquisitions face a higher risk of judicial attention and later attack, and the seller's representations have less weight against such risks than in a transaction between two healthy corporations. A distressed seller's indemnifications for buyer liabilities arising from the seller's pre-sale acts will also represent limited assurance. Buyers may want to carefully analyze their structuring options — weighing in favor of escrows and holdbacks — in light of what may be, for all practical purposes, an "as is" sale.

Buyers of a distressed business or one held by a distressed parent in out of court transactions should take care to enter into such transactions only with good planning, adequate preparation and a well-thought-out process, in order to mitigate the fraudulent conveyance and successor liability risks that may be present when extracting assets from a distressed seller. ■

Jasmine Powers
jpowers@debevoise.com

Derek Alexander
dalexand@debevoise.com

The End of Pay to Play? (cont. from page 1)

exempt from registration under Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act"). Section 203(b)(3) is the exemption relied upon by private fund sponsors that have fewer than 15 clients.

The Proposed Rule has created quite a bit of controversy in the private equity community — particularly over a proposal to prohibit fund sponsors and other investment advisers from compensating placement agents and solicitors in connection with the solicitation of governmental entities. However, the main focus of the Proposed Rule — political contributions by investment advisers that might be designed to induce state pension plan investments — could also have a significant impact on the activities of private fund sponsors and their employees. This article focuses on the political contribution component of the Proposed Rule.

Some Background

The proposal is modeled on Municipal Securities Rulemaking Board Rule G-37, adopted in 1994, which addressed pay to play practices in the municipal securities markets. Rule G-37 prohibits a broker-dealer from engaging in municipal securities business with a municipal issuer for two years after the broker or certain of its employees make a political contribution to an elected official of the municipality who can influence the selection of the broker-dealer. Another MSRB rule prohibits broker-dealers from using consultants to solicit government clients.

In 1999, the SEC turned its attention to pay to play practices in the investment advisory business, but the proposal was met with stiff resistance and was never adopted.

The SEC's interest in pay to play was renewed recently following allegations of pay to play practices in New York, New Mexico, Illinois, Ohio, Connecticut and Florida. In addition to enforcement actions by the states and the SEC, several states have moved forward with new regulations to combat pay to play practices including, among others, an executive order issued by the New York State Comptroller mirroring the proposed SEC rule, a pension reform bill banning the use of placement agents in Illinois and increased disclosure requirements for placement agents in Connecticut and California.

The SEC's Rationale for Action on Pay to Play

The regulation of state and local campaign contributions would not necessarily seem to be within the expertise of the SEC, the federal agency charged with overseeing the securities markets and securities professionals. Nevertheless, in proposing the Rule, the SEC stated that pay to play practices implicate the fiduciary duties that are at the core of the Advisers Act. According to the SEC, obtaining business or investments through pay to play "can distort the process by which investment advisers are selected and can harm advisers' public pension plan clients, and the pension plan beneficiaries, which may receive inferior advisory services and pay higher fees."

The Scope of the Rule

The Proposed Rule would prohibit investment advisers from accepting compensation for providing advisory services to a state or local government client for two years after the adviser or one of its "covered associates" makes a contribution to certain elected officials or candidates (the "Two-Year Bar"). In addition to the Two-Year Bar, an adviser and its "covered associates" would also be prohibited from coordinating or soliciting any contribution or payment to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services (as well as to a political party of a state or locality where such government entity exists).

The manager of a private fund in which a government entity invests would be treated as though the manager was providing investment advisory services directly to the government entity. Thus, the manager could not accept

... [T]he SEC is considering the over 200 comments that have been submitted in response to the Proposed Rule. While most of the comments have been critical, given that pay to play stories continue to appear in the press, it should not surprise anyone if the SEC adopts the Proposed Rule, or something very similar to it, this time around.

The End of Pay to Play? (cont. from page 21)

compensation (management fees, carried interest and other compensation) attributable to the investment of the government client.

As noted below, the broad and uncertain scope of the proposed rule may well result in a severe cutback in routine political contributions by private equity professionals to candidates for state and local office.

Contributions, Officials and Covered Associates

As is the case with any SEC rule, the devil is not so much in the details but in the definitions. The scope of the definitions are particularly important and sensitive in the case of the Proposed Rule due to the possible effects on constitutionally protected political speech. In this case, there are three definitions that deserve particular scrutiny: "contribution," "official" and "covered associate."

What Is a Contribution?

The term "contribution," while broad, is fairly straightforward. A contribution is any gift, subscription, loan, advance, or deposit of money or anything of value made for: (1) the purpose of influencing any election for federal, state or local office; (2) payment of debt incurred in connection with any such election; or (3) transition or inaugural expenses of the successful candidate for state or local office.

The Proposed Rule includes two exceptions for contributions of $250 or less. First, there is an exception for contributions of $250 or less made to the official for whom the contributor is entitled to vote. Second, the Proposed Rule also provides a less helpful exception with respect to contributions made by a covered associate to officials other than those for whom the covered associate was entitled to vote. There are several conditions to this exception, including: (1) the contributions by the covered associate must be $250 or less in the aggregate; (2) the adviser must have discovered the contribution by the covered associate within four months of the date of the contribution; and (3) the adviser must cause the contribution to be returned to the covered associate within 60 days of learning of the contribution.

Who Is an Official?

In order to trigger the rule's prohibition, the contribution must be made to an "official" who is (or who has the authority to appoint any person who is) directly or indirectly responsible for the selection of an adviser or who can influence the outcome of the selection process.

The definition of which officials of the state or local governments are covered presents a number of challenges. First, the term is not limited to incumbents, nor is it limited to candidates for the office that make the investment adviser selection. A candidate for the U.S. House of Representatives who will not, if he or she wins, be in a position to select the investment adviser, would nonetheless be an official if he or she is currently in a position to influence the selection of investment advisers. Furthermore, a contribution to a candidate who does not get elected would still trigger the Two-Year Bar. Interestingly, a government employee who does not hold elective office, but may be in a position to select or influence the selection of an investment adviser, would not be an official unless he or she is seeking an elective office that would put him or her in a position to influence the selection process.

The subjective judgments inherent in the definition of an "official" further expand the potential application of the Proposed Rule. In particular, it is difficult to see how an adviser can identify with confidence each person who is "indirectly" responsible for, or who "can influence the outcome of" the selection of an investment adviser.

Who Is a Covered Associate?

The expansive definition of "covered associates" also contains traps for the unwary. A political contribution by any of the following persons (or a PAC controlled by them) will trigger the Two-Year Bar:

- the adviser's general partners or managing members, the president and any vice president in charge of a principal business unit, division or function;
- any executive officer who in connection with his or her regular duties performs, or supervises any person who performs, investment advisory services;
- any executive officer who in connection with his or her regular duties solicits, or supervises any

CONTINUED ON PAGE 23

As is the case with any SEC rule, the devil is not so much in the details but in the definitions. ... In this case ... "contribution," "official" and "covered associate."

The End of Pay to Play? (cont. from page 22)

person who solicits, investment advisory business; and

- any employee who solicits a state or local government.

While the SEC stated in the proposing release that this definition would not include a comptroller, head of human resources or director of information services, it would include, for example, an executive officer who performs advisory services for one fund and contributes to an official of a government entity invested in another fund managed by the investment adviser. Donations by third parties including attorneys, family members, friends or companies affiliated with the adviser are not specifically included in the definition of "covered associate" but would also trigger the Two-Year Bar if they are really indirect donations by a "covered associate."

Further traps are created by temporal vagaries associated with one's status as a "covered associate." Suppose an employee makes a contribution and is subsequently promoted to a position in which he or she is a covered associate — does the political contribution trigger the Two-Year Bar? The Proposed Rule is clear that it would. Furthermore, the Two-Year Bar would continue even if a covered associate who made a donation leaves the firm or moves to another position where he or she is not a covered associate.

The Two-Year Bar would also apply if the advisory firm hires a person into a covered associate position who made a contribution prior to being hired. Thus, potential outside hires may be effectively disqualified from consideration due to their prior political contributions, even though those contributions were perfectly legal when made. This could lead to awkward politically-oriented questions during the hiring process of a new covered associate. It may also make business school students interested in positions in private equity and other investment advisory firms think thrice before making political contributions to candidates.

Grandfathering

It should be noted, however, that contributions made prior to the effective date of the Proposed Rule are "grandfathered" and thus will not trigger the Two-Year Bar. Contributions made after the effective date of the rule to officials of existing governmental clients, however, would not be "grandfathered."

The Two-Year Bar and Its Consequences

If the adviser or its employees make an inappropriate contribution, the adviser is not prohibited from providing advice, only from receiving compensation for such advice. In fact, the SEC assumes that the adviser would be required to provide uncompensated advisory services for a reasonable period of time until the client retains a new adviser. Due to the expansive definition of "compensation" under the Advisers Act, the types of banned compensation would include management fees, carry and any form of economic or other benefits received directly or indirectly by the adviser for providing investment advice with respect to the government entity in question. Reimbursement for overhead and other costs would also be considered compensation.

The Two-Year Ban could cause particular issues for private equity funds because investor withdrawals are often not permitted or impracticable. There are simple fairness issues, of course, that may also have fiduciary implications. For example, why should a government entity get services free that other investors have to pay for? Also, who ultimately pays for the uncompensated advice, the adviser or the other investors? The impact of providing uncompensated advice could also trigger "most favored nation" agreements. One suggestion that has been made to the SEC in comment letters is that a fund adviser, if it is faced with the Two-Year Bar, should be permitted to return to the fund the fees that are attributable to the government entity. This seems like an unsatisfactory result, at best.

The Two-Year Bar will be the same regardless of the severity of the infraction. In addition to the possibility

CONTINUED ON PAGE 24

The Two-Year Bar would also apply if the advisory firm hires a person into a covered associate position who made a contribution prior to being hired. Thus, potential outside hires may be effectively disqualified from consideration due to their prior political contributions, even though those contributions were perfectly legal when made.

The End of Pay to Play? (cont. from page 23)

of returning certain contributions as discussed above, the Proposed Rule provides that the SEC may grant the adviser an exemption if it concludes the imposition of the prohibitions is unnecessary to achieve the rule's purpose. Each exemption would be examined based on a facts and circumstances approach. Along with the nature of the contribution itself (including the timing, amount, the contributor's status at that time, and the contributor's intent), the SEC will also consider whether the adviser (1) has adopted and implemented policies and procedures reasonably designed to prevent violations of the Proposed Rule; (2) had no actual prior knowledge of the contribution; and (3) after learning of the contribution, has taken all available remedial or preventive measures as may be appropriate under the circumstances including the return of the contribution.

Conclusion

At this writing, the SEC is considering the over 200 comments that have been submitted in response to the Proposed Rule. While most of the comments have been critical, given that pay to play stories continue to appear in the press, it should not surprise anyone if the SEC adopts the Proposed Rule, or something very similar to it, this time around.

Given the complexities of the Proposed Rule, as well as the state rules governing pay to play, there may be a natural inclination for a firm simply to prohibit employees from making political contributions to candidates for state and local office altogether. Unfortunately, such a policy may not be sufficient, since, for example, a contribution to a candidate for federal office may trigger the Two-Year Bar if the candidate is currently a state or local "official." For these reasons, developing a sufficiently comprehensive and up-to-date list of candidates and officials to whom contributions are prohibited may be the most cumbersome, and potentially costly, task for sponsors, even in circumstances where a sponsor imposes an outright ban on contributions to candidates for state and local office.

In all events, we believe private fund managers should resist the temptation to wait until after the Proposed Rule is finalized to adopt or revisit their existing policies relating to political contributions. Some states and localities are ahead of the SEC in adopting anti-pay to play rules that mirror the SEC approach. At a minimum, a private fund manager that is soliciting an investment by state or local entity should determine whether that jurisdiction has anti-pay to play rules and assure that its employees have not made any political contributions that may be problematic under those rules.

We will update this article to reflect the definitive SEC rule in this area once and if it is adopted. ■

Kenneth J. Berman
kjberman@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

Looking for a past article?

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