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AHYDO Savers: Not Life Savers After All for PIK Toggle Issuers?

Many private equity portfolio companies that issued PIK Toggle debt during the credit boom are beginning to wrestle with the problem of how to calculate mandatory partial redemption payments that were intended to avoid adverse tax consequences. These payments, affectionately known as AHYDO savers, will come due for many issuers over the course of the next two years.

During the middle of the decade just past, when the leveraged finance market was awash in easy credit, corporate borrowers issued large sums of high-yield junior debt bearing original issue discount ("OID"). In some cases, issuers built in "PIK or pay" features, which allowed them to conserve cash if business conditions required. Under these "PIK Toggle" instruments, borrowers were permitted during the first few years of the instrument's term (and sometimes longer) either to pay cash interest currently, capitalize interest into the principal of the debt, or elect a combination of current payment and capitalization. Although these instruments would in many cases otherwise be Applicable High Yield Discount Obligations ("AHYDOs"), many borrowers avoided classification of the instruments as AHYDOs by providing for one or more special mandatory partial redemption payments to be made more than five years after issuance.

Under normal credit market

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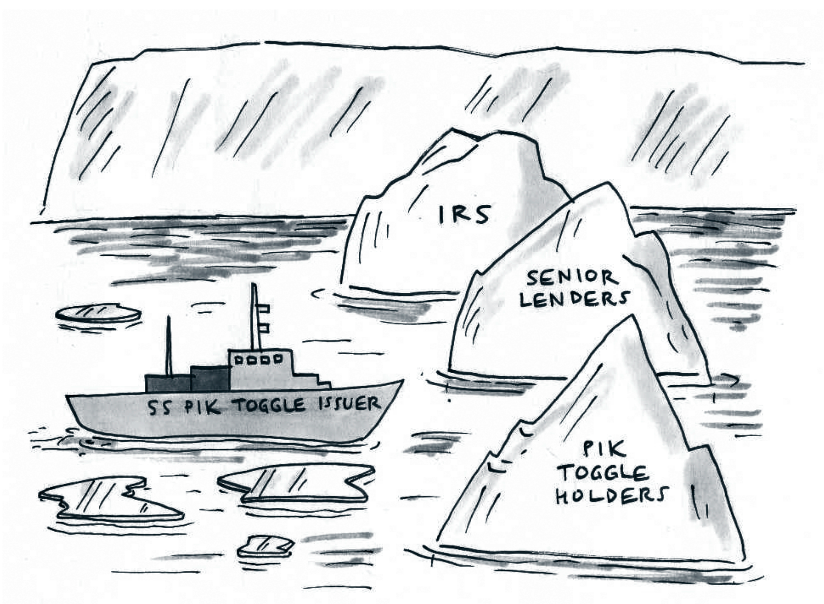

WHAT'S INSIDE

Letter from the Editor

After a very long winter, the private equity industry is poised for a period of renewal. Deal activity is clearly on the uptick, the financing markets are showing signs of activity, the IPO market is no longer in the doldrums and asset allocations to private equity are no longer just a memory.

The challenges facing the private equity industry are too numerous to list. In this issue, we suggest ways in which to tackle many of them.

On our cover, we remind those who financed transactions with "PIK toggle" instruments that, while cash interest payments can certainly be avoided, mandatory partial redemption payments may soon be due. These partial redemption payments were designed to avoid adverse tax consequences, but will certainly now give rise to thorny calculation issues which were unanticipated when it was expected that the debt could easily be refinanced well in advance of its due date.

The legislative scene seems like no friend of private equity these days. We report on the recent changes to UK tax law, which will limit to some degree both the leverage available to UK companies and the advantages of repurchasing portfolio company debt. We also report on the state of the EU's Alternative Investment Fund Managers Directive, which is poised for passage in some form in the near term. Whether it will threaten the ability of London to continue as a private equity hub remains to be seen.

Climate change and other "green" legislation is on the legislative agenda in both the U.S. and Europe. From our London office, we herald some good news for private equity sponsors with UK portfolio companies because the final Carbon Reduction Commitment legislation due to become effective this spring offers more options for compliance than initially proposed. It is expected that climate change legislation in the U.S. is also forthcoming, and we offer a primer on its many sources as well as why private equity players should stay abreast of its progress.

As the IPO market improves, we offer some guidance to those private equity sponsors who have been away from the market for a while by reviewing the new SEC disclosure requirements relating to compensation, corporate governance and climate change.

We have previously highlighted the use of earnouts to bridge valuation gaps in unsettled markets. In this issue, we remind you that earnouts are no panacea. Two recent decisions in two U.S. circuits suggest that in order to avoid an affirmative duty to help a seller realize the earnout payments, buyers may need to negotiate a complete set of rules for the operation of a business during the earnout period.

We also report on the challenges and opportunities of private equity investment in the U.S. defense industry.

As always, we look forward to your comments and your suggestions on what aspects of the private equity industry you would like to see featured in future issues of the *Debevoise & Plimpton Private Equity Report.*

Franci J. Blassberg
Editor-in-Chief

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Mission Possible: PE Investments in the Defense Industry

Despite a host of unusual deal challenges, private equity firms have in the past made a number of significant investments in defense, aerospace and other companies with military operational elements. Significant examples include KKR and General Atlantic's acquisition of TASC Inc. in 2009, Carlyle's acquisitions of Booz Allen's government consulting arm in 2008 and Sequa in 2006, Goldman and Onex's acquisition of Hawker Beechcraft in 2007 and the 2006 acquisition by a consortium of private equity firms of a minority stake in EADS. While M&A activity in the aerospace and defense sector slowed in 2009 and President Obama's recently announced defense budget shows a slight decrease in defense spending for 2010, many analysts are cautiously optimistic about growth and related merger activity in the space in the coming year. Some positive factors include the surge in Afghanistan, the continued U.S. presence in Iraq, low leverage at many defense-related companies and growth in foreign military sales. More generally, rampant and continuing worldwide security concerns seem to make for a bullish environment for investment in this sector.

Given the potential opportunities in this space, we think it is a good time to highlight some of the legal and regulatory issues which raise special challenges for investments in this arena, particularly for private equity buyers. There are many such challenges, but don't be dismayed! For the determined sponsor, it is not as bad as it may seem at first blush.

Security Clearances

Unlike many strategic buyers of defense companies, most sponsors are unlikely to have on staff anyone with active security clearances. This poses significant challenges to the diligence process because the sponsor will not only be denied access to important contracts and facilities relating to any classified projects of the target, but also may not be entitled even to be told of the existence or nature of the project. While a target may always disclose to an uncleared buyer that it is involved in one or more "black box" projects, it cannot provide any additional color as to what the projects are, who the customer is (what branch of the government or military) or the nature and scope of the contracts. This can force private equity and other buyers to fly blind on important operational aspects of the target, thereby greatly complicating valuation and other risk allocation judgments.

The process for obtaining a security clearance can be time-consuming and intrusive. It may even include always welcome questions like "Have you paid all of your 'nanny taxes'?" or "Did you smoke pot in college?" It is not for the faint of heart, and can often take up to a year to complete. But it is doable. One approach for private equity firms with a particular focus in this sector would be for the firm to hire an investment professional who already has security clearance, such as an individual with the requisite military experience. Still, if that is not feasible, and if no investment professional at the private equity firm is willing to endure the aggravation of obtaining the needed clearances, the sponsor can of course move forward with the transaction without diligencing the classified projects. There are many public companies with classified projects whose stockholders make investment decisions on the basis of limited disclosure made in the companies' public reports. In addition, the private equity buyer may attempt to shift the risk of what it doesn't know about the general size, duration and reliability of the projects to the seller via representations and indemnities. Still, it is difficult to negotiate appropriate contractual protections in a vacuum, and in any event, they do not afford a buyer the same perspective as reading the contracts and discussing the actual projects with management.

Another possible alternative is to retain a third party, ideally one whose business judgment is strong and well-known to the sponsor, with the necessary clearance to perform diligence on the classified projects. Of course, that person (who will also need to get approval from the relevant agency before being granted access) would be unable to disclose any of its findings or conclusions to the buyer. Still, the buyer may be at least able to take

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some cold comfort from the fact that one of its representatives has reviewed the classified projects and has had an opportunity to raise a red flag.

Unfortunately, none of this changes when the sponsor wins control of the target. Unless and until someone obtains the required security clearance, the sponsor will have to rely on the target's management and will be left in the dark as to its black box projects.

Exon-Florio

Under the Exon-Florio Act, private equity firms constituting "foreign persons" may need to obtain clearance with the Committee on Foreign Investment in the United States (CFIUS) prior to acquiring control of a U.S. defense-related business. Moreover, as we noted in our article "Final Exon-Florio Regulations: What They Mean for Private Equity" in the Winter 2009 *Debevoise & Plimpton Private Equity Report*, under new final regulations adopted in 2008 with respect to Exon-Florio, under certain circumstances, a private equity fund that views itself as a U.S. person may nonetheless be deemed to be a "foreign person" for purposes of Exon-Florio.

[M]ost sponsors are unlikely to have on staff anyone with active security clearances. This poses significant challenges to the diligence process because the sponsor will not only be denied access to important contracts and facilities relating to any classified projects of the target, but also may not be entitled even to be told of the existence or nature of the project.

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

An acquirer who believes it is subject to Exon-Florio may voluntarily make a filing with CFIUS, which will trigger a review and waiting period of the proposed transaction. If CFIUS clears the transaction without further review, the parties can close without fear of subsequent Presidential interference, unless the parties submit false or misleading material to CFIUS or materially breach their mitigation agreement, described below. By contrast, if no filing is made, the President has the power to unwind the transaction after it has closed. It is, therefore, almost always prudent in this context for a foreign buyer, including a private equity buyer who is a "foreign person" under Exon-Florio, voluntarily to make the appropriate filing with CFIUS.

Exon-Florio was amended in 2007 by the Foreign Investment and National Security Act of 2007 (FINSA). One of the changes implemented by FINSA involves so-called "mitigation agreements." Prior to FINSA, these agreements were informally entered into from time to time between a foreign person exercising foreign ownership, control or influence (FOCI) over a company with a U.S. national security interest and the relevant federal agency. The purpose of such agreements was to mitigate the effect of FOCI by, for instance, limiting involvement by foreign personnel on the company's board of directors and in certain sensitive tasks, requiring audits and the oversight of electronic communications to and from the foreign shareholder, establishing a security plan and a designated security officer and guaranteeing the right of the government to site visits and access to books and records. Each agreement would be individually tailored to the particular circumstances.

FINSA now specifically authorizes CFIUS to enter into mitigation agreements with buyers as a means of enabling them to receive clearance of particular transactions. Unlike the informal pre-FINSA process, however, the entire committee must approve both the appropriateness of mitigation and the proposed mitigation measures themselves before a mitigation agreement may be negotiated or executed. Executive Order 13456 also prevents CFIUS in most cases from coercing a company into complying with authority to which it would otherwise not be subject. Although these provisions may delay somewhat the process of entering into a mitigation agreement and thus clearing a transaction through CFIUS, they will have the beneficial effect of circumscribing the conditions that a foreign buyer will need to comply with in order to complete a transaction. On

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Thinking About an IPO? —

The Road to Market Is Paved With New Disclosure Requirements

The long awaited flurry of private equity backed IPOs is edging closer to reality, providing private equity firms with a potential opportunity to rationalize the balance sheets of portfolio companies, generate welcome returns on investment and begin the process of exiting legacy investments.

Private equity sponsors who are reentering the market after the long drought stoked by the financial crisis will face not only uncertain markets, but also a panoply of new disclosure requirements. Here's a "Cliff Notes" version of these new requirements, which relate to compensation, corporate governance and climate change:

Compensation and Corporate Governance Disclosure

Concern about the impact of compensation practices on corporate risk-taking prompted the SEC to adopt amendments in late 2009 to rules governing compensation and other corporate governance disclosure. The rule amendments apply to registration statements with an initial filing date on or after December 20, 2009 and that are declared effective on or after February 28, 2010.

Compensation policies and risk management. Registrants (other than small business issuers) must now discuss their compensation policies and practices for employees generally, including non-executive officers, as they relate to risk management practices and risk-taking incentives, if these compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. In determining whether risks are reasonably likely to have a material adverse effect, companies may consider policies and practices that mitigate or balance incentives to offset the risks involved.

While situations requiring disclosure will vary depending on the particular registrant and compensation policies and practices, the rule amendments provide a non-exclusive list of situations where compensation programs have the potential to trigger a requirement for disclosure, including policies and practices: (1) at a business unit that carries a significant portion of the company's risk profile; (2) at a business unit with compensation structured significantly differently than other units within the company; (3) at a business unit that is significantly more profitable than others within the company; (4) at a business unit where compensation expense is a significant percentage of the unit's revenues; and (5) that vary significantly from the overall risk and reward structure of the company.

The rule amendments also provide the following examples of issues that a company may need to discuss if it determines that any such disclosure is required: (1) the general design philosophy of the compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices and the manner of their implementation; (2) the company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or awarding and paying compensation; (3) how the compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term; (4) the company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile; (5) material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and (6) the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees. Although disclosure that is responsive to the rule amendments is not generally required to be included in the company's Compensation Discussion & Analysis ("CD&A"), the relevant risk considerations must be discussed in the CD&A if they are a material aspect of the compensation decisions for named executive officers.

Equity compensation. Registrants must now report the full grant date fair value of options and other equity awards in the now all-too-familiar Summary Compensation Table and the Directors Compensation Table for the year in which they are awarded to executives, rather than the amount recognized for financial statement purposes for the relevant fiscal year. For performance awards, the value reported should be computed based upon the probable outcome of the performance condition (or conditions) as of the grant date, consistent with the estimate

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Private equity sponsors who are reentering the market after the long drought ... will face not only uncertain markets, but also a panoply of new disclosure requirements..., which relate to compensation, corporate governance and climate change. ...

Thinking About an IPO? (cont. from page 5)

used for accounting purposes, and footnote disclosure of the maximum value of the awards assuming the highest level of performance conditions is achieved is now also required. For an equity award granted in a certain fiscal year to an executive officer that is forfeited due to the executive officer's separation from the company, the grant date fair value for such award is required to be included for the purpose of determining that year's total compensation. The grant date value of an award subject to time-based vesting should exclude the effect of estimated forfeitures.

Being responsive to these new disclosure rules could easily impact the determination of which executive officers, other than the CEO and CFO, are the highest paid officers and therefore required to be included in the Summary Compensation Table as named executive officers. Where company compensation decisions, including decisions to grant "new hire" or "retention" awards, do cause the named executive officers to change, the rule amendments permit companies to include supplemental compensation disclosure for executive officers who otherwise would have been subject to reporting (allowing disclosure for more than five officers, but not relieving a company of the obligation to disclose the new hire or retention award recipients in the table).

Board and executive officer disclosure requirements. Disclosure regarding each director's and director nominee's particular experience, qualifications, attributes or skills that led the board of the company to conclude that the person should serve as a director or be nominated to so serve is now required to be disclosed. The SEC has not specified the particular information that must be included with the disclosure, providing flexibility to include information most relevant to the company. However, disclosure of criteria or attributes as a group is insufficient, and a company must include an explanation as to why each individual director was chosen.

The rule amendments require disclosure of directorships at public companies and registered investment companies held by each director during the past five years. Previously, only current directorships were required to be disclosed. The rule amendments also lengthen the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years and expand the list of legal proceedings required to be disclosed in the registration statement to include: (1) judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity; (2) judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws and regulations, or any settlement to such actions (not including settlements of private civil litigation); and (3) disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Disclosure Related to Climate Change Matters

On January 27, 2010, the SEC issued interpretative guidance regarding disclosure related to climate change. Existing SEC disclosure rules require "material" effects on a company's business to be disclosed in a registration statement, including in the Risk Factors, Business, Legal Proceedings and Management's Discussion and Analysis of Financial Condition and Results of Operations sections.

The SEC's interpretive guidance clarifies the disclosure obligations of a company regarding the impact of climate change in these sections, and provides examples where climate change may trigger disclosure that a company may need to consider. These examples include: (1) the impact of certain existing laws and regulations regarding climate change and the potential impact of pending legislation and regulation, and the difficulties involved in assessing the timing and effect of the pending legislation or regulation; (2) the risks or effects on a company's business of international accords and treaties and other international activities in connection with climate change remediation; (3) legal, technological, political and scientific developments regarding climate change which may create new opportunities or risks for companies and the actual or potential indirect consequences they may face due to climate change-related regulatory or business trends; and (4) actual and potential physical impacts of climate change on a company's business. For IPO candidates that operate in an industry that is regarded as environmentally "challenged" or is otherwise affected by climate-related developments, the SEC's guidance is a "must read."

* * *

While the devil in any SEC rules and interpretive guidance is always in the details, IPO candidates will need to ensure compliance with and adherence to the rule amendments and guidance summarized above in order to avoid potential delays in having their registration statements declared effective. ■

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UPDATE

How Green Is Your Portfolio?—Update II

Private equity firms with UK portfolio companies can no longer delay focusing on the implications of the final Carbon Reduction Commitment ("CRC") legislation which is expected to become effective on 1 April 2010

The draft CRC Energy Efficiency Scheme Order 2010 (the "CRC Order") was submitted to the House of Commons and House of Lords in England and the relevant legislative bodies in Scotland, Wales and Northern Ireland for approval in January 2010, and it appears that such approval has now been received in England and Northern Ireland. On the whole, the updated draft reflects the UK government's final policy position set out in its response to the third and final consultation on the scheme issued on 7 October 2009.

Readers of our prior articles will remember that the CRC legislation as originally proposed presented severe 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 parent. Corporate groups were (and indeed still are) to be determined based on their structure as of 31 December 2008, applying the definitions of "parent undertaking" and "subsidiary undertaking" in the UK Companies Act 2006. The ultimate parent of the combined organization, including parent entities based outside of the UK, were to bear primary responsibility for compliance with the legislation by their qualifying UK portfolio companies.

Although this is still the default position, there is good news for the private equity industry: the updated CRC Order permits the ultimate parent of a CRC group to select any "Significant Group Undertaking" (an "SGU") within its group to participate separately in the scheme, as promised in the October 7 response. Once an SGU is split from its CRC group, it will participate as a separate entity (with no joint and several liability with its parent) for the whole of the relevant phase of the scheme, even if it subsequently reduces in size.

It is apparent from the CRC Order that, although the ultimate parent of a large corporate group may be able to decrease the size of its participant group by using this so-called "disaggregation" procedure, the ultimate parent must still participate with one or more of its subsidiaries and will be jointly and severally liable with those subsidiaries for compliance with the scheme, as disaggregation is not permitted if it would result in the rest of the group falling below the 6,000MWh participation threshold.

If the ultimate parent of the group is based outside the UK, it will be required to nominate a group company based in the UK to act as "Primary Member" on behalf of the whole group. The UK Environment Agency (the Government body responsible for implementing and monitoring the CRC) has indicated that although it intends primarily to pursue the Primary Member to enforce compliance with the CRC Order and recover any unpaid fines or other sums, it did not discount pursuing other group members if this was not successful, using the principle of joint and several liability.

In order for an SGU to be eligible for disaggregation, the ultimate parent must have applied for registration in the scheme at least three months before the registration deadline, being 30 September 2010 for the first phase. A group must therefore have applied for registration by 30 June 2010 in order to disaggregate any of its SGUs for the first phase of the scheme.

There are special rules dealing with the transfer of SGUs during the period between the end of a qualification year and the end of the registration period for a particular phase (from 1 January 2009 until 30 September 2010 for the first phase). In short, the SGU will become part of the purchaser's group for monitoring and compliance purposes, and if the purchaser's ultimate parent was not originally obliged to register as a participant (because its group emissions in the qualification year fell below the participation threshold), it will need to register as a participant, but will only be required to participate in respect of the emissions of that SGU and will not be required to include emissions of any other UK subsidiaries held during the qualification year.

Accordingly, funds will not only need to identify their participant group as of 31 December 2008, if any, but also consider whether any subsequently acquired portfolio company would have been classified as an SGU of the seller as at that date. This potentially complicated exercise will need to be undertaken by private equity investors as soon as possible so that they can assess and potentially limit their exposure to the scheme before the June 30 registration deadline. ■

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Thomas M. Britt, III
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International Bar Association
London

March 15, 2010

Kenneth J. Berman
"Understanding the Impact of Legislative and Regulatory Changes on Mutual Funds"
2010 Mutual Funds and Investment Management Conference
Investment Company Institute
Phoenix

March 26-27, 2010

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"The Financial Crisis, the Rise of Asia, and the Role of Anti-Bribery Enforcement Compliance"
Twenty-eighth Annual Symposium 2010
Queensland Law Society
Brisbane, Australia

April 23, 2010

Gregory J. Lyons
"Private Equity and Institutional Investments in the Banking Industry"
ABA's Business Law Section
Spring Meeting 2010
American Bar Association
Denver

May 13, 2010

Kevin M. Schmidt
"Special Issues Involved in Acquiring Divisions or Subsidiaries of Larger Companies"
Acquiring or Selling the Privately Held Company 2010
Practicing Law Institute
New York

May 13, 2010

W. Neil Eggleston
"The Role of Directors in a Challenging Economic Environment"
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EU Alternative Investment Fund Managers Directive: A Tale of Two (or Three) Proposals

A cynical observer of the tortured path of financial reform legislation in the European Union might argue that EU policymakers are almost as determined as their American counterparts to violate Rahm Emanuel's first rule of governing by letting a good crisis go to waste. But the legislation that most directly affects the private equity industry — the draft directive on alternative investment fund managers — remains very much alive, even if attempts to reach early agreement between Member States on the outstanding issues have been put on hold following some heavy lobbying. Whether this bolsters or disproves the cynic's argument may be both a matter of perspective and the final shaping of the directive as it enters a critical stage in the legislative process.

European Commission Proposal

It is hard to put all the recent chatter in context without a little history. The directive was first proposed by the European Commission (the "Commission")[1] in April 2009, as part of the Commission's response to the worldwide financial crisis. Intended to create a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers in the EU, and also to help develop a single European market for alternative investment funds,[2] the draft directive augured a dramatic change in the EU regulatory landscape for private equity managers. See the Spring 2009 edition of the *Debevoise & Plimpton Private Equity Report*, "What You Need to Know About the Proposed EU Directive on Alternative Investment Fund Managers."

The proposal put forward by the Commission (the "Commission Proposal") did not follow the usual lengthy consultation process for EU financial services legislation. Instead, it was produced in haste and with limited scope for prior comment. As a result, some of the provisions are vague and do not fit easily into the EU's existing financial services framework. In part because of these drafting problems, but also because the proposed legislation would impose significant new capital, disclosure, valuation and other regulatory burdens on private equity and hedge fund managers, the Commission Proposal set off a firestorm of criticism from the industry.

The Commission Proposal requires that fund managers based in the EU be authorized in order to provide 'management services' (the activities of managing and administering one or more funds on behalf of investors). In one of the more controversial aspects of the legislation, after a three-year transition period, authorization would also be required for managers based outside the EU which market their funds to investors within the EU.

Specifically, authorization under the Commission Proposal would mean that fund managers:

- must have minimum capital of €125,000, plus 0.02% of the value of assets under management in excess of €250 million (subject to an overriding 'own funds' requirement of 25% of annual fixed overhead);
- must ensure that an independent valuer is appointed to value the assets of each fund they manage;
- must ensure that an independent EU authorized credit institution is appointed as a depositary (custodian) to hold the assets of each fund they manage;

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The proposal put forward by the Commission ... did not follow the usual lengthy consultation process for EU financial services legislation. Instead, it was produced in haste ... [and] set off a firestorm of criticism from the industry.

1 *The Commission is the EU institution with responsibility, among other things, for proposing new legislation that applies throughout the EU. The Commission has the sole right to propose new laws, but the laws must be adopted by the European Parliament and the EU Council before becoming binding on Member States.*

2 *Investment funds that are not subject to the UCITS Directive, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, which permits open-ended funds that comply with certain criteria to be marketed to retail investors across the EU under an EU passport.*

EU Alternative Investment Fund Managers Directive (cont. from page 9)

- may delegate their functions to appropriately qualified third parties, but must first obtain prior authorization from their regulator;
- must comply with extensive disclosure and reporting requirements, including (in the case of fund managers managing leveraged funds) information on the levels of leverage they employ;
- must make additional disclosures to their regulators and their portfolio companies and the companies' shareholders and employee representatives, when acquiring voting interests in portfolio companies of 30% or more (except for acquisitions of interests in small and medium enterprises);
- may market EU-based funds that they manage to 'professional investors' throughout the EU, under an EU 'passport' (*i.e.*, without requiring marketing authorization from each Member State);
- may market non-EU-based funds to professional investors in their home Member State, provided that, after the expiry of a three-year transitional period following the Directive's implementation, an OECD compliant tax agreement has been signed between their home Member State and the country where the fund is based; and
- may market non-EU-based funds to professional investors in other Member States under an EU passport, after the expiry of a three-year transitional period following the directive's implementation, provided an OECD compliant tax agreement has been signed between the Member State where the marketing is carried out and the country where the fund is based.

In response to the heavy criticism and vociferous lobbying from the alternative investment fund industry, the EU Council has issued a series of compromise proposals for the directive.

EU Council's Proposal — Some Relief, But Additional Requirements

The directive is being legislated under the EU's 'codecision procedure', which means it has to be approved by both the EU Council (the "Council")[3] and the European Parliament. In response to the heavy criticism and vociferous lobbying from the alternative investment fund industry, the EU Council has issued a series of compromise proposals for the directive. The latest version, published on March 11 (the "Council Proposal") differs from the Commission Proposal in a number of respects that are beneficial to fund managers.

For the purposes of the directive, the definition of 'marketing' is narrowed, to exclude cases where the initial approach comes from the investor rather than the fund manager; the minimum capital requirement for fund managers is capped at €10 million (but still subject to the overriding 'own funds' requirement of 25% of annual fixed overhead); the valuer is no longer required to be independent; individual Member States (rather than the Commission) will have the power to set leverage limits; and the threshold for making additional disclosures on the acquisition of interests in non-listed portfolio companies is increased to 50%.

The Council Proposal added some new obligations, however, that raised the hackles of the private equity industry and the City of London. Most prominent of these, the Council Proposal contains new provisions which require fund managers to have in place remuneration policies and practices that meet specific criteria, including the deferral of at least 40% of variable remuneration paid by both the fund manager and the fund itself (such as carried interest). The deferral would be "over a period which is appropriate in view of the life cycle and redemption policy of the fund concerned." In the case of variable remuneration of a "particularly high amount" at least 60% would be deferred.

In addition, the Council Proposal dropped the provisions allowing fund managers not based in the EU to obtain authorization to market funds across the EU under an EU passport. Instead, Member States are to be permitted to

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3 *The Council is made up of one member from each Member State. The Presidency of the Council rotates every six months to ensure that no Member State has too great an influence in the development of any single policy. Spain currently holds the Presidency of the Council.*

UPDATE

Bridging the Gap—

Implied Obligations in Earnout Contracts

Caveat Emptor, or buyer beware, is taking on an important new dimension in the context of M&A deals featuring earnout provisions. Two recent decisions reflecting courts' willingness to impose affirmative obligations to meet earnout targets deserve serious attention from any private equity buyer considering entering into such a provision.

In our article entitled "Bridging the Gap," published in the Winter 2009 edition of the *Debevoise & Plimpton Private Equity Report*, we noted that private equity deal professionals were finding earnouts to be an increasingly effective tool in bridging valuation gaps in today's unsettled markets. We also noted that while earnouts could make it easier for parties to come to terms on price, they often led to complex negotiations calibrating a seller's desire to protect its earnout opportunity through restrictive covenants, veto rights and other protective provisions and a buyer's desire to be able to run the acquired business autonomously.

For these reasons, many buyers have historically approached earnout negotiations with the goal of limiting the number and scope of a seller's protective provisions to the greatest extent possible. We cautioned in our earlier article, however, that in circumstances where a definitive agreement sets forth incomplete ground rules for the operation of an acquired business during an earnout period, buyers have been held to have an implied covenant of good faith and fair dealing, precluding them from taking actions in bad faith to interfere with a seller's ability to achieve an earnout even though such actions were not prohibited by the express terms of the applicable purchase agreement.

A recent decision of the Court of Appeals for the First Circuit goes even further in this regard by holding that in circumstances where a definitive agreement contains such incomplete ground rules, a buyer may have an implied affirmative obligation under Massachusetts law to use reasonable efforts to operate an acquired business so as to support a seller's earnout opportunity. Another recent decision of a U.S. District Court found a similar affirmative obligation under Ohio law. These cases, coupled with the implied covenant of good faith and fair dealing, are noteworthy to deal professionals because they demonstrate the willingness of certain courts to impose important duties on buyers to help sellers realize earnouts, even (and, indeed, particularly) where the parties' respective rights and obligations with respect to the earnout are not set forth with clarity in the four corners of the purchase agreement.

Sonoran Scanners (Massachusetts Law)

Facts

Sonoran Scanners v. PerkinElmer, Inc. (1st Cir. Oct. 29, 2009) arose out of the 2001 purchase by PerkinElmer, Inc. from Sonoran Scanners, Inc. of its computer-to-plate (CTP) business, which involved developing and marketing high-speed digital printing technology for the newspaper industry. Under the asset purchase agreement, PerkinElmer paid Sonoran $3.5 million at the closing and agreed to make additional payments (up to $3.5 million) if certain product sale targets for Sonoran's CTP products were met each year between 2001 and 2006. The purchased business turned out to be a failure. PerkinElmer made a single sale of the CTP products and, before the expiration of the earnout period, sold the acquired assets and laid off affiliated staff. No additional amounts were paid by PerkinElmer to Sonoran under the earnout.

Sonoran sued, alleging, among other things, that PerkinElmer breached the asset purchase agreement by failing to make good faith and reasonably competent and diligent efforts to develop, market and sell Sonoran's products. The district court granted summary judgment to PerkinElmer, but the First Circuit reversed.

Implied Covenant to Use Reasonable Efforts

The First Circuit stated that Massachusetts courts follow the principle formulated by Justice Cardozo in *Wood v. Lucy, Lady Duff-Gordon* (N.Y. 1917) that "[the] promise to pay … profits and revenues resulting from [an] exclusive agency … was a promise to use reasonable efforts to bring profits and revenues into existence." In *Eno Sys., Inc. v. Eno* (Mass. 1942), the Supreme Court of Massachusetts held that a person that obtains an exclusive license to manufacture a product under a patent has an implied obligation to use

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reasonable efforts to promote sales of the product and maximize revenue. Although PerkinElmer argued that the implied duty to use reasonable efforts recognized by the Supreme Court of Massachusetts in *Eno* was limited to exclusive licensing arrangements, the First Circuit rejected that argument and held that the implied obligation could exist in other situations, including an earnout.

PerkinElmer also argued, citing cases from some other jurisdictions, that the implied obligation to use reasonable efforts to support an earnout is limited to contracts where there is no consideration supporting the existence of a contract other than the earnout. Since PerkinElmer paid $3.5 million for the acquired business at the closing, it contended that the implied obligation to use reasonable efforts did not apply to its deal with Sonoran. The First Circuit disagreed. The key inquiry under Massachusetts law, the court stated, is whether the acquisition agreement as a whole supports an inference of a reasonable efforts obligation.

Applying this standard to the terms of the asset purchase agreement, the First Circuit held that there were several factors that supported Sonoran's argument that the reasonable efforts obligation was implicit. The court pointed out that the earnout was substantial in relation to the up-front closing payment, that a significant portion of the closing payment went to Sonoran's creditors and did not benefit its shareholders directly, and that the agreement contemplated a campaign to market Sonoran's products over the next five years (although, the court noted, that did not mean that it would not be reasonable to abandon those efforts sooner). Importantly, the First Circuit also noted that there were no express provisions in the agreement negating an obligation by PerkinElmer to use reasonable efforts or giving it absolute discretion to operate the purchased business.

Under these circumstances, the First Circuit concluded that PerkinElmer had an implied obligation to use reasonable efforts to develop and promote Sonoran's technology in order to make the earnout payments under the asset purchase agreement. The court remanded the case to the district court to determine the separate question of whether or not PerkinElmer had breached that obligation.

Eggert Agency (Ohio Law)

The existence of an implied obligation to use reasonable efforts to generate revenues to support an earnout was also recognized recently under Ohio law in *Eggert Agency Inc. v. NA Management Corp.* (S.D. Ohio 2009). In that case, NA Management purchased from Eggert Agency the stock of a subsidiary. The purchase price included payments based on revenues generated by the subsidiary's business during the three-year period after the closing. When the earnout payments did not meet the seller's expectations, the seller sued, alleging that the buyer had reduced the number of employees, closed a key office and converted clients to its own technology platform. The U.S. District Court for the Southern District of Ohio held that, because payouts to the seller were contingent on the buyer's revenues from the acquired business, the buyer had an obligation to use reasonable efforts to generate such revenues. The court also noted that the implied duty to use reasonable efforts was not modified or eliminated by the express terms of the purchase agreement, which did not specifically describe the buyer's obligations with respect to the earnout.

Other Jurisdictions

While *Sonoran* and *Eggert Agency* are limited to Massachusetts and Ohio law, respectively, it is possible that other courts, applying the laws of other states, could reach similar conclusions. For instance, although we are unaware of any case specifically recognizing an implied duty of reasonable efforts in an earnout case under New York law, New York courts generally follow the *Wood* case in recognizing the implied reasonable efforts obligation in the context of exclusive licensing agreements.

Implications

Sonoran and *Eggert Agency* are significant because they demonstrate the willingness of certain courts to impose important affirmative duties on buyers to help sellers realize earnouts, particularly in circumstances where the parties fail to set forth clear and comprehensive standards governing the operations of the acquired business during the earnout period.

Accordingly, one way for parties to avoid or at least limit the application of *Sonoran* and *Eggert Agency* could be for them to negotiate a comprehensive set of ground rules for the operation of the business during the earnout period. This has long been a prudent way to approach earnouts, but it is also likely to lead to protracted and painful negotiations, which in practice clients are often tempted to truncate by agreeing to a less developed earnout provision.

Alternatively, the parties to an earnout could agree on some generalized

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UPDATE

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

Federal, state and regional climate change initiatives are already having an impact on private equity acquisitions, and M&A deals more generally, and passage of a climate change bill by the U.S. Congress would likely have an even greater effect on the market. Below is a brief update to our Spring 2008 article on the status of climate change legislation and regulation and the effect on private equity deals.

Despite the introduction of a number of bills and some high-profile debate in recent years, the U.S. Congress has not passed comprehensive climate change legislation. The protracted legislative process and related uncertainties concerning the eventual regulatory landscape has created both an opportunity and a burden for private equity sponsors.

Private equity firms, particularly those contemplating acquisitions of carbon-intensive businesses, are analyzing issues associated with pending climate change legislation and regulation. They are investigating the potential costs of complying with proposed federal legislation, including expenditures necessary to upgrade plant equipment (to reduce greenhouse gas emissions) or purchase emissions allowances. Similarly, purchasers are investigating whether target businesses are subject to the U.S. Environmental Protection Agency's ("EPA") greenhouse gas ("GHG") reporting obligations and proposed climate change regulations. Purchasers are also assessing the costs necessary to comply with state and regional climate change initiatives. Additionally, private equity firms are finding new opportunities in businesses that are well-positioned to prosper if the regulatory landscape favors renewable energy sources, a price is put on GHG emissions, and a robust carbon-trading market emerges in the U.S.

With the U.S. House of Representatives' passage of a climate change and clean energy bill last summer and the Senate expected to debate a climate change bill this spring, some observers believe 2010 could be the year. In the meantime, state and regional initiatives have moved forward, and the EPA has been taking steps to regulate greenhouse gas emissions under existing laws.

Federal Legislation

Beginning with the introduction of legislation in the U.S. Senate in the fall of 2007, the adoption of some form of comprehensive federal legislation addressing climate change and regulating GHG emissions has seemed increasingly likely. Most recently, in June 2009, the U.S. House of Representatives passed the American Clean Energy and Security Act of 2009, also known as the Waxman-Markey bill, which introduced a nationwide federal renewable energy standard and created a nationwide cap-and-trade program designed to curb emissions of carbon dioxide and other GHGs.

The Waxman-Markey bill's renewable energy standard requires utilities to obtain a certain percentage of their electricity from renewable sources, including wind, solar and geothermal energy, biomass or landfill gas, hydropower, and marine and hydrokinetic renewable energy. The bill creates federal renewable energy credits ("RECs") which could be traded in a federal REC market.

With respect to cap-and-trade, the bill caps GHG emissions by certain

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Update: Climate Change Issues Are Turning Up the Heat (cont. from page 13)

heavy emitters, such as facilities emitting more than 25,000 tons of GHGs annually, which collectively account for approximately 85% of the nation's total GHG emissions. Total U.S. emissions are capped at 17% below 2005 levels by 2020 and 83% below 2005 levels by 2050. To comply with the cap, covered sources could reduce actual emissions by implementing technological or other changes, or purchase emissions allowances on the open market. The bill allows companies to trade and "bank" allowances for future use, and, in certain circumstances, borrow against future allowances.

In September, a climate change bill was introduced in the U.S. Senate by Senators Barbara Boxer (D-Calif.) and John Kerry (D-Mass.). The bill, the Clean Energy Jobs and American Power Act, is similar in many respects to the Waxman-Markey bill. The Senate bill, though, calls for deeper cuts in GHG emissions than the House bill. However, because of the Senate's focus on healthcare reform legislation, debate on the proposed Senate legislation stalled.

Senator Kerry and Senators Joseph Lieberman (I-Conn.) and Lindsey Graham (R-S.C.) have been trying to drum up bipartisan support for a new climate change bill that will be less costly to electric utilities, manufacturers and others. Their climate change bill is expected to be introduced this spring. However, it is not clear whether they will have the 60 votes necessary for the bill's passage. President Obama supports comprehensive climate change legislation and is expected to sign any climate change bill that Congress passes.

EPA Regulation

In 2009, the EPA took several steps to regulate GHG emissions under existing laws in the absence of Congressional passage of a comprehensive climate change bill. In December, the EPA issued its "endangerment finding," which concluded that GHG emissions endanger public health and welfare and are subject to regulation. This finding opened the door for the EPA to regulate GHG emissions under the existing federal Clean Air Act. However, legislation has been introduced in Congress to delay or stop the EPA from regulating GHG emissions.

In addition, in September, the EPA finalized a rule requiring certain large emitters of GHGs to report their annual GHG emissions to the EPA. That rule is already effective and requires many facilities to collect data on their GHG emissions. The EPA estimates the rule will require reporting from approximately 10,000 facilities.

State and Regional Initiatives

In the absence of federal climate change legislation, various state and regional initiatives are regulating GHG emissions and promoting renewable energy by requiring emissions reporting, setting emissions reduction targets, implementing state renewable portfolio standards and launching energy efficiency campaigns. In November, for example, California released draft rules regulating GHG emissions from electricity generators, oil refineries and other industrial facilities and creating a statewide cap-and-trade program in 2012. The Regional Greenhouse Gas Initiative, a regional cap-and-trade system for carbon dioxide emissions from power plants involving 10 states in the northeastern U.S., is already up and running. Currently, more than half of the states have implemented mandatory renewable portfolio standards and a number of states have similar voluntary initiatives.

Conclusion

Over the next few months, the spotlight on climate change legislation will shine brightly as the U.S. Senate debates passage of a comprehensive climate change bill. The private equity community should monitor these developments as the proposed climate change laws could affect private equity investments. We will provide a full update on climate change legislation if the U.S. Senate passes a climate change bill. ■

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New UK Tax Hurdles for Debt Buy Backs and Leverage

Among the challenges facing the private equity community, the UK's regime for the taxation of corporate debt – long considered taxpayer friendly – recently became a little less hospitable. Changes to UK tax law have added additional complexity and potentially tax costs to acquisition financings and to debt repurchases by private equity sponsors.

As a result of new rules adopted by HM Revenue & Customs ("HMRC"), UK members of a group of companies face additional restrictions on the amount of tax relief for interest costs on intra-group financing which generally apply if the UK group companies are more leveraged (taking into account both external and intra-group financing) than the group as a whole (taking into account external financing only). The good news for private equity sponsors is that the restrictions on interest costs under the new Worldwide Debt Cap ("WDC") rules generally should not apply to shareholder loans that private equity funds typically use to finance UK acquisition vehicles. However, interest costs on intra-group loans from a non-UK parent company to a UK group company may be subject to limitation if the group as a whole is less leveraged than the UK group. In addition to the WDC rules, HMRC has imposed a significant new hurdle to tax efficient repurchases of portfolio company debt that trades at a discount, which generally will have the effect of narrowing considerably the circumstances in which debt can be repurchased at a discount without triggering income from the release of debt.

Worldwide Debt Cap: Limiting Tax Relief for Finance Costs

On January 1, 2010, the new Worldwide Debt Cap ("WDC") rules came into force. The rules limit the tax relief available to the UK members of a group of companies in respect of financing costs. If the UK group members have, in the aggregate, higher net finance costs than the gross external finance costs of the group, for example, because of loans made by a non-UK parent to a UK group member, HMRC now infer that the UK members' finance costs are not commercial and should be partially disallowed.

The rules apply to large groups which contain at least one company that is resident in the UK or carrying on a trade in the UK through a permanent establishment, subject to a "gateway" test and certain exemptions. Existing transactions and loans are not to be grandfathered and groups of companies will now need to determine each year whether they are subject to the WDC rules.

The Gateway

Determining whether a group is subject to the new WDC rules is made easier by a gateway test. Under the test, a group generally will be subject to the WDC regime only if the net debt of the UK group members (financing-related debt net of financing-related assets) exceeds 75% of the gross external debt of the entire group. For this purpose, a group includes the parent company and its 75% subsidiaries. The group must determine each year whether the gateway test is satisfied.

How Do the Rules Work?

If a group satisfies the gateway test and the WDC rules apply, the interest on the group's external debt sets a cap on the amount of intra-group interest costs of UK group members for which tax relief may be claimed. The amount disallowed is determined by comparing the aggregate net finance expense of the UK group members (the "tested amount") with the gross external finance expense of the group (the "available amount"). If the aggregate net finance expense of the UK group members (the excess of financing costs over financing income, calculated separately for each UK group member that has an excess amount, and then aggregated) exceeds the gross external finance expense of the group, the WDC rules disallow an amount of intra-group interest costs equal to the excess. To prevent a doubling up of the disallowance, UK group members with net financing income may be entitled to exemption from tax in an equivalent amount.

Certain types of business are excluded from the new WDC rules, including financial services businesses, and any company whose net finance expense is less than £500,000 is also disregarded. An election may be made to ignore any group treasury company, and similar elections are available for short-term financing

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... [There is] a significant new hurdle to tax efficient repurchases of portfolio company debt that trades at a discount, which generally will have the effect of narrowing ... the circumstances in which debt can be repurchased at a discount without triggering income from the release of debt.

arrangements within the group and for finance expenses that are "stranded" for UK corporation tax purposes.

The WDC regime is subject to so-called "targeted anti-avoidance rules" ("TAARs"). Each of these deals with attempted manipulation of different parts of the WDC code.

Interaction with Existing Law

The new rules add to UK tax law rather than replace any of it. HMRC have indicated, for example, that the transfer pricing rules, which control tax relief on financing costs incurred by thinly capitalized companies, will be applied before the application of the WDC rules.

Impact on Private Equity

The application of the WDC rules to existing and future structures will vary depending on the facts, but the news is not all bad. Shareholder loans that private equity funds typically use to fund UK acquisition companies generally should not be caught by the WDC rules. That is because shareholder loans from a fund that is structured as a limited partnership are likely to qualify as external financing, which carries with it an increase in the group's available amount. For example, if a private equity fund capitalizes a UK holding company with £10 million of equity and £90 million of shareholder loans (with 10% interest), and the UK holding company finances its subsidiary UK acquisition company with £10 million of equity, £90 million of shareholder loans from the UK holding company (with 10% interest) and £200 million of bank loans (with 8% interest), the gross external finance expense of the group is £25 million (£9 million attributable to the shareholder loans from the fund plus £16 million attributable to the bank loans) and the aggregate net finance expense of the UK group is also £25 million (£0 of holding company net finance expense (the excess of £9 million over £9 million) plus £25 million of acquisition company net finance expense (the excess of £9 million plus £16 million over £0)). Since the aggregate net finance expense of the UK group does not exceed the gross external finance expense of the group, the WDC limitation does not apply.

In contrast, a shareholder loan from an upper-tier non-UK company to its UK subsidiary may result in restricted tax relief for borrowing costs if the upper-tier company is less leveraged than the UK subsidiary, because the intra-group loan does not increase the group's available amount. For example, if a Dutch company is financed with the Euro equivalent of £50 million of bank loans (with 10% interest) and £50 million of equity, and the Dutch company finances a UK subsidiary with £50 million of shareholder loans (with 10.50% interest), £40 million of bank loans (with 10% interest) and £5 million of equity, a portion of the UK subsidiary's interest costs on the shareholder loans will be disallowed: the gross external finance expense of the group is £9 million (the Euro equivalent of £5 million at the Dutch company level and £4 million at the UK company level), whereas the net financing expense of the UK group is £9.25 million (£4 million plus £5.25 million). In this case, the aggregate net finance expense of the UK group exceeds the total external finance expense of the group by £250,000, resulting in £250,000 of disallowance of intra-group interest for UK tax purposes.

Any attempt to restructure existing arrangements purely in order to mitigate the effects of the new rules is likely to trigger one or more of the TAARs and so be ineffective.

Debt Buy-Backs: UK Tax Charge

During the credit crunch, a number of private equity fund sponsors took advantage of the heavily discounted pricing of their portfolio companies' external debt and bought back some of that debt. If structured properly, the acquisition could be effected without causing UK portfolio companies to recognize income from the release of debt. Since October 14, 2009, it has become much more difficult to buy back debt at a discount unless the portfolio company is distressed.

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Background: Debt Buy-Backs Can Be Tax-exempt

Companies that are subject to UK corporation tax generally are taxed on income or obtain relief from losses arising from indebtedness in a manner that follows the accounting treatment of the income and losses. As a result, if a debt is released in whole or in part, the general rule is that the debtor has income from the release of the debt and the creditor obtains relief for its loss, on the basis of the accounting treatment of the transaction. Under an exception to the general rule, if the debtor and the creditor are considered to be "connected" entities (which generally is the case if one of them controls the other, or the two entities are under common control), the debtor is not taxed on its accounting income and the creditor will not obtain relief for its accounting loss.

If the holder of debt that is trading at a discount sells the debt to an entity that is not connected to the debtor, the general rule is again that the seller and the debtor are taxed or obtain relief in accordance with their accounting treatment of the transaction. As a result, the seller generally would obtain relief for its loss but the debtor generally would not recognize any income. However, if the buyer is connected to the debtor, the UK tax rules provide that the acquisition triggers a "deemed release" of the impaired part of the debt for UK corporation tax purposes, thereby causing the debtor to recognize income.

It was recognized that the deemed release rule might obstruct corporate rescues. Therefore, the rule was relaxed so that there is no deemed release if the buyer acquires the debt pursuant to an arm's length transaction and was not connected with the borrower at any time in the period beginning four years before, and ending (a little curiously) 12 months before, the date of the acquisition. This relaxation provided a fairly simple means by which a debt buy-back could be structured without incurring any immediate tax charge for the debtor company under the deemed release rule. The debtor group would form a new subsidiary to buy the debt. Since the subsidiary would be newly formed, it would not be connected with the borrower in the three-year window, and therefore could acquire the debt at a discount without triggering a deemed release.

Restriction on the Exemption

From October 14, 2009, the circumstances in which there is no deemed release on the sale of impaired debt to a company that is connected to the debtor are limited considerably. In broad terms, the effect of the new rules is that a deemed release will arise in relation to an acquisition of impaired debt by a company connected with the debtor unless: (1) the acquisition occurs in the context of a restructuring which avoids an insolvency situation that would otherwise arise or (2) the buyer pays for the debt with its own debt (with the same nominal value and substantially the same market value) or its own equity. In addition, if there is no deemed release at the time of acquisition, any future cancellation of the debt by the buyer may result in the borrower being taxed on the amount of the previously untaxed impairment.

The new rules, although in force with effect from October 14, 2009, will not be formally introduced until later this year in the Finance Act 2010. The new regime is currently contained in draft legislation, which may change before it finds its way onto the statute book. Until the new rules are enacted, however, it would be dangerous to assume that they can be circumvented, and a deemed release avoided, outside an insolvency situation.

* * *

These new rules pose additional challenges, and potentially tax costs, for private equity sponsors in structuring acquisition and debt repurchases and on their ability to obtain tax relief for financing costs with respect to existing deals. Sponsors are well-advised to consult early with their tax advisors to assess the impact of the new regime on their deals, both those in place and in contemplation. ■

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conditions, many issuers would have refinanced the relatively expensive PIK Toggle instruments before these special payments came due. The current economic crisis, however, has made refinancing difficult, and many issuers will soon be forced to confront the issue of how to calculate these special payments. Because of ambiguities in the tax law, the amount of these special payments will be highly uncertain. Absent guidance from the IRS, the result will be a high-stakes dilemma for many issuers that will unfold over the next few years.

What Is an AHYDO?

An AHYDO is a debt instrument that has a term longer than 5 years, a yield to maturity greater than the Government borrowing rate plus 5 percentage points and OID that is not mostly paid off by the close of the first accrual period ending after the fifth anniversary of issuance. For tax purposes, an instrument bears OID unless interest is unconditionally payable in cash at least annually. PIK Toggle debt instruments bear OID, even if they are issued at par, because the issuer is not unconditionally obligated to pay cash interest at least annually. If an instrument is an AHYDO, some interest deductions are permanently disallowed and the remaining deductions are deferred until interest is paid in cash.

Congress enacted the AHYDO legislation in 1989 against the backdrop of the highly leveraged acquisitions of Beatrice Companies, RJR Nabisco and RH Macy & Co. Congress's intent was to curtail the use of deep discount obligations in leveraged takeovers. It also sought to disallow and defer interest deductions on instruments that it believed had many characteristics of equity (*e.g.*, high yield and long term).

... [M]any issuers ... will soon have to figure out the amount of the AHYDO Saver Payment. ... [T]he AHYDO statute contains a series of presumptions that clash with the presumptions used elsewhere in the tax law. Accordingly, many issuers will be uncertain as to the correct amount of the special payment.

AHYDO Saver Payments

Rather than forgo valuable interest deductions or see them deferred, many issuers of PIK Toggle debt in the 2005-2008 period included a provision requiring that the issuer make a special mandatory partial redemption payment to the holders at the close of the first accrual period ending after the fifth anniversary of the issue date (an "AHYDO Saver Payment"). The amount of the AHYDO Saver Payment was generally drafted as the minimum amount "necessary such that the instrument would not be classified as an AHYDO."

Making an AHYDO Saver Payment will not cause the issuer to pay more cash under the debt instrument. It merely accelerates the timing of payments that would be made in any event. Some issuers that project excess cash may welcome the AHYDO Saver Payment because it allows them to pay off expensive debt at par rather than at a make-whole price or with a redemption premium.

In the case of a PIK Toggle instrument with semi-annual accrual periods, the AHYDO Saver Payment must be made at the time of the first semi-annual payment due following the fifth anniversary of issuance. For many issuers, this date may be just around the corner. They will accordingly soon have to figure out the amount of the AHYDO Saver Payment. Broadly speaking, it is an amount equal to all the OID that has accrued on the instrument less the yield to maturity of the instrument multiplied by its issue price. The problem is that the term "yield to maturity" is not defined in the AHYDO statute and the term "issue price" is defined by an ambiguous cross reference. Although "yield to maturity" is a familiar concept under the tax law, the AHYDO statute contains a series of presumptions that clash with the presumptions used elsewhere in the tax law. Accordingly, many issuers will be uncertain as to the correct amount of the special payment.

There are many parties with an interest in the correct determination of the AHYDO Saver Payment, which raises the stakes for getting the calculation right. First, there is the IRS, which may scrutinize the payment to make sure the issuer actually did what it promised to do to make the instrument a non-AHYDO. Second, there are the holders of the instruments on which the payment is due, who have a contractual right to be paid the correct amount but no more than the correct amount, since any excess might properly be

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AHYDO Savers (cont. from page 18)

characterized as a redemption payment on which a premium or make-whole is due. Third, there are the senior lenders, whose own loan documents will generally prohibit the issuer from paying the holders of the PIK Toggle debt more than the required amount.

If the issuer has enough cash and decides to "play it safe" by making a large AHYDO Saver Payment, the holders of the PIK Toggle instrument could claim that the issuer, contrary to the debt documents, paid more than necessary. These holders would then claim they are owed a make-whole or a redemption premium on the overpayment. Moreover, the senior lenders may claim that the issuer violated the debt prepayment or restricted payment negative covenants under the senior debt documents, thereby causing an event of default. Alternatively, the issuer could pay a lesser amount, but then it runs the risk that the IRS will disagree, and more importantly, that the toggle debt holders, who may prefer to be paid cash sooner rather than later, even without a make-whole or redemption premium, will claim an event of payment default. This would likely cause the senior debt to cross default.

One may ask whether the professionals should have drafted AHYDO Saver Payment clauses in a way that would have avoided this dilemma. For example, should the saver clauses have included a provision allowing the issuer's board to make the required AHYDO Saver Payment determination in good faith, perhaps in consultation with a nationally recognized accounting firm? Here the answer, seen purely from a tax perspective, is likely "no." Such a clause may have failed from the outset to prevent the instrument from being an AHYDO. The correct amount of the AHYDO Saver Payment is a matter of federal tax law and is objective. The IRS might argue that leaving the determination to the board's discretion, whether exercised in good faith or otherwise, caused the AHYDO Saver Payment to be indeterminate and that the instrument therefore was an AHYDO from inception.

The Need for Guidance

As the above discussion demonstrates, the uncertainty regarding the proper computation of the AHYDO Saver Payment combined with the large sums involved creates a high-stakes dilemma in which issuers might not only lose tax benefits but may also face events of default on large amounts of junior and senior debt. Since PIK Toggle debt only became popular beginning in late 2005, there is still time before most issuers will face having to make the computation. Issuers seeking to avoid last-minute uncertainty should consider requesting a private letter ruling or other administrative determination from the IRS. The IRS will not get involved in the legal interpretation of PIK Toggle debt documents, but the IRS could be asked to rule whether the payment of $X on date Y will cause the instrument in question not to be an AHYDO. Issuers could also ask the IRS whether $X is the minimum amount necessary to cause the instrument not to be an AHYDO. It is hard to see why the IRS would object to ruling.

Rather than address the issue in a piecemeal fashion, the IRS would best address the issue by publishing a revenue ruling stating that it will accept any one of several enumerated methods of determining the AHYDO Saver Payment in a typical situation. Issuers could then make the necessary calculation of the AHYDO Saver Payment by choosing the method that results in the smallest payment. Alternatively, the IRS could choose one specific method of making the AHYDO Saver Payment determination. Although some methods of computing the AHYDO Saver Payment are better than others, the business community would probably be content with the IRS's selection of any reasonable method. It is the current uncertainty that produces the greatest concern.

Conclusion

The AHYDO provisions contain undefined or ambiguous terms such as yield to maturity and issue price. Although these terms have meanings in other areas of the tax law, conflicting presumptions in the AHYDO and other tax code provisions make it unclear what these terms mean in the context of AHYDO Saver Payments. As a result, the computation of an AHYDO Saver Payment, which should be a mechanical, arithmetic operation, becomes a confusing exercise with an uncertain outcome. Because issuers are answerable to senior and junior debtholders as well as to the IRS, many issuers may soon find themselves facing a high-stakes dilemma. There is a clear need for guidance from the IRS to avoid potentially costly controversies. ■

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the other hand, while pre-FINSA mitigation agreements on occasion included so-called "evergreen" provisions, those provisions are now formally built into the law, so that CFIUS is now authorized to reopen any transaction at any time if the parties materially breach their mitigation agreement.

Government Contracts in General

Contracting with the government can be a complex and frustrating affair. All government contracts between a target in this sector and the government are subject to the Federal Acquisition Regulations System, which is comprised of the dense and extensive Federal Acquisition Regulations (FAR), together with hordes of additional regulations, promulgated by individual agencies, that implement or supplement the FAR. Given the unique position of the government, many legal principles that govern contracts between two commercial parties in other contexts may be inapplicable to government contract. For instance, the principle of "apparent authority" does not apply — a contract negotiated or signed by a government official without actual authority to do so will be rejected by the government often without liability unless someone with actual authority ratifies the contract.

[I]t is critical to keep in mind that the government is like no other customer. ... A contract between a target in this sector and the government may also simply be illegal, and thus void *ab initio*. ... It is therefore wise to include in your acquisition agreement robust representations regarding the target's government contracts.

A contract between a target in this sector and the government may also simply be illegal, and thus void *ab initio*. An example is a "cost plus percentage of cost" contract, where the contractor's profit is based on the costs incurred. Once a contract is found to be illegal, it is not always clear whether the contractor can recover from the government any of the costs the contractor already incurred, even if the government has received a benefit.

It is therefore wise to include in your acquisition agreement robust representations regarding the target's government contracts. These may include compliance with laws and regulations, accuracy of all representations and certifications made to the government, absence of fraud investigations, absence of withholding of moneys owed, validity and enforceability of the contracts, absence of suspensions and debarments, absence of disputes or claims, and so on. In many cases it may be worthwhile having a government contracts lawyer look at the contracts (subject to security restrictions), ask the right questions and help tailor the representations in the acquisition agreement.

Assignment of Contracts

Read literally, the Anti-Assignment Act, which prohibits the assignment of government contracts, is triggered by virtually all deal structures involving the acquisition of a government contractor, including stock deals, reverse triangular mergers and other structures where there is no actual assignment of the contracting parties' rights under the government contract. Courts, however, have been practical in their application of the law, and have developed a "by operation of law" exception that has been interpreted to except an assignment pursuant to an acquisition after which the contracting party survives intact (such as a reverse merger or a stock acquisition) and its rights and obligations are unaffected. However, asset purchases and some forward mergers likely do not fall within the exception. If the Anti-Assignment Act applies to a transaction, the parties to the transaction and the government will typically enter into a Novation Agreement, a standard form of which can be found in the FAR. The prospect of negotiating one or more Novation Agreements with different branches of the government may be daunting and may involve a good deal of potentially intrusive diligence by the government on the buyer. Accordingly, structuring a deal so as to avoid the application of the Anti-Assignment Act can play a significant role in the formative stages of negotiating an acquisition.

Intellectual Property

A contract in which the government funds any "experimental, development or research work" may fall under the Bayh-Dole Act. Many agreements with defense contractors may include

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provisions relating to expenditures for the research and development of a component, a system, a newly designed weapon or vehicle, or the like. If so, Bayh-Dole in most cases allows the contractor to retain title to an invention developed under the agreement. In return, the government receives a world-wide non-transferable, irrevocable, royalty-free license to use the invention. Perhaps more importantly, the government also obtains "march-in" rights, allowing it to force the contractor to grant licenses in the invention to third parties if the contractor fails to reduce the invention to practical application in a reasonable amount of time. Thus, if a contractor develops a new missile launcher at the government's expense but does not take steps to make actual missile launchers available within a reasonable time period, the government can require the contractor to license the invention to one of its competitors. While these sorts of issues do not often plague contractors, they are worth keeping in mind as a sponsor diligences its defense-related target.

Export Controls

There are three basic sets of export controls that may affect the products and services of a defense company. These controls, which are complex and often confusingly interrelated, focus among other things on licensing, registration and the imposition of penalties for violations, including debarments, suspensions and monetary penalties. Understanding how a target is regulated under these regimes and whether it is complying with the regulations or subject to non-monetary penalties that can affect its ability to continue doing business with the government in one or more areas is critical to the diligence process, the valuation of the company and the drafting of the risk allocation provisions in the acquisition agreement.

First, the State Department, through the Directorate of Defense Trade Controls (DDTC) and under authority prescribed by the Arms Export Control Act, controls the export of "defense articles" and "defense services." Items that have been so designated are set out in twenty-one categories in the United States Munitions List, which is part of the International Traffic in Arms Regulations (ITAR). The ITAR contain certain licensing requirements, and also mandate the registration not only of persons who import or export defense articles but also of those who manufacture or "broker" defense articles or furnish defense services. Registrants must give advance notice to DDTC of any proposed transfer to foreign ownership or control, a process that may dovetail with the Exon-Florio filings. DDTC will often approve blanket licenses for the export of defense articles pursuant to a particular contract. Such approvals are generally embodied in Manufacturing License Agreements or Technical Assistance Agreements, which can be extremely complex and detailed arrangements.

The Bureau of Industry and Security under the Commerce Department administers a second set of export controls found in the Export Administration Regulations (EAR). While most exports are subject to the EAR (although only a very small proportion actually fall under its licensing regime), these controls are less likely to affect a defense company's business, because in practice they are generally limited to "dual-use" items, that is, items that may be adapted to either military or nonmilitary use. If the item has been expressly designed for military use or its export is exclusively controlled by another agency (*e.g.*, the DDTC), the EAR likely will not apply.

Finally, the Office of Foreign Asset Control under the Treasury Department administers economic sanctions programs, including export or import embargoes relating to designated persons, entities or countries. The relevant regulations sometimes overlap or interrelate with the ITAR and EAR.

* * *

Acquiring a defense company can be daunting, but the mission is possible! As noted above, there have been many examples over the years of private equity firms buying defense companies or aerospace or other companies with a military aspect to them. Foreign acquirers buy them regularly. Still, it is critical to keep in mind that the government is like no other customer. Alerting the government's point persons on the target's important projects early in the process, keeping them up to speed and receiving their approval of the transactions can often be what makes or breaks a transaction. Teaming up with a strategic partner may also ease some of the challenges, but going solo is perfectly feasible when you know what questions to ask and have assembled the right team to ask them. ■

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allow a non-EU-based fund manager to market its funds to professional investors on their territory, but only if the fund manager complies with the directive's disclosure and transparency requirements, and "appropriate cooperation arrangements[4]" in line with international standards are in place between the fund manager's regulator and the authorities of the Member State where the fund is marketed. In other words, individual private placement regimes, which currently allow non-EU-based funds to be marketed in some Member States, would in future have to comply with rules set by the Commission.

European Parliament's Proposal

Meanwhile, parallel discussions on the directive have been taking place in the European Parliament's Economic and Monetary Affairs Committee ("ECON"). In November last year, Jean-Paul Gauzès, the directive's "rapporteur," presented his draft report (the "Gauzès Report") to ECON. This contained a series of amendments, some of which (such as the provisions on remuneration and the dropping of the EU passport for non-EU-based fund managers) mirror those in the Council Proposal.

According to the Gauzès Report, however, the directive would apply to all fund managers based in the EU, regardless of size, and would cover a wide range of activities, including investment management, administration and marketing. On the positive side, an independent valuer would no longer be required for private equity funds, but fund managers would only be able to delegate portfolio management to other authorized fund managers, and would be required to set leverage limits for their funds.

The Gauzès Report also contained a strangely-worded provision which would only allow professional investors in a Member State to invest in a non-EU-based fund if the fund is managed by an authorised fund manager, or the country where the fund is based has signed an information-sharing cooperation agreement in line with relevant international standards. It is not clear how this would be enforced in practice.

Some 1,700 amendments (a record for EU legislation) have been proposed to the Gauzès Report by members of the European Parliament, and Jean-Paul Gauzès now has the unenviable task of collating these into an amended draft and managing the forthcoming debate within ECON, following which a vote will be taken on the final text of the directive at a plenary session of the European Parliament, currently scheduled for July 6.

Current State of Play — The Politics of Postponement

As previously mentioned, in order to become law, the directive has to be approved by the Council as well as the European Parliament. The Spanish Presidency of the Council has identified three key issues where there is not a sufficient majority in the Council (255 votes out of a total of 345, under the Council's complicated 'qualified majority' voting system) to support an overall compromise between Member States. These are:

- the overall scope of the directive, particularly the availability of the exemption for fund managers whose managed assets are below a €100 million threshold (€500 million for fund managers managing unleveraged funds with five year lock-up periods) set forth in the Commission Proposal;
- whether the role of depositary should be restricted to EU credit institutions and authorised investment firms, or whether other entities should be eligible; and
- so-called 'third country issues', particularly whether allowing fund managers based outside the EU to market funds to investors in the EU should be subject to certain minimum standards and requirements

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4 *Details of the "appropriate cooperation arrangements" are to be contained in implementing measures to be adopted by the Commission.*

Postponement of the decision provides an opportunity for more measured debate ... [and] the prospect of the directive becoming law by early July now looks less likely.

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laid down by the Commission, or left up to individual Member States.

It is the third country issues that are giving rise to increasing concern, both on the part of fund managers based outside the EU, who are concerned that their ability to raise funds from EU investors would be heavily restricted, and on the part of EU investors, whose access to non-EU funds could be similarly limited. Some high-level lobbying has been carried out by UK Treasury Financial Services Secretary Paul Myners and by U.S. Treasury Secretary Tim Geithner, who wrote to Michel Barnier, the EU Commissioner for the internal market, to warn that the directive could cause a transatlantic rift by discriminating against U.S. groups. EMPEA, the Emerging Markets Private Equity Association, ILPA, the Institutional Limited Partners Association, and Gordon Brown, the British Prime Minister, have recently added their voices to the debate.

In an effort to speed up the legislative process, the Spanish Presidency of the Council asked the Committee of Permanent Representatives to the Council (Coreper) to intervene. The Spanish Presidency hoped that this would have enabled agreement on the outstanding issues to be reached at a meeting of EU finance ministers in Brussels on March 16. However, discussion of the directive was dropped from the agenda at the last minute, either because a qualified majority for a compromise agreement between Member States was not achievable, or possibly in response to the recent lobbying. Postponement of the decision provides an opportunity for more measured debate, but the Spanish Presidency will still hope to achieve a compromise agreement on the directive before its term ends on June 30. The prospect of the directive becoming law by early July now looks less likely. But it is clear that a number of Member States are anxious to see the directive become law some time this year, while others, like the UK, are intent on reshaping the legislation along more industry-friendly lines before this is permitted to occur. ■

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Update: Bridging the Gap (cont. from page 12)

but clearly stated standard of conduct that would modify or replace the buyer's implied duty to use reasonable efforts to enable a seller to achieve its earnout. For instance, the parties could accept that a buyer has an obligation to use reasonable efforts to facilitate a seller's ability to achieve an earnout, along the lines of the duties implied in *Sonoran* and *Eggert Agency*, but could also establish monetary or other objective limits on that obligation. Or the parties could specifically disclaim any obligation of the buyer to use reasonable efforts to enable a seller to achieve the earnout, either on an absolute basis or in lieu of a different clearly stated standard, such as permitting a buyer to take, or fail to take, any action with respect to an earnout so long as the buyer would reasonably be expected to take, or fail to take, such action independent of the buyer's obligation to make any earnout payments.

In the wake of *Sonoran* and *Eggert Agency,* parties to earnout arrangements should, in all circumstances, carefully consider the impact of their choice of governing law on the interpretation of their earnout. Our earlier article pointed out that parties to an earnout may also wish, as a general proposition, to agree to binding arbitration or another alternative dispute resolution mechanic in order to streamline the process of resolving any earnout related disputes. Given the inherent subjectivity of applying the reasonableness standards imposed under *Sonoran* and *Eggert Agency*, parties to an earnout now have an additional reason to consider alternative dispute resolution mechanics in order to reduce the time and cost it could otherwise take to resolve that subjective issue in a litigation. ■

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