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Is Dual Track the New Normal?

Simultaneously pursuing an IPO and a private auction process is an increasingly popular option for PE sponsors and other sellers wishing to preserve flexibility while maximizing competitive pressure.

Recent examples of deals that started out on a "dual track" include: the IPO of AIG's Asian life insurance business, AIA Group Limited; the sale of the Logan's Roadhouse restaurant group to Kelso; Clayton, Dubilier & Rice's investment in Univar's chemical distribution business; and the sale of Pets at Home to KKR. Many hail the practice as a win-win proposition for the seller. A study published in the July 2010 issue of the Journal of Business Venturing found that companies sold privately in the course of a dual-track process realized a 22-26% premium over companies acquired without a concurrent IPO. A *Wall Street Journal* article headlined "IPOs, it seems, are key to M&A success" followed on the heels of the study, joining the chorus of news articles heralding the return of the dual track deal. According to Reuters, about two-thirds of companies preparing for an IPO in the third-quarter of 2010 were simultaneously pursuing a sale.

Of course, the dual track phenomenon runs both ways: sponsors are just as likely these days to end up on the buy-side end of line as well as the sell-side terminal. Given the increasing prevalence of dual track auctions, sponsors need to be attuned to the opportunities and pitfalls of these processes from the buyer's perspective too.

Why Dual Track?

What are the advantages of running a dual track process from the seller's point of view?

First, and foremost, recent academic research confirms the common sense view that (in the right market conditions) a dual-track approach can maximize the price obtained by the seller. If the IPO valuation seems likely to be most attractive, that option is there. And even if a private sale is ultimately pursued, the additional competitive pressure of a viable IPO process can drive bidders to put more money on the table. For instance, Bridgepoint Capital's dual

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"I think you're going to need a bigger box"

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Letter from the Editor

The fact that our Fall issue is being disseminated electronically in the very late Fall (and in the middle of the Holiday season) tells you a lot about the level of private equity activity. Deal rhythm has accelerated, financing markets have revived, the regulatory scene has become more settled and there is more optimism about future fundraising than there has been in many quarters. That will explain why our issue is arriving with flurries and not foliage.

Traditionally, the simultaneous pursuit of an IPO and a potential private sale to a private equity firm or strategic buyer has been perceived as providing a seller with optionality in uncertain markets. On our cover, we examine the dual track approach to exits and note that there may well be significant advantages for buyers as well as sellers in the dual track process.

Elsewhere in this issue, Jeff Rosen and Peter Furci analyze the recent use of tax receivable agreements. These somewhat esoteric arrangements first developed as a way for pre-IPO shareholders to retain the economic benefits of certain tax attributes post-IPO. These arrangements can also be used to bridge valuation gaps in valuing tax benefits attributable to, among other things, NOLs and options.

In our Guest Column, Daniel Feder, formerly with the Princeton Endowment and currently a private equity advisor, examines whether the endowment model of investing for institutional investors is being replaced by a more activist model.

We also report on some lessons to be learned from the well-publicized case brought by Terra Firma against Citibank alleging fraud in connection with a 2007 auction in which Citibank acted as a financing source as well as a sell-side advisor.

Private equity firms and deals continue to be the focus of regulatory attention in the European Union and the U.S. In this issue, we examine proposed exemptions from SEC registration available to non-U.S. advisers and report on the recent decision by the European Parliament to extend the "passport" allowing fund managers to market alternative investment funds within the EU to fund managers based outside the European Union.

We also report on possible changes to the HSR reporting regime which could create added filing burdens for private equity buyers, and update you on the status of proposals to reform the UK Takeover Code which would, among other things, prohibit break fees unless an auction process is commenced by the target.

As always, we welcome your input on topics you would like to see addressed in future issues of *The Private Equity Report* and we wish you a happy, healthy and prosperous New Year.

Franci J. Blassberg
Editor-in-Chief

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Learning to Live with Regulatory Uncertainty: Recent Foreign Public Exits from PRC Investments

Notwithstanding expectations that regulatory hurdles imposed in 2006 would make offshore listings of China-based companies rare, offerings of Chinese companies on U.S. and Hong Kong stock exchanges have been the stars of 2010. By the end of the third quarter, China surpassed Israel as NASDAQ's No. 1 foreign market, with 156 companies listed, including a number of private equity-sponsored companies. Perhaps most importantly, IPOs of China-based companies have been amongst the top performing IPOs in the United States. For example, the shares of Soufun Holdings, the operator of China's largest property website, soared 73% in its September trading debut, and the shares of JinkoSolar, a Chinese solar company, have recently been trading at more than 250% of their IPO price. It has also been a banner year for IPOs in Hong Kong, the leading market for offshore IPOs of China-based companies. By the end of October, there had been 78 new listings on the Main Board of the Hong Kong Stock Exchange (HKSE), raising a jaw-dropping total of US$44 billion, with another 72 listings said to be in the pipeline.

In comparison, it has been a relatively difficult year for domestic Chinese IPOs. The value of stocks listed on Chinese stock markets dropped approximately 26% in the first six months of 2010 and remained volatile throughout the rest of the year. As U.S. listings of Chinese IPOs were responding to the enthusiasm of U.S. and global investors for China-based companies, a number of domestic Chinese listings, including companies such as Ningpo, one of China's largest port operators, were slashing their offering size and pricing at the low end of the range. In mid-October, China announced the first increase in interest rates in three years and the Shanghai Composite Index fell more than 10%. In recent weeks, a number of large cities in China have introduced pricing controls, and in early November, the People's Bank of China increased reserve requirements twice within two weeks in an effort to suck excess liquidity out of the domestic market.

These trends are particularly striking because they are contrary to widespread expectations that offshore offerings of China-based companies would wind down as a result of significant regulatory hurdles to listing a China-based business offshore. Not long ago, most pundits were predicting that offshore IPOs of mainland Chinese businesses would be completely supplanted by domestic IPOs as companies took advantage of the higher valuations and captive liquidity of mainland China's maturing domestic exchanges. In reality, 2010 appears to be the year in which a critical mass of China-based companies learned to live with, and work around, the regulatory hurdles that have limited offshore listings since China's cross-border M&A rules came into effect on September 8, 2006. In order to better understand these trends and the relevant regulatory uncertainty, it helps to briefly review the regulatory environment for offshore listings before and after September 2006.

Until 2006, the preferred exit from China-based private equity investments was a public offering in Hong Kong or the United States of a special purpose vehicle ("SPV") that acted as a holding company for the issuer's China-based operations. Many of China's leading public companies, including Baidu and Alibaba, have been structured in this way. This type of exit was typically structured as a so-called "round-trip investment" in which investors would establish an offshore SPV, typically in the Cayman Islands or the British Virgin Islands, to acquire the assets or equity of the Chinese company. Generally the founders would acquire a significant equity stake in the SPV in exchange for their equity in the Chinese business.

In August 2006, China's Ministry of Commerce ("MOFCOM"), together with five other regulatory authorities, promulgated the Provisions for Foreign Investors to Merge and Acquire Domestic Enterprises (关于外国投资者并购境内企业的规定), commonly referred to as Circular 10. Circular 10 not only provides for procedures for foreign investors to acquire Chinese companies but also gives MOFCOM and other Chinese regulators comprehensive control over the offshore listing process of the Chinese companies. An SPV established in the "round-trip investment" described above generally falls within the scope of Circular 10 and therefore an offshore listing using the "round-trip investment" is subject to

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Learning to Live with Regulatory Uncertainty (cont. from page 3)

MOFCOM's approval and registrations with other Chinese regulatory authorities.

Because of the stringent requirements of Circular 10, it has been practically impossible for China-based businesses to obtain the relevant approvals, and there is no publicly known case of any successful offshore listing with the required approvals. From the moment these rules were announced in 2006, foreign private equity firms scrambled to reorganize their Chinese investments so that they could be grandfathered prior to the rules' effective date of September 8, 2006. Until relatively recently, it was widely believed that once the pipeline of grandfathered portfolio companies ran dry, most Chinese portfolio companies would forego the offshore model in favor of an IPO on one of China's domestic exchanges. Not surprisingly, the expectation that domestic IPOs are likely to become an increasingly likely option for successful China-based companies has also been one of the key factors fueling the increasing popularity of funds denominated in local currency or renminbi for foreign private equity investors.

The diverging performance of offshore and onshore offerings, as well as other factors such as the longer lock-up periods common in onshore offerings, however, appear to have inspired a number of issuers that were reorganized post-Circular 10 (and not grandfathered thereunder) to go to significant lengths to work around the regulatory hurdles. Post-Circular 10, many Chinese companies and their advisors have been innovative in devising alternative structures that some Chinese law firms have blessed by opining that they do not trigger Circular 10 approval requirements. As a result, offshore IPOs have been undertaken on the basis that these alternative structures are not subject to MOFCOM approvals.

For example, a widely used alternative structure (often coupled with other structures) involves the use of a variable interest entity ("VIE"). Interestingly, the VIE structure was not specifically developed in response to Circular 10; rather, it was initially used for IPOs of Chinese Internet companies, in which foreign investors were not allowed to hold a direct equity interest in the business. Sina.com utilized this structure for its successful IPO on NASDAQ in 2000, and the VIE structure is now widely referred to as the Sina model.

The VIE structure typically establishes a wholly-foreign-owned enterprise ("WFOE") in China through an offshore SPV. However, rather than acquiring an equity stake in the Chinese business, the SPV acquires control of the Chinese operating company and is entitled to all of the economics via a series of contractual arrangements between the Chinese operating company and its original owners, on the one hand, and the SPV and the WFOE, on the other hand. Accounting standards generally require that the WFOE and the Chinese operating company be treated as consolidated subsidiaries of the SPV, which is desirable for the IPO of the SPV.

The VIE structure has been particularly popular with China-based companies listing on the NYSE or NASDAQ. Both exchanges have recently permitted China-based companies to list such structures with relatively unattractive disclosure about whether the issuer has complied fully with Chinese law. For example, JinkoSolar's offering documents contained the following risk factor: "If we were required to obtain the prior approval of the PRC Ministry of Commerce, or MOFCOM, for or in connection with our corporate restructuring in 2007 and 2008, our failure to do so could have a material adverse effect on our business, operating results and trading price of our ADSs."

In Hong Kong, where the regulator is less likely to rely on disclosure of regulatory risk and seeks comfort that the corporate structure is fully compliant with local law, the exchange has been considerably less enthusiastic about VIE offerings. So far, the HKSE seems to be comfortable with companies using the VIE structure only if they are in the IT industry or other industries which do not allow direct foreign ownership. Anecdotally, this appears to be driving some small- and medium-size China-based companies that would otherwise have listed in Hong Kong to list in the United States. However, this does not mean that China-based companies have sworn off listings in Hong Kong. Rather, it appears that the uncertain regulatory environment has only inspired issuers and their investors to devise even more innovative structures.

The work-around structures developed since the enactment of Circular 10 more than four years ago have made it possible for a number of China-based companies formed in the new regulatory environment to successfully list in the United States or in Hong Kong with the VIE structure and other innovative structures. Neither the VIE structure nor any other work-around structure has been blessed by MOFCOM or other Chinese authorities, and accordingly, these structures are not risk-free. However, the use of these structures is no secret and as long as MOFCOM and other Chinese authorities do not expressly prohibit these alternative structures, one can expect the work-around trend to continue.

In any event, the desire of Chinese businesses to seek access to offshore

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GUEST COLUMN

Active Private Equity Fund Management in the Context of Asset Allocation

The relationship between institutional investors and private equity fund managers is evolving to allow for more active engagement by investors. Endowments, foundations, pension funds, and other multi-asset class investors have traditionally allocated capital to private equity (including venture capital) to enhance portfolio returns and improve diversification. While these investors have generally treated private equity as an asset class that can be passively managed through carefully selected fund managers, some institutions (including sovereign wealth funds) have taken a more active role in the development and management of their private equity portfolios.

Active Investing Within an Asset Allocation Approach

A small number of endowments and foundations have a track record of active engagement with regard to selection and relationship management. These investors have been successful in creating distinctive and high-performing private equity programs, but have tended to avoid direct investments and have mostly invested using customary fund structures.

The wide dispersion of returns among private equity firms clearly establishes the importance of selection. While effective selection involves identification of the best groups, active investors have essentially created their own deal flow by backing first-time or newly developed investment vehicles through a process that optimizes alignment of interests within the constraints of the typical fund structure. The best investors have also been willing to exercise independent judgment in rooting out managers whose investment strategies are defined more by creativity than a predictable formula. Because this type of selection is based primarily on bottom-up analysis, portfolios of the best investors are idiosyncratic in nature. Imbalances with regard to macro factors are generally accommodated through more liquid investments in which a top-down orientation is more appropriate.

Limitations of the Asset Allocation Approach

The general approach of allocating capital to private equity as an asset class does not present a one size fits all solution. Smaller pools of capital cannot support the internal resources necessary to excel in the selection and oversight of private equity fund relationships — this is especially true in the context of global markets. This dynamic is evident in the realm of endowment management, where large endowments have tended to be more aggressive with their allocations to private equity — the ability to create investment relationships with best-in-class fund managers has perhaps been the primary factor in explaining high allocations to private equity funds (as well as other alternative asset classes) by large endowments.

At the other end of the continuum, very large institutions cannot reasonably expect to rely on superior selection to outperform a market in which the best fund managers tend to come in small packages. Moreover, the traditional (asset allocation) approach to private equity investing contains several inconsistencies and shortcomings that are more acute with larger pools of capital.

- Private equity is not an "asset class" — it has some unique features and can reach corners of the market not otherwise easily accessed. Private equity is more appropriately described as an "investment class" and used as a mode of implementation.
- The private equity industry, as a whole, requires investors to pay fund managers for the value of the liquidity they bring to the table — this is most easily seen in the obvious disconnect between actual fund operating expenses and management fees charged, as well as carry/profit-sharing schemes that operate independently of the amount of capital employed.

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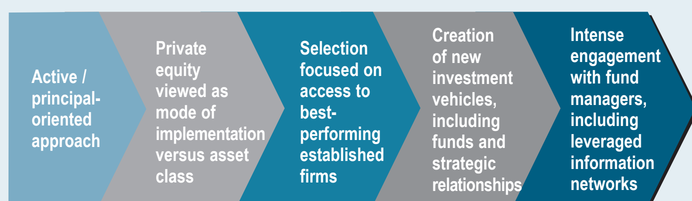
Guest Column (cont. from page 5)

- Typical fund structures are blunt instruments – it is puzzling that "sophisticated" investors are willing to accept essentially standardized terms (*e.g.*, two & twenty fees, five-year investment periods, holding periods of less than ten years, etc.) to access a wide range of investment types and strategies.

These factors have led some investors to take a more active and direct role in their private equity portfolios. The most recent iteration of this desire to be more active goes beyond a simple goal of reducing fees (which has long been the typical rationale for direct and co-investment programs). Instead, the newer form of active engagement is aimed at improving the underlying quality of investment programs. Sovereign wealth funds and some pension funds have garnered the most press for taking this type of active role in developing their private equity portfolios.

Active Investing Outside the Asset Allocation Approach

The current trend among some large institutional investors toward active involvement embodies a rejection of certain elements of the asset allocation-based approach to private equity investing. With this type of active approach, private equity funds are not viewed as comprising an asset class, but instead are treated as one of perhaps several ways to access specific types of investments in an operationally efficient manner.



Included in this more active approach is an understanding that investors in private equity funds are bringing value to the table in the form of liquidity and that the terms of the relationship between investor and fund manager should take that into account. By providing capital when liquidity is constrained ("flexible capital") active investors can counteract the tendency of funds to be pro-cyclical in their deployment of committed capital (*i.e.*, increasing their investment pace when liquidity is expensive and pulling back when premiums for illiquidity are high). By acting as a principal investor with regard to the use of flexible capital, investors can evolve from passive investors to strategic partners with fund managers.

It would be natural for fund managers to consider active investors (particularly those with substantial direct investment programs) as potential competitors. While increased active engagement by investors will necessarily result in some disintermediation, there may be substantial opportunities for strategic alliances that could expand the universe of potential transactions and create unique pathways for generating investment returns. For instance, sovereign wealth funds have regional expertise and information networks that can meaningfully improve a fund manager's capabilities in deal sourcing and due diligence.

Is There a "Right" Answer?

Unfortunately, the answer to the question, "Is there a right answer?" is an unfulfilling one: it depends. With each evolution of the private equity market, there is inevitable debate about whether prior strategies have become invalid. The current set of evolutionary change (from passive asset allocation, to selection-driven asset allocation, to active principal-oriented investing) reflects a natural and healthy progression in which discreet segments of the market strive to create investment programs that are best-suited to the nature of their capital. ■

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

EU Directive on Alternative Investment Fund Managers: Good News at Last

Private equity firms based outside of Europe breathed a sigh of relief when the European Parliament finally decided that even fund managers based outside the European Union may well be entitled to a "passport" entitling them to market alternative investment funds within the EU. In November, the European Parliament voted to adopt the text of the directive on alternative investment fund managers (the "Directive") that was agreed in October following months upon months of negotiation among the European Parliament, the EU Council and the European Commission (the "Commission").

Much of the negotiation centered around whether or not fund managers based outside the European Union ("non-EU managers") should be allowed to benefit from a European fund "passport" that grants managers the ability to market alternative investment funds ("funds")[1] to investors in EU Member States using a single notification procedure. The negotiated compromise extends the passport to non-EU managers, but only after a two-year waiting period, and only if the new European Securities and Markets Authority ("ESMA") based in Paris advises the Commission that extending the passport to non-EU managers is appropriate.

The Directive is likely to enter into force by mid-2011 and will then have to be implemented (*i.e.*, transposed into national law) by Member States within two years — by mid-2013. It will have a profound impact on the management and marketing of private equity funds in the EU and impose significant increases on the compliance costs of funds and their managers. This article summarizes the Directive's principal features. (*For the quickest overview of the Directive, see the tables entitled 'AIFM Directive at a glance,' on page 8, and 'AIFM Directive — Anticipated Timeline,' below.*)

Scope of the Directive

The Directive will apply to all (1) EU managers (managers with a registered office in the EU) that manage[2] one or more funds, and (2) non-EU managers that manage one or more funds established in the EU or that market[3] one or more funds (wherever established) in the EU.

There is a limited exemption for EU managers with combined assets under management of less than €100 million (€500 million in the case of funds that are not leveraged and have no redemption rights exercisable for a period of 5 years from initial investment). However, these managers will still need to be registered in their home Member States and will not be able to benefit from any of the rights under the Directive (including passport rights), unless they elect to comply with the Directive.

Authorization and the Fund Passport

Once the Directive is implemented sometime in 2013, an EU manager will need to be authorized by its home State regulator in order to be able to manage and market funds. Authorization will involve significant compliance and reporting obligations. However, once authorized, an EU manager will be able to market the EU

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1 *"Alternative investment funds" are defined in the Directive as collective investment undertakings which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors (but excluding retail open-ended funds complying with the EU UCITS Directive). Most private equity funds are "alternative investment funds."*

2 *"Manage" for the purposes of the Directive means discretionary investment management rather than merely providing investment advice or recommendations.*

3 *"Marketing" is defined in the Directive as any direct or indirect offering or placement at the initiative of the manager (or on behalf of the manager of units or shares in a fund it manages) to or with investors domiciled in the EU.*

AIFM Directive — Anticipated Timeline

April 2011	Entry into force of the Directive.
April 2013	Time limit for transposition of the Directive into national law by EU Member States.
April 2015	ESMA to report to the Commission on possible extension of the passport to non-EU managers and funds.
July 2015	Commission to decide, subject to ESMA's advice, whether the passport should be extended to non-EU managers and funds.
April 2017	Commission to begin a review of the application and scope of the Directive.
July 2018	ESMA to report to the Commission on the possible termination of national private placement regimes.
October 2018	Commission to decide, subject to ESMA's advice, when national private placement regimes are to end.

EU Directive on Alternative Investment Fund Managers (cont. from page 7)

funds[4] that it manages to professional investors[5] in the manager's home State, and in other Member States, using a passport. This means that, instead of having to comply with multiple EU private placement regimes, an EU manager will be able to market its funds to professional investors throughout the EU following a single notification to its home State regulator.

A non-EU manager proposing to manage EU funds or market funds in the EU will not be able to apply for authorization (or market funds using a passport) until the Commission extends the passport to non-EU managers. The earliest will be in 2015, two years after the Directive is implemented, provided that the Commission receives a favorable opinion from ESMA recommending the passport's extension to non-EU managers. Until the passport is extended, non-EU managers will be able to continue marketing their funds to investors in the EU under national private placement regimes. However, once the Directive is implemented in 2013, certain minimum conditions[6] will apply:

- non-EU managers will have to comply with the Directive's disclosure requirements and (if relevant) portfolio company requirements;
- appropriate cooperation arrangements will have to be in place between the regulator of the Member State where the fund is to be marketed and each of the non-EU manager's regulators and the regulator of the non-EU fund; and
- the country where the non-EU manager or the fund is established must not be listed as non-cooperative by the Financial Action Task Force (FATF).

National private placement regimes are unlikely to last indefinitely. Approximately three years after the Commission extends the passport to non-EU managers and funds (2018, assuming it does so in 2015), the Commission will decide when national private placement regimes are to end, after which the fund passport will be the only means of marketing EU and non-EU funds to EU investors.

Authorization of non-EU managers

Non-EU managers who wish to become

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AIFM Directive at a Glance

Scope	Applies to all EU managers of alternative investment funds (hedge funds, private equity funds and real estate funds) and non-EU managers who manage or market such funds in the EU.
Authorization	EU managers will need to be authorized to manage and market funds from 2013. Non-EU managers may need to be authorized to manage (EU Funds from 2015) and market funds in the EU from 2018.
Fund passport	Fund passport (allowing funds to be marketed throughout the EU) to be introduced for EU managers and funds from 2013. European Commission to decide whether to extend the fund passport to non-EU managers and funds in 2015.
National private placement regimes	National private placement regimes to continue (subject to some additional conditions for non-EU managers from 2013), but European Commission may decide to end them in 2018.
Compliance obligations	Significant compliance and reporting obligations are imposed on authorized managers, including requirement to appoint a depositary (custodian) for each fund they manage.
Leverage disclosure	Managers of funds using leverage must disclose information on use of leverage to their regulator. Member States can impose leverage limits on managers.
Portfolio company disclosure	Managers of funds acquiring interests in unlisted companies must disclose information to their regulator and, in the case of acquisition of control, to the company and its shareholders.
Asset stripping	Managers of funds acquiring control of unlisted companies will be subject to restrictions on asset stripping for two years following acquisition.
ESMA	Enhanced supervisory role for the new European Securities and Markets Authority ("ESMA").

4 *EU managers will not be able to market non-EU funds in the EU using a passport until the Commission extends the passport to such funds. Until then (probably in 2015), EU managers will only be able to market non-EU funds to investors in Member States under national private placement regimes, and only if the country where the fund is established satisfies certain conditions.*

5 *"Professional investors" include entities required to be regulated or authorized to operate in the financial markets, such as banks, investment managers, insurance companies, pension funds and institutional investors, and large undertakings (businesses) meeting at least two of the following three size requirements: (1) balance sheet totals of €20 million or more, (2) net turnover of €40 million or more, and (3) own funds of €2 million or more.*

6 *Individual Member States may impose stricter requirements.*

Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals

There has long been a pervasive view that public markets systematically undervalue tax assets of various sorts — perhaps because they are inherently arcane, or perhaps because the ability to realize upon them depends upon so many imponderables. Whatever the reason, in a number of public offerings in recent years the pre-IPO shareholders have devised ways of retaining for themselves the economic benefits of identified tax attributes. Called "tax receivable agreements" or "TRAs," these arrangements generally provide that the existing shareholders will be compensated as the pertinent tax attributes are utilized, with the result that the company is effectively taken public ex those attributes. TRAs may well have a role to play in other types of transactions where the valuation of tax assets may be valued differently by various consituencies.

TRAs

TRAs made their first appearance in the public offerings of private equity and hedge fund management companies such as Fortress, Blackstone, Och Ziff and others. Those offerings were structured so that the public entity was treated as a partnership for tax purposes. In order to avoid treatment as a corporation for tax purposes, those entities are required to derive 90% of their gross income from passive sources such as investment gains and dividends. Fee income would not have qualified, so the public vehicle set up a subsidiary corporation to own the interests in the fee-earning operating entities that were allocable to the public ownership. The balance of the interests in those operating entities were owned by the pre-IPO shareholders. The resulting structure, with a public partnership owning a corporation that in turn owned some of the interests in one or more lower-tier partnerships, was a variation of the "UPREIT" structure (in which a publicly traded corporation or REIT owns interests in a lower-tier operating partnership along with other partners.)

In these offerings, the individual equity owners of the sponsor would typically sell a portion of their partnership interests to the public entity, while receiving the right to exchange their retained interests for equity of the public entity at a fixed exchange rate. Future exchanges of the interests of the individual sponsors in the fee-earning partnership entities would be structured as taxable sales. Both the initial acquisition of interests at the time of the offering and the future exchanges would result in a "step-up" in the basis of the interest of the subsidiary corporation in the assets of the underlying fee-earning partnerships, creating an intangible asset that would be amortizable over 15 years for income tax purposes. Under the TRAs, the sponsors would be compensated in an amount equal to 85% of the tax savings realized by the subsidiary corporation from such amortization deductions. Payments would be made as the deductions reduced the actual tax liability of the corporation (determined on a cumulative basis comparing the corporation's actual tax liability to its notional tax liability if such amortization deductions did not exist.)

The structure described above reserves to the existing owners the tax benefits (or 85% of the tax benefits) associated with a basis step-up that results from a taxable exchange on which the existing owners were taxable — in short it has a certain symmetry because existing owners receive tax benefits associated with a tax liability they have borne.

Endo Pharmaceuticals

A broadly similar form of symmetry was present in the 2000 IPO involving Endo Pharmaceuticals. There, the terms of Endo's existing options were modified so that they would be exercisable only into shares held by existing shareholders rather than newly-issued shares. As a result, the dilution associated with the exercise of these options would be borne entirely by the existing shareholders. However, under the tax rules, Endo would still receive the compensation deduction associated with future option exercises. The parties entered into a TRA under which Endo would pay to the existing shareholders the amount of any realized tax benefit from such compensation deductions.

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[I]n a number of public offerings in recent years the pre-IPO shareholders have devised ways of retaining for themselves the economic benefits of identified tax attributes....TRAs may well have a role to play in other types of transactions where the valuation of tax assets may be valued differently by various consituencies.

Monetizing the Shield (cont. from page 9)

TRAs for NOLs

Both the basis step-up TRAs and the Endo arrangement have the effect of giving the existing shareholder group the benefit of tax attributes that flow from transactions (pre- or post-IPO) with respect to which they had borne or would bear the cost. A similar logic arguably supports TRAs that are intended to give pre-IPO shareholders the benefit of any pre-IPO net operating loss carryforwards, and TRAs have begun to be utilized in that context as well. A case in point is the recent (February 2010) IPO of Graham Packaging, a Blackstone portfolio company. Graham Packaging was also an UPREIT-type structure, with a corporation controlled by Blackstone owning a majority interest in a lower-tier operating partnership in which the founders of the company retained an interest. The 1998 acquisition by the corporation of the majority interest in the partnership had created a stepped-up basis and amortization deductions that produced a large net operating loss ("NOL") at the corporate level. In connection with the offering, the public entity entered into two TRAs: one with the founders, to compensate them for 85% of the cash tax savings arising from amortization deductions created on future exchanges of partnership interests for public stock; and another with the shareholders of the corporation, to compensate them for 85% of the cash tax savings arising from the use of the NOL and any additional amortization deductions arising from the 1998 acquisition.

The market seems to have become accustomed to seeing [tax receivable agreements] in the UPREIT/exchange context; in other situations, sponsors may wish to consider the relative advantages of retaining such value through TRAs versus providing more detail on the expected utilization of such benefits in an effort to cause such benefits to be properly valued in the offering price.

As with other TRAs, the amount payable under the Graham Packaging arrangement is calculated by comparing the corporation's actual tax liability with its notional tax liability excluding the tax attributes in question. However, due to the dual TRA structure and the entitlement of different parties to payments for usage of different attributes, it was necessary to determine some allocation of payments between the founders and the existing shareholders of the corporation. Each TRA first compares the cash tax savings that would arise from one set of attributes as if the corporation's actual tax liability excluded the effect of tax attributes covered by the other TRA. To the extent that the amounts otherwise due under the TRAs exceeded a cap equal to 85% of the overall realized tax benefits (with the actual tax liability determined taking into account both sets of attributes), the aggregate TRA payments would be limited to the cap and apportioned between the founders and the existing shareholders in proportion to the relative amounts that would have been due under each TRA before giving effect to the cap.

Graham Packaging's use of TRAs for existing tax attributes gives further shape to a fairly nuanced landscape for such arrangements — they can apply to attributes that exist at the time of the IPO, to attributes that will be created post-IPO as a result of gains realized by the original owner group (the UPREIT/basis step-up case) and to attributes that will be created post-IPO as a result of costs borne by the original owner group (the Endo Pharmaceuticals options). The final possible case would be tax attributes that will be created in the future where the costs of the transactions creating those attributes will be borne by all shareholders — this would be the case if the options in Endo Pharmaceuticals diluted all shareholders. Although the *quid pro quo* in such transactions is not as readily apparent as in the others, there is no reason that they could not be structured and such structures may be appropriate in cases where the market is discounting the offering price for the option dilution without adequately reflecting the tax benefits associated with the options.

Tax Treatment of Holders of TRAs

Two related tax questions arise for holders of TRAs. The first concerns the tax treatment of payments made under the arrangement and the second relates to the tax treatment of the receipt of the right to receive the payments (if any). In the UPREIT/exchange transactions, the TRA payments were treated as additional consideration for the exchanged equity, providing exchanging equityholders with

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Reform of the UK Takeover Code: The End of the Affair?

As we reported in the Spring 2010 edition of the *Private Equity Report*, on 1 June, 2010 the UK's Takeover Panel (the "Panel") published its consultation paper on the possibility of reforming the UK's Takeover Code (the "Code"). The June consultation was prompted by growing concerns that it has become too easy to achieve takeovers of UK companies subject to the Code and that the outcome of such offers may be unduly influenced by the actions of hedge funds and other "short-term" shareholders who become interested in shares only during an offer period. Although such concerns were not necessarily new, the circumstances surrounding Kraft's £11.6 billion hostile takeover of UK confectioner Cadbury plc, suggested to many political and industry commentators (particularly in a General Election year in the UK) that something needed to be done.

As previously reported, the June consultation paper did not contain specific proposals for reform. Instead, reflecting political and commentator suggestions, it rehearsed a number of possible changes to the Code, with a non-exhaustive list of arguments for and against each of them. Some of the possible changes — such as disenfranchising shareholders who have acquired shares during an offer period or increasing the current minimum acceptance threshold of 50% plus one of the voting rights in a target — go to the heart of UK company law and would therefore, if implemented, require legislation by Parliament to change.

The Panel's Response

On 21 October, 2010, the Panel published its much-awaited response to the June consultation paper. In its response, the Panel concedes, citing a range of reasons, that *"hostile offerors have, in recent times, been able to obtain a tactical advantage over the offeree company to the detriment of the offeree company and its shareholders,"* and indicates that it intends to bring forward certain proposals to amend the Code with a view to redressing the balance in favour of target companies. The changes being proposed by the Panel include:

- *Requiring potential offerors to quickly clarify their position.* The Panel proposes to restrict the "put-up or shut-up" period following the announcement of a possible offer to 4 weeks, after which time the potential offeror must either make a binding offer or walk away (in which event it cannot usually return with another offer for at least six months). This time limit would not apply to auctions where the target board has established a formal sale process.
- *Prohibiting deal protection measures.* Despite most consultation responses suggesting the opposite, the Panel intends to prohibit inducement fees and undertakings by the target board to support an offer (other than in certain limited circumstances). This prohibition will not apply to auctions where the target board has established a formal sale process.
- *Requiring disclosure of offer-related fees.* The Panel chose not to prohibit advisory and other fees involving an incentive or success based component, but proposed that the minimum and maximum amount of such fees should be disclosed along with the fees of other advisers.
- *Requiring disclosure of the same financial information in relation to all types of bidders.* The Code has traditionally provided that financial information about the offeror was relevant only in respect of securities exchange offers. However, in light of a number of consultation responses, the Panel has now concluded that, irrespective of the nature of the offer in question, financial information about the offeror is also of concern to shareholders in the offeror as well as creditors, customers and employees of both parties. The Panel has, therefore, proposed that such information be incorporated into cash offer documents as well.
- *Requiring further disclosure in relation to the financing of an offer.* With an eye, no doubt, on the controversy surrounding Kraft's closure of the Cadbury plant at Somerdale in the UK, the Panel has proposed amendments to the Code to make it clear that the target board is entitled to consider the longer-term effects of a successful takeover on the merged business in all the circumstances. In fact, the Code does not currently contain a restriction on what factors the target board may consider, albeit price has traditionally dominated. Bidders will now be required to include in the offer document a pro forma balance sheet for the combined group and greater disclosure of any bank facilities taken out to finance a bid.
- *Improving disclosure relating to the offeror's intentions regarding the target and its employees.* Again, with an eye on the Somerdale plant closure, the Panel has proposed that an offeror's plans for target employees, assets and places of business should be the subject of greater

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Reform of the UK Takeover Code (cont. from page 11)

disclosure and that if no time periods are indicated, such plans will be expected to hold true for at least one year after the offer becomes unconditional. The Panel also intends that it should be easier for employee representatives to make their views known.

A Bridge Too Far

The Panel does not propose, however, to take forward some of the more controversial proposals in the June consultation. By reference to the views of respondents, and not the views of the Panel *per se*, the response paper notes that the acceptance threshold of "50% plus one" is inextricably linked with the passing of an ordinary resolution under UK company law, and that if such a change were to be made, it should be the domain of Parliament and not the Panel. Similarly, the suggestion that shares acquired during an offer period should be disenfranchised, compromised the company law principle of "one share, one vote" and accordingly, any introduction of weighted voting rights or qualifying periods before voting rights could be exercised was rejected as also requiring legislation.

The End of the Affair?

Few will be surprised that the Panel has not proposed sweeping reform, even if it may purport to do so. Its response does not fully address the vague concept of "short termism" which has so dominated the debate. Neither, of course, does it address the issue of foreign ownership of UK public companies (up from 36% of quoted company shares in 2000 to 41% in 2008) which was arguably the real reason for the furor surrounding the Cadbury-Kraft deal.

Still, sweeping or not, there are some important changes proposed and it is likely that private equity firms will be affected by some of them. For example, buy-out firms which have traditionally used "break fees" as a means of deal protection (capped at 1% of deal value under the current regime) will no longer be able to use this as a method of offsetting costs in the event of a failed bid unless an auction process is instigated by the target. Additionally, the proposed shortening of the "put-up or shut-up" period will significantly restrict the tactical ploy of putting the target management under pressure by announcing only an intention to make an offer without having first secured financing.

Does the Panel's response mark the end of the affair, at least for now? Comments made over the last few months by the UK's Secretary of State for Business, Innovation and Skills, Vince Cable MP, in relation to "short termism" and the takeover market in general suggest that he, at least, within Britain's Coalition Government, was looking for a particular outcome from the consultation. Whether he feels that the Panel's response is adequate remains to be seen. Detailed rule changes are expected to be published for consultation in the first quarter of 2011, with implementation following by early summer. We will keep you apprised of any developments ■

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Learning to Live with Regulatory Uncertainty (cont. from page 4)

markets, particularly U.S. capital markets, coupled with a spike in global interest in the region, has inspired many issuers and investors to take a new look at an exit option that many private equity investors had assumed was off the table. Increasingly, investors and capital markets appear willing to accept a certain amount of regulatory uncertainty in supporting IPOs of Chinese businesses that rely on relatively creative and complicated corporate structures to delicately navigate through China's evolving regulatory regimes. In China, the reopening of the IPO window and offshore exit opportunities in 2010 after the more difficult period of 2008 and 2009 is causing some investors to cite the Chinese idiom "雨过天晴" (after rain comes sunshine). Although there is no certainty that Chinese regulators will not move to restrict the use of some of these alternative structures, it is hardly surprising that investors have, in the words of the American idiom, been quick to "make hay while the sun shines." ■

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ALERT

FTC Considers Changes to the HSR Form Impacting PE Sponsors

Unless the business community is able to convince the Federal Trade Commission ("FTC") that its proposed new rules are unduly burdensome, private equity firms seeking to acquire businesses may have a significantly harder time making routine filings for anti-trust clearance. The FTC is currently reviewing public comments on several substantial proposed amendments to the Premerger Notification Rules and the Notification and Report Form (the "Form") that is used to report certain mergers and acquisitions under the Hart-Scott-Rodino Act ("HSR"). While many of the FTC's proposed modifications simplify preparation of the Form by removing outdated data and documentary requirements, others would significantly expand the burden of HSR compliance, especially for private equity sponsors. Recognizing this, the Private Equity Growth Capital Council ("PEGCC") and other organizations have submitted comments, which are available on the FTC's website at www.ftc.gov/os/comments/hsrformrevisions/index.shtm.

The FTC's Notice of Proposed Rulemaking (see www.ftc.gov/os/2010/08/100812hsrfrn.pdf), issued August 13, 2010, states that the purpose of the changes is to streamline the Form and to capture new information that will help the FTC and the Antitrust Division of the Department of Justice ("DOJ") conduct their initial review of a proposed transaction's competitive impact. Welcome changes to the Form and its associated Instructions include elimination of the requirements to provide copies of, or internet links to, certain SEC filings by the filing party and its controlled subsidiaries in Item 4(a), balance sheets for the filing party and its unconsolidated U.S. subsidiaries in Item 4(b), and "base year" (currently 2002) revenue data by NAICS code in Item 5. This Alert discusses some of the less welcome changes, particularly for private equity firms.

"Item 4(d)" Documents

As many private equity managers know, responding to Item 4(c) of the Form is one of the most time-consuming parts of preparing the filing, and the associated rules are some of the most complex. Item 4(c) seeks documents prepared by or for officers or directors of either party for the purpose of evaluating or analyzing the proposed transaction with respect to markets, market shares, competition, competitors, potential for sales growth or expansion into product or geographic markets. The proposed rule changes would add an "Item 4(d)" to the Form, which would require submission of three additional categories of documents:

1. Item 4(d)(i) would ask for any offering memorandum that refers to the entity or assets to be acquired and was prepared in the two years preceding the HSR filing. This item goes well beyond codifying the FTC's existing interpretation of Item 4(c), which requires offering memoranda relating to the transaction being reported, by requiring firms to collect and submit offering memoranda "or documents that serve that function" that have no relation to the reported transaction and were not prepared by or for officers or directors.

2. Item 4(d)(ii) would require documents prepared within two years preceding the HSR filing by "investment bankers, consultants or other third-party advisors" for an officer or director of either party if they contain content of the type responsive to Item 4(c) and refer to the entity or assets to be acquired, regardless of whether they relate to the reported (or any) transaction.

3. Item 4(d)(iii) would seek all documents "evaluating or analyzing synergies and/or efficiencies" that were prepared by or for an officer or director of either party for the purpose of evaluating or analyzing the proposed transaction. Under existing practice, documents discussing revenue synergies are considered responsive to Item 4(c), but documents exclusively considering cost synergies are not. This proposed change would include the latter, but would exclude financial models without stated assumptions.

The Item 4(d) proposals have been the subject of much controversy because many HSR practitioners believe they would greatly expand the scope of a filing party's search for responsive documents, even in transactions raising no competitive issues and where the parties report no product or service overlaps on their HSR Forms. The public comments have also highlighted the risk to deal confidentiality arising from the apparent need to search the files of individuals having no prior knowledge of the transaction (including officers and directors of other portfolio companies) but who might have documents responsive to Items 4(d)(i) or (ii). Comments have also expressed

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Alert: FTC Considers Changes to the HSR Form (cont. from page 13)

concern about potentially expansive interpretation of new terms such as "consultants or other third-party advisors."

"Associates"

Proposed changes involving the new term "associate" are specifically aimed at private equity firms and other capital management groups structured as multiple limited partnership funds under common management but whose equity interests are widely held. Under the current HSR rules, each such fund is its own "ultimate parent entity" because it is not "controlled" (for HSR purposes) by any limited partner, general partner or manager. This means that a HSR Form reporting an acquisition by one such fund (or its controlled portfolio company) does not include any information relating to other funds under common management nor to those funds' investments. Such information might be of great interest to the antitrust agencies where, for example, a portfolio company of a related fund is a competitor of the target in the reported transaction, or where a related fund already holds a minority interest in the target company.

The proposed rules would alter this reporting requirement by creating the term "associate" and defining it as any entity (a "managing entity") that has the "right to manage, direct or oversee the affairs and/or the investments" of an acquiring entity, as well as any entity that has its "affairs and/or investments, directly or indirectly managed, directed or overseen" by the acquiring person or by a managing entity.

The proposed rules also impose additional information requirements under Items 6 and 7 of the HSR Form with respect to an acquiring person's associates. The proposed change to Item 6(c) of the Form would require an acquiring party to disclose, based on its knowledge or belief, its associates' minority investments (defined as investments of at least 5% but less than 50%) in entities making U.S. sales in the same 6-digit NAICS industry codes as the target entity or assets. Similarly, revised Item 7 would extend the existing requirement that filing parties identify NAICS code overlaps between the acquiring party (including its controlled entities) and the target entity or assets to include overlaps with any associates of the acquiring person. In the case of a private equity firm, these changes would mean that the HSR Form filed by an acquiring fund would have to disclose any such overlaps between the target entity or assets, on the one hand, and any control and applicable minority investments of any fund under common management with the acquiring fund, on the other hand.

As the PEGCC noted in its comments, it may be difficult for private equity firms to know about overlaps or collect NAICS code data from portfolio companies in which the firm has only a small minority interest. This difficulty would be multiplied if the "associate" in question was a third-party investment adviser, as that individual or entity would not likely be willing to provide information about its minority holdings or about other clients it advises. In addition, the public comments have focused on the excessive breadth and vagueness of the definition of "associate," especially because the term "oversee" could be interpreted to include entities and individuals having no decision-making authority.

Item 5 Revenue Reporting

The proposed modifications to Item 5 of the HSR Form would require a filing party to report its manufacturing revenues from U.S. operations for the most recent fiscal year by 10-digit NAICS code rather than 7-digit codes, which should not be a very burdensome exercise. However, the new rules would also expand Item 5 to include revenues of certain foreign operations. The current rules limit Item 5 revenue reporting to operations conducted within the U.S. Thus, revenues from U.S. sales of foreign manufacturing operations are reported only when the products are sold through a controlled entity located in the U.S., but not when sold directly from the foreign manufacturer to a U.S. customer. The FTC's proposal would require that revenue from all U.S. sales of foreign manufacturing operations be reported at the 10-digit NAICS code level regardless of how the sales are made to the U.S.

Other Changes

The FTC's proposed revisions also include numerous minor changes to the HSR Form, many of ministerial or organizational nature (*e.g.*, requesting the filing party's website address), and some of which reflect prior changes to the HSR Rules or their interpretation (*e.g.*, the change in civil penalties to $16,000 per day that became effective in early 2009).

* * *

Given the controversial nature of some of the proposed rule changes, and the substantial objections and suggestions provided by HSR practitioners and the business community, it is likely that the FTC will modify some of the proposed rules before they are implemented. The timing of the FTC's issuance of the final rules is uncertain, but it is not likely that the rule changes will take effect before early 2011. ■

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Terra Firma v. Citibank: A Cautionary Tale?

Five years ago few in the New York financial community would have imagined that a preeminent London-based private equity firm would sue a global bank in New York federal court and argue before a jury that the bank had defrauded the private equity firm in connection with an auction. Nor would many have suspected that the global bank would have let the case go to a jury. Terra Firma's recent case against Citibank provided plenty of intrigue in a headline-grabbing trial conducted by two high-profile trial lawyers and covered daily in the business press. The case was resolved when the jury quickly rejected all of Terra Firma's claims, determining that Terra Firma had not sustained its burden of proof that there was a misrepresentation that Terra Firma relied on. The case provided an intimate look at the auction process and at how highly leveraged private equity transactions are negotiated and structured. At the end of the day, however, the biggest surprise was that the case was brought and that it was tried in front of a jury.

A quick review of the facts can also serve as a reminder of several things worth keeping in mind during "deal heat."

The saga began in 2007, when EMI, a British music company in deteriorating financial health, commenced an auction to sell itself, with Citibank acting as its secondary advisor on the deal. After three private equity firms submitted indicative bids, David Wormsley — then head of UK Investment Banking for Citibank — contacted his friend and frequent client, Guy Hands, chairman of Terra Firma, about EMI. Terra Firma expressed interest and, as it prepared to submit a bid, the other bidders, unbeknownst to Terra Firma, dropped out of the process. On May 21, 2007, Terra Firma, by then the sole bidder in the auction, bid £2.65 a share and succeeded in acquiring EMI. Almost immediately after the closing, it became clear that EMI's financial condition would continue to deteriorate and that Terra Firma's price might not have been justified. Citibank received £92.5 million in fees on the deal.

In December 2009, Terra Firma filed a complaint against Citibank in New York state court, and Citibank removed the case to federal district court in New York City. Terra Firma's central allegation was that David Wormsley lied to Guy Hands and induced Terra Firma to bid £2.65 a share by telling Mr. Hands, falsely, that Cerberus Capital Management was a competing bidder at £2.62 a share. The complaint further asserted that Wormsley's motives to deceive Hands, for whom Wormsley had acted as a close advisor for over 20 years, included (1) receiving a substantial advisory fee from EMI, (2) avoiding the embarrassment of a busted auction, (3) protecting Citibank from an EMI default on Citibank debt, and (4) creating an opportunity for Citibank to provide Terra Firma with financing for the acquisition.

Although much of the media coverage of the trial seemed to suggest that Citibank's relationships on the sell side and in providing financing to bidders put it in a conflicted, and thus, unusual position, it is, in fact, not particularly unusual, as those in the deal community know only too well, for a bank serving as a financial advisor on the sell side of a transaction to have a financial interest (*e.g.*, as a lender) on the buy side of the same transaction. And because private equity transactions routinely rely on leveraged financing, virtually all major private equity firms have well-established and long-standing relationships with the banks capable of acting as both lenders and financial advisors. And, perhaps most importantly, private equity firms understand the ethical walls that financial institutions have put in place to deal with these potential issues and the way in which those ethical walls operate. Indeed, the evidence at trial suggested that Mr. Hands, who was well aware of Citibank's role and relationships with parties on both sides of the transaction, viewed Citibank's dual role as a plus to the extent that his close relationship with Mr. Wormsley might be helpful in providing Terra Firma with access to information about the auction that it might not otherwise have had.

What was, in fact, more unusual about the case was Terra Firma's decision to sue Citibank and Citibank's willingness to let the case go all the way to the jury. As the *Wall Street Journal* put it, the case represented an "unprecedented attack by a private equity firm on a bank it depends on to help originate and fund its takeovers," and was essentially a referendum on Citibank's trustworthiness. Trial commenced on October 18, 2010, with Terra Firma arguing that Citibank's loyalties were divided, and that Wormsley had, in a moment of desperation, blatantly lied about

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The case provided an intimate look at the auction process and at how highly leveraged private equity transactions are negotiated and structured. At the end of the day, however, the biggest surprise was that the case was brought and that it was tried in front of a jury.

the Cerberus bid. Citibank, on the other hand, depicted the case as Mr. Hands' attempt to shift responsibility for a bad business decision to Citibank and to gain leverage in negotiations with Citibank regarding EMI's debt. Both sides agreed at the trial that there were essentially two issues for the jury to decide: (1) whether Mr. Wormsley lied to Mr. Hands by telling him that Cerberus was planning to bid £2.62, and (2) whether Mr. Hands relied on that lie in formulating Terra Firma's bid. After a three-week trial, the jury returned a verdict for Citibank on both counts after relatively short deliberations. The press coverage of the case didn't provide much in the way of insight into how the jury reached its verdict. But a review of the closing arguments and some of the evidence relied on by the parties suggests the bases on which the jury decided the case.

First and foremost, there was no documentation or other independent corroboration of Mr. Hands' claim that Mr. Wormsley in fact represented to him that Cerberus was going to bid £2.62 on May 21. In a case involving a $4 billion transaction in which the parties introduced hundreds of communications and records containing both key and trivial information exchanged between the parties — including dinner menus and receipts — there was not a single email, note or other document in which Mr. Hands had written down, contemporaneously or otherwise, the all important representation he claimed to have received from Mr. Wormsley, and relied on. And no witness other than Mr. Hands could testify to having first-hand knowledge of Mr. Hands' conversations with Mr. Wormsley.

[F]inancial institutions should carefully consider whether to require their clients to waive jury trials in any disputes, regardless of whether they originate from an a formal engagement or not.

Additionally, Terra Firma's assertion of reliance on the Wormsley conversations was undermined at trial by evidence that Terra Firma's internal financial modeling of the transaction reflected a determination that £2.65 was a "good deal" that would allow for a 22% return rate. Even more strikingly, Citibank's lawyer made reference in his closing to evidence indicating that Terra Firma had considered offering as much as £2.85 a share on the basis of its belief that it could "still make a lot of money at 2.85."

Moreover, while Terra Firma depicted Mr. Wormsley as being the sole source of information driving the final bid price, witnesses on both sides apparently testified that Terra Firma representatives had spoken to EMI representatives other than Wormsley about price: EMI's CFO testified that EMI's board "had set 2.65 as being our aim" independent of any discussion with Wormsley, and an internal Terra Firma memo dated weeks before the Wormsley discussions suggested a bidding price of £2.60 "[b]ased on the operating and financing assumptions that have emerged through conversations between Eric Nicoli, CEO of [EMI], and Guy Hands."

Finally, the notion that Mr. Hands had relied on information about the Cerberus bid seemed to be undermined by evidence showing that Mr. Hands received an email from the *Financial Times* on the morning of May 21, the day Cerberus allegedly was going to bid £2.60, bearing the headline "Cerberus is out." Similarly, on September 24, 2007, Mr. Hands received an email from Stephen Alexander, a top Terra Firma executive, stating that "Cerberus never actually submitted a formal offer." The existence of these emails, and the fact that Mr. Hands did not try to walk away after the FT email was sent or complain about being misled in September, provided a substantial counter to Mr. Hands' crucial assertion that he had not learned, until 2009, that Cerberus had not submitted a bid.

Of course, as is always the case, particularly in a fraud trial, credibility and reputation played a critical role. Citibank presented extensive evidence of Mr. Hands' reputation as an aggressive businessman who relished challenges, quoting him as having touted his ability to "find potential where other people saw problems," and having stated weeks before the conversations with Wormsley, that Terra Firma "intend[ed] to win" the auction.

Are there lessons to be learned from this drama? Nothing profound, but the case reminds us of a few fundamental points.

First of all, financial institutions should carefully consider whether to require their clients to waive jury trials in any disputes, regardless of whether they originate from a formal engagement or not. While juries often get it right, particularly in criminal cases, handing a complex financial case to a jury generally creates greater risk than requiring that any dispute be resolved by a judge or an arbitrator.

Secondly, email and other documents

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ALERT

Proposed Exemptions from SEC Registration Available to Non-U.S. Advisers

Unlike most advisers to private equity funds, non-U.S. private equity advisers and advisers to venture capital funds may be able to avoid registration with the U.S. Securities and Exchange Commission (the "SEC"). By now, virtually everyone in the industry knows that Title IV of the Dodd-Frank Act repealed the current exemption from registration in the Investment Advisers Act of 1940 (the "Advisers Act") for private fund advisers with fewer than 15 clients and replaced it with three new exemptions. What they may not realize is the scope of the new exemptions, which apply to (1) advisers *solely to* "venture capital funds" ("VC Advisers"), (2) advisers *solely to* private funds with less than $150 million in *assets under management in the United States* without regard to the number and type of private funds advised ("PF Advisers"), and (3) non-U.S. advisers with less than $25 million in *aggregate assets under management from U.S. clients and private fund investors* and fewer than 15 such clients and investors ("Foreign Private Advisers") (emphasis added).[1] The Dodd-Frank Act will take effect on July 21, 2011.

The SEC was directed under the Dodd-Frank Act to promulgate rules to implement these new exemptions. On November 19, 2010, the SEC issued a 135-page release proposing three new rules. This article focuses on how the SEC's proposed rules would apply to non-U.S. advisers to private funds.

1 *See also "Investment Advisor Registration: Preparing for the New Environment" in Vol. 10, Number 4 of the Debevoise & Plimpton Private Equity Report, which discusses some additional exemptions not relevant for the discussion here.*

VC Advisers Exemption

Proposed Section 203(l) of the Advisers Act exempts from SEC registration advisers solely to "venture capital funds." Of relevance to private equity fund advisers, the SEC takes pains in its release to point out that Congress wanted to distinguish between advisers to private equity funds, for which there is no specific exemption, and advisers to venture capital funds which are eligible for this exemption from registration.

Proposed new rule 203(l)-1 would define a "venture capital fund" as a private fund[2] that has all the following characteristics:

- Invests in "equity securities," as that term is defined in the Securities Exchange Act of 1934, of "qualifying portfolio companies." A qualifying portfolio company means any company that is not publicly traded, does not incur leverage in connection with the private fund investment, and is an operating company. Thus, a fund of venture capital funds would not fall within this definition. The proposal would permit non-U.S. companies to be qualifying portfolio companies, but the SEC seeks comments on this approach.
- Acquired at least 80% of the securities of each qualifying portfolio company directly from the company and not from its securities holders.
- Provides, or offers to provide, "significant managerial assistance" to, or controls, the qualifying portfolio company.
- Does not incur leverage other than short term borrowings.
- Does not offer investors redemption rights except in extraordinary circumstances. A fund that permits withdrawals periodically would be considered to be granting redemption rights even if the withdrawals are subject to gating or similar restrictions.
- Represents itself as a venture capital fund to investors.

2 *For purposes of all of the SEC's proposed rules, a "private fund" (as previously defined in Section 202(a)(29) of the Advisers Act) is any issuer that would be an investment company under the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) under the Investment Company Act. In general, a section 3(c)(1) fund has fewer than 100 beneficial owners and a section 3(c)(7) fund can be offered only to qualified purchasers which already own a specified dollar amount of investments.*

Of particular relevance for non-U.S. advisers, the proposed definition of venture capital fund does not currently require that the fund *needs to* be managed by an investment adviser based in the U.S. Indeed, the SEC acknowledges in its release that venture capital funds with advisers operating principally outside the U.S. may seek access to U.S. portfolio companies or U.S. investors, and that U.S. investors may wish to invest with non-U.S. venture capital advisers.

Still, a key issue for non-U.S. advisers is whether or not the VC Adviser exemption will be available at all once the final rules are adopted by the SEC. The fact that the SEC is seeking comment on a number of issues makes it difficult for advisers based outside the U.S. to make plans based on

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the assumption that the VC Advisers exemption will ultimately be available for them. Fortunately, they may be able to rely on the more flexible PF Advisers exemption discussed below.

PF Advisers Exemption

Section 203(m) of the Dodd-Frank Act directs the SEC to exempt from registration any investment adviser *solely to private funds with less than $150 million of assets under management in the United States*. We and many private fund advisers anxiously awaited how the SEC would interpret the phrase "assets under management in the United States."

Happily, the SEC in proposed rule 203(m)-1 provides a holiday gift for investment advisers that have their *principal office and place of business outside of the U.S.* ("Offshore Advisers"). The proposed exemption would be available to an Offshore Adviser as long as all of the adviser's funds that are U.S. persons are "qualifying private funds" — *i.e.* Section 3(c)(1) or 3(c)(7) funds. And even better, for Offshore Advisers that do not have any place of business in the U.S., it does not matter how many private funds are advised in the U.S., where the funds are organized, the amount of assets under management, or how many U.S. investors the funds have. Moreover, the Offshore Adviser is free to conduct any type of business outside the U.S.

An adviser's "principal office and place of business" is defined in the proposed rule as "the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control and coordinate the activities of the investment adviser." The SEC explains that this is the location where the adviser controls, or "has ultimate responsibility for" the management of the private fund assets and is thus considered *the* place where the adviser's assets are managed, even if some day-to-day management of assets takes place elsewhere. Thus, an Offshore Adviser with its principal office and place of business in London would be deemed to have *all* private fund assets under management in London. For Offshore Advisers with personnel in different offices providing advice or research for private funds, the proposed definition attempts to deal with the difficult issue of determining where the important advisory activities take place. Nonetheless, there remain some important interpretive issues, as discussed below.

An Offshore Adviser will need to examine whether, in fact, it has *a place of business in the U.S.* and whether it manages assets of private funds from that location in order to calculate its assets under management in the U.S. toward the $150 million cap. A "place of business" in the U.S. would be defined in the proposed rule as "an office where the investment adviser regularly provides investment advisory services, solicits, meets with or otherwise communicates with clients …." If the adviser provides "continuous and regular supervisory or management services" from its U.S. place of business with respect to U.S. private funds, then it would be deemed to have "assets under management" in the U.S. An Offshore Adviser with a place of business in the U.S. would need only count private fund assets it manages from the U.S. place of business toward the $150 million limit under the exemption and can disregard non-fund clients that are not U.S. persons and whose assets are managed from non-U.S. offices. Such an adviser would have to calculate the amount of assets it manages quarterly based on the fair value of the private fund assets, including undrawn commitments. If the value of the assets from a place of business in the U.S. exceeds $150 million, the Offshore Adviser would no longer be able to rely on the exemption. If any assets are managed from a U.S. place of business for any client that is a U.S. person other than a private fund, the exemption is unavailable. This also holds true for any Offshore Adviser attempting to rely on the private fund adviser exemption.

Foreign Private Adviser Exemption

The Dodd-Frank Act replaced the current private adviser exemption with the Foreign Private Advisers exemption, which we believe will be of limited, if any, utility for most non-U.S. private fund advisers in light of the way "foreign private adviser" is defined. The Dodd-Frank Act defines the term to mean any investment adviser that has all of the following characteristics:

- No place of business in the United States.
- Fewer than a total of 15 clients in the United States *and* (fatally) investors in the United States in private funds advised by the investment adviser.
- Aggregate assets under management attributable to clients in the U.S. *and* investors in the United States in private funds of less than $25 million.
- Does not hold itself out to the U.S. public as an investment adviser.

As proposed to be implemented in rule 202(a)(30)-1, this Foreign Private Advisers exemption is of little to no use for most non-U.S. private fund advisers or other financial institutions that relied on the old exemption, even leaving aside the small $25 million cap. Specifically, unlike the broader language in the PF Advisers exemption (which refers to "assets under management in the United States"), the

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clear direction from the Congress was to repeal the old "fewer than 15 clients" interpretation that treated each fund as one client and to instead take into account U.S. investors in the funds as well.

The SEC makes it clear that setting up intermediate accounts to avoid counting U.S. clients or investors is not possible under its proposed rule. It specifically deals with master-feeder fund structures; the adviser to the master fund would have to look all the way through to the holders of the feeder funds formed for the purpose of investing in the master fund. The holder of a total return swap would also be counted as an investor.

The proposed rule also eliminates the ability of non-U.S. private fund advisers to offer interests in private funds to their U.S.-based knowledgeable employees without having to count them as investors. The proposed rule specifically states that knowledgeable employees will count as investors in a private fund.

The Foreign Private Advisers exemption refers to the term "in the United States" in several contexts. As is the case with the PF Advisers exemption, the proposed rule incorporates the definitions of "in the United States," "U.S. person" and "United States" as those terms are defined in Regulation S, with a few tweaks to make it clear that a discretionary account held for the benefit of a U.S. person outside the U.S. will count if the account is held by a related person of the investment adviser.

How Do These Proposed Exemptions Apply to Subadvisory Relationships or to Affiliates of the Adviser?

As a general matter, a subadviser to a private fund is deemed to be an adviser for purposes of the proposed PF Advisers and VC Advisers exemptive rules. That means that the subadviser can avail itself of the proposed exemptions if it can satisfy the terms and conditions of the rules implementing them.

The SEC attempts to clarify how a subadviser, for example, might be able to rely on the PF Advisers exemption. For example, if the subadviser's services to the primary adviser relate solely to private funds and the other conditions of the exemption are met (such as if the subadviser has its principal office and place of business outside the U.S.), then the subadviser would also be eligible to rely on the PF Advisers exemption.

More interesting interpretive issues will be presented in the case of non-U.S. advisers with advisory affiliates. Specifically, will the non-U.S. adviser be able to rely on the proposed exemptions without the need to integrate the activities of its affiliates? Integration could be an issue if the non-U.S. adviser has affiliates that are registered with the SEC or cannot rely on the new exemptions (because they advise registered investment companies or separate accounts) even though the non-U.S. adviser standing alone could rely, for example, on the PF Advisers exemption. The proposed rules are silent on how this will play out. The SEC is well aware that numerous interpretive issues will arise, particularly, for advisers with multi-national operations that include operations in the U.S. We would encourage our non-U.S. clients, in particular, to consider how their specific advisory activities are organized and how those activities are viewed under the proposed exemptions from registration. It will be much easier to address interpretive issues during the comment period and before the rules are finally adopted.

Conclusion

The comment period on the proposed rules ends January 24, 2011 and we anticipate that it will take the SEC a few weeks to digest what are expected to be a flood of comments. The betting is that the SEC intends to issue the final rules in early Spring of 2011.

As noted above, we believe the most promising exemption for non-U.S. advisers under the SEC's proposed rules is for PF Advisors. The SEC could, however, make the VC Adviser exemption much more useful and practical for non-U.S. advisers if it determines to permit such advisers with a principal office and place of business outside of the U.S. to provide advice to any client or fund outside the U.S. — in fact, taking the same approach proposed for PF Advisers.

In any case, we note that in the companion release to the proposed rules described in this article, the SEC proposed other related rules, including amendments to Form ADV, the Advisers Act registration form. Among other things, these proposals impose reporting requirements on advisers relying on the VC Advisers and PF Advisers exemptions. Significantly, the proposing release specifically states that the SEC has the authority to require VC Advisers and PF Advisers to provide the SEC with reports and to maintain books and records and that the SEC has authority to examine such books and records. So, while VC Advisers and PF Advisers may be exempt from SEC registration, the regulatory burdens associated with being exempt may nonetheless be significant. ■

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Is Dual Track the New Normal? (cont. from page 1)

track approach to selling Pets at Home culminated in KKR's January 2010 acquisition of the British retailer for $1.4 billion, a price that was $300 million more than early reports of the proposed IPO valuation.

Second, a dual track process can give a seller significant negotiating leverage over deal terms in a private sale. Sellers will argue that a "public M&A"-style contract, with limited representations and warranties and no post-closing indemnification remedy, is appropriate — given that the business being sold has made detailed SEC filings in connection with the proposed offering and that these contract terms generally parallel the situation a buyer would be in if it were purchasing a public company. (A buyer, of course, will counter that a private sale does not expose the seller to the securities litigation risk present in an IPO exit, and that underwriting agreements typically contain both representations and warranties and an indemnity against liability for material misstatements and omissions in the offering materials.)

Every advantage a seller can extract by running a dual track process is to some extent an equal and opposite disadvantage to the buyer. There can, however, be a silver lining for bidders in a dual track auction. An IPO process...can provide a potential buyer of a private company with significant insights into the company's business and the risks it faces that may not otherwise be readily available.

Third, a dual track approach allows a seller to keep its options open until it becomes clear which route will yield the highest value, thus preserving flexibility and hedging against deal uncertainty. Particularly when market conditions are volatile, a dual track approach can increase the odds of being able to take advantage of favorable conditions and therefore of a successful exit.

Fourth, while a dual track approach magnifies the cost, complexity and management distraction inherent in any sale process, it may also enjoy useful synergies. For instance, the electronic data room prepared for private buyer diligence will generally suffice for underwriter diligence as well. A company's preliminary securities filings in connection with an IPO (typically, on Form S-1) can, if the company ends up being sold to a private buyer who requires financing, offer a significant head start on a debt offering memorandum. Disclosure in a preliminary Form S-1 can be made an exception to representations and warranties in a private sale agreement, permitting the seller to prepare shorter disclosure schedules. Diligence by the company's outside counsel in preparation for giving a customary legal opinion and negative assurance letter to underwriters in an IPO can also be converted into vendor due diligence reports (common in Europe) and facilitate the preparation of disclosure schedules for a private sale agreement. The familiarity that outside counsel in an IPO will achieve with the business being sold will allow them better to anticipate potential issues in a private sale and ensure that these issues are addressed efficiently and flushed out early in the private sale process.

The Buyer's Perspective

Every advantage a seller can extract by running a dual track process is to some extent an equal and opposite disadvantage to the buyer. There can, however, be a silver lining for bidders in a dual track auction. An IPO process, particularly one that has advanced to a point that SEC comments have been received on a Form S-1, can provide a potential buyer of a private company with significant insights into the company's business and the risks it faces that may not otherwise be readily available. Particularly when faced with auction pressure to live with a contract that contains limited representations and warranties, the Form S-1 can provide a helpful supplement to the confirmation of buyer's due diligence provided through the sale agreement, particularly if — as is often the case when the IPO process is sufficiently advanced — the seller gives a representation in the sale agreement as to the absence of material misstatements and omissions in the preliminary Form S-1. Bidders may also be able to take some practical comfort from the knowledge that the company's outside counsel have done the diligence work necessary to be ready if called upon to give legal opinions and a negative assurance letter to the underwriters. Finally, in a dual track process a buyer is better assured of receiving SEC-compliant audited financial statements and current unaudited financial statements, the creation (and

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cost) of which can be hotly contested between a buyer and seller in a carve-out divestiture not done on a dual track.

Weighing the options

Despite the potentially significant advantages to sellers of running a dual-track process, one size does not fit all. Key considerations that sellers should take into account include:

- *Credibility of an IPO vs. Private Sale.* Is an IPO viable given the state of the equity markets and the company's financial situation? Failure to generate much interest as a company is being prepared for an IPO could potentially dampen its private sale prospects. Is an IPO a credible alternative given interest from potential strategic buyers? It may be hard to generate public market demand or auction leverage from a dual track process if there is a natural strategic buyer who would reap significant synergies and is therefore able to offer a significantly higher valuation for the business than the public markets.
- *Cash Now, or Upside Later?* A private sale typically allows the seller to dispose of its entire interest at once for a lump sum, whereas in an IPO the seller will be required to retain a significant stake that can only be sold off over time — exposing the seller to future public market risk and potentially negatively affecting a private equity seller's internal rate of return. At the same time, an IPO may be an attractive way to create a path to exit and achieve some initial liquidity while continuing to participate in the upside of the business. For instance, according to press reports, Providence Equity Partners rejected bids for its portfolio company Kabel Deutschland GmbH that valued the company at approximately €5.5 billion, opting instead to take the company public and sell only part of its stake in March 2010. Although the IPO priced at the low end of the expected range, the decision to pursue an IPO rather than a sale suggests that Providence saw opportunities ahead for the company. These are complex business judgments that vary with each potential transaction.
- *Incentivizing Management.* Sellers should keep in mind that management's financial and other personal incentives may lead them to prefer one alternative over another. For example, senior management at some companies may prefer an IPO exit because of the potential for a liquid market for their equity and the opportunity an IPO presents over time to run the business without oversight (and risk of being replaced) by a private buyer. On the other hand, a private exit may result in accelerated vesting of management equity and equivalents and a quicker payday for management. These incentives may affect the energy and attitude with which a management team approaches the sale process. Care should be taken to ensure that management's incentives are aligned with those of the seller to achieve the best available valuation.
- *Advisors.* Sellers need to be attentive to the fact that M&A financial advisors and securities underwriters in a dual track process will have differing financial incentives, and these may cause each of them to seek to push the process in one direction or another. One solution for the seller is to have a single firm as both M&A financial advisor and lead underwriter in order to minimize these potential conflicts, although this is not always feasible.

The recent buzz generated by dual track deals obscures an important fact: dual track deals have been in and out of fashion since the mid-1990s, rising and falling in popularity with broader industry trends and the ups and downs of the public markets. While these deals can have pluses or minuses for PE firms, depending on which side of the track they are on, there is no question their continued popularity would auger well for the general state of the global capital markets. ■

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[R]ecent academic research confirms the common sense view that (in the right market conditions) a dual-track approach can maximize the price obtained by the seller....[Yet,] despite the potentially significant advantages to sellers of running a dual-track process, one size does not fit all.

EU Directive on Alternative Investment Fund Managers (cont. from page 8)

authorized under the Directive once they are able to do so (*i.e.*, from 2015) will need to apply to their "Member State of reference" — generally, the Member State where the manager intends to market its funds (that may include multiple Member States, one of which will be designated as the Member State of reference under a "tie-breaker" procedure) or, in the case of a manager proposing to manage an EU fund, the Member State where the fund is established. Authorization will involve full compliance with the provisions of the Directive, and:

- appropriate cooperation arrangements will have to be in place between the manager's regulator and the regulator of the Member State of reference;
- the manager's home jurisdiction must not be listed as non-cooperative by FATF, and must have signed an OECD compliant tax treaty with the Member State of reference; and
- the laws, regulations and administrative provisions of the manager's home jurisdiction must not prevent the effective exercise by regulators of their supervisory functions under the Directive.

Private equity firms based outside of Europe breathed a sigh of relief when the European Parliament finally decided that even fund managers based outside the European Union may well be entitled to a "passport" entitling them to market alternative investment funds within the EU.

In addition, a non-EU manager will have to appoint a "legal representative" in its Member State of reference to act on its behalf in relation to its obligations under the Directive. In order to market into the EU under the passport, similar conditions to those mentioned above in relation to marketing under national private placement regions will have to be satisfied.

Transitional Provisions

The Directive contains only limited transitional provisions:

- Managers that are managing funds before the Directive is implemented must apply for authorization within one year of the implementation date. (It is not clear what activities they may carry on prior to obtaining authorization.)
- Managers that manage closed-ended funds before the Directive is implemented that do not make any additional investments after the implementation date may continue to manage those funds without being authorized.
- Managers that manage closed-ended funds with subscription periods that close prior to the entry into force of the Directive (in 2011), and where the fund life is not intended to continue more than three years after the implementation date (beyond 2016), may continue to manage those funds without applying for authorization or complying with the Directive, except for the disclosure and, if relevant, portfolio company requirements.

Implementation Measures

Although the Directive runs to over 200 pages, it is only a "framework directive." More than 90 implementing measures need to be drafted and finalized by ESMA and the Commission before the Directive is fully implemented (the Commission has already issued a detailed provisional request for technical advice on the implementing measures). The Commission has said that consultation will be at the heart of the implementation process and that it has an open door policy — there should be opportunity during the next 18 months for Member States, managers, industry associations and other participants to comment on the final shape of the Directive.

Managers should begin now to consider whether any changes will be required to the management and marketing of their funds in order to ensure that appropriate arrangements are in place in respect of the Directive. In particular, non-EU managers that manage or propose to manage EU funds should consider whether the transitional provisions will allow them to continue to do so after the Directive is implemented in 2013.

* * *

We will provide regular updates on the implementation process and other developments in forthcoming issues of *The Private Equity Report*. ■

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Terra Firma v. Citibank: Cautionary Tale? (cont. from page 16)

can and will be used as both a sword and a shield. Any time a party in a negotiation places substantial reliance on information received from a counterparty, the content of the information received, and the fact of the reliance on it, should be quickly and carefully documented. If there had been a contemporaneous note that a reliable source had reported on another bidder's anticiapted price, this case might have gone differently.

Private equity firms should also think carefully about how their internal modeling might later be used to draw unintended conclusions. Models should either be written over, or should include cautionary statements limiting the ability of third parties to draw such conclusions.

In addition, while it is not unusual for a financial advisor to have relationships with both the seller and a potential bidder in a transaction, it is prudent, under such circumstances, for (1) the financial advisor to fully disclose the scope and nature of those relationships to the parties and (2) the advisor and the bidder to be explicit that their pre-existing relationship in other contexts does not enhance their duties or obligations to, or reliance upon, one another in connection with the current transaction. ■

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Monetizing the Shield (cont. from page 10)

the ability to claim capital gains treatment on the payments (to the extent that a sale of the underlying partnership interest would give rise to capital gains, and subject to the rules imputing interest income on installment payments). In cases where the offering entity is an existing corporation with tax attributes, the tax treatment is more uncertain. To the extent that existing shareholders receive TRAs prior to the offering, the distribution of the TRAs is likely to be viewed as a taxable dividend in an amount equal to the present value of the future TRA payments. One potential planning opportunity would be to reclassify the stock held by the existing holders into a class that, in addition to normal dividend rights enjoyed by the stock issued to the public, contained the entitlement to receive additional dividends calculated in a manner similar to TRA payments. This reclassification, instead of being treated as a taxable dividend, could be treated as a tax-free recapitalization, resulting in no taxable event until TRA payments are made. Upon an exchange of such class of stock for the publicly-traded class and a TRA, the receipt of the TRA would either be taxable as a dividend or tax-deferred as an installment redemption of shares. Even if taxable as a dividend, the receipt of the right to tax benefit payments would occur in connection with a liquidity event that should generate cash sufficient to pay the tax.

Conclusion

The question of whether a TRA is appropriate or beneficial in any particular offering is ultimately a question of pricing and atmospherics. On the one hand, to the extent that the market is not fully valuing existing or future tax attributes, due to uncertainties about timing or ability to fully realize them, it may make sense to compensate existing equity holders through TRAs, so that the equity holders retain the associated value but are only paid if, and when, the tax benefits are realized. On the other hand, it may be difficult to ascertain in any particular case the degree to which the market has improperly discounted tax attributes, and the complexity of the TRA arrangements may be viewed as creating "noise" that complicates the overall marketing of the offering. The market seems to have become accustomed to seeing TRAs in the UPREIT/exchange context; in other situations, sponsors may wish to consider the relative advantages of retaining such value through TRAs versus providing more detail on the expected utilization of such benefits in an effort to cause such benefits to be properly valued in the offering price. ■

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December 15, 2010

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