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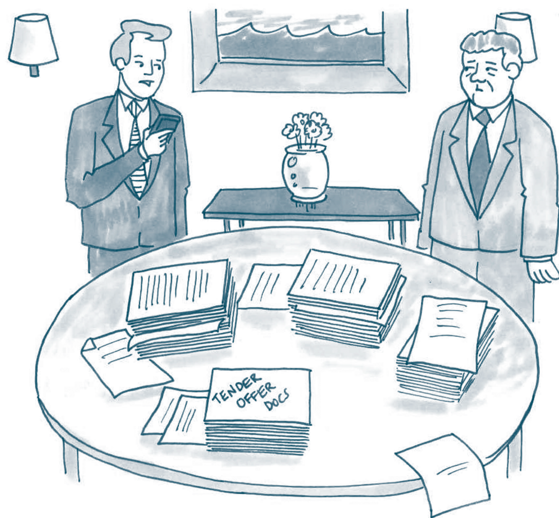
Speed Is King: Pointers and Pitfalls on Sponsor-Led Tender Offers

As we predicted almost five years ago, the desire to close transactions as quickly as possible has led to an increase in the number of private equity transactions structured as tender offers. There are two primary legal reasons for this increase, in addition to the ever present practical concern about financial market turmoil that was the cause of so many busted deals in 2007 and 2008. The first is the regulatory developments relating to the "best price rule," which we discussed in an article entitled "The Tender Offer Returns: What Does It Mean for Private Equity" in our Winter/Spring 2007 issue. The second is the recent Delaware case law accepting the use of a crucial structuring device known as a "top up option," making it easier to effect a "short-form" merger following the completion of a tender offer, thereby expediting deal execution and also facilitating compliance with the tricky federal "margin rule" requirements. In several recent sponsor-led take-private transactions, most notably 3G's $3.3 billion acquisition of Burger King and Bain Capital's $1.8 billion acquisition of Gymboree, sponsors have used a tender offer/top-up option-based structure to get deals closed more quickly than would otherwise likely have been the case. Both Burger King and Gymboree closed a bit more than 40 days after signing, as opposed to the 60-90 days generally typical for a more traditional, all cash merger proxy structure.

While the potential timing advantage may be only a matter of weeks or even days, even a single day can help secure a deal in today's volatile markets. Here is more detail on the structure used in these deals, the legal developments that have permitted its emergence, and some limitations and pitfalls to keep in mind.



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"Doing deals via tender offers may be much quicker than using merger proxies, but why can't we use Twitter and finally enter the 21st century?"

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Letter from the Editor

While this spring has not spawned the type of monumental changes in the private equity world as it has across the globe, it has nonetheless been a time of continued evolution of the asset class. Luckily, most of that movement has been in the positive direction, with allocations to the asset class increasing, deal activity flourishing once again, lenders stepping up to sizeable leverage, sponsors focusing on new high growth jurisdictions and government regulation seeming manageable.

In this issue, we survey some of these developments. On our cover we examine how, by virtue of some recent Delaware decisions, the tender offer has emerged as a feasible alternative to structuring private equity sponsored going private transactions in the U.S. In addition to explaining the legal framework for "getting the deal done," we highlight some pitfalls that may derail sponsor-led tender offers.

In our Guest Column, David Snow, a founder of Privcap and one of the most respected journalists and commentators on private equity, describes the growing demand for private equity performance data among investors, academics and sponsors and the history and market position of some of the major data providers who have emerged to fill this demand.

It is difficult these days to talk about private equity without reference to the emerging markets and, in particular, the BRIC countries and the role that private equity is playing in those jurisdictions. In this issue, we are pleased to debut a new series targeted at those of you looking to invest — or at least to better understand investing — in the BRIC countries. This series will examine the many ways in which Western due diligence practices and expectations need to be adapted for the BRIC jurisdictions and how that shapes risk analysis for local transactions. We begin the series with China.

One of the important developments in the Middle East that is not being covered by CSPAN or AL Jeezera is the increased complexity of fundraising in the Middle East. We explore why some of the current and proposed regulations designed to protect retail investors are simply not appropriate for private equity.

Few will argue that the Dodd Frank Act has had a significant impact on the private equity organizations, although surely not to the degree it has had on other financial institutions. The scope of the impact on private equity, though, is still being developed as rules are being written to implement the Act. In this issue we discuss how those rules may impact incentive compensation (though not primarily carry) paid by private equity firms to its professionals and "unpack" the potential restrictions on banks participating in unaffiliated private equity funds under the Volcker Rule.

Also in this issue, we explore the potential use of contingent value rights in private equity backed health care deals and recent decisions by the Seventh Circuit Court of Appeals that appear to expand successor liability for an expanded list of ERISA liabilities including "top hat" plans.

As always, we look forward to your input on how we can best use our global private equity presence to keep you informed about developments and trends of interest to you and your colleagues.

Franci J. Blassberg
Editor-in-Chief

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Proposed SEC Rules Could Limit Incentive Compensation Paid by Private Equity Firms

While private equity professionals have been keenly aware in recent years of proposed changes to the U.S. tax code which could impact the taxation of carried interest, few in the industry have focused on the possibility that bonus or carried interest payments made to private equity professionals could become subject to limitations or other regulation under U.S. law. Yet, that scenario could develop if recently proposed rules from a range of federal agencies are adopted in their proposed form. Still, commentators have suggested modifications to the proposed rules to take into account important differences between compensation practices at PE firms, on the one hand, and at banks and other financial institutions, on the other hand.

On April 14, 2011, the Securities and Exchange Commission ("SEC") and several other federal agencies jointly published proposed rules aimed at governing incentive compensation practices at a broad range of banks and other financial institutions, including private equity firms. The proposed rules were intended in part to address situations where employees at financial firms were perceived to have exposed their institutions to long-term risks in exchange for near-term fees to the institutions (and large near-term bonuses to the employees), leading to excessive risk taking and even, possibly, the risk of adverse impacts on the financial system should those institutions find themselves in material distress.

The proposed rules implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which prohibits certain incentive compensation arrangements that encourage inappropriate risks through excessive compensation or compensation that could lead to material financial loss. The SEC's version of the proposed rules, approved by the SEC Commissioners in a 3-2 vote, covers both registered and unregistered investment advisers (including private equity firms) having $1 billion or more of consolidated assets ("IAs"). The proposed rules were open for public comment through May 31, 2011. Unless the scope of the proposed rules is narrowed in response to public comment, the new incentive compensation rules (other than the deferral provisions of the rules, which would apply only to very large IAs) could apply to a significant number of PE firms.

Scope and Impact of the Proposed Rules

The SEC's version of the proposed rules limits compensation practices at covered IAs, as follows:

Prohibitions. Each IA is prohibited from establishing or maintaining incentive-based compensation arrangements for "covered persons" that encourage inappropriate risk by providing (1) excessive compensation or (2) compensation that could lead to a material financial loss by the IA. A "covered person" means any executive officer, employee, director or principal shareholder (*i.e.*, a 10% or greater owner).

The proposed rules specify six factors to consider when determining whether compensation is excessive. The factor most relevant to private equity firms is whether compensation arrangements are in line with industry practice. A private equity firm that has industry-standard compensation arrangements — a 20% carry allocated among investment professionals, and salaries and bonuses paid out of its 1.5% to 2.0% management fees — could take the position that its compensation arrangements are consistent with industry practice and, therefore, should not be deemed excessive. Under the rules as currently written, however, industry practice is only one of the factors that may be considered in determining whether compensation is excessive — leaving considerable leeway for regulators to second-guess a private equity firm's decisions concerning compensation arrangements. Other factors include the combined value of all cash and non-cash benefits provided to a covered person, the covered person's compensation history, and the financial condition of the covered financial institution.

Reporting. Each IA must submit a brief annual report to the SEC describing the structure of its incentive-based compensation arrangements and the policies and procedures governing such arrangements. IAs are not required to disclose the compensation of particular individuals, however. The annual report

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Proposed SEC Rules Could Limit Incentive Compensation (cont. from page 3)

must explain why the IA believes that those arrangements comply with the prohibitions against compensation that is excessive or that could lead to material financial loss by the IA.

Three-Year Deferral of Incentive-Based Compensation by Very Large IAs. IAs having $50 billion or more in "consolidated assets" must defer for at least three years at least 50% of the annual "incentive-based compensation" for executive officers (including the chief investment officer and chief legal officer, among others). During the deferral period, the deferred amount must be adjusted (down) for (poor) performance during the deferral period. This deferral requirement appears to apply to annual bonuses paid to employees of the IA, but does not appear to apply to carried interest arrangements (since carried interest is not "annual" compensation).

Definition of Consolidated Assets. "Consolidated assets" means the IA's "total assets" as reflected on the balance sheet for the IA's most recent fiscal year end. Under GAAP as currently in effect, certain IAs, including private equity firms, are required to consolidate their affiliated funds if the limited partners of those funds do not have the right to remove the funds' general partner(s) without cause by a vote of a majority in interest (or less).

Only a very small number of private equity firms are likely in the near term to have balance sheets showing total assets of $50 billion or more (the trigger for the deferral requirement). However, a private equity firm that is required to consolidate third-party managed assets could become subject to the proposed rules as such third-party managed assets rise in value, absent (1) a change in the GAAP consolidation rules, which are under discussion, or (2) a change in the SEC's proposed rules, such as a change to make clear that (notwithstanding what GAAP might require generally for private equity firms) for purposes of these rules consolidated assets are deemed to include only the proprietary assets of the firm, including the firm's own investments in the funds (and portfolio companies) that the firm manages, and exclude assets that the private equity firm manages for third-party investors. As noted below, the SEC has asked for comments on this question.

Definition of Incentive-Based Compensation. "Incentive-based compensation" means "any variable compensation that serves as an incentive for performance." The deferral requirement for larger IAs applies only to "annual" incentive-based compensation. Therefore, as noted above, the deferral requirements appear not to apply to private equity carried interest arrangements (since they should not constitute annual compensation), even if those arrangements are subject to vesting, as is typical. (In addition, vested equity, including partnership interests that are already fully vested, is not considered incentive-based compensation under the proposed rules.)

Policies and Procedures. Each IA must develop and maintain specified policies and procedures governing incentive-based compensation that are consistent with the restrictions of Section 956 of the Dodd-Frank Act. In addition, each IA having $50 billion or more in total consolidated assets must have in place a process for the board of directors (or a committee thereof) to review and approve incentive-based compensation for covered persons who individually have the ability to expose the IA to losses that are substantial in relation to the IA's size, capital or overall risk tolerance.

Requests for Public Comment

The SEC specifically requested public comment on various aspects of the proposed rules, including on:

- the proposed definition of "incentive-based compensation;"
- whether the SEC should clarify that any specific forms of compensation are not incentive-based compensation;
- the proposed method of determining asset size for investment advisers, and whether the determination of total assets should be further tailored for certain types of advisers, such as private equity funds or hedge funds;
- whether there are additional factors that should be considered in evaluating whether compensation is excessive or could lead to material financial loss; and
- whether it would it be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not require such deferral for other institutions (*e.g.*, investment advisers) based on the business risks inherent to that business or other relevant factors.

What's Next?

During the comment period, the SEC received a great deal of public comment on the proposed rules, including from the private equity industry. While the ultimate outcome remains to be seen, several factors noted in the public comments may result in the final rules being modified as to PE firms. First, because PE firms negotiate their funds' carried interest and management fee

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GUEST COLUMN

The Secret History of Private Equity Performance

Private equity performance remains a hugely under-researched topic, but help may be on the way for an information-starved market. This is good, because investors shouldn't commit capital to an asset class they can't effectively measure.

With assets approaching $3 trillion, private equity is an asset class badly in need of unimpeachable measurement standards.

It is not hard to see why private equity has flown under the radar for so long — its participants have historically been resolutely private, it operates out of highly illiquid, long-term partnerships and the values of its underlying assets — private companies — are often arrived at using, at best, idiosyncratic methodologies, and at worst, guesstimates.

It might be said that private equity is inherently unwieldy. Some investors like to joke that it represents "10 percent of my allocation, 90 percent of my headache," a reference to the time and money that must be spent monitoring, processing, communicating and measuring the performance of this asset class.

The measuring part can be challenging in two ways — first you need to get timely and robust information from your own managers, then you need to place that information in a broader context to better understand what it means. In other words, you might know that the 2003 energy-focused private equity fund you're in has a realized net IRR of 20 percent and an unrealized net IRR of 30 percent, but without meaningful benchmarks you're not sure whether you should be thanking the GPs or cursing them.

Indeed, for most of its brief history, private equity has been data-starved and research-poor relative to the highly scrutinized public equity and fixed-income asset classes. In recent years, several commercial data sources have introduced tools to improve investor understanding of private equity. This is good news. Some would argue, however, that the often contradictory information that is available does not further a common understanding of how this asset class behaves.

Here's the background. There are three broad categories of private equity data — deal statistics, fundraising statistics and performance statistics. Deal and fundraising numbers have for years been culled from publicly available sources — primarily announcements and press reports. The information is sold by a growing number of data providers, including Thomson Reuters, Dow Jones, Capital IQ, Mergermarket, Dealogic, Preqin, Pitchbook and PEI. Each provider employs different collection and aggregation methodologies, and these differences can make it hard for LPs and other users to harmonize this data. In the extreme, it's as if the slices of the available data were coming from different pies. The third category — performance data — has been an even tougher nut to crack. Not only does private fund performance measurement involve a complex mix of realized and unrealized returns and time-horizon calculations, but the people who arrive at the final numbers typically don't want to share them with the world.

Imagine trying to create the S&P 500 index when only some of the 500 component companies are willing to disclose the value of their shares, and those that are willing use differing valuation methodologies. This is essentially the challenge for anyone attempting to create accurate performance benchmarks in private equity. But the quest for better information has been making headway, What follows is a partial list of performance-data providers in roughly the order that each endeavor was launched:

- **Thomson Reuters:** Started as Venture Economics in the 1990s, for a long time this was the only performance game in town. Venture Economics receives regular fund performance updates directly from the general partners themselves, but on a highly confidential basis. The individual fund performances are then anonymized and blended into indices. The dependence on voluntary data submission has made some wonder about whether the data is sometimes skewed to the stronger-performing GPs. The company's performance information is now offered as part of the ThomsonONE platform.
- **Cambridge Associates:** This firm is primarily a consultant to institutional investors and has a specialty in

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Guest Column: The Secret History of Private Equity Performance (cont. from page 5)

alternative assets. It has leveraged its access to client fund information and developed a suite of benchmarking tools, including the Cambridge Associates US Venture Capital Index and the Cambridge Associates Private Equity Index. Cambridge Associates is also partnering with the Emerging Markets Private Equity Association to create private equity performance indices specific to the emerging markets.

- **Preqin:** In the early 2000s, this company, founded by entrepreneur Mark O'Hare, began sourcing private equity fund performances using a novel approach — relying on state open-records policies to gather fund-level performance information from public institutions like pension funds. This method neutralized potential voluntary-submission biases but was met by howls of disapproval from some GPs, who complained that their trade secrets were being compromised for a commercial endeavor. Preqin offers the performances of individual funds and also aggregates these into indices. The initial outrage has today largely given way to acceptance that fund-level performance information is nearly impossible to keep private, and that the benefits of collective transparency outweigh whatever benefits privacy offered.
- **State Street Private Equity Index:** As a major provider of services to institutional investors, State Street has long collected and administered detailed information on clients' private equity funds. Two years ago State Street launched an index and benchmarking tool based on this database. The index, of course, does not detail individual fund performances. It also has the benefit of having its information captured in an involuntary, "warts and all" fashion.
- **PitchBook Data:** Along with its information on deals, investors, managers and public-market comparables, PitchBook also offers data on specific fund performances as well as benchmarking tools.
- **Private Equity Growth Capital Council:** The PEGCC is a lobbying and advocacy group for private equity in Washington, D.C. In 2010, it launched its own Private Equity Index based on information from its own members, as well as Thomson Reuters, PitchBook and Preqin. Unfortunately, and, in many respects, unfairly, the PEGCC's performance metrics have been characterized by some as biased, due to the group's lobbying roots.
- **Burgiss Group:** Burgiss is a major administrator of private equity programs for institutional investors. It has detailed, involuntarily submitted information on some 3,000 private equity fund performances going back to the 1970s. This year, Burgiss made commercially available a benchmarking tool called Private iQ based on this underlying data, which does not reveal the identities of any underlying funds.
- **Institutional Limited Partners Association:** While the ILPA, a trade association for institutions that back private equity funds, does not currently offer a performance benchmark, a key initiative of the group will make such benchmarks far more powerful in the future. The association is working on standardized financial reporting templates, which, if adopted, would facilitate a more comprehensive, apples-to-apples aggregation of performance information that looks through funds and all the way down to individual portfolio companies.
- **Private Capital Research Institute:** This new non-profit initiative, launched by Harvard's Professor Josh Lerner, is partnering with a number of market participants to promote independent and credible research into private capital and also to create a benchmark for fund performance to support such research. The PCRI is in active discussions with many LPs, GPs and commercial data providers about data sharing and hopes to become a true coalition effort to create the industry information gold standard. The Institute's focus on policy analysis, through its alliance with the Brookings Institution, also means it will seek to generate dialogue about private capital among regulators and lawmakers around the world.

Not unlike so many artifacts being unearthed, dusted off and compared against one another, the history of private equity performance is being discovered in disparate locations and aggregated for the benefit of those who hope to rely on the lessons of the past in building better investment programs.

Treasure troves of information exist beyond performance figures, of course. There are yet other classes of private equity information that are being created and benchmarked. For example, Debevoise & Plimpton LLP has created a unique database of fund terms and conditions that can be used to chart trends in the way that fund managers and investors structure their partnerships.

Stay tuned as the secrets of private equity are unlocked. My hunch is that as data treasure troves are cracked open and the light shines through, we will like what we see. ■

David Snow

Founder, Privcap, a new media venture that provides high-quality video and audio programming to participants in the private capital markets.

Brick by Brick:

A Primer for Due Diligence in Each BRIC, Beginning with China

What's the difference between performing due diligence in Suzhou, rather than Cleveland? Or, in St. Petersburg Russia as opposed to St. Petersburg, Florida? The difficulty most readers will have answering those questions, either intuitively, or based on hands-on experience, illustrates some of the challenges PE firms and other Western investors face in evaluating investment opportunities in the world's largest emerging markets, now known, colloquially of course, as BRICS.

In our experience, certain common due diligence themes run across Brazil, Russia, India and China. For example, businesses in BRIC countries often feature the kind of tangled related party transactions that would necessitate (and reward) detailed due diligence in the West. Unfortunately, unlike their Western counterparts, these businesses also share a general lack of familiarity with, and reluctance to be subjected to, the due diligence process. On the other hand, there are important differences among BRIC targets. The level of financial transparency and legal compliance, for instance, varies widely among the BRIC countries.

Based on our experience in executing deals and performing due diligence in each of Brazil, Russia, India and China, we will highlight some important (albeit by no means exhaustive) considerations associated with performing business, legal and accounting due diligence in each of these jurisdictions in separate articles in this, and upcoming, editions of the *Debevoise & Plimpton Private Equity Report*. In this issue, we will focus on China.

Due Diligence Process

- *Lack of familiarity with due diligence process and requirements.* "Due diligence" is a relatively new concept in China; Chinese companies and their personnel often do not appreciate its relevance and importance. Moreover, Chinese companies traditionally are reluctant to share information with outsiders.
- *Poor internal organization.* Chinese companies are relatively weak on internal organization. Many Chinese companies do not have a legal department or even any in-house counsel. Decentralization of information and knowledge is a common issue. Another issue is the lack of standardized documentation – material information or events may not have been properly documented; some important documents may be missing or contain errors.
- *Limited public search resources.* Some of the public search resources that are widely consulted in the due diligence process in Western countries, such as searchable litigation records, are not yet well developed in China.

Business Due Diligence

- *FCPA; UK Bribery Act.* China is a "high-risk" country in so far as bribery is concerned. Chinese officials tend to seek free meals, gifts, entertainment, travel and other business-related opportunities that may be deemed to be "kickbacks." Since many large companies in China are state-owned or controlled, their directors and employees are deemed to be "government officials" under the FCPA, and these companies may also be subject to the UK Bribery Act.
- *Occupational safety and health.* Chinese companies generally neglect to ensure safe and healthy working conditions. China does not yet have sophisticated occupational safety/health laws and regulations, and any enforcement of safety standards is weak and difficult. A foreign investor may face reputation risk if the company in which it invests, or with which it does business, has serious occupational safety/health issues. For instance, Apple recently suffered a blow to its image and reputation in China when over 100 employees working at a factory of a main supplier to Apple were reported to have serious health problems caused by exposure to a toxic chemical used to clean the iPhone's touch screen.
- *Environmental protection.* Many Chinese companies do not conduct their business in compliance with environmental laws, partly because statutory penalties for environmental violations usually consist only of a modest fine which can be substantially lower than the compliance cost (mandatory remedial action is rare). Moreover, there is currently no active government enforcement of environmental violations. Under current

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Further complicating matters is the lack of a well-developed legal infrastructure in China that would aid a buyer's ability to streamline its diligence and provide certainty with respect to contractual risk allocations by the parties based on potential exposures discovered in the diligence process.

law, it is less likely that a foreign investor will be required to shoulder or share a large bill for pre-existing environmental issues.

- *Insurance.* Many Chinese companies do not purchase insurance policies covering property loss/damage, third party liability, product liability, etc. Even if a company has purchased insurance policies, the scope or amount of coverage may be inadequate in view of the type/nature of the business conducted by such company. In addition, missed premium payments are quite common in China.

- *Land use rights.* In China, land is owned by the state (or, in the case of farmland, collectively by village residents). Land use rights can be transferred only after statutory premiums, which can sometimes amount to a large sum, have been paid to the state.

Legal Due Diligence

- *Regulatory environment.* The Chinese legal system is based on written statutes. Compared to common law jurisdictions, prior court decisions have limited precedential authority or value in China. Chinese laws and regulations have undergone substantial development over the past decade and are still evolving rapidly. Many laws and regulations are relatively new and contain broad and sometimes ambiguous provisions. As a result, government authorities and courts have much discretion in interpreting and enforcing Chinese laws and regulations.

- *Foreign investment approvals.* All foreign investments into China are subject to governmental approvals. In most cases, approvals from the Ministry of Commerce and the National Development and Reform Commission (the top government agent in charge of economic planning) or their respective local counterparts are required. Moreover, most subsequent changes (*e.g.*, ownership, capital, name, constituent documents) concerning a foreign-invested enterprise require approvals by the same governmental authorities that approved the original investment. Chinese authorities have enormous discretion to approve or block an investment; they are also often free to dictate the approval process (timing, application documents). Foreign investors should also bear in mind that except for the few standard approvals that are required to be issued in writing, Chinese authorities are generally reluctant to communicate or confirm anything in writing — for instance, no-action or no-objection letters do not exist in China.

- *Foreign investment restrictions.* Foreign investments are categorized under Chinese law into four categories — encouraged, permitted, restricted and prohibited. In particular, investments in "prohibited" industries (*e.g.*, operations of news agencies and radio/television networks) are off-limits for foreign investment. On top of the classification described above, Chinese regulators may impose additional foreign investment restrictions with respect to specific industries (*e.g.*, online games, steel).

PE firms must recognize that even in the best of circumstances, diligence of Chinese-based companies may well provide them with scant information or, even worse, raise more questions than it answers.

Financial Due Diligence

- *Accounting records.* Accounting books and financial records of Chinese companies are less transparent than those of U.S. companies. Furthermore, some Chinese companies deliberately keep two sets of accounting records, one for the statutory reporting purpose and the other for internal use. The latter reflects a company's actual financial condition and results, whereas the former set of records tend to reflect less revenue and/or more expenditures with a view to reducing the company's tax liability.

- *Financial Audit.* Compared to the "big four" accounting firms, Chinese local accounting firms may be less credible and impartial in performing audits, as they tend to react to pressures from the company under audit due to their eagerness to win engagements or maintain relationships.

- *Related party transactions.* Chinese companies tend to have extensive, and sometimes messy, related-party transactions or arrangements, and are almost always reluctant to fully disclose such transactions/arrangements to foreign investors, third parties or government authorities.

- *Accounting standards.* Chinese companies are required by law to prepare audited financial statements under Chinese GAAP. Following multiple rounds of revisions, the current version of Chinese GAAP is believed to be substantially in line with the IFRS, although differences still exist between the two standards.

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Bank Participation in Private Equity and Hedge Funds: Charting the Volcker Rules' Murky Waters

Banks have traditionally been significant investors in private equity funds, accounting by some estimates for as much as 9% of all capital raised. But as PE pros know, the world has changed in this regard since the financial crisis of 2008. And a central question for sponsors of private equity and hedge funds in the wake of the passage of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "V*olcker Rule*") is the extent to which "banking entities" (as defined under the Volcker Rule) will continue to be permitted to invest in PE and hedge funds that are not otherwise affiliated with such banking entities. As we have noted in prior editions of the *Debevoise & Plimpton Private Equity Report*, the precise answer to this question won't be known until the implementing rules for the Volker Rule are proposed and adopted. These rules are currently expected to be proposed this Summer and finalized in the Fall.

Given the significance of the Volcker Rule to the private equity community, Debevoise lawyers, on behalf of a number of our fund, bank and insurance company clients, have been engaged (through comment letters and meetings with regulators) in this rulemaking process, including the process relating to the study performed by the Financial Stability Oversight Council (the "*FSOC*"), the transition period rulemaking carried out by the Federal Reserve Board, and the implementing rule process coordinated across several regulatory agencies.

Still, many sponsors of private equity funds and hedge funds, particularly those in the process of fund raising, or considering fund raising, are currently facing the difficulties of determining if banking entities (as defined in the Volcker Rule) may invest in their funds in advance of the completion of the rulemaking process. Based on our review of the Volker Rule and our engagement in the rule making process, we can provide the following guidance in the form of a "cheat sheet" identifying the current lay of the land under the Volcker Rule for investment by banks and bank affiliates in unaffiliated private funds. *All guidance provided below is preliminary and subject to revision pending the adoption of the implementing rules.*

Options for a U.S. Banking Entity Seeking to Invest in an Unaffiliated U.S. Fund

A U.S. bank (or other insured depository institution) or its affiliates (a "*banking entity*") will generally be unable to invest directly from its own balance sheet in a fund that is either (1) organized in the U.S. or (2) offered to any U.S. persons (a "*U.S. Fund*"), unless it can satisfy one of the exceptions below.

- *Customer Funds.* A U.S. banking entity could set up a "customer" fund to act as either a fund of funds or a feeder fund that invests in a U.S. Fund. The banking entity's investment in the "customer" fund would be limited to 3% of the fund and 3% of the banking entity's Tier 1 capital. There is substantial uncertainty, however, as to how the "customer" fund exemption will be implemented. For instance, it is unclear what type of customer relationship the banking entity will need to establish with the investors. In addition, the two 3% tests will be subject to further clarification. Although the FSOC's study appears to bless feeder funds, it also appears to suggest that no banking entity assets should be invested in the feeder funds. Clarification on how these percentages are to be calculated and on various other important "customer" funds issues has been requested. Despite this uncertainty, we believe that certain banking entities are currently forming funds with the intention of qualifying them for treatment as "customer" funds once the Volcker Rule becomes effective.
- *Merchant Banking Activities.* A U.S. banking entity might be able to set up a separate account that is managed by a Fund manager not affiliated with the U.S. banking entity, and that makes direct investments in portfolio companies, in accordance with merchant banking regulations, roughly in parallel with a U.S. Fund. It is unclear, however, if the Volcker Rule will indirectly impinge on the ability of a U.S. banking entity to engage in merchant banking.
- *Insurance Company General Account Assets.* An insurance company that is affiliated with a U.S. banking entity should be able to invest the insurance company's general account assets in unaffiliated U.S. Funds, subject to compliance with applicable state laws on permitted investments, and we understand that some insurance companies are proceeding to do so. Regulatory clarification on this point has been requested.
- *Insurance Company Separate Account Assets.* An insurance company that is affiliated with a U.S. banking entity may be able to invest separate account assets in unaffiliated U.S. funds, also subject to compliance with applicable state law. Clarification on this point has also been requested from regulators.

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Charting the Volcker Rules' Murky Waters (cont. from page 9)

Options for a U.S. Banking Entity Seeking to Invest in an Unaffiliated Non-U.S. Fund

- *Same Options as Above.* The options listed in the bullets above that are also available to U.S. banking entities seeking to invest in unaffiliated U.S. Funds are also available to such entities seeking to invest in other unaffiliated funds, including Non-U.S. Funds (as defined below).
- *Non-U.S. Funds.* There is also some chance that it will be possible for a U.S. banking entity to invest (via a non-U.S. subsidiary) in a fund that is organized outside the United States and that does not sell interests to U.S. persons (a "Non-U.S. Fund"). This is because under current SEC positions, a Non-U.S. Fund does not need to rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") and, therefore, does not fall within the statutory definition of "hedge fund or private equity fund" under the Volcker Rule. Note though that this outcome could change if either the SEC changes its interpretative position or regulators in the rulemaking process for the Volcker Rule expand it's coverage to include these funds as "similar funds."

Options for a Non-U.S. Banking Entity with a U.S. Banking Presence

- *Non-U.S. Funds.* A non-U.S. banking entity with a U.S. banking presence (*i.e.*, a branch, agency office, or commercial lending company) is allowed to invest solely outside the U.S. in a Non-U.S. Fund. However, it is not clear if this option would be eliminated if the manager of the Non-U.S. Fund is a U.S.-based manager or if the Non-U.S. Fund invests principally in U.S. companies and invests side by side with a U.S. Fund in the same portfolio companies and on the same terms. Note, however, that under certain circumstances, the Investment Company Act will require the "integration" for regulatory purposes of two funds that are distinct legal entities (*e.g.*, two parallel funds set up to evade the 100-person limitation of Section 3(c)(1)). It would be necessary to evaluate any Non-U.S. Fund and any similar U.S. Fund for any integration issues. Clarification on this point has been requested from regulators.
- *Other Options.* A non-U.S. banking entity also has the same options to invest in unaffiliated funds (including U.S. Funds and Non-U.S. Funds) as a U.S. banking entity.

Options for a Non-U.S. Banking Entity with No U.S. Banking Presence

- *No Restrictions.* A non-U.S. banking entity with no U.S. banking presence is not subject to the Volcker Rule and should be able to invest in all types of funds (including both U.S. Funds and Non-U.S. Funds). ■

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Can "Top Hat" Employees Find Gold in a Successor's Pockets?

Liabilities to management employees under "top hat" plans may be poised to join the expanding list of liabilities which buyers of the assets of on-going businesses assume by operation of law, thereby creating uncertainty as to whether the contractual allocation of such liabilities between a buyer and a seller will be respected.

As all PE deal professionals know, one of the benefits of doing an asset deal is that, in most instances, the buyer becomes responsible only for the liabilities it agrees to assume contractually. There are well-known exceptions to this principle for environmental liabilities, state tax liabilities and product liability claims, among others, where successor liability is imposed on a buyer of a business as a matter of law. But PE professionals may be less familiar with a line of cases originating in the Seventh Circuit which have imposed successor liability on the purchaser of the assets of an on-going business with respect to certain labor and ERISA-related obligations, in order to vindicate what the courts have called "important federal policies." A recent decision in the Seventh Circuit Court of Appeals involving a PE buyer suggests the expansion of this doctrine to a broader range of ERISA-related claims than had previously been considered to be within its scope, specifically "top hat" plans.

The successor liability doctrine relating to "important federal policies" initially arose in the context of the federal employment laws, where the remedies for violations of law require payment of back pay and reinstatement of employment. In such cases, courts have held that the failure to carry these obligations forward to an asset purchaser could leave the wronged party without recourse for illegal conduct under federal law, thereby undermining "important federal policies." These courts have imposed successor liability on such purchasers with respect to such obligations provided that there was both (1) sufficient notice of the liability to the purchaser and (2) continuity of the seller's operations at the purchaser. Subsequently, some courts had expanded this doctrine to include certain ERISA claims.

Many of the ERISA cases have related to claims by multi-employer plans for delinquent contributions that were required to be made by the predecessor under a collective bargaining agreement. In such situations, the multi-employer plans are liable to the affected employees for the promised benefits even where the employers fail to make the necessary contributions. While the courts did not necessarily articulate the "important federal policies" involved in this context, applying the successor liability doctrine in these cases arguably advances the efficacy of the collective bargaining system, by not allowing a purchaser who succeeds to the underlying business and continues to employ the union members pursuant to a collective bargaining agreement to avoid payments due under such agreement by not assuming such payment obligations from its predecessor.

Earlier this year, in *Feinberg v. RM Acquisition, LLC*, No. 10-1890 (7th Cir. 2011), however, the Seventh Circuit addressed whether a purchaser of assets could be liable under this successor liability doctrine with respect to benefits payable under a "top hat" plan. A "top hat" plan is an unfunded ERISA plan of deferred compensation, such as a SERP, maintained primarily for the benefit of highly compensated or management employees to provide such executives with benefits on top of those provided under a company's basic pension plan. As opposed to the cases where a predecessor had violated employees' federal statutory employment rights or missed contributions that could frustrate the collective bargaining system established under the federal labor laws, the obligations relating to a "top hat" plan generally accrue in the ordinary course of business with the understanding that the participants have only the same rights against the employer as a general creditor of the business. While the Seventh Circuit concluded in *Feinberg* that successor liability could not be imposed under the facts presented in that particular case because the plaintiffs had failed to show any continuity of the seller's operations at the purchaser, the Court, albeit *in dicta*, appears to accept without question that the principle of successor liability would apply to "top hat" plans provided that there was both (1) sufficient notice of the liability to the purchaser and (2) continuity of the seller's operations at the purchaser.

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[T]he Court...appears to accept without question that the principle of successor liability would apply to "top hat" plans provided that there was both (1) sufficient notice of the liability to the purchaser and (2) continuity of the seller's operations at the purchaser.

Can "Top Hat" Employees Find Gold in a Successor's Pockets? (cont. from page 11)

Contrary to the Seventh Circuit's *dicta*, however, applying this doctrine to such "top hat" plans would be a startling expansion of the successor liability doctrine relating to other labor obligations. Like other cases that have imposed successor liability for labor obligations, the Seventh Circuit appears to suggest that when a purchaser has been provided with adequate notice of the pre-existing liability with respect to a "top hat" plan, it can protect itself through indemnities from the seller. On first blush, this argument may seem logical, since the seller will have agreed to retain these liabilities and so should not object to providing an appropriate indemnity. But the payments under these "top hat" plans often are linked to the employees achieving a stated age, and may be payable over an employee's lifetime. Thus, any indemnity would need to survive for an indefinite period, and it will be impossible to predict whether the seller will remain financially solvent over the period during which the payments would be due to be made. Accelerating the payment of such amounts would eliminate the risk for the buyer, but would likely implicate fairly draconian tax consequences for the affected employees under Section 409A of the Internal Revenue Code, unless the payments are otherwise designed to be made in connection with the employee's termination of employment or the seller and all members of its controlled group are willing to terminate all of their similar deferred compensation plans in connection with the sale.

Moreover, any such indemnity will be without value in a bankruptcy setting. While one might well assume that assets bought out of a "free and clear" bankruptcy sale under Section 363 of the Bankruptcy Code would not be subject to this judicially-created successor liability doctrine, in an earlier decision involving pre-bankruptcy multi-employer withdrawal liability (*Chicago Truck Drivers, Helpers & Warehouse Workers Union Pension Fund v. Tasemkin*, 59 F.3d 48 (7th Cir. 1995)), the Seventh Circuit found that the purchaser of assets in a bankruptcy proceeding could still be liable under this doctrine. The Seventh Circuit acknowledged that its holding in *Chicago Truck Drivers* could "chill" bankruptcy sales, but concluded that — despite the clear statutory basis for this distinction — there was no reason to afford the purchaser greater protection from liability in the bankruptcy context than would be available to the purchaser of the assets of a financially ailing, but not yet bankrupt, entity. But applying the successor liability doctrine in the context of a Section 363 sale — especially in respect of liabilities accrued in the ordinary course of business, such as those provided under a "top hat" plan— would seemingly result in a clear frustration of the bankruptcy scheme, as it would essentially transform an employee's general creditor claim into a priority claim. Alternatively, such an expansion of the doctrine could lead bankrupt sellers to break up the business, so that no buyer meets the continuity of business standard. While this could avoid elevating the priority of the employee claims, it would likely result in lower sales proceeds for the bankrupt estate. Either such result would frustrate important federal policies embodied in the Bankruptcy Code.

Given the actual outcome in *Feinberg*, the particularly cryptic nature of its *dicta* and the other federal policy implications discussed above, it remains to be seen if the successor liability doctrine relating to "important federal policies" will be applied to impose "top hat," or potentially similar, obligations on buyers who have not assumed those liabilities contractually. However, that risk does exist, and PE purchasers are certainly on notice now that they may face an unanticipated imposition of liability.

One way purchasers may be able to avoid successor liability for "top hat" claims is by purposefully failing the "continuity of the business" prong of the doctrine. The Supreme Court has noted that this prong involves a highly factual, case-by-case analysis where courts should consider the following factors: (1) whether the business of both employers is essentially the same; (2) whether the employees of the new company are doing the same jobs in the same working conditions under the same supervisors; and (3) whether the new entity has the same production process, produces the same products, and basically has the same body of customers. However, taking the actions necessary to avoid such status — such as making sufficient personnel changes or eliminating sufficient products or services — may be impracticable from a business perspective. Moreover, because the analysis is so inherently factual and the scope of the doctrine is certainly unsettled, the benefit of any material deviation in the operation of the seller's business is impossible to predict with any accuracy. For that reason, the best advice may be to recognize the potential liability and simply "price" it into a transaction. ■

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ALERT

Private Equity, Meet the FCPA

One rainy morning in May distinguished itself from all the other rainy mornings in May. The Department of Justice announced the first successful trial and conviction of a company on FCPA charges, and warned that it would not be "the last." That same morning, as if anticipating the news, over 100 private equity professionals and members of the private equity community gathered (either in person or via web cast) at Debevoise & Plimpton LLP's New York offices to focus on how increased FCPA enforcement efforts might impact their fundraising and transactional activities as well as their portfolio companies.

In a seminar entitled, "Private Equity, Meet the FCPA: What PE Professionals Need to Know About Anti-Corruption and Related Laws," four seasoned white collar litigators guided private equity firms on how to minimize their exposure under the confusing regulatory regimes in international fundraising, transactional and business activities.

Franci Blassberg, Co-Chair of Debevoise's private equity group, moderated the program and reminded the audience that the private equity community was among those being targeted for aggressive enforcement, in part, due the increased role that sovereign wealth funds and foreign public pension funds were playing as investors in private equity funds. Noting that implementing robust anti-bribery compliance measures would be the best route to avoiding expensive and embarrassing issues, she introduced a series of hypotheticals to illustrate the broad scope of the FCPA and the potentially broader scope of the UK Bribery Act, which will become effective this summer.

Paul R. Berger agreed, adding that the passage of the UK Bribery Act raised an additional set of concerns for private equity firms operating globally. While the full impact of the UK Bribery Act will not be known until it begins to be enforced, Mr. Berger described the "breathtaking" scope of the statute's jurisdiction, which could potentially reach any officer, director, employee or agent of any entity that does business in the UK, or any person whose actions benefit any entity that does business in the UK. Furthermore, certain of the UK Bribery Act's provisions, such as the elimination of an exception for facilitating payments, make it even more restrictive than the FCPA. That said, unlike the FCPA, the UK Bribery Act provides for an affirmative defense to corporate liability for firms which implement an "adequate" compliance program, which provides a meaningful incentive for firms to enhance their compliance programs. Implementing such a program is particularly important because the UK Bribery Act provides for strict liability for a company where personnel may have engaged in bribery.

Faced with this enhanced scrutiny and new regulatory requirements, private equity firms should take appropriate steps to ensure that both they and the portfolio companies they "control" (broadly defined) adopt and follow anti-bribery policies and procedures. Mark P. Goodman described how this might play out in the key areas of gifts, travel, and entertainment, where regulators take an aggressive view of what is or is not appropriate when dealing with foreign government officials. Mr. Goodman highlighted the different perspectives that might apply to certain types of entertainment, depending on the location, and explained that well-constructed compliance programs were the key to avoiding potentially troublesome scenarios.

Bruce E. Yannett noted that the U.S. government has taken a broad position on who is a "foreign government official." He also reminded those less familiar with government investigations that regulators investigating possible FCPA infractions will be acting with hindsight: regulators will take a critical view of any red flags that may have been overlooked or any compliance measures that were not taken. Mr. Yannett also cautioned the private equity community to be suspicious when the phrase "that's how its done here" is used in jurisdictions known for being high on the TI Index which ranks areas known for corruption. He also focused on the appropriate way to handle intermediaries who sought to represent sponsors in raising funds in various jurisdictions.

Given these concerns, Sean Hecker emphasized the practical measures that private equity firms and their portfolio companies should take to minimize their risk, including carefully documented compliance and due diligence programs and regular training sessions for individuals whose position place them at risk of FCPA and UK Bribery Act liability. He noted that the costs of responding to a government inquiry, which could result in an extensive internal investigation or other expenses, would far outweigh the costs of up-front compliance and training measures.

During a question-and-answer period following the presentation, audience members asked about the difficulties that a PE firm might face in convincing one of its portfolio companies to comply with anti-bribery measures, particularly where

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Alert: Private Equity, Meet the FCPA (cont. from page 13)

the private equity firm had only a minority interest in the company. The panel explained that the appropriate response ought to depend on the levels of knowledge and control possessed by the PE firm or its members who may be serving as directors on the portfolio company's board. As the panel emphasized, given the government's demonstrated willingness to enforce aggressively the FCPA, including the bringing of criminal charges against individuals, failing to take the FCPA seriously is a risk not worth taking either for the individuals or firms involved or for their limited partners.

For more information about the presentation, including information about how to view a webcast of the event available in Debevoise's online CLE library, please contact events@debevoise.com. ■

Recent Speaking Engagements

February 11, 2011

Michael P. Harrell
"Private Equity Funds — Terms and Trends"
Maples Investment Funds Forum 2011
Maples and Calder
Grand Cayman, Cayman Islands

April 19, 2011

Alyona Kucher
"D&O Insurance: Legal Framework in Russia and Abroad"
D&O Insurance in Russia
Chartis Insurance
Moscow

May 10, 2011

Franci Blassberg
Paul Berger
Bruce Yannett
Sean Hecker
Mark Goodman
Private Equity, Meet the FCPA
Debevoise & Plimpton LLP
New York

May 12, 2011

W. Neil Eggleston
Matthew Kaplan
Jonathan Tuttle
Bruce Yannett
Hot Topics in the Boardroom After Dodd-Frank
Debevoise & Plimpton LLP
Directors & Boards
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May 17, 2011

Michael P. Harrell
"Private Equity Fund Transparency and Reporting"
ILPA Members-Only Spring Conference
Institutional Limited Partners Association
New York

May 23, 2011

Geoff Kittredge
Michael P. Harrell
ILPA 2.0 and the Shifting Landscape of Private Equity Fund Terms
Debevoise & Plimpton LLP
London

June 10, 2011

David Schnabel
"Beyond the Basics: Partnerships in M&A and Capital Markets Transactions"
27th Annual Texas Federal Tax Institute
Tax Section of the State Bar of Texas
San Antonio, Texas

June 10, 2011

Kevin Schmidt
"Special Issues Involved in Acquiring Divisions or Subsidiaries of Larger Companies"
Acquiring or Selling the Privately Held Company 2011
Practising Law Institute
New York

June 15-16, 2011

Paul S. Bird
"Current M&A Issues"
Franci J. Blassberg
"Private Equity Today"
Tenth Annual International Mergers and Acquisitions Conference
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New York

June 21, 2011

Lord Goldsmith QC
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Private Equity and the UK Bribery Act
Debevoise & Plimpton LLP
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Contingent Value Rights for Private Equity-Backed Healthcare M&A

Contingent value rights, or "CVRs," have been used in merger and acquisition transactions for many decades to bridge valuation differences and provide additional value in the face of uncertainty. Today, the most common type of CVRs are event-driven CVRs in healthcare deals. In 2010, the value of CVRs in healthcare M&A transactions was around $5.8 billion, more than three times the figure for 2005. While CVR's have principally been used in strategic M&A transactions to date, they can also be used by financial buyers in going private deals in lieu of, or in addition to, earn-outs, receivables guarantees and purchase price adjustments that PE firms often use to bridge valuation gaps in private deals. Still, CVRs can present some important challenges and opportunities unique to financial buyers, many of which we highlight below.

Background

While CVRs tied to litigation outcomes, contingent tax assets and other eventualities have been used in many different industries, CVRs are particularly well-suited to transactions involving pharmaceutical and biotech targets because of the degree of uncertainty associated with valuing the development and commercialization of new drugs of these targets. For example, will the molecule or compound make it out of clinical trials? Will the drug obtain FDA approval, and if so will there be any required labeling that could adversely affect marketing? Will it sell? For instance, when Sanofi-Aventis recently sought to acquire Genzyme, one of the major hurdles was the fundamental disagreement over the potential value of Genzyme's experimental multiple sclerosis drug Lemtrada. Sanofi's solution was to include in the acquisition consideration a CVR which would require Sanofi to pay each holder $1 per CVR upon FDA approval of Lemtrada, provided approval is received by March 31, 2014, and up to $12 per CVR if sales of Lemtrada hit certain targets within specified time frames.

In healthcare deals, payouts under the CVR are generally tied to five possible triggers: (1) the filing of an application for a drug with the FDA (an IND, NDA or other application); (2) the initiation or success of clinical or phased trials or studies; (3) the approval of a drug application by the FDA; (4) the achievement of net sales targets for a particular drug; or (5) the net sales of a drug, in which case the CVR would pay out a percentage of the net sales as royalty payments.

In general, CVRs have no voting rights and receive no regular dividend payments. They usually are general, unsecured obligations of the issuer, ranking *pari passu* with the issuer's other unsecured obligations. As such, CVRs are more akin to debt instruments than to equity, although there is no reason they could not be structured with more equity features.

As noted above, CVRs can present unique challenges for financial buyers. For instance, because CVRs are generally viewed as debt-like instruments, they may have to be considered in calculating a sponsor's overall borrowing capacity and in formulating leverage ratios and other negative covenants in any acquisition financing package. Moreover, because they will be obligations, directly or indirectly, of what may be a highly leveraged portfolio company, they may carry less value for sellers than CVRs issued by strategic buyers with healthier looking balance sheets. Nevertheless, while these challenges make deals involving CVRs somewhat more difficult for sponsors to negotiate than strategic buyers, none of them are preclusive in appropriate circumstances, including situations where a sponsor is tapped out on its equity check and other financing sources. The remainder of this article discusses some of the other considerations that may arise in any healthcare deal involving CVRs, and other unique aspects of CVRs applicable to financial buyers.

Is the CVR a Security?

Under the *Celina* line of no-action letters issued by the Staff of the SEC Division of

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...[W]hile...challenges make deals involving CVRs somewhat more difficult for sponsors to negotiate than strategic buyers, none of them are preclusive in appropriate circumstances, including situations where a sponsor is tapped out on its equity check and other financing sources.

Corporation Finance, a CVR generally will be deemed to be a contract right and not a security so long as the CVR does not link payments on the CVR to the operations of the issuer or the target, and is not transferable or assignable except by operation of law (*i.e.*, is not tradable).

In most deals, so long as the parties do not require the CVRs to trade, these criteria should be relatively simple to meet. However, where the target is a biotech company, and a single drug constitutes all or a substantial portion of the sales, operations or profits of the company, will a CVR linked to the performance of that drug violate the no linkage to payments prong noted above? At least one 1989 no-action letter suggests not, assuming all of the other factors hold true.

...[S]tructuring a CVR as a security would generate potentially burdensome registration, disclosure and reporting obligations for a target in the process of going private....[U]nlike a standard 144A A/B Exchange Offer which does not require any filing with the SEC prior to the consummation of the acquisition, a tradable CVR would impose on sponsors the additional effort and delay of preparing a registration statement, shepherding it through the SEC, and conditioning the overall deal on its being declared effective.

While the added liquidity of tradable CVRs will make them more attractive to target shareholders, possibly allowing the acquirer to take more up-front consideration off the table, PE sponsors will need to balance this benefit against other costs and consequences associated with structuring the CVR as a security. This is, in part, because structuring a CVR as a security would generate potentially burdensome registration, disclosure and reporting obligations for a target in the process of going private. While these burdens may seem incremental to sponsors to the extent the target will have public debt outstanding following a customary 144A A/B Exchange Offer, sponsors should be aware that the disclosure obligations associated with a contingency-based instrument such as a CVR are likely to be more rigorous than they would be for an issuer which has only public debt outstanding. Also, unlike a standard 144A A/B Exchange Offer which does not require any filing with the SEC prior to the consummation of the acquisition, a tradable CVR would impose on sponsors the additional effort and delay of preparing a registration statement, shepherding it through the SEC, and conditioning the overall deal on its being declared effective.

Tax and Accounting

Tax

Although the tax implications of receiving a CVR are uncertain, in most cases, the value of the CVR will be considered part of the overall merger consideration. Holders of target stock will recognize gain or loss on the disposition of target stock, and part of the amount realized will be the value of the CVR, which is typically established based on the public trading value of the CVR, in the case of a tradable CVR, or the fairness opinion delivered in the deal, in the case of a non-tradable CVR. The holder will take a basis in the CVR equal to such value.

Accounting

CVRs generally are carried as a liability on the issuer's balance sheet. The issuer will need to establish an opening valuation for the CVRs. Each quarter, the CVRs must then be marked to market. If the CVRs trade, each revaluation will in most cases simply be the product of the number of outstanding CVRs and the trading price. Otherwise, the issuer will need to utilize more cumbersome valuation exercises.

In healthcare deals, where the CVR typically is tied to the performance of a single drug or compound, an intangible asset will be booked on the other side of the balance sheet. It too will need to be valued at the time the acquisition closes.

While one might expect some symmetry between the intangible asset and the related CVR liability, changes in the valuation (and the resulting expense or income) of one does not generally offset changes in the other. For instance, while the intangible asset will be subject to annual impairment testing, the CVR liability is marked to market quarterly (and the tests are different). Moreover, the intangible value of the drug can never be written *up*, even though the related CVR liability can fluctuate in either direction.

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Raising Capital from LPs in the Middle East: Caught in a Web of Regulatory Complexity

Middle Eastern investors are among the most affluent and active investors in private equity funds. In fact, Middle Eastern fundraising trips have become almost ubiquitous among international senior private equity professionals. Those trips, however, may need to be refocused in light of the recent increase in regulation of marketing activities of private equity and other investment funds by a number of countries in the region. The regulations not only provide rescission rights for investors and regiment the fundraising process, but may also subject private equity firms to significant contractual, civil and criminal exposures.

This article outlines some of the key regulatory reforms that have been, or are proposed to be, placed on international private equity funds seeking to raise capital in the Middle East. It also describes some of the steps that the industry is taking to establish a dialogue with local regulators with a view to reversing or ameliorating the current reform. Finally, the article goes on to suggest some potential approaches to managing the impact of the regulations on fundraising.

Saudi Arabia: Among the First to Tighten Its Grip

Four years ago, the Kingdom of Saudi Arabia initiated the reform bandwagon by enacting its current marketing restrictions. The Saudi regulations left no question as to whether they were intended to apply to foreign investment funds, stating clearly that an investment fund established in a jurisdiction other than Saudi Arabia could no longer be offered on a private placement basis in the Kingdom without the consent of its Capital Market Authority (the "*CMA*"). Although foreign fund sponsors need not themselves be licensed to conduct marketing activities in Saudi Arabia, they must now engage an entity authorized by the CMA in order to have the potential to engage in private-placement fundraising. (For a list of authorized persons, refer to the CMA's website: http://www.cma.org.sa/En/Pages/AuthorisedPersons.aspx). Such authorized "chaperone" must then seek prior approval from the CMA for each offering and must participate in all aspects of marketing to investors in the Kingdom. In addition, we understand the CMA has suggested that the chaperone must continue to serve as an intermediary between a fund and its Saudi limited partners with respect to capital calls, distributions and financial reports throughout the life of the fund.

While such chaperones may be helpful in protecting retail investors, their use in the placement of fund interests with institutional and other sophisticated investors is likely to add very limited value and raises a number of concerns for both fund sponsors and investors. The chaperone requirement often imposes unnecessary logistical, financial and commercial impediments for both fund managers and prospective investors, perhaps even undermining their longstanding valuable commercial associations and otherwise increasing the cost of capital raising. The requirement also increases a foreign investment fund sponsor's potential for exposure under the Foreign Corrupt Practices Act and introduces a number of additional procedural requirements upon sponsors who could be held responsible for the activities of their local custodians.

The UAE and Kuwait: Following Suit and Going a Step Further

In the past year, the United Arab Emirates (the "UAE") and Kuwait have introduced regulations following Saudi Arabia's lead. The UAE released a draft of its proposed regulations on January 6, 2011, and Kuwait released its final regulations on March 13, 2011, effective immediately. Both regulations appear tailored to protecting retail investors from making uninformed investments in mutual funds and other publicly offered securities. However, they are drafted so broadly that they apply to private equity funds across the board, without an exemption for private placements to sophisticated investors as in most developed jurisdictions. Because the regulations were not drafted with private equity funds

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While...chaperones may be helpful in protecting retail investors, their use in the placement of fund interests with institutional and other sophisticated investors is likely to add very limited value and raises a number of concerns for both fund sponsors and investors. The requirement also increases a foreign investment fund sponsor's potential for exposure under the Foreign Corrupt Practices Act....

in mind, a number of their requirements impose more than just an additional cost or administrative burden on private equity fund managers and their funds. Rather, they introduce rules which most managers and funds are simply unable to satisfy.

The Requirements. Some of the most restrictive requirements in the Kuwait and UAE regulations are outlined below.

Similar to Saudi Arabia, both Kuwait and the UAE now require foreign investment funds to engage local chaperones to conduct local marketing activities.

In addition, both Kuwait and the UAE have introduced significant reporting requirements to their regimes, many of which are totally impractical for private equity funds in light of the timeframes imposed. The regulations require that private equity funds provide quarterly audited reports to their investors within as early as 15 days after the end of each quarter and yearly audited reports to the government authorities within as early as 30 days after the end of each fiscal year. The Kuwait regulation also demands that each fund manager make available to the Kuwaiti regulator and the public the annual audited financial statements of each investment fund.

Due to the fact that it is impossible (or nearly impossible) for fund sponsors to comply with certain aspects of the new regulations, the historical practice of informal exemptions, reverse solicitation and offshore marketing is likely to continue to some degree.

The Kuwait regulation requires that an investor pay its entire "unit value" at the time of its subscription to an investment fund (rather than having capital called down on an "as needed" basis).

The Kuwait regulation also provides that no investment fund may own more than 10% of the securities of any one entity. In addition, employees and officers of a fund manager may not serve on the board of, or hold any position in, any portfolio company. These requirements are fundamentally inconsistent with the private equity buyout and growth capital fund models, which are premised upon seeking control or significant minority positions in portfolio companies and appointing board members, in each case to add value by actively influencing the management and operations of portfolio companies. In addition, an investment fund may not hold more than 10% of its net asset value in a single portfolio company. This requirement is obviously more restrictive than many funds' diversification requirements.

The Kuwait regulation provides that at least one-third of the members of an investment fund's board of directors must be independent, and approval of the Kuwaiti regulator is required prior to making any change in such board's membership, which of course is entirely inconsistent with how private equity fund managers generally structure their investment committees.

The UAE regulation requires that a foreign investment fund obtain approval from both the local regulator and the UAE Central Bank prior to conducting any marketing of fund interests in the UAE.

On April 12, 2011, the Kuwaiti regulator released Resolution No. 2, which establishes that foreign investment fund sponsors must pay a fee equal to 1% of the total value of the units intended to be marketed in Kuwait. The licensing application fee structure places a substantial financial burden on foreign fund sponsors and is expected to have a significant chilling effect on marketing in Kuwait to the detriment of Kuwait's competitiveness as a leading financial center in the region (particularly since no other major jurisdiction, to our knowledge, has adopted a similar approach).

Reaction by the Private Equity Industry

A number of advocacy groups and trade organizations have submitted, or are in the process of submitting, comment letters to the regulators in the UAE and Kuwait in reaction to these regulatory changes. Certain Middle Eastern investors (such as some of the sovereign wealth funds) have also inserted themselves in the debate. The primary focus of both groups has been to secure a formal private placement exemption from the regulations, allowing international private equity managers to safely market fund interests to qualified investors in a manner consistent with that permitted by other leading jurisdictions, thereby obviating, for instance, the need for a chaperone in connection with private placements.

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500 and Counting:

Proposed Law Would Make It Easier to Stay Private

As we have reported in prior issues of the *Debevoise & Plimpton Private Equity Report*, large portfolio companies that grant equity deeply into the employee ranks can run the risk of becoming "accidentally" public and subject to public company disclosure and compliance obligations. On June 14th, a bill was introduced in the House of Representatives which, if enacted, would greatly reduce this risk. While it is too early to see whether this legislation will gain the support necessary to become law, and while the change in law would likely have only a limited effect on private equity, advisors to private equity sponsors should monitor its progress over the remainder of 2011 and into 2012.

Background

Private companies are generally not subject to public-company registration and disclosure requirements under Federal securities laws or compliance with Sarbanes-Oxley. This is one of the primary advantages of private ownership, as it results in private companies not being required to file Forms 10-K and 10-Q and being exempt from proxy and tender offer rules as well as Sarbanes-Oxley's independence requirements for audit committees and outside auditors. However, under Section 12(g) of the Securities Exchange Act of 1934, a private company that has more than 500 shareholders (and more than $10 million in assets) would find itself required to comply with these requirements. It is a perception in the business community (in particular in the venture capital world, but less so with respect to private equity) that this 500 shareholder rule effectively forces large private companies (such as Google and Facebook) to go public earlier than they might otherwise choose to because of equity grants to the employee population. For example, Facebook has reported that it expects to have more than 500 shareholders by the end of 2011, thus leading to speculation of a need to begin complying with public company requirements by April of 2012. If this is the case, then it would be reasonable to expect a Facebook IPO before then. Private equity portfolio companies typically grant equity on a more limited basis than in the venture capital context, but this limit can also occasionally be problematic in the private equity context as well.

In the context of employee options, the SEC has granted limited relief from the 500-shareholder rule. This limited relief included no-action relief on a case-by-case basis prior to 2007, and, since 2007, private companies have been able to rely on Rule 12h-1(f) under the Exchange Act to exclude employees who hold options granted as compensation. The rule includes several restrictions, including transferability restrictions and a requirement that employees be provided with periodic financial and other information. Most importantly, however, the exemption applies only to options. Once an employee exercises his or her options and acquires the underlying shares, the rule is no longer available for those shares.

H.R. 2167: Relief for Private Companies from the Requirement to Go Public

The new bill, H.R. 2167 — named the Private Company Flexibility and Growth Act — would have two effects: First, it would double the number of investors necessary to trigger the public company disclosure requirements, from 500 to 1,000. Second, and more importantly, accredited investors and employee equity would not be included in determining whether the 1,000-investor threshold has been reached.

The combination of the exclusion for accredited investors and employees would be a significant development in the securities laws, as these two groups may be the only shareholders in many private companies, or at least may predominate over unaccredited, non-employee investors. Certainly in private equity, and even in the venture capital context, it is often the case that the shareholder base consists only of accredited investors and employees. Thus, if adopted, the bill would almost certainly achieve the goal of permitting private companies to exercise greater control over the timing of their becoming public. And, with the development of the private trading platforms such as SecondMarket, some private companies could conceivably choose to side-step the public markets altogether.

Opposition to the bill will likely center around two clusters of issues. The first of these relates to disclosure and investor

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The new bill...would have two effects: First, it would double the number of investors necessary to trigger the public company disclosure requirements, from 500 to 1,000. Second, and more importantly, accredited investors and employee equity would not be included in determining whether the 1,000-investor threshold has been reached.

Proposed Law Would Make It Easier to Stay Private (cont. from page 19)

protection. Would allowing large private companies to remain private (perhaps coupled with the growth of less regulated private trading platforms) result in less protection to investors? Would investors have access to disclosures necessary to make prudent investment decisions? The bill's implicit answer to these questions is that accredited investors are sophisticated enough to take care of themselves, and that transactions between companies and their employees require less scrutiny than capital-raising transactions. There is support for both of these propositions under existing regulations relating to securities offerings, especially with respect to employees: offers and sales to employees that are not capital raising transactions are treated more leniently as a general rule under the securities laws, for example by requiring far less disclosure than other offerings.

The second cluster of issues is likely to involve access to investment opportunities by small individual investors, *i.e.*, issues that are more macroeconomic than legal. If the bill became law, it would be possible for markets to develop in which only accredited investors (or investors with greater sophistication) could buy and sell securities. Currently, private trading platforms limit participation to qualified institutional buyers, or QIBs, which require much higher levels of net worth or assets under management than accredited investors. Would the development of these alternative platforms and their extension to accredited investors, potentially to the exclusion of unaccredited investors, limit the investment opportunities of the average (unaccredited) individual investor? Or would the mutual fund markets be viewed as providing sufficient access for this group? Would accredited investors be able to participate effectively in the same unregulated markets as QIBs? Private equity sponsors might well be interested in the development of robust private trading platforms, as these platforms could result in new exit opportunities, although potentially at less than true public company valuations.

It will also be interesting to see how the SEC responds to the bill. In an April letter to Congressman Darrell Issa, the SEC's Chair, Mary Schapiro, disclosed that the 500-shareholder rule and related issues are under review by the SEC, but, since the 500- shareholder rule is a statutory requirement, revolutionary changes are unlikely to be established through SEC rulemaking. Rather, these changes are likely to occur only through changes to the statute itself. And, while it is premature to speculate on whether the bill will pass in its current form, or at all, investors in private companies would be well-advised to focus on how the discussion of these issues develop in 2011 and 2012 in light of a looming Facebook IPO and the explosive growth of social buying sites such as LivingSocial. ■

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Pointers and Pitfalls on Sponsor-Led Tender Offers (cont. from page 1)

A Race to the Finish

Under a structure like the one utilized in Burger King and Gymboree, a sponsor and a public target enter into an acquisition agreement in which the parties agree to proceed simultaneously to closing under two separate parallel paths, only one of which will ultimately be used to consummate the deal: (1) a tender offer followed by a short-form merger, and (2) a traditional merger proxy followed by a shareholders' meeting to approve the transaction. The parties ultimately close by whichever path turns out to be shortest. In practice, it works as follows.

Shortly after signing, the sponsor's counsel prepares cash tender offer documentation and the offer is launched. Under the tender offer rules, the offer must remain open for a minimum of 20 business days, so the transaction could potentially be consummated as few as 35-40 days after signing. The catch is that, for reasons explained below, including the need to comply with the "margin rules," embodied in SEC Regulations U and X, the tender offer must be conditioned on acceptance by a sufficient supermajority of the target's shareholders to permit the acquirer to close a short-form merger and acquire ownership of 100% of the target's shares substantially concurrently with the closing of the tender offer. The necessary supermajority varies by state, but Delaware's 90% requirement is typical. Use of a top-up option (discussed elsewhere in this article and in the side bar to this Article entitled "More on Top Up Options" on page 21) and of tender agreements with any stockholders holding large positions in the target can make it more likely that the tender offer will succeed in permitting the buyer to consummate a short-form merger.

Also shortly after signing, the parties prepare a merger proxy, which is then filed as soon as possible with the SEC. This parallel path ensures against the risk of

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Pointers and Pitfalls on Sponsor-Led Tender Offers (cont. from page 20)

insufficient tenders to allow for a short-form merger. The SEC reviews the proxy while the tender offer is open. If the tender does not result in the buyer having enough shares to close a short-form merger under applicable state law, the parties will instead be able to mail the proxy after resolving any SEC comments and proceed with the traditional merger/proxy solicitation process, culminating in a shareholders meeting to approve the transaction.

The upshot of this approach is to provide the buyer with a path to the fastest possible closing of a going-private transaction if it is in a position to consummate a short-form merger following its tender offer, while also preserving its ability to close on a more typical timeframe for a merger proxy if it can not consummate a short-form merger following the tender offer.

Making Room for the Margin Rules

There are a number of landmines in the path of structuring the leverage in an LBO that is to be completed as a tender offer. Lenders cannot use the assets of the target as collateral to finance a tender offer, or obtain parity with the target's trade and other existing creditors until the buyer completes a short-form merger and acquires ownership of 100 percent of the target's equity securities. At the same time, the "margin rules" under SEC Regulations U and X severely limit a buyer's ability to secure their third party financing with the stock acquired in the tender offer.The margin rules limit lenders' ability to extend financing for the purpose of buying the stock of a public company (referred to as "margin stock") that is "secured directly or indirectly" by that stock and are, therefore, always a significant consideration in structuring sponsor-led tender offers. The margin requirements are complex, but the bottom line is that to comply with the rules in the tender offer context a sponsor must either write a very big equity check (upwards of 50% of the consideration being paid to the target's shareholders) or use a structure designed to comply with the rules and their exceptions. We described a number of these structures in our previous article "The Tender Offer

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More on Top-Up Options

Given the significance of "top-up options" to the increasing use of tender offer structures by PE sponsors, this side bar expands on some of the key points discussed in our accompanying article and identifies several other important considerations that private equity sponsors should keep in mind when evaluating a top-up option.

As noted in our accompanying article, a top-up option gives a buyer the right, upon the completion of a tender offer that reaches the minimum tender condition level, to purchase newly issued shares of the target so as to increase the buyer's common stock ownership interest to the 90 percent level required to effect a "short-form" merger in Delaware. By effectively reducing the percentage of shares that must be achieved in the tender offer and still effect a short-form merger, top-up options make tender offers, and their associated advantage of expeditious deal execution, more practical for financial buyers.

Under Delaware law, as well as the corporate law of most other states, a parent of a 90% owned subsidiary can unilaterally effect a short-form merger into that subsidiary without a shareholders meeting or other action on the part of the subsidiary company. Thus, absent a top-up option, a tender offeror can effect a short-form merger and cash out all non-tendered shares immediately after the closing of a tender offer only if it is able to reach the 90% ownership threshold in the tender offer.

Top-up options can provide a buyer a way to effect a prompt short-form merger even if it comes up short of the 90% threshold in the tender offer. Provided that the buyer acquires more than the number of shares necessary to approve a long-form merger (usually 50.1 percent) — and the shares subject to the top-up option are sufficient, when added to the shares acquired in the tender offer, to reach a 90% ownership level — the buyer can exercise the top-up option and get sufficient shares to consummate the short-form merger. Although the top-up shares are issued at the tender offer price, the buyer (*i.e.*, the special purpose vehicle set up by the private equity sponsor to make the tender offer) typically pays for those shares with a note. The note is then effectively cancelled when the buyer consolidates with the target in the merger.

Given the clear advantages of top-up options, it is no surprise that, as Chancellor Laster observed recently in *Olson v. EV3*, "[t]op up options have become ubiquitous in two step acquisitions.

There are several important additional considerations that private equity sponsors

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Pointers and Pitfalls on Sponsor-Led Tender Offers (cont. from page 21)

Returns," referred to above. Each has advantages and disadvantages, but notwithstanding the recent revival of tender offer based structures, most sponsors most of the time have decided to stick with a single path, traditional merger proxy structure when pursuing a going private deal.

But the sponsors in the Burger King and Gymboree transactions opted to pursue the parallel path approach, in part because in each deal the buyer received a top-up option from the seller, which allowed it to reduce its minimum tender condition in its tender offer to a level significantly lower than would normally be required to consummate a short-form merger immediately after the closing of the tender offer. This allowed the parties to take the view that under the margin rules and their exceptions, there was no purchase of "margin stock" since the closing of the short-form merger which resulted in the sponsor owning all of the target stock would occur substantially concurrently with the closing of the debt financing for the tender offer. Equally, closing the debt financing and the short-form merger substantially concurrently permits a sponsor to secure debt financing with the assets of the target company. Had the required tender threshold for a short-form merger not been met, the merger proxy process would have proceeded and, again, funding of the debt financing would have taken place substantially concurrently with a traditional merger following a shareholders' meeting approving the deal

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More on Top-Up Options (cont. from page 21)

should keep in mind when evaluating a tender offer/top-up structure.

- *Sufficient Authorized Shares.* As noted in the accompanying article, the amount of shares issued when a buyer exercises its top-up option is limited by the number of authorized and unissued shares of the target. The general rule is that for each one percent that a buyer's tender offer falls short of 90 percent, a top-up option will require the target to issue a number of shares equal to ten percent of its issued and outstanding stock. If the number of authorized shares is insufficient to permit the buyer to reach the 90 percent threshold at the close of a tender offer, then the minimum tender condition must be increased from the traditional 50.1 percent to make up the difference.
- *NYSE/Nasdaq Rules.* Is the target running afoul of NYSE and NASDAQ rules by issuing the top-up option? The stock exchange listing rules generally limit new issuances of more than 20 percent of a company's outstanding shares without a shareholder vote. Given the 1:10 ratio discussed above, any option that would allow a buyer exercising a top-up option to increase its ownership of the target's outstanding shares by more than two percentage points would technically be in violation of these rules. However, because the likeliest remedy for such violation would be a delisting of the target, which would happen regardless as a result of the merger, issuers generally do not feel constrained by the NYSE/NASDAQ rules in connection with top-up options.
- *Potential Delaware Law Pitfalls.* While recent Delaware decisions, including *Olson v. EV3* (2011) and *In Re Cogent, Inc.* (2010) have affirmed the use of top-up options in connection with tender offer acquisitions, they have identified traps for the unwary that exist under Delaware law. In particular:

1. The par value of the top-up shares should be paid in cash to ensure satisfaction of DGCL 157(d), which requires that consideration received for shares shall be no less than the par value of such shares.
2. The remaining consideration for the top-up shares can be in the form of a promissory note. However, the material terms of the note should be specified in the merger agreement.
3. The merger agreement should include a provision excluding the top-up shares from consideration in any appraisal proceeding arising out of the merger.

As noted in our accompanying article, top-up options are powerful tools that make the advantages of the tender offer structure accessible to private equity sponsors. For sponsors looking to tender offer to pave the way for shorter closing periods, top-up options can provide a welcome boost that brings a deal across the finish line. ■

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Pointers and Pitfalls on Sponsor-Led Tender Offers (cont. from page 22)

in which the sponsor would have acquired all of the stock of the target.

Why Now?

As noted above, a key development facilitating the parallel path structure is the growing acceptance of the top-up option by Delaware courts in recent decisions. As more fully described in the side bar to this article entitled "More on Top Up Options" on page 21, a top-up option is a feature of a negotiated merger agreement structured as a tender offer in which the target company agrees to issue to the acquirer at the closing of the tender offer any unissued shares of common stock that it is authorized to issue under its charter. The result is to lower the hurdle to achieving the supermajority threshold necessary for a short-form merger.

The top-up option is not a panacea. Since each additional share purchased by the acquirer under the top-up option increases the denominator as well as the numerator in the calculation of whether at least 90% of the target's shares have been tendered, a target must have a very large number of authorized and unissued shares in order to meaningfully reduce the percentage of outstanding shares that must be tendered in the offer and still allow for a short-form merger. But, if the target has sufficient authorized but unissued shares, a top-up option can provide a meaningful boost as it did in Burger King and Gymboree. The acquirers in those deals were able to set the minimum tender condition at 79.1% and 66% respectively, rather than the 90% that would otherwise have been required.

In the Burger King transaction, there was another helpful element. While Burger King was publicly traded, 31% of its shares were held by private equity sponsors. These sponsors agreed as a part of the deal to tender their shares into the tender offer, significantly increasing the likelihood that the 79.1% threshold required in that deal for a successful tender offer would be met.

The other key legal development, as was first noted to our readers in 2007 (see "The Tender Offer Returns"), was the SEC's late 2006 clarification of Rule 14d-10 – known among deal professionals as the "best price" rule. As a result of judicial decisions in the early 1990s holding that typical buy-out and employment arrangements with target management teams may violate the requirement that all security holders be paid the highest price paid to any security holder in a tender offer, the tender offer had become a disfavored structure for negotiated acquisitions because of the potentially exponential impact on the cost of consummating the tender offer. The SEC amendments to the "best price" rule clarified the circumstances under which such arrangements were permitted, opening the door to the revival of tender offer-based buy out structures.

Is This Structure Right for my Deal?

While there are important advantages to the Burger King/Gymboree structure, it is not for every deal.

The structure is only attractive if the target has a sufficiently large number of authorized but unissued shares to permit the requisite supermajority vote for a short-form merger to be obtained at a threshold meaningfully lower than 90%, a "Mr. Big" shareholder able to sign up a tender agreement easing the path to meeting the minimum tender condition, or both. Where the target is not a Delaware company, buyers need to consider the risk that a top-up option will be deemed invalid if challenged by shareholder plaintiffs.

Buyers should also keep in mind that if there are significant regulatory hurdles to the closing of the transaction other than a routine Hart Scott Rodino antitrust filing, there will be no opportunity for meaningful time savings. While the U.S. authorities will provide expedited treatment of an HSR filing in the case of a cash tender offer (with a 15-day waiting period rather than 30 days, in each case subject to early termination where there are no real issues), non-U.S. authorities do not generally provide such expedited treatment. Transactions in regulated industries are also likely to have closing conditions that will take longer to satisfy than it would take to obtain approval at a shareholder meeting. (Indeed, in these cases it will be preferable for a sponsor to seek shareholder approval at a special meeting before regulatory approvals have been obtained. While a tender offer cannot be closed until regulatory approvals are in hand,

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The top-up option is not a panacea....[A] target must have a very large number of authorized and unissued shares in order to meaningfully reduce the percentage of outstanding shares that must be tendered in the offer and still allow for a short-form merger. But, if the target has sufficient authorized but unissued shares, a top-up option can provide a meaningful boost...

Pointers and Pitfalls on Sponsor-Led Tender Offers (cont. from page 23)

competing bidders are foreclosed from jumping a deal once shareholders vote their approval at a special meeting.)

Adopting the parallel path structure will also obviously add complexity and transaction expense. Any relatively novel structure will require additional time by counsel on both sides to work through the details and negotiate key points that have not yet settled into clear market practice. The need to pursue, simultaneously, both a tender offer and a merger proxy will also add to the effort of the deal team and ultimately to the legal expenses incurred by the sponsor.

Sponsors should also consider whether they wish to subject their deal to an initial referendum in which a supermajority vote (even in the form of a reduced minimum tender condition) is required to move the deal forward, even with a merger proxy as a back-up for which a lower voting threshold is required. In a deal where it may be uncertain whether shareholders will support the transaction, sponsors should consider whether they would rather shareholders have a single voting opportunity in which the sponsors may be more likely to prevail. Tender agreements with large shareholders and a strong top up option can mitigate this risk, but they cannot assure the reduced minimum tender condition will be satisfied. Litigators should be consulted as to the atmospheric effect of a failed tender on any anticipated shareholder litigation.

Sponsors should also take care that their desire to get the deal done quickly does not outstrip their ability to execute on a financing package. Given the need to prepare an offering memorandum (including preparation of *pro forma* financial statements), some cushion should be built into the timeline for launching the tender offer to ensure that the debt marketing can take place simultaneously with the tender offer period. Sponsors should, as always, take care to seek protection against the possibility that a failure by the target to provide necessary cooperation with the financing in a timely manner does not result in a sponsor breach, and, potentially, the obligation to pay a substantial "reverse termination fee." This is a particularly sensitive issue when the timing is tight, as it can be in these deals. Equally, before commencing the marketing of the debt offering, sponsors should take into account the additional expense that may be incurred if the debt must be closed into escrow or the debt offering must be delayed because the tender offer is unsuccessful, and the merger closing does not occur when anticipated.

Above all, sponsors considering proceeding with this structure should be certain to work with sophisticated counsel, and take the time to understand the risks and traps for the unwary, as well as the potential advantages, of this new approach. ■

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Proposed SEC Rules Could Limit Incentive Compensation (cont. from page 4)

arrangements with sophisticated third party investors, there is a market check on excessive compensation. Second, private equity firms and funds do not raise systemic risk concerns. Third, the compensation arrangements at private equity firms and funds do not present the perceived problem that drove much of this rulemaking, namely financial institutions taking long-term risks but being compensated currently with no adjustment if the risk fails to pay off in the long run. Private equity is different, because private equity professionals receive the bulk of their income earnings in the form of carried interest distributions, consisting primarily of a share of the realized gain from the sale of long-term investments.

Following review of public comments, final rules will be adopted by the various agencies. The final rules applicable to IAs are scheduled to become effective six months after they are adopted by the SEC in final form and published in the Federal Register. ■

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Brick by Brick (cont. from page 8)

Conclusion

As should now be clear, the difference between performing due diligence in Suzhou rather than Cleveland is about as great as the geographic distance between those two cities. Concepts that are taken for granted in a typical western due diligence exercise such as appreciation (albeit not affection) for the legitimacy of a buyer's need to perform diligence, the availability of accurate internal records, extensive public search resources and one set of financial statements prepared in accordance with a well-established, standardized set of accounting principles and audited by a Big Four type accounting firm are simply not common in China. Further complicating matters is the lack of a well-developed legal infrastructure in China that would aid a buyer's ability to streamline its diligence and provide certainty with respect to contractual risk allocations by the parties based on potential exposures discovered in the diligence process.

Buyers can nonetheless seek to maximize the success of their diligence in this challenging environment by, among other tactics (1) engaging advisor teams consisting of people who can speak Chinese, know China well, and fully understand the intricacies and unique features of China deals, (2) relying, to the extent feasible, less on well stocked data rooms and complete paper trails and more on talking to employees, customers, competitors and other commercial constituents of the target as a basis to spot issues, and (3) spending time early in the transaction process emphasizing the importance of due diligence as a basis to build trust and maximize deal value from a Western-based buyer. This process may be a bit easier now given the recent suspension of trading of 12 Chinese small cap firms in the U.S. amid accusations of fraud and mismanagement and the recent decline in value, due to scandals involving unrelated Chinese companies, of many Chinese small-cap firms listed in the U.S. (as opposed to valuations for similar companies listed in Mainland China and HK, which have been less affected), presumably reflecting different risk tolerances and informational requirements for these types of matters between U.S. and Asian-based investors. Still, PE firms must recognize that even in the best of circumstances, diligence of Chinese-based companies may well provide them with scant information or, even worse, raise more questions than it answers. In that respect, buyers will likely need to rely on the same measures they utilize when confronting similarly inadequate diligence targets in, say, Cleveland: discounting valuation to self insure against contingent exposures, utilizing earn-outs, negotiating funded indemnities and, in the most extreme cases, simply deciding not to proceed with the deal. ■

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Contingent Value Rights in Private Equity-Backed Healthcare M&A (cont. from page 16)

Like all liabilities subject to variable accounting, sponsors will want to consider whether these sorts of accounting fluctuations could have a potentially adverse effect on the valuation of their portfolio companies for purposes of option grants, put and call rights, covenant compliance under applicable acquisition financing documents and reporting obligations to limited partners. Moreover, depending on the magnitude, the accounting could have an effect on exit, particularly if exit is through an IPO.

Selected Structuring and Documentary Issues

Efforts

When contingent payments are to be made in the future, the question arises as to what efforts must be exerted by the buyer in order to maximize the value of the contingent payment for the benefit of the beneficiaries of these payments. For instance, in the case of CVRs, how much money must be invested in research and development of an early stage drug, the success of which would trigger payments under a CVR? What other resources must be dedicated to the effort? What if the FDA requires expensive new trials before it will agree to approve the drug?

CVRs do and will continue to serve a valuable function in healthcare M&A. They are not only useful in bridging valuation gaps, but can also provide real value in the face of timing, regulatory and other types of uncertainties.

The scant caselaw relating to CVRs does not touch on these questions, but several recent earnout cases do. For instance, in *Sonoran Scanners v. PerkinElmer, Inc.* and *Eggert Agency, Inc. v. NA Management Corp.*, both of which we profiled in an Alert we published in the Winter 2010 edition of the *Debevoise & Plimpton Private Equity Report* entitled "Bridging the Gap — Implied Obligations in Earn-Out Contracts," the courts concluded that in the absence of any clear guidelines or disclaimers in the governing documents, there existed an implied covenant to use reasonable efforts to achieve the relevant sales or milestones so that payments could be made under the earnout. As Justice Cardozo put it in an earlier case cited in both *Sonoran* and *Eggert*, "[the] promise to pay...profits and revenues resulting from [an] exclusive agency...was a promise to use reasonable efforts to bring profits and revenues into existence." As with earn-outs, drafters of CVR agreements should address the question of efforts one way or another, because remaining silent about performance guidelines and standards of efforts could spur a court to imply a duty of reasonable efforts.

Issuers have addressed this point in different ways. Fresenius, which issued a CVR that was effectively an earnout, expressly disclaimed any obligation to initiate or continue any research and development or commercialization activities and reserved the right to abandon any product. On the other hand, Ligand Pharmaceuticals, when it issued a CVR in connection with its acquisition of CyDex Pharmaceuticals in January 2011, agreed to dedicate a specific number of employees to the CyDex business and to invest a minimum amount in the business each year.

Most commonly, however, CVR issuers agree to use "commercially reasonable efforts" or "diligent efforts" to achieve milestones, but to qualify those efforts in a host of ways—"consistent with pharmaceutical industry practice," "relating to products in a similar stage of marketing, development and approval," and "relating to products of similar economic potential." The language often specifically allows companies to take into account the product profile, including efficacy and safety, the competitiveness of alternative products (under development or already in the market), the launch or sale of biosimilar products, the regulatory environment, the profitability of the product — and "other factors." While definitions of this sort have the appearance of imposing broad obligations, as a practical matter, their generality and the ability to consider just about anything in deciding what actions to take limit significantly the CVR issuer's commitment. They also make it more difficult for a dispersed group of holders to obtain redress in the event the CVRs produce no payout.

Material Adverse Effect

Sometimes the inclusion of CVRs in a transaction comes into play in negotiating the Material Adverse Effect provisions in the underlying acquisition agreement. For instance, in the Sanofi/Genzyme merger agreement, Genzyme was precluded from invoking a

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Material Adverse Effect on the basis of developments relating to Lemtrada in order to avoid closing the deal, based in part on the argument that Sanofi was already protected on adverse developments relating to Lemtrada due to the contingent nature of the payments under the deal's CVR.

Other targets also have negotiated exclusions from the definition of Material Adverse Effect tied to the drug that is the subject of the CVR based on similar theories. Conversely, buyers have specified events tied to the relevant drug that expressly *would* result in an Material Adverse Effect. In all cases, a buyer considering using CVRs as part of its consideration should be aware that the seller might take the position that in order to require the seller to accept a CVR instead of an upfront payment, the buyer must relinquish its walkaway right related to problems with the drug subject to the CVR. While this argument may seem logical on its face, ultimately a buyer's willingness to accept such a trade off may be based more on the long-term strategic importance of the drug to the buyer than the savings the buyer would achieve if the payouts under the related CVR were reduced or eliminated due to problems with the drug.

Other Provisions

Other provisions that are often heavily negotiated in CVR deals include the expiration date, the definition of "net sales," when and the extent to which assets relating to the drug that is the subject of the CVR can be sold and, in the case of tradable CVRs, when, and if, the issuer is permitted to redeem them or even buy them in the market. While issuers will be subject to securities law restrictions on trading in their own tradable CVRs with non-public material information, sellers like to know that buyers cannot take actions that could affect the value of the CVRs in the market. Buyers, on the other hand, often negotiate for some ability to redeem the CVRs if, for instance, the likelihood of any payment has become remote.

CVRs in Practice.

Performance of CVRs

While only a few healthcare CVRs actually trade, it is worth noting how they have performed. The Celgene CVR opened trading on October 18, 2010, at $5.55 — approximately 43 percent of its maximum value — but is currently trading at around $2.10 after Celgene disclosed in January disappointing results in the clinical trials for Abraxene. The CVR does not expire until 2025 at the earliest. The Fresenius CVR, tied to EBITDA, opened at 16.5 percent of its maximum value, but expired at the end of last year without any payment being made.

In its most recent 10-K, Emergent BioSolutions recorded its CVR liability at $14.5 million, only 37 percent of the maximum payout. In the face of a response letter from the FDA raising concerns about the safety of Nebido and the company's proposed risk evaluation and mitigation strategy, Endo's Nebido CVR was written down to $7.5 million, from $134 million. When the FDA granted a third party orphan exclusivity for a drug that competes with ViroPharma's Cinryze, achievement of the first milestone under ViroPharma's CVR (that Cinryze would be granted exclusivity) became impossible. It is still possible, however, for the second milestone to be satisfied.

Although it is difficult to discern any useful pattern from this data, one conclusion that does emerge is that the risks associated with achieving milestones in this area can be both significant and unexpected, particularly where the CVR is tied to an early-stage drug.

Usefulness of CVRs

Still, CVRs do and will continue to serve a valuable function in healthcare M&A. They are not only useful in bridging valuation gaps, but can also provide real value in the face of timing, regulatory and other types of uncertainties. Plus, for PE sponsors, CVRs can lessen the amount of equity and debt financing it would otherwise require to finance a going private transaction. Ultimately, the number of CVRs proposed in the course of negotiations far exceeds the number actually used in transactions—but often, just proposing a CVR, keeps the ball rolling until the parties can figure out how to strike the right compromise.

Sponsors must keep in mind, however, that CVRs are often complex instruments that have to work in a future full of uncertainty. Buyers using CVRs will not want their portfolio companies to be forced to expend more resources or effort to achieve goals than expected. They will not want their portfolio companies to be prevented from operating their business for the benefit of their stockholders. Nor will they want their portfolio companies to be the subject of a lawsuit challenging their performance or the interpretation of the milestones. However, if the right alignment of stars comes together on a particular deal, including the financing, credit, valuation, regulatory and other challenges discussed above, CVRs could be a very important tool for getting PE deals done. ■

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Raising Capital from LPs in the Middle East (cont. from page 18)

Other Potential Approaches

In light of the impracticality of rules such as those described above, private equity funds have devised a number of approaches in order to continue marketing their funds to institutional investors in the Middle East.

Informal Exemptions. Historically, fund managers have often relied on informal "exemptions" for placements of fund interests to sophisticated investors on a one-to-one basis. In some instances, such exemptions have been offered directly by regulators who have stated off-the-record that they will not bring enforcement actions against such types of marketing activities. In other instances, fund sponsors have relied on advice from local counsel that the regulators are unlikely, based on historic course of conduct, to enforce the rules for such narrow marketing activities. Although informal exemptions are marginally better than no exemptions at all, they produce a number of negative consequences of their own, such as greater uncertainty for sophisticated fund sponsors and investors, who rely on clear rules and regulations in structuring their commercial dealings. In other words, on the one hand, the *ad hoc* application of the rules by regulators leads to inequitable and ineffective investor protections. But, on the other hand, significant uncertainty in the application of a regulatory regime may discourage foreign fund sponsors from fully marketing in the region because of potential contractual, civil and criminal exposure. The decline in marketing activity may ultimately have a negative impact on local investors and the region's ability to further develop and maintain its status as a desirable jurisdiction for investment activity.

Reverse Solicitation. It is also generally-accepted market practice, and sometimes even informally permitted to various degrees by regulators, to distinguish between cases where a fund sponsor discusses a product with an investor on an unsolicited basis at such investor's initiative (so called "reverse solicitation") and cases where a fund sponsor actively approaches the investor. The argument is that an investor who actively approaches a fund sponsor about a potential fund investment is less in need of protection by the regulator. This approach is not without risk, particularly where an investor's formal inquiry is in fact directed or otherwise prompted by the fund sponsor.

Offshore Marketing. Other fund sponsors carry out the entire marketing process overseas, so as to avoid falling within the scope of the local regulatory regime completely. This approach may impose some strain on the marketing process, including from an investor-relationship perspective, since meetings with the Middle Eastern investors would need to take place outside of their home country.

Due to the fact that it is impossible (or nearly impossible) for fund sponsors to comply with certain aspects of the new regulations, the historical practice of informal exemptions, reverse solicitation and offshore marketing is likely to continue to some degree.

Impact on Fundraising in the Region

Although the regulations governing fundraising in the Middle East may be rooted in commendable consumer-protection policies, the overly stringent requirements with respect to private-equity marketing activities to sophisticated investors may discourage fund sponsors from marketing in the Middle East and ultimately disadvantage sophisticated Middle Eastern investors. Practical experience has shown that the Saudi rules have negatively impacted sophisticated Saudi Arabian investors, because certain international fund sponsors are no longer fundraising in the Kingdom. Instead, certain investors and fundraising activities are migrating to other free zones and jurisdictions like the Dubai International Financial Centre, Switzerland and the United Kingdom. As the private equity industry has pointed out to regulators in Kuwait and the UAE, without clarification of the new rules, a similar movement away from marketing in both Kuwait and the UAE may ensue. That marketing withdrawal by private equity firms may well hinder the UAE's ability to maintain its status as a leading regional financial center and Kuwait's aspirations to become such a center. We are hopeful that cooperation between the industry and regulators will help devise an approach to private equity fundraising in the Middle Eastern markets that makes sense for both investors and fund sponsors. ■

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