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PRIVATE EQUITY REPORT

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The IPO Exit:

"Recent" Market Trends in IPOs of Sponsor Portfolio Companies

Although it may seem like a dim memory in light of the recent public market performance, during the 19-month period ended July 31, 2011, the public equity markets rebounded resoundingly, with a particular increase in sponsor-backed IPOs. Sponsor-backed IPO global activity doubled (in deal size) in 2010 as compared to 2009 and continued on an upward trend during the first six months of 2011, with more than 20 sponsor-backed IPOs for Nasdaq and NYSE listed companies, raising approximately $19.6 billion. We expect that while many sponsors will be contemplating dual track exit routes for several months, a number will be (somewhat wistfully) anticipating the return of the IPO window for their portfolio companies. When the market returns, sponsors should be ready to make the critical decisions that will 'set up' their portfolio companies for the next realization.

In our Summer 2005 issue of the *Debevoise & Plimpton Private Equity Report*, we published an article entitled "Selected Issues to Consider When Taking a Portfolio Company Public." In that article, we discussed the important decisions sponsors must make regarding the governance profile of IPO candidates. These decisions include board composition and designation rights, whether to qualify as a "controlled company," the treatment of veto, management fees and other sponsor rights, and the type, combination and magnitude of any anti-takeover defenses to put into place for the newly public company.

In the wake of the robust IPO activity discussed above, we have surveyed all sponsor-backed IPOs of Delaware corporations completed in 2010 and the first seven months of 2011 that resulted in proceeds in excess of $250 million to assess how these issues were addressed. Our survey yielded 11 companies that met our search criteria and reflect the state of the

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"Now, that's a change of control."

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Letter from the Editor

We all grew up thinking that an endless summer would be heaven, but the combined impact of the volatility in the markets and the brutal weather have us all longing for autumn. Although our summer issue is technically a bit late, it is uncanningly timely in light of both the weather and the markets.

In the current climate, the IPO exit strategy seems aspirational at best. However, it was not that long ago that sponsored-backed IPOs were making headlines and that is when we started our survey of sponsor-backed IPOs in 2010 and the first half of 2011 to determine how the governance profile of those companies looked after the IPO was completed. On our cover, we report on the results of our comprehensive survey so that you will be poised for the next IPO window.

Private equity is an ever more international asset class. In this issue, we continue our series on doing due diligence in the largest emerging markets, or BRICs, with a focus on India. We caution potential investors in India to be prepared to untangle a web of related party transactions, analyze complex litigation risks, and evaluate Byzantine land title issues as well as deal with targets largely unfamiliar with, and reluctant to fully cooperate in, the due diligence process.

Brazil has been one of the largest areas of growth for private equity. We report on the differences between the expectations of Brazilian investors and international investors in the negotiation of the terms for Brazil-focused funds as well as on the ways in which inflation, currency fluctuations and capital controls play a role in fund terms.

Elsewhere in this issue, our Guest Columnists, Alexander Pankov and Kirill Samsonov, co-founders of the Russian Private Equity Initiative, outline the Initiative's efforts to promote growth in the nascent Russian private equity sector through education and collaboration between stakeholders, the government and domestic and international investors.

Our Asian colleagues caution that, notwithstanding the wide spread use of "VIE" structures to address regulatory hurdles relating to foreign ownership in certain industries, recent challenges by the Chinese government raise concerns as to the viability of such structures, particularly in certain sensitive sectors, and at a minimum indicate that these structures are likely to be subject to enhanced scrutiny and additional risk for foreign investors going forward.

An ongoing focus of the *Private Equity Report* has been to keep you up-to-date on relevant legal developments in the courts and from regulators. In this issue, we feature a concise primer (together with a cheat sheet) on recent cases from Delaware focusing on directors' *Revlon* duties, takeover defenses and going private transactions. Every director of a portfolio company will find the three minutes it takes to read it well worth the time. We also provide an update on the UK Bribery Act, which finally became law this summer, and offer insight on its practical implications for private equity firms and their portfolio companies. (Beware—The UK Bribery Act is broader in many respects than the U.S. Foreign Corrupt Practices Act.) Finally, we alert our readers to recent changes made to the HSR reporting form that expand somewhat the burden of HSR compliance particularly for private equity firms.

If there are any issues that you would like to see covered in future issues of the *Report* or any ways in which we can make the publication more useful to you or the other members of the private equity community, we would appreciate hearing from you.

Franci J. Blassberg
Editor-in-Chief

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Investing in China: New Risks?

In the Fall 2010 issue of the *Debevoise & Plimpton Private Equity Report*, we discussed how China-based companies keen on listing outside China have been innovative in adopting structures designed to address Chinese regulatory hurdles, including the widely used variable interest entity ("VIE") structure. Although long perceived as one of the many "gray areas" of Chinese law, over the past decade or so, companies using VIE structures have not received real negative attention from the Chinese government or the market. However, the recent high profile challenges faced by Buddha Steel and Alibaba Group, along with the even more recent news that government regulation of VIEs may be under active consideration, remind foreign investors that these structures may be subject to increasing regulatory scrutiny in China and could pose significant risks for investors.

Background

Chinese law prohibits foreign investors from directly investing in certain industries, such as publishing, gaming and the internet sector. From time to time, the Chinese government publishes the "Catalogue for the Guidance of Foreign Investment" to indicate which industries fall into this "prohibited" category (and which are encouraged, permitted or partially restricted). In addition, the Chinese government limits foreign investment by prohibiting companies with foreign investors from obtaining permits to conduct certain types of business. Naturally, with the ever-growing enthusiasm for investing in China and the determination of Chinese companies to seek foreign capital, it wasn't long before a seemingly acceptable work-around of this foreign ownership limitation was developed.

The now prevalent VIE structure was initially introduced by internet companies in the early 2000's. Typically, under a VIE structure, a foreign holding company creates a wholly owned subsidiary in China (which is a wholly foreign owned enterprise, or "WFOE"). Instead of directly operating the restricted business or owning equity interests in a company that operates such business, the WFOE enters into a set of contractual arrangements with an operating company organized in China (the so-called VIE) which allow the WFOE to obtain control over, and substantially all of the economic benefits from, the VIE.

United States and international accounting standards generally permit (and require) the offshore holding company to consolidate the financial results of the VIE. Accordingly, the VIE structure allows foreign investors to consolidate the financial and operating results of the restricted business without direct equity ownership in the operating company, thereby allowing foreign investors to participate in restricted industries.

More recently, the VIE structure has also been used to address a different regulatory issue in China. Because the Chinese regulations (namely Circular 10) promulgated in 2006 have made it nearly impossible for Chinese companies looking to list outside China to set up the offshore holding company structure required for an offshore listing with direct ownership of the Chinese operating company, some companies have opted to use the VIE structure to circumvent the Circular 10 restrictions.

In the past decade, many Chinese companies have successfully used the VIE structure, often referred to as the Sina model after Sina.com successfully used the structure for its U.S. IPO and NASDAQ listing in 2000. Nearly all offshore-listed internet companies, including renowned giants Sohu and Baidu, as well as hot IPO newcomers Renren, Youku and DangDang, operate under VIE structures. These asset-light internet companies have been generally accepted as the model candidates for VIE structures, primarily because of the large number of precedents for the structure in the internet industry. Despite their popularity with foreign investors, largely due to the fact that a VIE structure does not require Chinese government approval, there has been no clear indication from the government as to whether the structure actually complies with Chinese law. Though obviously used as an avenue to circumvent restrictions on foreign investment or regulatory hurdles with respect to offshore listings, the Chinese government has yet to take any overt enforcement measures against the companies utilizing these structures. Thus far, the strongest indication that the Chinese Government will issue a position with respect to VIEs came during a monthly news briefing earlier this month at which a spokesman for the Ministry of Commerce stated that the Ministry of Commerce and other relevant agencies were

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collectively researching whether, and to what extent, the VIE structure should be regulated. This notably vague and brief comment was issued just days after rumors began spreading in the Chinese market that China's securities regulator was applying pressure on the government to restrict VIE schemes.

In addition to potential enforcement action at some point, investors need to assess carefully certain related risks that are inherent in the structure. The contractual arrangements that are the foundation of the VIE structure are infinitely more tenuous than outright ownership. Without direct shareholder rights and, thus, the ability to effect changes at the board and management levels, operational control of the VIE is not absolute, particularly if the VIE decides not to perform its contractual obligations under the VIE agreements with the offshore holding company. Enforcement of the VIE's obligations would likely involve substantial cost and would be subject to the legal remedies available under Chinese law, which may not be sufficient or effective. Furthermore, the regulatory uncertainty regarding the validity of the VIE contracts may impact the willingness of a court to enforce them.

Companies employing the VIE structure are certainly aware of the various risks they face, as they routinely include a specific risk factor in their securities filings describing the potential issues. For example, Renren's offering document filed in April 2011 included the following warning: "If the PRC government finds that the agreements that establish the structure for operating our services in China do not comply with PRC governmental restrictions on foreign investment in internet businesses, or if these regulations or the interpretation of existing regulations change in the future, we could be subject to severe penalties or be forced to relinquish our interests in those operations."

Buddha Steel

In March 2011, Buddha Steel, a China-based company that went public in the U.S. by means of backdoor listing (*i.e.*, a reverse merger with a U.S. shell company), withdrew its registration statement for a U.S.$38 million underwritten public offering in the U.S. The company stated in a press release that they were advised by local governmental authorities in China's Hebei Province that their VIE agreements "contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy." (The fact that this challenge arose at the local rather than national level itself is indicative of a trend in China toward increased power and autonomy of local governments, which is further discussed below.)

Since this case occurred, lawyers, scholars, and other observers have been debating whether this marks the beginning of the end for VIEs or was a more limited attack, possibly targeted at the particular industry, reverse merger companies, or other unique circumstances. One arguably distinguishing factor in the Buddha Steel case is that the company is not engaged in an asset-light business such as the internet. A handful of internet companies with VIE structures have successfully completed U.S. initial public offerings in the months following the Buddha Steel case, including 21Vianet Group, an internet data center operator, and Renren, commonly referred to as China's facebook.

Alibaba/Alipay

However, even among asset light internet businesses, VIEs are not completely immune. Another curious incident was revealed in May 2011 as the events surrounding Alibaba and the disappearing act of Alipay unfolded. The situation developed when Yahoo Inc., a major shareholder of Alibaba, revealed in a regulatory filing that unknown to them, Alibaba had transferred the assets of its leading online payment unit, Alipay, to a Chinese company controlled by Alibaba's chief executive and acclaimed entrepreneur Jack Ma.

According to Alibaba, in response to a recent PRC regulation enacted by the Chinese banking authorities, which stated that only domestically-owned enterprises can obtain licenses for operating third-party payment systems, Alibaba decided to transfer Alipay to a Chinese company owned by Jack Ma with which Alibaba had a VIE arrangement. However, Alipay was still unable to obtain the license from the banking authorities due to its VIE ties with the partially foreign-owned Alibaba. Alibaba then terminated the VIE

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The contractual arrangements that are the foundation of the VIE structure are infinitely more tenuous than outright ownership. ...Furthermore, the regulatory uncertainty regarding the validity of the VIE contracts may impact the willingness of a court to enforce them.

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contracts, essentially breaking the ties between Alibaba and Alipay, and de-consolidating Alipay from Alibaba's financials.

Mr. Ma said that he believed terminating the VIE contracts was the right decision given that the VIE structure remains unapproved by the Chinese government and that Alipay could not otherwise acquire the necessary license to enable it to operate legally. Yahoo claimed that the transfer of Alipay to Mr. Ma's private company was not approved by Alibaba's board and was not disclosed to Alibaba's investors until March 2011.

Four months after the dispute arose, Yahoo and Alibaba resolved the issue in a deal that at the moment appears to have appeased all parties, guaranteeing Alibaba a $2 billion to $6 billion payment upon the occurrence of a liquidity event by Alipay, such as an initial public offering. Alipay has also secured the necessary license.

Implications/Conclusion

While the Buddha Steel and Alipay situations may not definitively foretell VIEs' fate, they certainly highlight the need for foreign investors to understand, and Chinese regulators to clarify and address, the risks associated with investments using the VIE structure. These cases serve as a clear reminder that the risks associated with VIE's (and similar legal "gray areas" in China) should not be underestimated.

Although it is still too early to tell whether the Chinese government will enact regulations systematically prohibiting VIE structures, there may well be increased scrutiny of these companies, perhaps by local authorities, as was the case in Buddha Steel. The growing independence of local governments clearly increases the risk that these structures, which Beijing seems to have largely accepted, might be challenged, and that different rules will apply depending on which local government is overseeing the particular company. In light of the significant attention the Buddha Steel and Alipay cases received, and the recent comments by the Ministry of Commerce, the Chinese government will hopefully move to address the uncertainty surrounding the validity of VIE structures by simply clarifying the legal status of VIE's, but unless and until that occurs, investors in these structures will have cause for concern.

The Buddha Steel and Alipay cases indicate that the Chinese government may completely ban the use of VIE structures in certain sectors. With respect to Buddha Steel, it should be noted that China is the world's largest steel producer and consumer, and almost all major Chinese steel producers have some government ownership. It is not surprising then that China has heavily regulated its steel industry, a key pillar of its economy, and may, therefore, be sensitive to how companies like Buddha Steel are structured and to the extent of foreign involvement. Likewise, the government's regulation of online payment platforms like Alipay, which led to Alibaba spinning off the company, could be considered consistent with the government's considerable oversight of its banking industry. While China is still developing the legal framework governing the online payment industry, the industry's involvement with the sensitive financial and banking sector certainly makes it a likely target for heightened government scrutiny.

Foreign investors who are involved in any VIE arrangements should carefully assess the related risks with experienced counsel, particularly if the company is involved in a sensitive or highly-regulated industry in China. Even though there are many successful asset-light internet companies whose VIE structures have not been challenged, the Alipay case and the recent comments by the Ministry of Commerce demonstrate that even asset-light structures are not bullet proof. It is too early to tell whether and when the Chinese government will start to regulate VIEs. Investors in China should keep an eye out for further developments, if only to honor the Chinese adage that warns 空穴来风未必无因 ("the wind does not blow from a cave for no reason," which roughly translates as "where there is smoke there may be fire"). Foreign interest and involvement in China will only increase as China continues its rise as a major world player, and it will be more important than ever for foreign investors to proceed with caution as they take advantage of the many opportunities China has to offer. ■

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It seems unlikely that the Chinese government will enact regulations systematically prohibiting VIE structures, but there may well be increased scrutiny of these companies....

Rehoboth Beach Reading: Catching Up on Delaware Cases

On the off chance that your summer beach reading did not involve plowing through a stack of opinions of the Delaware Court of Chancery, we offer this brief review of cases decided over the last year or so that are likely to be of interest to the private equity community.

Three of these cases review the conduct of target company directors under the *Revlon* doctrine, which imposes upon directors a duty to seek the best price reasonably available in a change of control transaction. Those cases are Dollar Thrifty, which reviewed the Dollar Thrifty board's decision to sign a merger agreement with Hertz, including deal protection provisions, without giving Avis a chance to bid; *Forgo v. Health Grades*, which looked at the Health Grades board's decision to agree to a sale to a private equity sponsor without a pre-signing market check, and *Del Monte*, which discussed the process leading up to Del Monte's sale to a consortium of private equity sponsors. Taken together, these cases show that while Delaware courts give broad latitude to target boards in structuring a sale process, they take a closer look when the buyer is a financial sponsor, particularly in the absence of a pre-signing market check.

The other two cases cover areas that have long been fertile ground for M&A litigation: the *Airgas* case, which arose from Air Products' long and ultimately unsuccessful takeover battle for Airgas, considered whether a board can use a poison pill to "just say 'no'" to a fully financed cash tender offer made to well-informed target stockholders; and *Krieger v. Wesco Financial Corp.*, which arose from a going-private transaction between a publicly traded company and its controlling stockholder, which discussed the standard of scrutiny applicable to such a transaction when there are robust procedural protections for the minority stockholders. ■

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Case	What It Held	Why It Matters
Dollar Thrifty (Del. Ch. Sept. 8, 2010)	Dollar Thrifty's directors did not breach their Revlon duties by signing a merger agreement with Hertz without trying to induce Avis to make a higher bid or by agreeing to include deal protection provisions in the merger agreement	• Affirms concept that Revlon does not mandate an auction process, and that boards have broad discretion in structuring a sale process • Acknowledges that boards can consider risk of non-completion (including antitrust risk) in determining whether an offer is superior
Forgo v. Health Grades, Inc. (Del. Ch. Sept. 3, 2010)	Vestar tender offer for Health Grades allowed to proceed, but plaintiffs showed reasonable probability of success in proving their Revlon claim given exclusive sale process	• Suggests that courts will look more closely at an exclusive process resulting in a sale to a PE sponsor • Reinforces idea that while they have broad discretion, boards need sound reasons for selecting a particular sale process
Air Products & Chemicals v. Airgas (Del. Ch. Feb. 15, 2011)	Airgas directors did not breach their fiduciary duties by refusing to dismantle a poison pill in the face of an all-cash, fully-financed and non-discriminatory tender offer by Air Products	• Reminds that directors, and not stockholders, have authority to manage the corporation • Upholds idea that companies can 'just say 'no'"—under the right circumstances
Del Monte (Del. Ch. Feb. 14, 2011)	Del Monte directors, aided and abetted by buyers, probably breached their fiduciary duties by failing to provide adequate oversight of sale process where two bidders were permitted to bid jointly and the target financial adviser conducting the sale both participated in buy-side financing and conducted go-shop	• Demonstrates that target's process problems can become buyer's problems • Highlights Delaware court focus on financial adviser conflicts and related disclosure (see also, *Art Technology Group, Steinhardt* and *Atheros Communications* cases)
Krieger v. Wesco Financial Corp. (Del. Ch. May 10, 2011)	Berkshire Hathaway's going-private merger with Wesco upheld under the business judgment rule, given duly empowered special committee and non-waivable majority-of-minority vote condition	• Proves that Vice Chancellor Laster is willing to review going-private deals under the deferential business judgment rule standard, if proper procedural protections are in place • Shows that the Delaware legal standard for going-privates remains unsettled, since other judges use different tests

GUEST COLUMN

Is Russia Ready for Serious Attention from Private Equity Investors?

Of all of the major emerging markets, Russia has the least developed private equity industry. Yet, it has significant potential for development in a variety of areas, ranging from health care to technology to financial services. And the much-heralded Russian Direct Investment Fund, a $10 billion vehicle, backed by the Russian government and advised by some of the biggest names in private equity, presents opportunities to co-invest alongside a government partner, which should provide a greater degree of comfort to foreign private equity firms investing in Russia for the first time. Debevoise's Geoff Burgess, Geoff Kittredge and Kristina Chapala Barker recently had an opportunity to speak with Alexander Pankov and Kirill Samsonov, the co-founders of the Russian Private Equity Initiative (RPEI, or the Initiative), to learn more about the burgeoning private equity industry in Russia, as well as the Initiative's role in fostering its growth through collaboration with government stakeholders and domestic and international industry participants.

RPEI was created in 2010 with the aim of facilitating the development of private equity industry in Russia. What are the primary goals of the Initiative?

RPEI's primary goal is to create a private equity industry in Russia, which is currently in its infancy and does not have a unified representative body or forum. There are only about ten major Russian private equity sponsors; limited partners of local origin do not invest in this asset class, and the country is still below the radar for most international investors. We decided we needed a collaboration in order to improve the image of Russian private equity, influence relevant legislation, and enable the flow of capital into Russian private equity funds.

Who are the current members of the Initiative?

The Initiative has been supported by all major players of this very small universe of GPs, including Baring Vostok Capital Partners, Alfa Capital Partners, Troika Capital Partners, NRG Advisers, DaVinci, and UFG Capital. And, we have a very strong commitment from a number of leading service providers and advisers in this area including law firms, large audit companies and management consultants. We also believe it is important, in this still very fragmented private equity ecosystem, to build relationships with government regulators, trade unions and associations representing both large corporations and small and medium enterprises, the entrepreneurial community in Russia, and different industry-related groups like the Russian Union of Insurance Companies and the Russian Association of Banks.

What measures/actions has RPEI initiated/commenced so far to promote Russia's image as a safe market for foreign investment relative to other emerging markets?

First, we cannot say that Russia is a truly safe, comfortable market for foreign LPs at this time, and our objective is not to position it that way. Rather, we wish to communicate to the broader global investor community that Russia is one of the most dynamic and fastest growing consumer markets in the world, with the largest consumer base in Europe and very attractive investment opportunities. We see no reason why the LP/GP structure, which has proven effective throughout the world, shouldn't work here.

With that message in mind, we decided that rather than focusing only on the local market, we should cooperate with private equity groups outside of Russia to bring foreign capital into this country. In March 2010, we co-hosted a

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We launched [the] Initiative to make [the PE] asset class more important, both in monetary terms and in terms of impact on the Russian economy... With [these] efforts and...the government's interest in attracting foreign capital and raising the profile of the Russian economy in general, we expect very dynamic growth in the Russian private equity industry in the next two to five years.

Is Russia Ready for Serious Attention from Private Equity Investors? (cont. from page 7)

seminar in London with the British Private Equity & Venture Capital Association on Russian private equity, and we hope to host similar events with other European, U.S. or Asian associations. This sort of marketing is a really important step in bridging the gap in perception of how the markets work and what Russian private equity is all about.

What measures have been taken by RPEI to improve the visibility and availability of exit information and performance data to make a case for Russian private equity investors' ability to deliver returns that outweigh the risks?

This is the primary mandate of the Initiative's information and statistic policy campaigning committee. Their goal is to increase the transparency of the Russian private equity market by creating a comprehensive database on the market, which simply does not exist today. We have teamed up with Thompson Reuters to conduct the first Russian private equity performance survey, pooling data from individual GPs, from the launch of their funds and their first investments to 2010. Our intent is to distribute the results to all major associations, large media companies and stakeholders in finance and private equity. Once we publish the data (in the fourth quarter of 2011, we believe), many people will realize that the Russian market is really overlooked. If you look at Baring's returns, for instance, you see stellar growth and stellar IRR, especially given their latest exit from Yandex, the largest online company in Russia and one of the largest in Europe.

How would you describe the current state of the private equity market in Russia, its role in the economy of the country and its outlook?

Although nearly 20 years of private equity investing is already behind us and there have been some visible results, given the size of the Russian economy and the many opportunities in the Russian market, private equity is still in its infancy compared to emerging markets such as Brazil, China, India, and Vietnam. The generally accepted estimate is that private equity investment as a percentage of GDP totals less than 0.1%, well below most other private equity markets in Europe, Asia and the Americas. We launched our Initiative to make this asset class more important, both in monetary terms and in terms of impact on the Russian economy, because the growth potential here is really phenomenal. With our efforts and with the government's interest in attracting foreign capital and raising the profile of the Russian economy in general, we expect very dynamic growth in the Russian private equity industry in the next two to five years.

In your opinion, what industries currently represent the greatest interest and potential for private equity investments in the region and will be the most active over the next 2-3 years for private equity investments and exits?

Historically, private equity firms have exploited opportunities in the consumer sector, and the recent credit crunch actually has not changed this strategy so far. One emerging sub-sector in the consumer space is definitely health care. The consumer class is growing, people are becoming more demanding in terms of the level of services rendered by health care institutions, and the state sector has no capacity to deliver this level of service to the public. So, we are seeing spectacular growth in private health care centers, such as diagnostic labs, private nursing homes, and general health care facilities, especially in large cities.

Another area would be specialty retail—in household goods, electronics, books, and other sub-segments, there are a lot of opportunities. The Moscow and St. Petersburg markets are fairly saturated, but in regions where the market is not consolidated, especially in Siberia and the Far East, unstructured retail is still very dominant—a lot of open-air markets and kiosks and other unstructured formats—so on this front there is a lot of potential.

Given the ambitions of our authorities to create an international financial center here, the financial services market will definitely be given an additional boost.

Finally, another promising and young industry is technology. There are already some major success stories, including Yandex, the largest online search engine in Russia, and Kaspersky, a very high profile antivirus software developer with a minority stake owned by General Atlantic.

What do you think are the main concerns and challenges that deter international private equity investors from investing in Russia?

The most significant challenge is the perception. It is not really the state of the industry, because while it is new, it is developing rapidly and presents some great opportunities to explore. But there is a lot of negative foreign press around Russia in general. Very few success stories are really communicated to the investor community. Most people have heard about DST, mail.ru and now Yandex, but there are a lot of other interesting cases like Pepsico, McDonald's, Ford, Coca-Cola, UniCredit, and Ikea (in terms of profit per square meter, Ikea Russia is the most successful unit of Ikea globally), but very few people recognize how successful strategic players are in Russia. Of course

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Doing Business in the UK Under the Newly-Enacted Bribery Act

The much-heralded UK Bribery Act of 2010 (the "Act") has finally become effective. It is a sweeping law that reaches companies around the world and criminalizes the offer, provision and acceptance of bribes, both to public officials and, importantly, and in contrast to the United States Foreign Corrupt Practices Act ("FCPA"), to private individuals. The Act also imposes criminal liability on commercial organizations (including private equity firms) for the new offence of failure to prevent bribery by an associated person—the so-called "corporate offence." It is, therefore, crucial that private equity firms (and their portfolio companies) consider whether they could be liable under the Act, and take appropriate steps to protect themselves.

We previewed the Act in the Summer 2010 *Debevoise & Plimpton Private Equity Report*. That report described in detail the offences under the Act, the Act's global assertion of jurisdiction, and the defence of "adequate procedures." Since then, the UK government has released further guidance regarding the Act, and Debevoise has hosted a round table between leading members of the private equity industry and Richard Alderman, the Director of the Serious Fraud Office ("SFO"), the chief prosecutor of the Act. As a result, our understanding of how the Act will affect private equity firms and their portfolio companies in practice has been greatly enhanced.

Jurisdiction

The test of whether an act outside the UK is subject to the Act varies according to the particular offence. In relation to the corporate offence, it applies to companies and partnerships "carrying on business" or a "part of a business" in the UK. The UK Ministry of Justice has stated in guidance that this would make firms with a "demonstrable business presence" in the UK subject to the Act's jurisdiction. Therefore, private equity firms or portfolio companies that are organized in the UK or that engage in the following types of activities are well-advised to consider their exposure as they may be subject to the Act:

- Operating an office in the UK;
- Regularly holding business meetings in the UK;
- Fundraising in the UK; or
- Having a UK-organized subsidiary or one that itself carries on business in the UK (unless the subsidiary acts entirely independently of the parent).

It is clear that many private equity firms are likely to be subject to the Act. For example, a firm with portfolio companies that have operations in the UK would be subject to the Act, unless the firm has no, or minimal, control or influence over the portfolio companies (which is unlikely to be the case other than where the firm holds a minority stake).

If a firm is subject to the Act, there are four particular areas of focus: (1) corporate hospitality; (2) intermediaries; (3) responsibility for activities of portfolio companies; and (4) individual employees' responsibilities.

Corporate Hospitality

Prior to the Act's implementation, there was great concern that it would ban or severely limit corporate hospitality, particularly since the Act, unlike the FCPA, criminalizes commercial bribery as well as bribes of government officials (so-called Foreign Public Officials or "FPOs"). The concern was particularly acute with respect to hospitality offered to FPOs, given that Section 6 of the Act criminalizes the offering, promising or giving of a financial or other advantage to an FPO, even absent any intent to induce the improper performance of his or her duties.

The government has assured the public that reasonable and proportionate business hospitality is acceptable if it is for a legitimate business purpose, such as better presenting a company's products or services, improving its image or creating or maintaining cordial relations with contacts. Industry norms are relevant, although spending that is too lavish or extravagant may lead to an inference of attempts to improperly influence the recipients.

Companies may take account of what business contacts expect. For example, Director Alderman has stated that flying a senior individual from a sovereign wealth fund business class and putting him or her up in a good hotel would not be problematic—though putting him or her up for a month with family would be. In sum, hospitality is fine, but it must be sensible; one rough test that has been suggested is whether it would cause embarrassment if it were to be disclosed on the front page of the *Financial Times* or *The Wall Street Journal*.

Private equity firms are strongly advised to review their corporate hospitality policies and practices, and, in particular, to ensure that corporate entertainment (particularly at large-scale events, like investor conferences) is reported and tracked, and can always be justified from a commercial point of view.

Intermediaries

As a general matter, the most common circumstance in which companies fall foul of anti-corruption laws is when intermediaries, particularly, but not solely, those hired to do business with governments on a company's behalf, pay bribes. Private equity firms must take care

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to guard against such dangers, especially as regards intermediaries dealing on their behalf with sovereign wealth funds or public pension funds.

Best practices should include a threefold approach to the hiring of intermediaries. *First*, thorough due diligence should be carried out (and documented) in order to understand who the intermediary is, what services it will provide, and how it will provide the services. *Second*, contracts with intermediaries should include appropriate safeguards, such as representations and covenants against improper payments; audit rights and termination clauses are also particularly important. *Third*, firms must monitor and oversee intermediaries' activities, and must continually satisfy themselves that they know exactly what they are paying for. These practices may be no different from those generally applied to guard against FCPA risks, but the fact that the activities of intermediaries may now be scrutinized by the SFO, in addition to the U.S. authorities, raises the stakes considerably.

Responsibility for Portfolio Companies

Possibly the most important and complex question for private equity firms arising from the Act is whether a firm's portfolio company is an "associated person," thus making the firm itself liable for improper actions of the portfolio company. The answer remains unclear, though it will depend on the circumstances and the precise relationship between the sponsor and the portfolio company.

As Director Alderman stated at the round table: "*If this is simply a portfolio investment and your role is simply one of owners, then employees and agents of the company are not performing services for you [and are therefore not associated persons]. It could be different though if you were far more actively involved in the management of the company and were running it.*" The SFO assumes that most private equity firms are active and sophisticated investors who know what is happening in their portfolio companies. This does not, however, mean that wrongdoing at a portfolio company will automatically be attributed to a private equity firm that owns a majority of it. Where the private equity firm did not know about the problems, the SFO will be unlikely to ascribe responsibility to it (although the portfolio company itself would of course still have a problem). In addition, holding a firm responsible for a bribe paid by a third-party agent of a portfolio company might be difficult given the Act's requirement that such payments be made in order to obtain or retain business or a business advantage for the private equity firm itself (rather than solely the portfolio company in question).

Nonetheless, the SFO will expect private equity firms to take some responsibility for good governance at their portfolio companies, including fostering an anti-corruption culture. Where possible, this would include reviewing, and, if necessary, revising or instituting, anti-corruption policies at portfolio companies. Where that is not possible, firms should use their position of influence to recommend that such actions are taken. If a firm finds that a portfolio company has followed or intends to follow an improper course of conduct, and is refusing to halt or remediate that activity, the private equity firm's directors should seek counsel on whether it is appropriate for them to stay in office.

In order to minimize the risk of facing such situations, private equity firms should ensure that their standard pre-investment due diligence includes a well-resourced, well-considered, fully documented compliance review. The SFO has offered to provide guidance to companies that discover corruption problems during such pre-acquisition due diligence.

Individuals' responsibility

Finally, private equity firm employees, especially those who sit on the boards of portfolio companies, should be aware that section 14 of the Act provides that they will be individually and criminally liable if they consent to, or connive in, bribery at the portfolio company. Note that to "connive" is to be aware of what is going on and to provide tacit agreement even though there may be no active encouragement; "consenting" requires a somewhat greater level of involvement. Such employees, therefore, have an even greater incentive to ensure that portfolio companies have a robust anti-bribery culture.

Conclusion

Taking appropriate action on all of the above measures would go a long way towards the implementation of the "adequate procedures" envisioned by the Act, which would provide private equity firms with an absolute defense if problems ever do arise at a firm, a portfolio company or through any other associated persons. Private equity firms with any connection to the UK should consult with their legal advisors to determine whether the Act applies to them, and if so, should move quickly to establish such measures. ■

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Boosting EBITDA: The Cost Savings Add-Back

The recent performance of the financial markets obviously engenders some uncertainty as to the near-term health of the credit markets. But, assuming that negotiation of a credit agreement will not become a lost art, we will discuss in this article a crucial aspect of that negotiation, which are the various adjustments that a sponsor's portfolio company can make to net income in order to compute EBITDA. These adjustments always command a great deal of attention and discussion in the course of negotiations of leveraged acquisitions, as the impact of various events and circumstances can have a significant impact on EBITDA (particularly in the current ecomomy) and, thus, on a portfolio company's ability to meet applicable financial tests under their credit agreements.

One such adjustment that has been a particular focus of attention even prior to the recent dislocation in the financial markets is a *pro forma* add-back for cost savings—specific events that reduce the expenses of the borrower on a recurring basis and, therefore, can have a positive impact on net income under credit agreements providing for such add-backs. This article focuses on this type of add-back to EBITDA and contrasts it with two other common adjustments to net income under credit agreements in the leveraged acquisition context: the add-back based on permitted acquisitions or dispositions and the add-back for business optimization expenses or restructuring charges.

Distinguishing the Cost Savings Add-Back from Other Add-Backs

An add-back to EBITDA based on a cost savings program shares some features with, but is different from, the add-back based on permitted acquisitions or dispositions and the add-back for business optimization expenses or restructuring charges.

Cost Savings Versus Permitted Acquisitions or Dispositions

Credit agreements often permit a borrower to adjust its EBITDA to account for the EBITDA of an entity acquired by the borrower or of a line of business sold by the borrower. This adjustment sometimes makes it possible to take into account anticipated costs savings or synergies resulting from the relevant acquisition or disposition.

The main difference between that adjustment and a cost savings add-back is the trigger. In its most open ended form, a cost savings based add-back is available as a result of any specific action or operational change that can lead to ongoing expense savings for a borrower and does not require that such change be connected in any way to the acquisition or disposition of a business. For instance, cost saving add-backs could consist of recurring savings associated with the elimination of employee redundancies, the closure of a plant, the implementation of a change in the supply chain or any other operating improvement. Actions of that sort are more solely within the control of a borrower than an acquisition or sale of a business, which necessarily involves a third party. A cost savings-based add-back to EBITDA can accordingly be a very attractive provision in a credit agreement, particularly for portfolio company borrowers that expect to attain business improvements principally through internal change instead of, or in addition to, activity in the M&A market.

While differing in this way, the two add-backs share a key feature: both adjustments are typically made on a *pro forma* basis.

Financial covenants—such as a leverage ratio, an interest coverage ratio or a fixed charge coverage ratio—are typically calculated using inputs that are derived from the financial statements of the borrower—*e.g.*, indebtedness, EBITDA, interest expense, and fixed charges. Credit agreements typically define the test period over which EBITDA and other items, such as interest expense or fixed charges are measured, often a rolling four quarter period (which may include an annualization mechanic for the first few quarters). In all cases, because EBITDA and other items are determined over an entire test period, events that occur towards the end of the test period may have a relatively modest impact on EBITDA or the relevant item for the period, and events that occur after the test period will have no impact at all. *Pro forma* adjustments, however, enable borrowers to treat certain events as if they had occurred at the beginning of a test period, thereby giving effect to such events for the entire test period regardless of when they actually occurred. In the context of an acquisition, this approach allows a borrower to add to its own EBITDA the EBITDA of the acquired entity for the entire test period as if the acquisition had been consummated as of the first day of such period, regardless of when the acquisition actually closed in that period. In the context of the sale of a business, this enables the borrower to back out from its EBITDA calculation for the entire period the EBITDA of the line

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of business that was sold (that is, for the period of time prior to the sale when the business was still owned by the borrower), thereby improving EBITDA to the extent the business that was sold was generating negative EBITDA.

The add-back for cost savings operates in the same manner: the borrower can be allowed to add back the relevant cost savings on a *pro forma* basis as if the relevant action or program that triggered the savings had been taken at the beginning of the test period in question.

Cost Savings Versus Business Optimization Expenses and Other Restructuring Charges

Business optimization expenses and restructuring charges—such as one time costs associated with (1) inventory optimization programs, costs relating to closure or consolidation of facilities, (2) retention, severance or relocation costs, (3) system establishment costs and (4) excess pension charges—reduce net income for the period during which they are incurred. Under certain credit agreements, borrowers may be permitted to add back these expenses to EBITDA under a separate, general add-back for "extraordinary, unusual or nonrecurring items." Credit agreements also sometimes include a specific add-back for business optimization expenses and other restructuring charges of this kind. Such a specific add-back eliminates the need to analyze whether or not the relevant expenses are of an "extraordinary, unusual or nonrecurring" nature.

Importantly, this type of add-back is not applied on a *pro forma* basis. Rather, these one-time expenses are added back to net income so that the relevant expenses do not impact the EBITDA calculation. So, the add-back provides no benefit beyond neutralizing the impact of the relevant expenses. Put differently, the one time expense is simply ignored for purposes of the EBITDA calculation. By contrast, an add-back for recurring cost savings of the type described above enables a borrower to increase EBITDA by enabling the borrower to go back in time and give effect to a cost savings program with respect to the test periods prior to its implementation.

The distinction between a cost savings based add-back to EBITDA on a *pro forma* basis as compared to the add-back for business optimization and other restructuring charges is illustrated by an employer's rationalization of its work force. The one-time severance, retention and relocation costs potentially associated with such a rationalization may constitute "extraordinary, unusual, and non-recurring items" and, depending on the credit agreement in question, can be eliminated from the calculation of a borrower's EBITDA as of the date incurred. In contrast, the recurring cost savings associated with the lower labor cost and other potential synergies associated with the same rationalization can, again depending on the credit agreement in question, potentially be added back on a *pro forma* basis from the beginning of the applicable test period, thereby increasing a borrower's EBITDA for the test period not just neutralizing such cost.

Types of Permitted Adjustments

The type of action or cost savings plan taken into account for a cost savings add-back is rarely defined with specificity.

The Regulation S-X Standard

Credit agreements sometimes try to limit permitted *pro forma* adjustments to those that would be permitted or required by Regulation S-X under the Securities Act of 1933, as amended ("Regulation S-X") or that are based on assumptions approved by the Administrative Agent. Effectively, this would give the Administrative Agent control over all *pro forma* adjustments that go beyond the Regulation S-X standard. The relevant provisions of Regulation S-X describe the circumstances in which *pro forma* financial statements should be presented in filings in the context of business combinations, acquisitions and dispositions and provide guidance to be considered in their preparation. Rule 11-02(b)(6) contemplates that *pro forma* adjustments to the income statement shall include adjustments that give effect to events that are "(1) directly attributable to the transaction, (2) expected to have a continuing impact on the registrant, and (3) factually supportable." By way of example, infrequent or nonrecurring items included in the underlying historical financial statements of a registrant or other combining entities and that are not directly affected by a transaction should not be eliminated in arriving at *pro forma* results.[1]

Limiting the *pro forma* adjustments by reference to Regulation S-X would considerably narrow the universe of possible adjustments. Indeed, under Regulation S-X, the *pro forma* financial information should illustrate only the isolated and objectively measurable (based on historically determined amounts) effects of a particular transaction, while excluding effects that rely on highly judgmental estimates of how historical management practices and operating decisions may or may not have

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[1] *Division of Corporation Finance's Financial Reporting Manual, Section 3230.4.*

Brick by Brick:

A Primer for Due Diligence in Each BRIC Country, Continuing with India

Our four-part series on doing due diligence in the world's largest emerging markets, now known colloquially as BRICS, continues in this issue with a discussion of India.

Some of the themes that we have explored in the first installment of this series, covering China, are equally relevant in India. For instance, tangled related party transactions and a general lack of familiarity with, and reluctance to be subjected to, the due diligence process also feature prominently in India. On the other hand, Indian targets often present additional challenges, including assessing complex and costly litigation risks and sorting through Byzantine land title issues. At the end of the day, performing business, legal and accounting due diligence in India starts with an appreciation of the unique characteristics of many Indian businesses.

Due Diligence Process

- *Familiarity with due diligence process and requirements:* While there is no statutory definition of "due diligence" in India, contracting parties are expected to exercise diligence while entering into a contract, and the law does not enable a party to avoid a contract on account of a fraudulent misrepresentation if the aggrieved party had the means of discovering the truth with "ordinary diligence." Public companies in India are familiar with the due diligence process since Indian securities laws require them to disclose certain information to the Securities Exchange Board of India. Private companies need much more guidance and are less willing to share information with outsiders. In fact, it is not uncommon for private companies to stage the availability of documentation, such that the most sensitive materials (whether related-party transaction documentation or otherwise) are provided only at the end of the process, and sometimes in a very limited format. This access might consist solely of having materials shown for a fixed period of time to local counsel only, without the ability to make copies or even to take notes!
- *Internal organization:* Indian businesses are mostly promoter led and family controlled and usually have their in-house legal, compliance and accounting-related work being handled by a single department. Information and knowledge regarding company matters are generally centralized (since the owners retain tight control), but it can still take companies some time to gather such information. Companies also routinely rely on chartered accountants to take care of corporate formalities. This can create issues with corporate records, such as board or shareholders' meeting minutes, as well as the registry of share ownership and transfers.
- *Availability of public search resources:* Database searches, such as litigation and lien searches, that are widely consulted in the due diligence process in western countries, are not available in India. Coupled with the broad geographical span of the country, the various levels and hierarchy of courts and tribunals, the overlapping, but limited, jurisdiction of various courts makes it an uphill battle to track such information online. Courts in India have recently starting making decisions available online, and there are initiatives to make land records available on the internet as well. However, these efforts are in a nascent stage and do not currently ensure that the information is accurate or comprehensive.

Business Due Diligence

- *Foreign investment restrictions:* Foreign Direct Investment (FDI) into India is governed by, among other things, the FDI policy of the Government of India, and the inflow and outflow of

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While foreign investors are permitted to own 100% of businesses in most sectors..., certain critical sectors (such as defense, telecom, insurance and energy) are subject to foreign ownership caps and restrictions, and prior approval from the Government of India or registration and approval from the RBI is required before investing in these sectors.

A Primer for Due Diligence in Each BRIC Country (cont. from page 13)

foreign capital is regulated by the Foreign Exchange Management Act, 1999. While foreign investors are permitted to own 100% of businesses in most sectors and can invest via the "automatic route," which does not require prior approval by either the Government of India or the Reserve Bank of India (RBI), certain critical sectors (such as defense, telecom, insurance and energy) are subject to foreign ownership caps and restrictions, and prior approval from the Government of India or registration and approval from the RBI is required before investing in these sectors. In addition, wholly-owned Indian domestic subsidiaries of non-resident entities are treated as foreign companies for FDI purposes.

- *Licenses and approvals:* Companies operating in India must navigate an exceedingly complex bureaucracy and a regulatory system with seemingly ambiguous and imprecise rules. Each sector has its own list of licenses and approvals that are required from both the central and state governments. Usually, a financially stable company that has been in business for a while will have its licenses and approvals in order, but there are many companies that do not.

  The undue red tape linked to doing business in India has prompted the World Bank to rank its economy 135th out of 183 world economies for "ease of doing business." In response, the Government of India and various state governments have recently been aggressively trying to remove regulatory logjams by creating "single window clearances" for setting up businesses in various non-critical sectors. These initiatives to more streamlined approvals should be particularly helpful to companies operating in the infrastructure sector, where development permits take more time than expected to obtain, if they can be obtained at all.

- *Corruption:* Corruption remains a challenge of investing and doing business in India. The risk is higher in business sectors that operate under governmental concessions or authorization (sectors such as real estate, infrastructure, telecom and power). It should be noted that many large companies in India are State-owned or controlled, and, therefore directors and employees of such companies are deemed to be "government officials" under the Foreign Corrupt Practices Act and the UK Bribery Act, with the result that payments made to them fall within the laws' restrictions.

- *Corporate governance:* Newly-listed companies in India and public companies above a certain prescribed size have to comply with the listing agreement of the stock exchanges, which imposes certain U.S.-style independent director and audit committee requirements. However, the reality is that independent directors do not play the type of proactive role that has become more common in the United States and the UK, and are very rarely willing to present conflicting viewpoints from those favored by the promoters. Importantly, private companies are under no obligation to install any corporate governance mechanisms.

Legal Due Diligence

- *Litigation:* India has the world's largest backlog of cases with over 30 million proceedings pending before the courts. It is estimated that an average lawsuit takes 15 years to get resolved in India. When investigating pending litigation of the target company, foreign investors should keep in mind the potential delays and the costs of such delays (litigation related legal costs are relatively high when compared to other countries, including even the U.S.), as well as the unpredictability of court decisions. It is worth noting, however, that India does have a good arbitration law, which is drafted along the lines of the UNCITRAL model and most companies typically include an arbitration clause in their business agreements.

- *Labor laws:* There are over 50 laws at the national level and several more at the state level that govern and regulate the Indian labor market. These laws

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When investigating pending litigation of the target company, foreign investors should keep in mind the potential delays and the costs of such delays.... India has the world's largest backlog of cases with over 30 million proceedings pending before the courts. It is estimated that an average lawsuit takes 15 years to get resolved in India.

Brazilian Private Equity Funds: Current Developments

As previously reported in this publication (see, *"Coming to Brazil: The World Cup, The Olympics and More Private Equity,"* Spring 2010 *Debevoise & Plimpton Private Equity Report*), Brazil has become an increasingly popular destination for private equity fundraising and investment. Events since that article was published certainly indicate that the trend is continuing. The latter part of 2010 and the first half of 2011 witnessed successful closings of several Brazil-focused funds with commitments exceeding $1 billion, and sources indicate that other funds in the capital-raising stage are seeking upwards of an additional $10 billion. The sponsors of these funds include both established and relatively new Brazilian private equity firms, as well as U.S.-based and international sponsors expanding operations into the country.

The factors driving private equity interest in Brazil, such as the consumer spending potential of its large and increasingly affluent population, its rich commodity resources, and stable democratic government, and the relative maturity of its capital markets, remain compelling to many investors even as the broader world economy falters. Two recent trends in fundraising are of particular interest. First, it is becoming increasingly common for Brazil-focused funds to raise capital both in Brazil and internationally, using separate vehicles for Brazilian investors. In these cases, it is important for sponsors to understand the potentially significant differences in expectations of Brazilian investors as compared to international limited partners. Second, certain broader macroeconomic trends in Brazil have attracted investor attention as of late and have begun to be reflected in the negotiation of fund terms, paramount among these being inflation and the fluctuation of the Brazilian real against the U.S. dollar.

Brazilian Investor Considerations

Although Brazil has a relatively long-standing history of domestic private equity funds, the terms that Brazilian investors have historically commanded have not fully converged with the terms prevalent in the international funds market. This discrepancy is partly driven by regulation and partly by market practice. The differences are especially pronounced with respect to Brazilian pension fund investors in the area of fund governance. Brazilian pension funds generally require investor representation on fund investment committees, which gives investors the ability to influence, and perhaps even block, investments and exits. Rights of this nature are extremely rare in international funds. Sponsors seeking capital from Brazilian pension funds will not only need to get comfortable with such arrangements themselves, but they will also need to ensure that the non-Brazilian limited partners are ready to relinquish some investment control to other investors.

For this reason, among other tax and regulatory motives, it is typical that Brazil-focused funds create separate investment vehicles for international investors and Brazilian investors, so as to allow greater flexibility of operation in the fund designed for the international investors. As Brazilian fund sponsors have had increasing success raising money on the global stage, some firms have attempted to move away from taking commitments from local pension funds in order to avoid these requirements; it remains to be seen whether this bias will prompt the Brazilian pension funds, with their significant investment power, to move towards accepting more standard international fund terms.

Effect of Inflation and Currency Movements

The rate of consumer inflation in Brazil, presently running between 6% and 7%, is considered high, even for developing economies. Brazilian government efforts to control inflation have relied mostly on interest rate increases, and the base interest rate in Brazil (SELIC), currently at 12% (recently cut from 12.5%), remains among the highest in the world. High interest rates, combined with the continued financial torpor and low yields in developed economies, make Brazil particularly susceptible to speculative "carry trades" in which money is borrowed in foreign currencies at low interest rates and then converted into reais and invested in Brazil at high interest rates.

These infusions of capital have had the effect of causing the Brazilian real to appreciate, which in turn lifts asset prices and limits to some extent the anti-inflationary effects of increased interest rates. Because appreciation of the real has serious implications for Brazil's manufacturers and exporters, the government has sought to control the appreciation by periodically purchasing dollars in the market and increasing the tax on currency conversions (*Imposto sobre Operações Financeiras*, or IOF) with respect to fixed income investments with terms of less than two years, in an attempt to discourage "speculative" foreign investment.

Such inflation, currency fluctuations and capital controls may enter into investor negotiations and affect fund terms in a number of ways, as outlined below.

Tax on Currency Conversions. As described in our previous article, the most common structure for private equity funds investing in Brazil is the *Fundo de Investimento em Participaçoes* (FIP), which

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Brazilian Private Equity Funds: Current Developments (cont. from page 15)

permits foreign investors to invest in the equity of Brazilian companies and exit without capital gains taxes, so long as certain requirements are met. Although exempt from capital gains taxes, investments from outside Brazil into a FIP are subject to the IOF. The IOF tax rate on FIP investments was raised (as it turned out, temporarily) from 2% to 4%, and then again to 6%, in October 2010. These increases caused consternation among investors and sponsors, because the IOF is an upfront cost that is borne prior to any actual investment being made. At a 6% IOF, $100 is drawn from investors, but only $94 can be invested, requiring investment appreciation of more than 6% solely to reach a "break-even" point. It is as if Brazil imposes its own hurdle rate.

Fortunately, the IOF rate for FIPs was reduced to 2% in December 2010, a level viewed as sustainable given the attractive returns available in Brazil. Private equity investors were also reassured by the fact that the reduction in the rate applicable to FIPs was announced as part of a larger package designed to encourage long-term foreign investment in Brazil, considered necessary and desirable for the country's economic development, as distinguished from the "speculative" short-term investing blamed for the real's appreciation.

Some sponsors have questioned whether the IOF should be treated as a fund expense for purposes of the fund distribution waterfall, since the fund's investors would have incurred that tax in any event had they invested directly in Brazil. As an alternative, the IOF could be excluded from the investor's capital base for purposes of determining distributions by the fund, which has the effect of enabling the sponsor to earn carried interest earlier. Although treatment as a fund expense appears to be the more common approach, negotiation around this point is likely to persist.

Currency Movements. The appreciation of the real has been widely discussed, and controlling it remains a primary focus of the Brazilian government. After a protracted period of appreciation against the U.S. dollar, the real has recently given back some of its gains in response to the recent cut of the SELIC rate (the Brazilian Central bank's overnight lending rate) and measures adopted by the government to reduce currency speculation in the derivatives market. Funds organized solely for Brazilian investors are, of course, not directly sensitive to dollar/real currency fluctuations, as they are denominated in reais. However, funds targeting international investors typically have their commitments expressed and funded in dollars. These funds must convert the dollars received from investors into reais to acquire investments, and again from reais into dollars to make distributions to investors when investments are sold.

Currency movements can impact the sponsor's carried interest. If contributions and distributions under the fund distribution waterfall are measured in dollars, even though fund investments are in real-denominated assets, the carried interest will be affected by exchange rate fluctuations between the time of acquisition and disposition of investments. In other words, the carried interest effectively contains a "long" position in reais. Some investors feel that sponsors should not be compensated for currency movements if the real appreciates, while others worry that if the real devalues, sponsors may be disincentivized to maximize portfolio returns. In response, some Brazil-focused funds are seeing investor requests to compute the carried interest by measuring both contributions and distributions in reais, using the exchange rates prevailing at the time of contributions and distributions, to reduce the impact of currency movements on sponsor incentives.

Inflation. As our readers know, fund investors typically receive a "hurdle" return on invested capital prior to the sponsor receiving carried interest. The typical hurdle rate applicable to U.S. and European funds (8%) is also seen in Brazil-focused funds. However, recently, some investors have questioned whether the hurdle rate should be adjusted to reflect the relatively higher inflation in Brazil as compared to developed economies. Again, this concern relates to whether sponsors are being rewarded for investment performance, as opposed to benefiting from inflationary value increases. A number of variations have been used to address this concern. One is just to raise the fixed rate, which has the benefit of simplicity, but may not adequately address the potentially significant variation in inflation rates over the life of the fund. Another approach is to use a base fixed rate that could be increased by a variable amount tied either to the Brazilian inflation rate or to the amount by which such inflation rate exceeds a fixed target level, measured over the fund's term.

Conclusion

The private equity fundraising market for Brazilian strategies is still hot. While it remains to be seen whether Brazil's tremendous promise will ultimately produce the high returns sought by investors, the focus of sponsors and investors on Brazil, and the negotiation of fund terms, will likely continue to intensify and new issues unique to the Brazilian market will likely dominate negotiations between sponsors and both Brazilian and foreign investors alike. ■

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ALERT

FTC Implements Revisions to the HSR Form

Recent amendments to the pre-merger notification regime under the Hart-Scott-Rodino ("HSR") Act have somewhat expanded the burden of compliance for private equity firms, but the FTC scaled back some of the most controversial changes, which had engendered strenuous objections. On August 18, 2011, the Federal Trade Commission ("FTC") implemented long-anticipated amendments to the Premerger Notification Rules and the Notification and Report Form (the "Form") that is used to report certain mergers and acquisitions under the HSR Act. While many of the FTC's modifications simplify preparation of the Form by removing outdated data and documentary requirements, others expand the burden of HSR compliance, especially for private equity firms.

These changes had been in the works for a long time. The FTC proposed numerous amendments to the Form on August 13, 2010. During the public comment period, the FTC received a number of comments (including from the Private Equity Growth Capital Council) objecting strenuously to certain of the changes. Following review of those comments, the FTC issued the final amendments, which scaled back and revised some of the more controversial amendments. The FTC has also indicated in subsequent meetings with practitioners that it will interpret the amended rules narrowly.

First, the good news. Welcome changes to the Form include elimination of the requirements to provide (1) copies of or internet links to certain SEC filings by the filing party and its controlled subsidiaries, (2) balance sheets for the filing party and its unconsolidated U.S. subsidiaries, and (3) "base year" revenue data by NAICS code. In addition, the amendment reduces the sometimes burdensome requirement to provide a list of all entities controlled by the filing party to those located in the U.S. or having sales in or into the U.S.

The less welcome changes include a requirement that private equity firms and others provide information about competitive overlaps between the acquired business and entities they manage but do not "control" for HSR purposes (*e.g.*, portfolio companies of affiliated funds), and a new Item 4(d), which somewhat expands the scope of documents previously required to be provided under Item 4(c).

Expansion of Information Requirement to "Associates"

Private equity firms and other investment management organizations, which previously reported information only about the particular fund (or other entity) making an acquisition and that fund's portfolio companies, are now required to report certain information about investments by other funds that are under common management. The revised Form includes requirements that the filing party provide limited information concerning "associates" that overlap competitively with the target, associates being defined as any entity (a "managing entity") that has the "right, directly or indirectly, to manage the... investment decisions" of an acquiring entity, as well as any entity that has its "investment decisions, directly or indirectly, managed" by the acquiring person or by its managing entity.[1] This change, which is intended to allow the antitrust agencies to analyze the holdings of entities that are under common investment management with the filing party, is specifically aimed at private equity firms and other capital management groups (such as master limited partnerships) whose investments are typically made through entities that are under common management, but not under common control because no investor owns more than a 50% interest. Under the HSR rules, which define "control" based on equity ownership, each private equity fund is generally its own "ultimate parent entity," because it is not "controlled" by any limited partner, general partner or manager. This means that a Form reporting an acquisition by one such fund (or its controlled portfolio company) previously did not include any information relating to other funds under common management or those funds' investments. Such information might be of obvious interest to the antitrust agencies where, for example, a portfolio company of a related fund is a competitor of the target in the reported transaction, or where a related fund already holds a minority

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1 *Although the revised HSR rules refer to management of "operations or investment decisions," the FTC has informed practitioners that it will narrowly interpret this rule to apply only to those having the power to direct investment decisions. Providing non-binding investment advice is not sufficient to make an entity or "associate."*

The FTC has separately clarified that an entity that is a general partner of a partnership or managing member of a LLC is always a "managing entity," but an individual who is a general partner of a partnership or managing member of a LLC will not be considered a "managing entity" unless there is a separate contract giving the individual the right to manage the investment decisions of the entity.

Alert: FTC Implements Revisions to the HSR Form (cont. from page 17)

interest in the target company.

Thus, the amendments impose new information requirements with respect to an acquiring person's associates. Revised Item 7 requires an acquiring party to report not only overlaps between it (and its controlled entities) and the target business in the NAICS codes used to report U.S. revenues, but also, based on its knowledge or belief, any such competitive overlaps between any of its associates (including their controlled entities) and the target business. The new Item 6(c)(ii) similarly requires the acquiring party to disclose its associates' minority investments in entities making U.S. sales in the same 6-digit NAICS industry codes as the target business.[2] Item 6(c)(ii) also requires the acquiring party to report any existing minority investment (of at least 5%) that its associates may already have in the target entity.

In the case of private equity firms, these changes mean that the HSR Form filed by an acquiring fund must now disclose not only the fund's own competitive overlaps with the target business, but also overlaps between the target business and control or minority investments of any fund under common management with the acquiring fund.

"Item 4(d)" Documents

Private equity firms are generally very familiar with Item 4(c) of the HSR Form, which requires submission of documents prepared by or for officers or directors of either party for the purpose of evaluating or analyzing the proposed transaction with respect to markets, market shares, competition, competitors or the potential for sales growth or expansion into product or geographic markets. The amendments add a new "Item 4(d)" to the Form, which requires submission of three categories of documents. This requirement largely codifies, but also somewhat expands, the FTC's existing interpretation of Item 4(c).

1. Item 4(d)(i) calls for any confidential information memoranda ("CIM") that was prepared by or for an officer or director of either party (or their ultimate parent entities) and that specifically relates to the sale of the acquired business, or, if no such CIM exists, any documents given to an officer or director of the buyer that were meant to serve the function of a CIM.

2. Item 4(d)(ii) requires documents prepared by "investment bankers, consultants or other third-party advisors," during an engagement or for the purpose of seeking an engagement, for an officer or director of either party (or their ultimate parent entities), if they contain content of the type responsive to Item 4(c) and specifically relate to the sale of the acquired business. This provision makes clear that even documents generated by advisors or potential advisors at the earliest stages of a transaction are required.[3]

3. Item 4(d)(iii) calls for all documents "evaluating or analyzing synergies and/or efficiencies" that were prepared by or for an officer or director of either party (or their ultimate parent entities) for the purpose of evaluating or analyzing the proposed transaction. Previously, documents discussing revenue synergies were considered responsive to Item 4(c), but documents exclusively considering cost synergies were not. This amended provision now clearly picks up the latter, but excludes financial models that do not have stated assumptions concerning synergies.

Item 5 Revenue Reporting

Revised Item 5(a) of the HSR Form expands the revenue reporting requirement to include all sales into the U.S. of products manufactured by the filing party's foreign operations, whether those sales are made directly or through a U.S. establishment. The new HSR Instructions also modify the reporting with respect to revenues derived from manufactured products that the reporting person both manufactures and sells at wholesale or retail, to eliminate potential double counting and ensure uniform treatment. A filing party must use only the more granular 10-digit NAICS codes to report U.S. revenues from products that it manufactures and sells (even if sold through a separate wholesaling or retail establishment). The 6-digit NAICS wholesaling or retailing codes are to be used only to report revenues of non-manufacturing U.S. operations and U.S. revenues from foreign operations of products that are manufactured by a third party under contract for the filing party. In addition, as noted above, Item 5 has been simplified by eliminating the

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2 *If the filing party is unable to identify which of its associates' minority holdings have sales in overlapping NAICS codes with the target, it may instead provide a list of such holdings in entities having operations in the same industry as the target. The party also may simply list all its associates' minority holdings, although the FTC has warned that this approach may result in follow-up requests that could delay the review of a filing.*

3 *The FTC limited the final version of Items 4(d)(i) and (ii) to materials prepared by or for officers and directors and clarified that the language "specifically related to the sale of the acquired [business]" means the current transaction that is the subject of the HSR filing, from its earliest consideration by either party, but not other contemplated transactions involving the same target. These changes were intended to address concerns expressed in the public comments about risks to deal confidentiality if parties were required, as apparently contemplated by the initial proposal, to search the files of a broad group of individuals, including some who might have no prior knowledge of the current transaction.*

UPDATE

New Proposal to Tax Carried Interest as Ordinary Income

As many of our readers likely know, on September 12, President Obama released the text of the proposed American Jobs Act of 2011, which includes provisions that would tax carried interest as ordinary income. The proposed carried interest provisions generally would become effective on January 1, 2013. The Jobs Act's carried interest provisions are based largely on prior Congressional proposals to tax carried interest as ordinary income and would fix a number of technical issues with the prior proposals (although certain other issues remain unresolved). Below is a summary of the key differences:

Taxation of carried interest. The bill would tax 100% of carried interest at ordinary income rates. Previous proposals generally would have treated only 75% of the carried interest as ordinary income and would have preserved the favorable treatment under current law for 25% of the carried interest.

Taxation of enterprise value. 100% of any gain from the sale of an interest in a carried interest partnership would be treated as ordinary income. This provision is particularly controversial because it would subject individuals to a higher rate of taxation on gain from the sale of a carried interest partnership than on gain from the sale of other businesses. A prior proposal generally would have taxed only 75% of such gain (50% in the case of a five-year holding period) at ordinary income rates.

Narrower definition of carried interest. The bill limits the scope of partnerships to which the new carried interest regime would apply. Previous proposals potentially applied to partnerships that held (directly or indirectly) any securities, real estate, interests in other partnerships or commodities, or options or derivative contracts with respect to the foregoing, or other specified assets, without regard to the materiality of these assets to the partnership. In contrast, the bill would only apply to a partnership if substantially all of the partnership's assets (other than goodwill and other intangible assets) consist of securities or any of the other specified assets described above and certain other conditions are met. Limiting the application of the carried interest rules in this manner may help protect, for example, the sale of management companies that hold specified assets from inadvertent taxation under the enterprise value regime. ■

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requirement to report "base year" revenues, so that only revenues for the most recent fiscal year need be included.

Other Changes

The FTC's amendments also include numerous other minor changes to the HSR Form, some of which address omissions from a prior FTC rulemaking (*e.g.*, inclusion of unincorporated entities in Items 6(b) and 6(c)), and many of a ministerial or organizational nature (*e.g.*, requesting the filing party's website address).

* * *

In sum, these amendments mean that private equity firms and their portfolio companies should be prepared for a potentially more time-consuming and intrusive data collection process in connection with future transactions (in particular where acquiring a target business in the same industry as an existing portfolio company), and should reach out to their antitrust advisors as early in the process as possible so that any issues can be spotted early and filings can be made as promptly and as painlessly as possible. ■

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"Recent" Market Trends in IPOs of Sponsor Portfolio Companies (cont. from page 1)

market—at least prior to the summer volatility. This assembled information and analysis should serve as a useful starting place when the market returns. The chart below provides specific information with respect to the deals we analyzed in our survey.

Board Control and Composition: The Controlled Company Exemption

You may recall that observers have wondered, particularly in a post-SOX and Dodd-Frank world, whether the public markets would be receptive to sponsors or groups (as defined under Section 13(d)(3) of the Exchange Act) which own more than 50% of the voting stock of a public company, invoking the "controlled company" exemption under either the Nasdaq or NYSE rules. This exemption allows such a sponsor or group to have the right to designate a majority of the board

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IPOs of Selected Private Equity Portfolio Companies

Deal	Post-IPO Ownership			Post-IPO Sponsor Control			Post-IPO Shark Repellants					
	Sponsor	Public	Mgmt.	Controlled Company	Director Nomination Rights	Veto Rights	DGCL 203	Poison Pill*	Staggered Board	Cumulative Voting	S'holder Written Consent	S'holder Called Meetings
Dunkin' Brands	76%	18%	3%	Yes	Yes	No	Applies, but modified to add certain sponsor-related exemptions	No	Yes	No	Only if sponsors own 50%	Only if sponsors own 50%
Bankrate	70%	20%	8%	Yes	Yes	Yes	Applies, but modified to add certain sponsor-related exemptions	No	Yes	No	Only if sponsors own 40%	Only if sponsors own 40%
HCA	70%	24%	2%	Yes	Yes	No	Applies	No	No	No	Only if sponsors own 50%	Only if sponsors own 50%
FleetCor Technologies	68%	16%	5%	No	No	No	Applies	No	Yes	No	No	No
GNC	66%	22%	6%	Yes	Yes	Yes	Applies	No	Yes	No	Only if sponsors own 50%	No
LPL Investment	64%	15%	6%	Yes, but majority indep. bd.	Yes	No	Opted out	No	If sponsor owns less than 40%	No	Only if sponsors own 40%	Only if sponsors own 40%
BankUnited	60%	27%	11%	No	Yes	No	Opted out	No	No	No	No	Yes
Kinder Morgan	52%	10%	35%	Yes, but majority indep. bd.	Yes	Yes	Applies	No	No	No	No	Yes
Targa Resources	48%	39%	12%	No	No	No	Opts out until sponsors own less than 15%, at which point it applies	No	Yes	No	No	No
Oasis Petroleum	31%	46%	14%	Yes (mgmt. and others in group)	No	No	Applies	No	Yes	No	Only if group owns 50%	Only if group owns 50%
Vanguard Health Systems	46%	35%	9%	Yes (mgmt. in group	Yes	Yes	Applies, but modified to add certain sponsor-related exemptions	No	Yes	No	Only if group owns 50%	No

*Note: Each company has the requisite authorized and unissued capital stock to implement a poison pill as, and when, desired.

"Recent" Market Trends in IPOs of Sponsor Portfolio Companies (cont. from page 20)

of any public portfolio company without regard to any "independence" requirements (other than with respect to the audit committee) so long as such individual or group's decision to treat such company as a "controlled company" is disclosed in the company's prospectus.

While the ability to appoint a majority of such directors to the newly public company's board is obviously significant to sponsors, it is important to keep in mind in this context that any director designated to the board of any public company by any sponsor or group, whether or not such company is a "controlled company" or such director is "independent," will have fiduciary duties to all stockholders, not just such sponsor or group, and therefore will not be able to make decisions solely on the basis of the interests of such sponsor or group. Our market survey suggests, perhaps in part for this reason, that the market is generally comfortable with sponsors electing to treat the portfolio company it is taking public as a "controlled company." Six of the eight companies in our survey that qualified as "controlled companies" at the time of their IPO chose to take advantage of the exemption. In some instances, such as APAX's IPO of Bankrate, Inc., a sponsor took advantage of the exemption due to its ownership of more than 50% of the voting stock of the portfolio company following the IPO. In many other instances, such as the recently completed IPO of Dunkin' Brands Group, Inc., sponsors in a club deal, sometimes with the inclusion of management, qualified as a "controlled company" by virtue of a voting agreement with respect to the election of directors designated by members of the club, thereby constituting a "group" holding more than 50% of the voting power of the portfolio company. In the case of Dunkin' Brands, for instance, this voting arrangement allows each of the three sponsors to appoint two of the company's nine directors.

Note, though, that sponsor practices are not uniform in this regard. Two of the newly public portfolio companies that otherwise qualified for the "controlled company" exemption at the time of their IPO disclosed in their prospectuses that their sponsors would not treat the portfolio company as a "controlled company" post-IPO and would instead abide by all of the corporate governance standards of the applicable exchange, including having a Board comprised of a majority of independent directors.

Board Designation Rights.

A successful IPO cannot be a "controlled company" for the long term since the sponsors liquidate their ownership stake over time. Moreover, in other cases, sponsors or groups of sponsors never hold 50% of the voting power of the post-IPO company to begin with or choose not to take advantage of the "controlled company" exemption.

In eight of the 11 deals we surveyed, sponsors or groups of sponsors entered into an agreement at the time of the IPO giving them the right to designate directors to the board of the company, even when it no longer qualifies as a "controlled company" or if it never qualified as one. In Vanguard Health Systems, Inc., where Blackstone held the vast majority of the stock held by all sponsors post-IPO, Blackstone retains the right to designate five of the 11 directors until such time as it owns less than 10% of the outstanding common stock of Vanguard. Similarly, in certain club deals, such as Dunkin' Brands and HCA Holdings, Inc., each sponsor has the right, after these companies cease to be "controlled companies," to appoint a significant portion of the company's board until such sponsor ceases to own a specified percentage of the voting power, often 10%. More frequently however, including, in "non-controlled company" situations, sponsors or groups of sponsors are provided with board designation rights in proportion to their respective equity interests in the newly public company, and these board designation rights typically decrease as the equity stake of the sponsor or group diminishes over time until they terminate entirely. Some sponsors retain nomination rights until they hold as little as a 3% ownership interest, whereas others provide for nomination rights to expire at higher ownership percentages, but provide sponsors with non-voting board observer rights once their board designation rights have terminated.

Veto Rights

In four of the 11 deals we surveyed, sponsors continued to enjoy certain veto rights in their capacities as shareholders with respect to certain corporate actions of the newly public company. Unsurprisingly, sponsors have generally received these rights in circumstances where the company qualifies as a "controlled company." But somewhat surprisingly, unlike the right of a sponsor or group of sponsors owning more than 50% of the voting power to appoint a majority of the board of that company, these veto rights do not sunset once a company ceases to be a "controlled company."

In the precedents we identified, these veto rights varied in scope but have included veto rights with respect to (1) the hiring and firing of the CEO, (2) certain major strategic corporate transactions, including mergers, consolidations or sales of assets and (3) bankruptcy filings. Sponsor veto rights of this kind typically terminate once the sponsor's percentage ownership falls below a specified level (generally between 25% and 40%). Notably, in Vanguard, Blackstone enjoys veto rights over certain significant company transactions for so long as it holds more

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"Recent" Market Trends in IPOs of Sponsor Portfolio Companies (cont. from page 21)

than 25% of the common stock. In many club deals, shareholders' agreements have recently been structured to either (1) provide each sponsor with certain veto rights so long as the club holds in the aggregate more than a specified percentage ownership or (2) provide the club with one veto right, therefore requiring a meeting of the minds of the club members prior to the exercise of such right.

Veto rights of this kind are particularly valuable for sponsors by permitting them to retain some absolute negative control over certain major decisions affecting their public portfolio companies, since, unlike sponsor-appointed directors who, as noted above, have fiduciary duties to all stockholders, sponsors do not have as significant fiduciary duties in their capacities as shareholders and can, therefore, generally focus solely on their own interests in electing whether or not to invoke any particular veto right.

Anti-Takeover Defenses

The decision to include one or more anti-takeover defenses in the constituent documents of a portfolio company a sponsor is about to take public (*e.g.*, a staggered board, the elimination of shareholders' ability to act by written consent and call special meetings, adoption of a poison pill and whether or not to opt out of the anti-takeover provisions of Section 203 of the DGCL ("203")), can be a nuanced one given that the utility of such defenses to a sponsor is subject to change based on a variety of factors.

Immediately following an IPO, such anti-takeover defenses are, at best, of limited usefulness for most sponsors because the most effective defense against an unwanted takeover attempt is the significant ownership percentage held by the sponsor or group of sponsors. However, as a sponsor's or group of sponsors' ownership stake in a public portfolio company gradually declines over time, its ownership stake will cease to constitute, by itself, a *de facto* deterrent to unwanted bids. Consequently, sponsors need to consider whether, at various points along this continuum, they would prefer to retain, as shareholders, the flexibility to decide whether or not to cause the sale of the company, and, under the right circumstances, perhaps obtain a control premium for their shares, or have in place anti-takeover defenses, such as 203 or a poison pill, that effectively shift the right to make such decision to the board, which, of course, is no longer controlled by the sponsors.

As a practical matter, sponsors must design the anti-takeover profile of a portfolio company at the time it goes public without retaining a realistic ability to modify these defenses as their ownership stake in the public company evolves.

As a point of reference, in our Winter 2003 edition of the *Debevoise & Plimpton Private Equity Report*, we published an article entitled, "Shark Repellents That Can Bite," noting similar considerations with respect to shark repellents, but also noting that out of a selected group of 21 IPOs by U.S. portfolio companies over the period from May 1996 to January 2003 only 8 companies (or 38%) opted out of 203 and did not adopt a pill, whereas 13 companies (or 62%) did not opt out of 203 (some of which also adopted pills).

Our survey of the current market reveals a trend towards fewer anti-takeover defenses, but the retention, in most cases, of meaningful anti-takeover defenses nonetheless. As an overview of this trend, (1) none of the 11 companies we surveyed adopted a poison pill at the time of their IPO, but all of them had sufficient authorized preferred stock to put one in place quickly, as needed, (2) eight of the 11 companies implemented a staggered board, and (3) most companies have adopted other significant anti-takeover devices, such as limitations on their shareholders' ability to act by written consent and to call special meetings.

As you may know, 203 imposes a three-year moratorium on business combinations between a public Delaware company and any 15% or greater shareholder unless the business combination or the crossing of the 15% threshold receives prior board approval, the bidder reaches the 85% threshold in the same transaction as it reaches the 15% threshold, or the combination is approved by the board and by holders of two-thirds of the shares not owned by the bidder. While 203 does not apply to a private equity sponsor who continuously holds 15% of the company's shares following the IPO, it does restrict the sponsor's ability to control or at least facilitate an exit by selling its shares to, or entering into lock-up agreements with, potential bidders, even bidders constituting affiliates of such sponsor, without the approval of the company's board, which will have fiduciary duties to all stockholders. A sponsor of a Delaware company can avoid these restrictions on exit by "opting out" of 203 at the time it goes public.

Our survey of the current market reveals

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"Recent" Market Trends in IPOs of Sponsor Portfolio Companies (cont. from page 22)

that two of the 11 companies opted out of 203 completely, five companies elected not to opt out and the remaining four companies took more bespoke approaches to 203 designed, in most cases, to retain most of the defensive benefits of 203, but also to modify it so as to confer greater flexibility for the sponsors to orchestrate exit transactions to their liking.

For instance, in the case of Vanguard and Bankrate, this was achieved by having the companies opt out of 203, while simultaneously adopting a charter provision virtually identical to 203, except that, unlike 203, the charter provision allows the sponsors to sell any or all of their shares to, or enter into lock-up agreements with, any bidder without such bidder being subject to any of the provisions of the new charter which otherwise mirror 203. In effect, these provisions allow a private equity sponsor to confer a blanket exception to the 203-like provisions in the company's charter to any third party of its choosing, thereby retaining the benefits of 203 for deals it does not support but eliminating them for deals it does support. Somewhat similarly, albeit less sponsor friendly, in Dunkin' Brands, a "club" deal where each of Bain Capital, Carlyle and Thomas H. Lee Partners held approximately 25% of the post-IPO shares, Dunkin' adopted the same approach as Vanguard and Bankrate but limited the blanket exception to the 203-like provisions in the company's charter to the sponsors' affiliates only and did not extend it to unaffiliated bidders. A third approach was adopted in Targa Resources Corp., where the company elected to opt out of 203 until such time as the sponsors, their affiliates and transferees own less than 15% of the company's common stock, at which point the company automatically opts back into 203 for all purposes.

While susceptible of different interpretations, if one counts Vanguard and Bankrate as effectively "opting-out" of 203 and Dunkin' and Targa as not "opting out," approximately 64% of the newly public companies in our survey did not opt out of 203 (similar to the 62% number noted in our 2003 article). Alternatively, if one views each of Vanguard, Bankrate, Dunkin' and Targa as effectively "opting out" of 203, then approximately 55% of the newly public companies in our survey did not opt out of 203. While unlike the case in our 2003 survey, none of the 11 companies we surveyed had any poison pills in place, as noted above, all of them have the capital structure to implement a poison pill very quickly, as and when needed.

Management Fees

Private equity sponsors usually enter into management or consulting agreements with their portfolio companies at the time of the initial acquisition that provide for the payment of periodic administrative, management or professional service fees to the sponsors. These agreements generally terminate upon the portfolio company's IPO and result in some instances in payments to the sponsors structured either as a one-time fee payment at the time of the IPO or periodic fee payments for a specified period of time following the IPO. Our survey suggests that the current trend seems to favor a termination of management agreements for a lump sum fee payment at the time of the IPO. More specifically, of the five deals which specifically mentioned sponsor management agreements, in one case the management agreement was terminated in the IPO for no fee, and in the other four cases, the management agreements were terminated in consideration for payments to the sponsors structured, in three instances, as a one-time fee payment at the time of the IPO and, in one instance, as periodic fee payments for a specified period of time following the IPO. It is important to note that, in addition to being negatively perceived by the market and having the potential of impacting the success of the offering, any such post-IPO fee payments and/or arrangements may affect the independence of the sponsor's board nominees under the applicable stock exchange rules.

* * *

The gist of our survey of current market terms for sponsor-backed IPOs suggests that (1) most sponsors, whether acting individually or as a member of a group, seek to nominate as many members of the newly public company's board as the law allows, (2) sponsors of companies constituting "controlled companies" at the time of the IPO often enjoy some form of veto rights in their capacities as shareholders, even after the company ceases to be a "controlled company," and (3) most sponsors are arming their newly public portfolio companies with significant shark repellants but are doing so in a way that gives them more flexibility to disarm or elect not to use those shark repellants for deals they support. Two examples of this are not adopting a pill but retaining the mechanics to do so quickly, if needed, and technically opting out of 203 but at the same time adopting 203-like charter provisions that allow such sponsors to utilize a modified form of 203 as a tool to influence their control over their ultimate exit, as well as to enjoy the general defensive mechanisms associated with 203. ■

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Is Russia Ready for Serious Attention from Private Equity Investors? (cont. from page 8)

there is a lot of red tape in originating and operating businesses in Russia. But by way of comparison, there are so many international PE firms actively investing in India, despite the very bureaucratic environment there, just because of different context and different connotations. So the major challenge is perception.

In an effort to boost foreign investment, the Russian government recently announced that it was establishing a U.S.$10 billion fund (Russian Direct Investment Fund) to invest alongside foreign private equity players. Could you tell us more about the fund's mandate, what kind of investors will be targeted and what role RPEI will have in connection with the fund?

The idea is to create a private equity vehicle to match the investments of leading international firms in certain sectors of the Russian economy. It is not a fund-of-funds structure, but more a co-investment vehicle that can partner with large buy-out shops and sovereign wealth funds. When an international (or local) investor sees an interesting investment proposition, but the deal size is very large, or the investor is more comfortable having a government affiliate co-investing, they can apply for capital from this fund to be invested in direct deals. We believe it could be a good opportunity to develop working relationships with a number of leading institutional players in this space who historically have never invested in Russia. David Bonderman of TPG has joined the international advisory board; Stephen Schwartzman from Blackstone, people from CIC and the Kuwait Investment Authority also showed some interest.

We still believe capital should flow first to Russia-focused local funds. The fundraising environment is very difficult, and these funds, apart from Baring Vostok and probably Russia Partners, have limited opportunities to raise capital abroad. Our view, then, which we have communicated to the government, is that instead of having just a stand-alone co-investment vehicle, we need a broader government-sponsored private equity platform with a fund-of-funds structure supporting local funds. More generally, we believe the government should act as a regulator or a passive investor rather than really a direct private equity player or stakeholder in the traditional sense. The government should create the framework and give a boost to industry, but by no means should it dominate the private equity market by its own investment.

Regarding our role, we plan to continue our talks with the government and VEB (the Russian Development Bank) in order to add other missing elements to the program announced by the government. It remains to be seen how the arrangement will develop, but, of course, if this is a success, it will be a major boost for the Russian private equity industry. ■

Boosting EBITDA: The Cost Savings Add-Back (cont. from page 12)

changed as a result of that transaction.[2] In the context of cost savings, the Division of Corporation Finance has specifically stated that *pro forma* adjustments that give effect to actions taken by management or are expected to occur after a business combination, including termination of employees, closure of facilities and other restructuring charges, are not appropriate.[3] Adopting this position in a credit agreement would largely, if not completely, exclude most adjustments based on expected or planned cost savings of the type discussed herein.

Key Issues for Negotiation

Credit agreements that permit cost savings-based *pro forma* adjustments typically refer to cost savings resulting from "actions," or "specified actions" or "a costs savings plan." Given the somewhat open-ended nature of the trigger, key questions for negotiations are:

- Whether the relevant action needs to have been taken (or the relevant cost savings plan needs to have been implemented) during the test period, or whether the add-back is also available with respect to actions "committed to be taken," "to be taken" or "expected to be taken" after the test period. Any timing flexibility of this sort differs from the add-back based on the acquisition or disposition of a line of business, which typically requires the relevant acquisition or disposition to have been completed during the period or

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2 *Division of Corporation Finance's Financial Reporting Manual, Section 3210.2.*

3 *Division of Corporation Finance's Financial Reporting Manual, Section 3310.3.*

Boosting EBITDA: The Cost Savings Add-Back (cont. from page 24)

at least before the date of the relevant financial calculation.

- Whether the cost savings are subject to a qualitative control. For instance, certain credit agreements limit the add-back to savings "actually realized" during the test period. Other credit agreements, in permitting add backs with respect to actions not yet taken, may require that the savings be "projected in good faith to be realized" and sometimes may require that the relevant action be expected or projected to be taken within a certain period of time following the EBITDA calculation date or the end of the relevant test period.
- Do the savings need to be "reasonably identifiable" and/or "factually supportable?" "Factually supportable" is a term that is used in the provisions of Regulation S-X discussed above. In general, to be factually supportable, an adjustment must be the quantifiable outcome of identified actions. The level of factual support for an adjustment would be a case-by-case analysis but it may well require that, for example, an expected new contract already be in place, or (in the context of redundancies) that the borrower have identified the personnel to be terminated.
- Whether management is required to prepare a certification with respect to the savings. The range of items to be certified can be very broad. Some credit agreements require no certification at all. Other credit agreements require a certification describing in reasonable detail the relevant savings or confirming that the relevant cost savings plan has been implemented or, in the case of savings based on actions not yet taken, confirming the reasonableness of the expectation that the cost savings will be realized during the relevant time frame.
- Whether the Administrative Agent can request that the savings be verified by an independent third party.
- Whether the add-back with respect to any test period is subject to an overall cap and whether the relevant action triggering the add-back is required to be taken within a certain period of time following the date of the credit agreement.

The Market Today

Of course, borrowers and lenders sometimes have different views as to whether or not specific add-backs are appropriate, especially in the case of cost savings plans that have not yet been implemented. As a result, even before the recent poor performance of the financial markets, some lenders have pushed to limit the add-back to savings actually realized, arguing that savings based on actions not yet taken are too speculative. However, the cost savings add-back, a popular feature in financing documents in the robust markets of several years ago, particularly large transactions involving major sponsors, was making a reappearance in financings during the first seven months of this year. It will be interesting to see if this trend continues when the markets regain stability. ■

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and regulations are quite dated and very protective of employees. The Industrial Disputes Act, 1947, for example, makes it difficult for companies employing more than 100 workers to conduct layoffs. It is also common to find workers organized into unions that prove to be very successful in negotiating pay increases and securing benefits for their members. Foreign investors ought to get a clear understanding of these issues, especially if they plan on restructuring the target's business in any way.

- *Land title issues:* Land registration in India does not involve a registration of title, but a registration of deed, *i.e.*, it is simply an acknowledgment that a transaction has taken place between the parties. Additionally, there is no system of issuing title certificates for land, which makes it necessary for a buyer to establish a "chain of title" that involves searching relevant land records for the preceding 30 years. Since land records are not computerized and can be in the local languages of the states, the process can be very time consuming and expensive, and there is no title insurance currently available. It is also important to point out that although there is a statutory requirement to register all sales of land, the reality in India is that due to the high cost of registration (in the form of stamp duty that varies from state to state), a large number of realty transactions are never registered. There is no mandatory registration of land acquisitions, court decrees, land orders, partitions, mortgages, agreements to sell, etc., under state legislation. Foreign investors used to deriving comfort from clear records of title are, therefore, often surprised at the complexity of, and lack of assurances provided by, a title search in India.
- *Tax-related issues:* The fiscal regime in India is extremely complex and poses numerous additional challenges. Each year's budget session brings with it new levies and taxes. Business entities in India are frequently involved in extensive litigation and administrative proceedings that challenge the interpretation and application of the tax framework. Anyone planning to establish or invest in a business in India should conduct a thorough review of the transaction by local consultants so the potential tax impact is clear. India also has Double Taxation Avoidance Agreements with various countries and most foreign investors prefer entering India through these jurisdictions. Adding to the confusion and complexity are recent court decisions and the introduction of the new Direct Tax Code, which purports to override certain aspects of existing treaties. It is no wonder then that many foreign investors are opting for tax insurance policies to safeguard their tax structures and exit options.
- *Intellectual property:* As a signatory to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), India has enacted all mandated intellectual property laws. However, even though sufficient laws are in place, intellectual property enforcement remains problematic, a big issue in this country, especially in the area of copyright. It is also important to note that there is no separate data protection law in India so all confidential information has to be protected by contract.

Financial Due Diligence

- *Accounting records:* The accounting books and records of Indian companies are sometimes less transparent and reliable than those of U.S. companies. In fact, some Indian 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 tends to book less revenue and/or more expenditures with a view to reducing the company's tax liability.
- *Financial auditing terms:* India does not permit FDI in accounting and auditing services businesses. However, the "big four" accounting firms have established offices in India and offer consultancy services through tie-ups and other arrangements with local partners. It should be noted that many local accounting firms in India may be less credible and impartial in

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Beyond governance and transparency, Western sponsors will also need to become accustomed to Indian bureaucracy.... Murky litigation risks, licensing and permitting uncertainties and vagaries surrounding real estate matters are significant problems in India.

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performing audits, as they are more susceptible to pressures from the company as a result of an eagerness to win engagements or maintain existing relationships.

- *Accounting standards:* Indian companies are required to prepare audited financial statements in accordance with Indian GAAP. The Government of India has proposals pending that would require certain entities including listed companies, banks, insurance companies and other large entities to comply with IFRS. However, these proposals have yet to be enacted.
- *Related party transactions:* Since many businesses in India are still structured as family-owned conglomerates with a great deal of interdependence, there can be extensive related-party transactions that must be identified and examined.

Conclusion

In sum, the diligence process is much different in Bangalore than in Bangor. Indian companies, particularly those on the smaller side, may need to be convinced that transparency and good governance are part of the growth process for an emerging company to begin operating at the next level. Their owners may also need to be convinced that foreign investors, including private equity investors, can be more than just sources of capital, and, perhaps more importantly, can assist in the growth of institutional structures and governance. Many private equity firms have been successful in fostering a spirit of openness by developing relationships with founders based on professionalism and trust. Strong personal relationships are clearly key in almost all successful business settings in India.

Beyond governance and transparency, Western sponsors will also need to become accustomed to Indian bureaucracy and its by-products. Murky litigation risks, licensing issues and vagaries surrounding real estate matters are significant problems in India. In addition, this backdrop tends to create fertile ground for corruption issues. In fact, India placed 87th out of 178 countries ranked in Transparency International's "Corruption Perception Index," behind China and Brazil, although well ahead of Russia.

Notwithstanding these challenges, the role played by private equity in India is growing, and many new funds have made successful investments in the country in the last few years. So, while prudent investment in India is possible, thoughtful and thorough due diligence will remain crucial to success. ■

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