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Del Monte: Staple Remover?

The attention of the private equity community was captured by both the Delaware Court of Chancery's injunction delaying KKR's acquisition of Del Monte over issues related in part to the sell-side financial advisor's participation in the buyers' financing, and the subsequent approval of an $89.4 million settlement of the underlying litigation. While it is difficult to come to a definitive view since the period following *Del Monte* coincided with a downturn in M&A activity, *Del Monte* appears to have led to a meaningful decrease in "stapled financings" (so called because the financing offer is coupled with—or "stapled" to—sales materials circulated by the sell-side advisor) in sales of public companies.

While the potential conflicts require careful monitoring, many sophisticated sellers have concluded over the years that the advantages of stapled financings are substantial and the risks manageable. Is *Del Monte* an asteroid that has rendered the staple extinct? In the case of private targets, certainly not, and, even in the case of public targets, we think not. As Vice Chancellor Laster noted in his *Del Monte* injunction decision, the fundamental problem was not the Del Monte board's decision to permit the sell-side advisor to participate in the buyer's financing but the absence of "some justification reasonably related to advancing stockholder interests..."

Here are the key factors to consider as you contemplate participation by sell-side advisors in buy-side financings, including how to structure a staple in ways that should mitigate litigation risk.

Why Offer a Staple?

One key lesson from *Del Monte* is that a board must be fully informed about the reasons for allowing a sell-side advisor to participate in buy-side financing, including by way of a staple. Whether the potential advantages exist, and to what degree, will vary from deal to deal.

A staple can be beneficial to a seller by providing a price signaling device to

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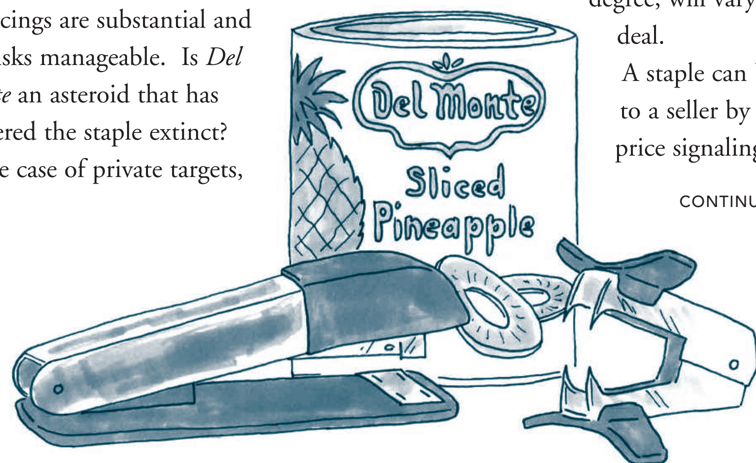

"Can't we just get along?"

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Letter from the Editor

In tumultuous economic times, creativity is a key ingredient in the deal recipe book. The articles in our current issue provide guidance on how to manage the risks and rewards inherent in creative structures and financings.

Stapled financings, once a "staple" in auctions of public companies, are less common these days, not only because the public deals are rare in the current market, but also as a result of reaction to the Delaware Chancery Court's injunction in connection with the acquisition of *Del Monte*. Heightened judicial scrutiny of transactions with potential conflicts of interest has made sellers wary not only of stapled financing, but also of even permitting sell side advisors to participate in buy-side financing. Especially in light of the decreasing number of financing sources for larger transactions and their more limited appetites, sellers who are at all open minded about permitting sell side advisors to participate in buy side financing will be interested in the structuring guidance we offer in our cover article on how to mitigate the potential litigation risks of doing so.

Seller financing has always been a "staple" of mid market deals, but never has it been more useful that when the financing markets are difficult and valuations are uncertain. In this issue, we provide a primer on the major issues to be considered in structuring seller notes and their role in the capital structure.

The private equity world remains concerned about the interpretation of the Volcker Rule during what seems like a never-ending process of finalizing the implementing rules. In this issue we continue our discussion of how and to what extent "banking entities" will be allowed to invest in unaffiliated private equity and hedge funds and provide an updated "cheat sheet" of the current state of the Volcker Rule and its proposed implementing rules.

Elsewhere in this issue, we focus on a number of topics which highlight the global nature of the private equity asset class. We continue our around the world survey of the BRIC countries with an examination of the due diligence climate in Brazil. While the Brazilian deal community is familiar with the due diligence process and is ahead of some other BRICs in its accounting standards, record keeping and public search functions, it faces challenges similar to the others in some areas, particularly with respect to corruption issues.

Private equity investors are beginning to look beyond the BRIC countries. Over the last decade, over $10 billion of private equity financing has been raised for investment in sub-Saharan Africa. In our Guest Column, Graham Sinclair, a Principal of SinCo and President of the Africa Sustainable Investment Forum, discusses the requirement to integrate so-called ESG (environmental, social and governance) factors into African investments, as well as recent changes to local regulations allowing African pension funds to increase allocations to private equity investment.

Given the economic climate, we also feature an article that reviews the process that will permit private equity firms to participate in auctions for assets being sold as part of a pre-packaged bankruptcy.

We hope you continue to find the Private Equity Report timely and helpful reading. If there are specific questions or topics you would like us to focus on in future issues, please feel free to let any of us in the Private Equity Group know.

Franci J. Blassberg
Editor-in-Chief

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Covering the Capital Structure: The Seller Note

Classics are always in vogue. The "seller note," a payable issued by a buyer to a seller as part of the purchase price for an acquisition, is a classic accessory in the LBO ensemble that tends to be most useful during periods of volatility in the capital markets and scarcity of debt capital. With the recent and ongoing stormy weather in the capital markets, and forecasts for more to come, deal professionals may wish to keep the seller note in mind for suitable occasions.

Overview

Extremely versatile, the seller note comes in a variety of sizes and can be tailored for a variety of purposes. For instance, a seller note can patch a hole in a capital structure (as when a debt issue would be too small or otherwise unappealing for a third-party lender). It can even constitute a significant piece in a capital structure (either as a bridge to a better debt market or as a long-term investment). It can serve as acquisition currency (as for a relatively small "tuck-in" by a leveraged company whose financing agreements permit acquisition debt). And, in many cases, it can enable a seller willing to invest in an instrument supported by a business it knows well to attain a higher headline valuation for its business.

Basic Patterns for a Seller Note

Seller notes follow many patterns, one of the most typical involving a transfer-restricted, subordinated note that is prepayable without penalty, that requires only limited mandatory cash payments, and that imposes some affirmative and negative covenants, often not extensive, on the buyer.

Transfer restrictions exist in seller notes, among other reasons, to keep the note with the seller, which in turn facilitates purchase price adjustments and, in some cases, tax planning (as discussed below), and supports off-sets of indemnification obligations. Some transfers, to sellers' families for example, may be permitted without consent. When a transaction is designed to allow the seller to realize near-term liquidity, however, transfer restrictions may be more limited, confined to those necessary to comply with securities laws or to prevent acquisition by competitors.

Subordination is typically if not universally required by third-party lenders. Subordination may be deep, requiring, for example, that there be few remedies, long "standstills" (periods during which the holder of the seller note cannot exercise any remedies), and little or no cash payments. In many cases, the subordination will be "structural," meaning that the holder of the seller note has a claim for payment only against a holding company with no assets but stock of its operating subsidiaries, while the senior debt has a direct claim for payment against the assets of such operating subsidiaries. (A structurally subordinated note, without its own direct claim on subsidiaries' assets, will not receive payment unless and until the holding company receives distributions (if any) from those subsidiaries.)

Prepayment is generally desirable to holders of seller notes, and, therefore, the absence of call protection is usually not controversial, unless a seller plans to market the notes to third-party investors who expect such protection.

Reduced cash payments on a seller note may not just be a result of subordination provisions imposed by senior lenders, but may also be part of the economics of the transaction, with the entire principal amount of the note due only at maturity and some or all of the interest payable by the accretion of original issue discount (OID) or payable through the issuance of more notes (so called "pay-in-kind" or PIK interest).

An absence of cash-pay requirements does implicate a tax issue that perennially confronts both the makers and holders of any OID instrument. In general, the holder of a seller note must recognize interest income currently, including interest that is not payable in cash, resulting in "phantom income" (*i.e.*, income taxable to the holder prior to its receipt of cash). In addition, depending on the terms of a seller note, there may be some risk that principal is recharacterized as interest and treated as OID, to be taken into account as interest income or expense annually, thereby augmenting the amount of phantom income. These issues may be especially problematic for individuals who might be selling a family business.

A buyer issuing a seller note will have its own concerns about interest expense arising from OID and PIK interest. (For tax purposes, OID and PIK are treated as the same.) The application of the "applicable high yield debt obligation" (AHYDO) rules

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may prevent an issuer of the note (*i.e.*, the buyer) from deducting some of the non-cash interest accruals altogether and requires such a buyer to defer the deduction of the rest of any interest not payable at least annually in cash until actually paid in cash. It is often possible, however, to structure the terms of a note to avoid this loss and deferral of valuable interest deductions, so any note that has significant OID and a term of more than five years should be reviewed carefully for possible AHYDO concerns and mitigants.

Negotiation of the buyer's obligations under the seller note often focuses, among other things, on the nature and extent of restrictions that the seller note may impose on the buyer's business. Seller notes in general are typically less restrictive than concurrent third-party financings, as the third-party financing both provides a benchmark and comes conditioned on the seller note having more flexibility than the third-party debt.

Variations

Beyond these basic patterns, there are numerous variations, including the following.

Adjustability. A seller note can be structured to permit the principal to be increased or decreased to implement any purchase price adjustment, earn-out or indemnification obligation. These provisions are typically found in private-to-private transactions, which, because of the limited number of sellers involved, are the sort most susceptible to the use of a seller note.

An adjustability feature, while very useful, can present a few additional wrinkles. The adjustment is rarely unilateral; therefore, an adjustable seller note should provide a basis, such as mutual agreement or court judgment, for definitively establishing the increase or decrease (similar to providing a basis for a release from an escrow). An adjustable seller note should also provide an end date, beyond which an adjustment can no longer be made, such as the date the note matures, the date an equivalent escrow arrangement would have terminated, or the date the indemnification obligations would terminate under the purchase agreement. The adjustability mechanisms will not work well, if at all, if the note is held by a party other than the seller, so this feature may be a key reason to defer cash payments (to keep the note outstanding), impose transfer restrictions or even require the escrowing of the seller note. In addition, for these mechanisms to work, any subordination agreement, no matter how restrictive otherwise, would have to permit any such increase or decrease; subordination that would in effect prohibit "all" changes to a seller note, for example, must at least have an exception to allow for these "non-cash" adjustments.

Note that adjustments based on earnings contingencies can raise questions as to whether the seller note should be classified as equity for tax purposes, which would of course prevent interest deductions entirely and could, if unanticipated, cause a variance to the buyer's projections.

Cash Payments. Mandatory cash interest payments are not unusual, even though some portion of the interest is often payable in kind. Amortization of principal in seller notes is very rare. But sellers will sometimes seek mandatory prepayment triggered by specific events. A refinancing of third-party debt may be one such event, with the seller arguing that a refinancing will mark the end of the need for the seller financing and the buyer countering that capacity to refinance third-party debt does not necessarily imply a capacity to refinance the seller note. A change of control may be another such trigger event, with the seller asserting that a change of control will mark the realization of the buyer's gains, the end of the buyer's investment, and, therefore, the end of the utility of the seller note as part of the capital structure or as a mechanism for adjusting amounts under the purchase agreement; while the buyer may counter that a change of control may not represent an exit that is complete or even partial or that is otherwise satisfactory.

Belts & Suspenders for the Senior Debt. The buyer proposing to issue a seller note may be called upon to broker subordination provisions that will satisfy a senior lender, adding an extra layer of negotiation to the deal. Lenders, in smaller deals, will occasionally request subordination that sellers and buyers may perceive to be unnecessary protection or extreme. These include, for example, that the seller note have absolutely no cash interest or prepayment rights, no defaults, no remedy other than to sue for non-payment at maturity, an extremely long remedy block, and/or extremely long-dated maturity. Indeed, even if a seller note is structurally subordinated (*i.e.*, having no recourse to the senior lenders' borrower), some lenders, in smaller transactions, may nonetheless still ask for the seller to submit to contractual subordination.

Disclosure. A seller will generally seek information rights to monitor its ongoing investment in the buyer. How much information is appropriate will be negotiated depending on the circumstances. A buyer may especially want to limit that information for a seller with a short non-competition agreement. Seller notes will often contain confidentiality provisions to deal with these issues, at least in part.

Installment method. In some cases, a seller may be permitted to elect to use the "installment method," for U.S. federal income tax purposes, to defer its recognition of gain (but not loss) on the sale, until it receives payments under the

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GUEST COLUMN

Trends in Private Equity in Africa:

Increased Commitments and Integration of (ESG) Factors in 2012

Led in part by private equity investment, sub-Saharan Africa is poised for significant growth in sustainable investment over the next five years, according to a new study commissioned by the International Finance Corporation (IFC).[1] That growth will be led not just by private equity (PE) funds, but by demand from asset owners, and new regulations that, consistent with the ethos of the continent, mandate the integration of environmental, social and governance factors (colloquially known as "ESG") in PE investments and also enable pension funds meaningfully to increase allocations to PE investments.

Growth Story

Although Africa currently comprises only a fraction of world investment markets, it is positioned for major growth. In December 2010, capitalization in Africa amounted to only one percent of global market capitalization in the benchmark MSCI Frontier Markets Index. However, the International Monetary Fund (IMF) projects the African economy will grow by five percent in 2011 – up from 4.7 percent in 2010. Private equity is growing rapidly in response to the region's improving economic fundamentals. In the past decade, PE funds have raised more than $10 billion in the region and now manage an estimated $24 billion in Africa, with South Africa alone accounting for $14 billion.

According to the IFC study, 92 percent of PE investors interviewed expect an increase in PE commitments in sub-Saharan Africa over the next five years and almost two-thirds of those investors expect the increase to be over 20 percent. Such an increase is welcomed by those concerned with sustainable investment in Africa because PE funds have greater exposure and experience in integrating ESG factors in the region than their general asset management counterparts.

Over the next three years, many PE funds will be targeting health care, infrastructure, and housing in Africa. In 2010, two agriculture-specific African PE funds completed multimillion dollar fundraisings. In the next three to ten years, PE investments are expected to flow into clean technology, alternative energy, and education. Infrastructure will also remain a key investment focus throughout the continent.

Asset Owners Demand ESG Integration

Because of the unique cultural sensibilities in a third-world region like Africa, success by investors on the continent will depend on their ability to demonstrate their commitment to sustainable ESG investments.

Historically, client mandates have driven the integration of ESG factors in PE investment, especially where development finance institutions ("DFIs") are anchor investors in private equity funds. Nearly half of all PE funds in sub-Saharan Africa have DFIs as investors. In September 2011, 30 DFIs adopted the Corporate Governance Development Framework, a common set of guidelines to support sustainable economic development in emerging markets.

In addition, a large number of private equity investors now consider ESG factors when selecting managers, which results in private equity managers focusing on creating value in their portfolio companies while remaining sensitive to any ESG issues in their portfolios.

The investment policies of South Africa's Government Employees Pension Fund ("GEPF"), which is Africa's largest institutional investor and among the world's 20 largest pension funds, is a large influence on the market. GEPF recently adopted both a Responsible Investment Policy, which calls for a portfolio-wide ESG-integration approach, and a Developmental Investment Policy, which allocates five percent of its assets (about $7 billion) to developmental investments. Because the GEPF has such a significant influence on the largest institutional investment market in Africa, a policy decision by GEPF makes the rest of the industry attentive to the sway of the US$131 billion fund.

Regulation Increases Funds Available for PE and Promotes ESG Integration

New pension fund regulations across Africa will both increase the possible market for PE in Africa, making up to R100 billion ($14.5 billion) of new pension funds available for investment into private equity or hedge funds, and encourage the adoption of ESG integration.

In Namibia, new regulations will increase the PE allocation limit from 2.5

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[1] *Sustainable Investment in Sub-Saharan Africa I, (IFC-SinCo, July 2011). http://www.ifc.org/ifcext/sustainability.nsf/Content/Publications_Report_SI-SubSaharanAfrica. The IFC-commissioned study authored by SinCo, interviewed over 160 practitioners in private equity and asset management in South Africa, Nigeria, and Kenya.*

Guest Column: Trends in Private Equity in Africa (cont. from page 5)

to five percent in 2011. Similarly, in 2011, Nigeria's pension regulator increased the PE allocation ceiling to five percent, while Kenya's Retirement Benefit Authority increased the PE allocation limit to ten percent. Historically, Kenyan and Nigerian pension funds have had little appetite for PE, something that the regulators and PE industry are looking to change with a series of workshops and education programs.

As of 1 January 2012, all retirement fund assets in South Africa will be subject to a piece of enabling regulation that specifically promotes the importance of ESG considerations in sustainable long-term investment performance. The regulation provides: *"Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of their investments, including those of an environmental, social, and governance character."* [2]

Voluntary codes also have a powerful influence by nudging industry participants, especially those seeking to be leaders in their industry, and creating reputation risks where institutional investors fail to live up to their commitments. Two ESG-related codes play a role in industry self-regulation: for companies, the King Code for Corporate Governance[3] and for investors, the Code for Responsible Investing by Institutional Investors in South Africa ("CRISA").[4]

2 *December 2, 2010 Government Notice (For Public Comment) Pension Funds Act, 24/1956: Publication of Amendment of Regulation 28 of the regulations made under Section 36.*

3 *See, http://www.iodsa.co.za/products_reports.asp?CatID=150. (First published in 1994 and updated most recently in 2009, King III).*

4 *See, http://www.iodsa.co.za/downloads/documents/CRISACode31Augl2010_For_Public_Comment.pdf.*

Other soft rules like the Principles for Responsible Investment ("PRI"), and the Extractive Industries Transparency Initiative are also raising the profile of ESG investment. Increasingly, the PRI, and CRISA, will be major drivers of ESG in investment as public commitments are contrasted with practices in Africa, and the clients of private equity managers, like pension funds, are subject to increased scrutiny from their stakeholders.

The particular importance of ESG factors distinguish PE investment in Africa from most other regions in the world, and will continue to be a major source of attention and opportunity for private equity firms in Africa. ■

Graham Sinclair
Principal of SinCo
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Brick by Brick:

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

With its political stability, vibrant and entrepreneurial culture and impending status as the center of the universe for the World Cup in 2014 and the Olympics in 2016, Brazil appears positioned to continue to grow, albeit likely at a slower pace than in recent years, due largely to the economic conditions prevailing elsewhere.

As with its fellow BRICs, however, Brazil is a challenging country in which to conduct due diligence on an investment opportunity, in its case, particularly due to the lack of a strong legal infrastructure, poor record keeping (historically), and the cultural sensitivities of Brazilian counter-parties to the kind of intrusiveness inherent in a normalized western due diligence process. But unlike Russia, for instance, Brazil's accounting standards are increasingly conforming with IFRS, and it is well on the way to digitizing its record keeping and public search functions. It also seems poised to increase the sophistication of its commercial and legal practices in order to sustain its growth.

Like its fellow BRICs, however, Brazil's rapid growth amid an evolving legal and enforcement system requires investors to evaluate carefully potential FCPA exposures in connection with any investment opportunity.

Against that backdrop, the third installment of our four-part series on doing due diligence in BRICs countries continues in this issue with Brazil.

Due Diligence Process

- *Familiarity with due diligence process and requirements:* Unlike China, most companies in Brazil are familiar with the due diligence process and are aware of its commercial importance. Still, management can be reluctant to share information with outsiders out of a cultural sense of invasiveness and likely some concern for its impact on its own future. In-house counsel, for example, may regard even ordinary requests and questions in connection with due diligence as personal attacks against their work and may respond negatively. As in all of the BRICs (and elsewhere), building trust with management is critically important to the success of the process.

- *Internal organization:* The strength of the internal organization of Brazilian companies varies greatly. While many companies in Brazil, including all public companies, are subject to mandatory audits, many others are not; companies subject to independent audits of their financial statements are generally better organized than those that are not subject to audits. Most companies have legal departments and in-house counsel; however, decentralization of information and knowledge is a common issue. There is a lack of standardized documentation practices generally in the country and corporate records, such as minutes of the meetings of shareholders or the board and the registry of share ownership and transfers, may not have been properly documented or registered with the competent authorities.

- *Availability of public search resources:* The Brazilian government has made substantial investments in public search resources, and a wide range of matters such as federal court litigation, trademarks, patents and domain, as well as certain tax debts can be searched through the internet. In some states, it is also possible to carry out public internet searches for labor and state court litigation and corporate records. As a general rule, if a public search cannot be made through the internet, it can be made at the public authority charged with keeping records of the particular information being sought.

Business Due Diligence

- *FCPA:* As reflected by the selective enforcement described in the next two bullets, Brazil is a "high-risk" country in the anti-bribery area. The risk is higher still in business sectors that operate under governmental concessions or authorizations and is also significantly higher in less developed regions of the country.

- *Occupational safety and health:* Unlike China, for instance, Brazil has extensive occupational safety/health laws and regulations, and employers that fail to comply with such laws and regulations are subject to fines and other sanctions. Like China, however, the enforcement of occupational safety/health laws and

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...Unlike Russia, for instance, Brazil's accounting standards are increasingly conforming with IFRS, and it is well on the way to digitizing its record keeping and public search functions.

regulations may vary depending on the region and the business sector. Also, from time to time, the Brazilian government and NGOs have denounced companies, especially those in the agricultural sector, for subjecting workers to inhumane conditions that amounted to slave labor. Foreign investors may face reputational risk if the company in which it invests or with which it does business has serious occupational safety/health issues.

- *Environmental compliance and enforcement:* In Brazil, federal, state, and municipal governments, have the power to regulate environmental matters. Although these matters are usually regulated by federal laws, states and municipalities have the power to implement additional requirements and proceedings for environmental compliance. As a result, compliance with environmental laws can be challenging, particularly for companies operating in multiple areas within Brazil. The enforcement and levels of compliance with environmental laws may also vary depending on the region and the size of a company's operation. While large corporations are closely monitored by environmental authorities, NGOs and smaller businesses, especially those operating in certain regions, are less likely to be closely monitored and are, therefore, less likely to be in strict compliance with environmental laws. Note that Brazil has its own "Superfund"—like laws providing that under certain circumstances, a new owner of a contaminated area may be held jointly and severally liable with the previous owners for the area's recovery, regardless of whether the new owner caused the environmental degradation.

- *Foreign investment restrictions:* On its face, Brazilian law prohibits foreign investments in certain areas and activities, such as nuclear energy, certain healthcare services, post office and telegraph services, certain aerospace activities, domestic airline services, newspaper and magazine publications and television and radio networks. Foreign investments in financial institutions, rural properties and in properties implicating national security are also restricted. While most of these restrictions can be waived by the government, or otherwise avoided by obtaining the prior authorization of the government or through other similar processes, this is not always the case. Since 2010, for example, the Brazilian government has been blocking foreign investment in rural properties by looking through Brazilian investment vehicles controlled by foreigners that had been utilized historically to attempt to comply with these restrictions. In the past, the Brazilian congress has passed amendments to the constitution to remove or ease certain of these restrictions, as was the case during the privatization process of the late 1990's, and it is currently discussing a bill that would address the issue of foreign ownership of rural properties.

Brazil's legal system is based on written statutes. Compared to common law jurisdictions, prior court decisions have limited precedential authority in Brazil. Many laws and regulations are relatively new and contain broad and sometimes ambiguous provisions. As a result, as with all the BRICs, there is significant uncertainty as to one's legal rights and obligations....

Legal Due Diligence

Regulatory environment: Brazil's legal system is based on written statutes. Compared to common law jurisdictions, prior court decisions have limited precedential authority in Brazil. Many laws and regulations are relatively new and contain broad and sometimes ambiguous provisions. As a result, as with all the BRICs, there is significant uncertainty as to one's legal rights and obligations and government authorities and courts have wide discretion in interpreting and enforcing Brazilian laws and regulations.

Foreign exchange control: Foreign investments in Brazil must be registered with the Central Bank. Non-compliance with Brazilian registration requirements may jeopardize a foreign investor's ability to remit dividends or other distributions payable to its investors outside of Brazil and may require the repatriation of the investment. Registrations are made electronically by the company receiving the investment through the electronic declaration registry of the Central Bank information system, but they are not subject to prior examination or verification by the Central Bank.

- *Regulated industries:* Some industries are regulated by the government, and

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What Are the Options?

Bank Investment in Unaffiliated Private Equity and Hedge Funds Under the Volcker Rule

A central question for sponsors of private equity and hedge funds in the wake of the passage of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule") has been the extent to which "banking entities" (as defined under the Volcker Rule) will be permitted to invest in private equity and hedge funds that are not otherwise affiliated with such banking entities. We discussed this question in the Spring issue of the *Debevoise & Plimpton Private Equity Report* and now provide an update based on the detailed proposed rules for implementing the Volcker Rule (the "Proposed Rules"), which were published for public comment on October 11th and 12th.

The precise answer to how the Volcker Rule will be implemented won't be known until these implementing rules are finalized, after the public comment period ends on January 13, 2012. The final implementing rules may contain substantial changes from the Proposed Rules. Indeed, there is considerable uncertainty as to the final form that the implementing rules ultimately will take, in part because there appears to be a substantial difference of opinion among the regulators involved in the rulemaking process.

Meanwhile, however, many sponsors of private equity and hedge funds, particularly those currently fund-raising or considering fund-raising, face the difficulty of determining which, if any, banks and bank affiliates may invest in their funds. Below we set forth a simplified, updated summary of the current lay of the land under the Volcker Rule and the Proposed Rules. This "cheat sheet" is based on our review of the Volcker Rule statute and the Proposed Rules, as well as our engagement in the rulemaking process. *All guidance provided below is preliminary and subject to revision pending the adoption of the Proposed Rules; of course, specific facts and circumstances should also be considered in any analysis.*

Options for a U.S. Banking Entity

If the Proposed Rules are adopted as published, a U.S. bank (or other insured depository institution) and its affiliates (a "banking entity") generally would *not* be permitted to invest directly from its own balance sheet in U.S. private equity or hedge funds, unless the fund satisfies one of the exemptions noted below. In addition, it appears that a U.S. banking entity generally would not be able to invest in non-U.S. private equity or hedge funds or, for that matter, even funds that are registered and publicly offered in other jurisdictions (including, for example, European UCITS vehicles).

Customer Funds. A U.S. banking entity could set up one or more so-called "customer funds" to act as either a fund of funds, a parallel fund or a feeder fund that invests in or alongside an unaffiliated private equity or hedge fund. The banking entity's investment in the "customer fund" would be limited to 3% of any such customer fund's capital and 3% of the banking entity's Tier 1 capital (aggregated across all of the banking entity's investments in customer funds). These 3% limits would not include rights to carried interest or, in most circumstances, the individual investments of employees providing services to the "customer fund" (unless the investments were guaranteed or funded by the banking entity). Investors in a customer fund would not be required to have a pre-existing relationship with the banking entity sponsoring the customer fund.

General Account and Separate Account Assets. Many commenters believe, based on specific language in the Volcker Rule and on policy grounds, that an insurance company affiliated with a U.S. bank should be able to invest the insurance company's general account and separate account assets in private funds, subject to compliance with applicable state insurance laws on permitted investments. We note, however, that the Proposed Rules do not address this point, even though the Proposed Rules provide a clear exemption from the proprietary trading prohibition for insurance company general account and separate account assets.

Hedging. A U.S. banking entity would be able to make investments in private equity and hedge funds designed to reduce the specific risks to the banking entity from

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...[U]nder...the Proposed Rules, it is possible that a U.S. private equity or hedge fund manager could establish a Non-U.S. Investor Fund to invest side-by-side with another fund sponsored by the U.S. manager in the same portfolio companies and on the same terms.

either (1) acting as intermediary on behalf of a customer (that is not a banking entity) to facilitate the exposure by the customer to the profits and losses of the private equity or hedge fund or (2) a compensation arrangement with an employee that directly provides investment advisory or other services to the private equity or hedge fund.

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

Non-U.S. Investor Funds. A non-U.S. banking entity with a U.S. banking presence (*i.e.*, a branch, agency office or commercial lending company or with a subsidiary U.S. bank) generally would be allowed under the Proposed Rules to invest in an unaffiliated private equity or hedge fund that is marketed and sold solely to non-U.S. residents so long as the non-U.S. banking entity's U.S. affiliates and employees are not involved in the offer or sale of the fund's interests (a "Non-U.S. Investor Fund"). A non-U.S. banking entity with a U.S. banking presence would be able to invest in a Non-U.S. Investor Fund without being subject to the Volcker Rule's limits, even if the Non-U.S. Investor Fund (1) were organized under U.S. law, (2) were managed by a U.S.-based manager and (3) invested principally in U.S. companies. We note that under this provision of the Proposed Rules, it is possible that a U.S. private equity or hedge fund manager could establish a Non-U.S. Investor Fund to invest side-by-side with another fund sponsored by the U.S. manager in the same portfolio companies and on the same terms. However, any such arrangement would need to be analyzed to ensure that the Non-U.S. Investor Fund is not deemed to be sold to U.S. residents. A Non-U.S. Investor Fund would not need to meet the conditions applicable to customer funds.

Other Options. A non-U.S. banking entity also would have the same options as a U.S. banking entity, described above, to invest in unaffiliated private equity and hedge funds.

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

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

Bank-Sponsored Pension Plans and Bank Employees

Pension Plans. A bank-sponsored pension plan would be permitted to invest in unaffiliated private equity and hedge funds if the plan is a "qualified plan" under the Internal Revenue Code.

Employees and Employee Vehicles. The Proposed Rules would allow bank employees providing services to customer funds generally to invest in those funds without such employee investments counting against either of the two separate 3% limits described above that apply to banking entity investments in customer funds (unless such investments were guaranteed or financed by the banking entity). Banking entity employees should be able to invest in unaffiliated private funds, although there is language in the preamble to the Proposed Rules that casts doubt on this point; clarification in the final regulations would be helpful.

Effect of Volcker Rule Restrictions on Fundraising by Private Funds That Are Not Affiliated with Banking Entities

The practical effect of the restrictions under the Volcker Rule and the Proposed Rules on U.S. and non-U.S. private equity and hedge fund managers that are not affiliated with banking entities is to limit significantly their ability to access the capital of U.S. banking organizations and non-U.S. banking organizations that have a U.S. banking presence.

Under the Proposed Rules, however, such U.S. and non-U.S. private equity and hedge fund managers generally *would* be permitted to raise capital for their funds from (1) banking entity-sponsored customer funds (organized as feeder funds, funds of funds or parallel funds), subject to the two separate 3% limits described above, (2) non-U.S. banks with no banking presence in the United States, (3) non-U.S. banks that have a U.S. banking presence, so long as the funds in which those non-U.S. banks invest are offered only to non-U.S. persons and (4) bank-sponsored pension plans. Such managers also *should* be able to raise capital from insurance company general accounts and separate accounts. Finally, such managers *may* be able to raise capital from employees and pooled employee vehicles of banking entities; however, further guidance would be helpful.

What's Next?

As mentioned above, the actual reach and operation of the Volcker Rule won't be known until the implementing rules summarized above are finalized. The rules could change substantially between now and then. First, there appears to be a substantial difference of opinion among the regulators involved in the rulemaking process as to the form that the final rules should take. Second, the release setting forth the Proposed Rules posed hundreds of questions for public comment. Third, advocates for greater or lesser regulation of banking entities have loudly and publicly expressed widely differing views on the form that the Proposed Rules should take,

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Buyer Beware (Delaware Law Edition):

Sometimes "Substantially All" Isn't All That Much

An unexpected stockholder approval requirement can throw a monkey wrench into the deal certainty calculus for divestiture transactions. In light of this year's uptick in subsidiary divestitures (particularly via spin-off), private equity buyers (and sellers) should be mindful of recent guidance from Delaware courts on whether a shareholder vote or lender consent would be required to approve such divestitures. A shareholder vote can significantly lengthen the time and increase the expense it takes to close the transaction, resulting in a private equity buyer's loss of appetite for a deal or their missing increasingly ephemeral financing windows.

Most people in the deal business know that the sale of all or substantially all of the assets of a Delaware or New York corporation would require shareholder approval, and depending on the indenture, consent from the seller's banks or bondholders.[1] Unsurprisingly, there is no bright-line rule as to when a divestiture constitutes "substantially all" of a corporation's assets. Practitioners will generally advise that a sale of 60% of the book value may be the tipping point, particularly when the corporation's remaining assets are unprofitable.[2] But, they recognize that there are multiple ways of slicing and dicing—while shareholder approval statutes and bond indenture provisions often refer to "assets," courts look not only at book value, but also at other indications of financial value including EBITDA, net income, and cash flow.

Less obvious is that a transaction for only a small fraction of a corporation's assets could trip those approval and consent requirements in certain circumstances. The Delaware Supreme Court recently reviewed a bondholder's challenge that a June, 2010 split-off from Liberty Media Corporation required shareholder approval.[3] Even though the assets divested represented only 15% of Liberty Media's book value at the time that the alleged "disaggregation strategy" commenced, the indenture trustee contended that those assets, when combined with Liberty Media's other three divestitures under the alleged plan, constituted substantially all of Liberty Media's assets. The Court confirmed that the "substantially all" analysis is not a snapshot, and that separate transactions, effected as part of an overall scheme, could be aggregated to determine if they constituted "substantially all" of the assets of the corporation. In the case of Liberty Media, however, the Delaware Supreme Court upheld the Chancery Court's determination that the four separate divestitures were not part of such an overall plan, and thus did not need to be aggregated.[4]

A review of the Liberty Media case, as well as other New York and Delaware precedent, identify some important questions a private equity buyer should ask in the context of a subsidiary divestiture.[5] The first step would be to identify any past, pending or near-term future divestitures. The next step would be to review the divestitures' materiality by assessing their size in terms of assets, EBITDA, and net income, as well as more qualitative factors including profit potential and importance to the remaining business. If the divestitures (taken together) could constitute "substantially all" of the seller's assets, the buyer should conduct a detailed review of the seller's board minutes and public statements to ensure there was no overarching plan or scheme of divestiture and that each transaction had independent justification, and review the other divestiture agreements to determine that each divestiture was not linked contractually (*e.g.*, as closing conditions) to one another. Although it may be tempting for a buyer to rely upon further protection in its own purchase agreement to ensure that it has the right to terminate the agreement if its transaction is credibly challenged or is determined to require shareholder approval, both the buyer and seller need to be careful not to create a record that might attract such challenges for hold-up value. Otherwise, a termination right is a hairline trigger and may be too drastic. Of course, a prudent seller would generally anticipate this line of inquiry and provide support for its conclusion that the various sales should not be aggregated.

Even if the parties have determined that shareholder approval is not required, they should be prepared for challenges from bondholders, activist shareholders, or the plaintiff's bar. Although this area has not been fertile ground for strike suits by the plaintiff's bar, in the wrong circumstances such an attack could unravel a deal. ■

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1 *See Del. Gen. Corp. Law. Section 271; NY BCL Section 909.*

2 *At least one court has found that the sale of 51% of a corporation's assets required shareholder approval. See Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981).*

3 *See Bank of New York Mellon Trust Co., N.A. v. Liberty Media Corp., 29 A.3d 225 (Del. 2011) (under the terms of an indenture, Liberty Media agreed not to transfer "substantially all of its assets" unless the successor entity assumed Liberty Media's obligations under the indenture).*

4 *Because the Court found that there was no overall scheme or plan, it did not need to determine if the four divestitures constituted "substantially all" of Liberty Media's assets, and the Court did not address the appropriate method for analyzing the "substantially all" calculation. Therefore, a thoughtful buyer would measure the divested businesses' size at both the time of sale as well as at the time of the alleged plan's adoption.*

5 *Similarly, careful sellers, mindful of the shareholder and bondholder litigation risk, would address these issues in advance of any planned divestiture.*

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Discount Shopping:
Making the Most Out of Distressed Asset Sales

Private equity lawyers may find some exceptional opportunities arising out of other people's problems. In the uncertain economic climate of the last few years, asset sales in bankruptcy—or "Section 363 sales" named after the section of the Bankruptcy Code that authorizes them—have become a common restructuring alternative for troubled companies. The Section 363 sale process offers considerable advantages to sellers and buyers alike and, in a growing number of cases, is viewed as an efficient and fair way to maximize the value of a distressed business for the benefit of all constituencies. Although default rates remain somewhat surprisingly low, many businesses that kicked the proverbial can down the road through "amends & extends" or favorable refinancings will need to face the music eventually, and some of them may be attractive targets for private equity buyers. To take full advantage of these opportunities, it is crucial to understand not only the basics of Section 363 sales and their distinctive features compared to standard M&A transactions, but also emerging trends and issues in distressed asset sales.

Section 363 Sale Basics

Section 363 of the Bankruptcy Code allows a debtor (*i.e.*, a company in bankruptcy), with court approval, to sell assets outside the ordinary course of business.[1] The debtor must establish that it obtained the highest or best price for the assets. This requirement is often satisfied by a "double auction." The company first markets the assets, runs a sale process and ultimately negotiates and signs a purchase agreement with the party that makes the best offer (otherwise known as the "stalking horse"). To minimize the impact of the bankruptcy on the business, the stalking horse agreement is usually signed just before the company enters Chapter 11, providing a more certain outcome for the debtor. The stalking horse agreement then serves as the floor in an auction conducted in accordance with bidding procedures negotiated with the stalking horse and then approved by the bankruptcy court.[2]

A Section 363 sale can be approved by the court only after notice to interested parties and a hearing. Until the court approves the sale, the purchase agreement is binding on the buyer, but not the debtor. For this reason, the bidding procedures as well as any break-up fee and expense reimbursement granted to the stalking horse are typically approved by the court before the auction so that they are binding on the debtor.

Section 363 sales offer many advantages to buyers, including the ability to purchase the assets free and clear of nearly all pre-closing liabilities and encumbrances,[3] an open auction process, and a relatively clean and easy transfer of title. In turn, these advantages can result in improved realization value for the debtor and its creditors and, coupled with an efficient administration of post-sale liabilities, may result in a confirmed Chapter 11 plan that includes releases of the debtor's directors and officers.

Who Are the Real Parties in Interest?

Secured creditors are key players in Section 363 sales. As a general matter, assets can only be sold free and clear of a lien if the creditor secured by the lien consents to the sale or is paid in full from the proceeds. If the proceeds are not sufficient to pay the secured debt in full, a potential buyer is effectively negotiating not only with the debtor and its management, but also with the secured creditors. Understanding how one's bid is valued by the secured creditors is essential. For example, a buyer's assumption of pre-bankruptcy unsecured trade obligations does not provide direct value to the secured creditors, who are focused on the actual proceeds of the sale. But leaving those obligations behind may affect the value of the debtor's account receivables if trade creditors exercise setoff rights or stop doing business with the debtor prior to the closing of the sale, which secured creditors may in fact care about.

By contrast, a Section 363 sale can usually be approved over the objection of unsecured creditors if the court finds that, among other things, the marketing process was robust and produced the highest or best price for the assets in the circumstances. Even if unsecured creditors can establish that typical valuation principles would tend to suggest a higher valuation, the market test is generally controlling. In other words, if the auction was conducted fairly and without collusion, the winning bid is assumed to represent the best price available in the market. Thus, unsecured creditors typically cannot prevent the sale under those circumstances, unless they are willing to put their money where their mouth is and purchase the assets themselves for a higher price.

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1 *For a detailed description of the Section 363 sale process, see "Section 363 Sales: How to Play the Game," Debevoise & Plimpton Private Equity Report, Summer 2007, Volume 7, Number 4.*

2 *The process is in some ways similar to a public M&A transaction in that the buyer is subject to being topped by other bidders even after it has signed a definitive agreement.*

3 *Exceptions to keep in mind are environmental liabilities and successor liability related to certain types of tort claims.*

Making the Most Out of Distressed Asset Sales (cont. from page 13)

How Fast is Too Fast?

The historic $1.85 billion sale of Lehman's North American business to Barclays in 2008, which was approved and consummated in a record seven days after Lehman's bankruptcy filing, appears to have opened the door to faster Section 363 sales. It is now customary for debtors to propose sale timelines of two months or less from the bankruptcy filing to the sale hearing, compared to what used to be a three-month rule of thumb.[4]

The actual length of the process will depend on many factors, including the judge's availability, whether objections are filed, the likelihood of other bidders, and whether, like in the Lehman sale, the business is truly a "melting ice cube" that must be sold without delay. Grumblings about the frequency and speed of Section 363 sales appear to be increasing. These are often coupled with concerns that Section 363 sales deprive unsecured creditors of certain protections that would otherwise be available if the business were sold pursuant to a Chapter 11 plan, including the requirement that the plan be approved by affected classes of creditors. A purchase of assets (or stock in a reorganized entity) pursuant to a Chapter 11 plan provides many of the same benefits as a Section 363 sale as well as additional advantages, including the ability to provide for appropriate releases in the plan and exemptions from certain transfer taxes and registration requirements under securities laws.

Courts are generally sympathetic to arguments that the Section 363 sale process should be slowed down to give interested parties a real opportunity to conduct diligence and submit bids. Ultimately, however, courts will be reluctant to meaningfully delay a sale if the only debtor-in-possession financing available is tied to an expedited process and the alternative is a Chapter 7 liquidation. This may be particularly true for companies burdened by high levels of secured debt and therefore with limited additional assets to finance a full operational and financial restructuring, which typically takes longer and is more expensive than an asset sale.

4 *This is similar to a public M&A transaction timeline, assuming no regulatory delays.*

Break-Up Fees: Are They at Risk?

In exchange for its investment of time and money to conduct due diligence and negotiate a purchase agreement, the stalking horse will usually insist on some deal protection in the form of a break-up fee, expense reimbursement and certain procedural advantages such as information rights and minimum bid requirements. Resistance to a large break-up fee, which could have a chilling effect on bidding, can be expected from the debtor and any creditors who will not be paid in full from the sale proceeds.

The stalking horse should also consider the possibility that another bidder might attack the break-up fee by offering to purchase the assets on the same terms as the stalking horse but without a break-up fee as evidence that a break-up fee is not necessary to induce a party to act as stalking horse. Although disappointed bidders generally do not have standing to object to a Section 363 sale, this tactic was successfully employed in a handful of cases in Delaware in recent years, where the court ultimately denied the break-up fee or approved a reduced break-up fee.[5] The willingness of a party to buy the assets without a break-up fee makes it difficult for the court to conclude that the fee is necessary to induce competitive bidding and therefore to preserve the value of the debtor's estate.

5 *In re Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010); In re Magic Brands, LLC et al., Case No. 10-11310 (BLS); In re SHC, Inc, et al., Case No. 03-12002 (MFW). Note a similar trend in recent public M&A auctions where topping bids have been made without a break-up fee in an attempt to pressure the stalking horse into eliminating or reducing its break-up fee.*

Credit Bidding: Risk or Strategy?

A secured creditor has the right to purchase its collateral in exchange for the satisfaction of its claim (or "credit bid") in a Section 363 sale. Because secured creditors can bid the face amount of their claim regardless of the value of the underlying collateral, secured debt trading at a discount can be a valuable currency for potential buyers.

Unless the secured creditors are willing to accept less than full payment of their claims, a cash buyer risks being outbid by the secured creditors. To minimize this risk, the stalking horse should request that the secured creditors consent to its bid. In addition, the stalking horse should make sure that its break-up fee will be paid in the event that a credit bid is selected as the winning bid. Because a credit bid by definition does not include cash, the debtor may not have sufficient funds to pay the break-up fee. Therefore, the bidding procedures should require that any credit bid include a cash component sufficient to pay the break-up fee.

Credit bidding is increasingly used by sophisticated distressed investors as a way to gain control over troubled businesses. The success of this "loan-to-own" strategy depends on a number of factors, including whether the liens securing the debt are valid, perfected and non-avoidable. In addition, if an investor does not purchase 100% of the debt, it is equally important to ensure that the financing documentation allows the investor to control the decision to credit bid. The

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Buyer Beware (Employee Edition):

Employee Benefit Covenants Could Have Unintended Consequences on ERISA Plans

It's the middle of the night and you're down to the last handful of issues in a complicated carve-out acquisition. You can probably get some of the more pressing deal points if you concede on a few employee benefits points that are seemingly of lesser importance—after all, the purchase agreement will provide that the employees are not third-party beneficiaries to the purchase agreement, so one can always take a second look at these promises in the future. But a recent Fifth Circuit decision serves as a useful reminder to buyers not to assume that this second look will be available. In October, the Court of Appeals for the Fifth Circuit ruled, in *Evans v. Sterling Chemicals, Inc.*, that a retiree-benefits related provision in an asset purchase agreement effectively amended the company's retiree medical plan. This plan amendment had two effects: first, it caused the buyer to give up its legal right to reduce or eliminate the assumed liabilities; and second, all the retirees were able to sue to enforce the provision.

The Employee Benefit Covenant

In 1996, Sterling Chemicals, Inc. ("Sterling") acquired the assets of Cytec Industries, Inc.'s ("Cytec") acrylic fibers business and hired the Cytec employees engaged in the business. As is typical in asset deals (especially "old economy" asset deals), the asset purchase agreement (the "APA") contained covenants addressing the terms of the transferred employees' employment with, and retirement from, Sterling following the closing. Sterling agreed in one covenant to provide retiree medical benefits to the transferred employees when they retired. These retiree medical benefits were to be no less favorable than the retiree medical benefits provided by Cytec under its plans. Sterling further agreed that it would not reduce the level of benefits or increase retiree premiums "without the prior written consent of [Cytec]." The APA was approved by Sterling's board of directors and signed by the chairman of the board. Sterling never amended its formal plan documents to reflect the APA covenant. But from the date of the acquisition until April 2003, it, in fact, provided transferred employees who retired from Sterling with retiree benefits under its retiree medical plan, and charged premiums for such benefits, in a manner consistent with the APA covenant.

In 2001 and 2002, Sterling went through bankruptcy, and, as part of that process, it "rejected" (that is, terminated) the APA and "assumed" all of its benefit plans, including the retiree medical plan. Thinking that its obligation to Cytec to maintain the levels of benefits and related costs had been terminated along with the rest of the APA, Sterling unilaterally increased the retirees' premiums by significant amounts. Not surprisingly, the retirees promptly sued.

An "Amendment" by Any Other Name

The court (relying on an earlier decision) noted that "as long as an agreement is in writing, it contains a provision directed to an ERISA plan, and the plan amendment formalities are satisfied, such agreement or other document will constitute a valid plan amendment." The court concluded that the first two prongs of this standard were satisfied because the APA was in writing, and the covenant was directed to Sterling's ERISA-covered retiree medical plan. As for the last point, the court noted that "[e]mployers generally are free under ERISA to modify or terminate plans, but if the plan sponsor cedes its right to do so, it will be bound by that contract." Sterling's plan contained no such limitation—the plan document allowed Sterling to amend the plan "at any time and from time to time." The court's bottom line was that the committee responsible for plan amendments did not have to act in order to satisfy the plan's formalities. It was sufficient that the board approved the APA and the chairman of the board signed it.

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The key lesson of the court's ruling is that a transaction agreement's enforcement provisions (which typically provide that only the parties to the agreement can pursue a breach of the agreement within the time period which the parties agreed to) may not be effective to prevent employees from enforcing an employee benefit covenant if the covenant is deemed to be an ERISA plan provision.

Buyer Beware (Employee Edition): Employee Benefit Covenants (cont. from page 15)

Asset Purchase Agreement v. ERISA Plan (Advantage, ERISA Plan)

The court also determined that the effect of the APA covenant survived bankruptcy, despite Sterling's rejection of the APA. The court observed that the covenant was *both* "(i) a contractual obligation between corporate parties, and (ii) an ERISA plan provision enforceable by plan participants." According to the court, the "contractual obligation between" Sterling and Cytec (that is, the APA) had been terminated in the bankruptcy, but the "ERISA plan provision enforceable by plan participants" (that is, the retiree medical plan as amended by the covenant) had been *assumed* by Sterling. This conclusion essentially punished Sterling for its failure to follow the "official" amendment process—if it had done so, Sterling would have realized that it also needed to reject the retiree medical plan in the bankruptcy (which is a complicated but not impossible process). However, because Sterling had never incorporated the APA provisions into the plan document, it likely didn't realize that the APA provision had replicated itself within the plan.

The key lesson of the court's ruling is that a transaction agreement's enforcement provisions (which typically provide that only the parties to the agreement can pursue a breach of the agreement within the time period which the parties agreed to) may not be effective to prevent employees from enforcing an employee benefit covenant if the covenant is deemed to be an ERISA plan provision.

Avoiding the Unintended

In light of the *Sterling* line of cases, when negotiating carve-out transactions, private equity sponsors should try to avoid long-lived employee covenants. This is especially (but not only) true with respect to retirees, who typically present the worst-case employee litigation scenario: (1) there are a lot of them and they usually have a lot of time to enforce their rights; (2) courts are sympathetic to them; and (3) unlike active employees, there are usually no other items of compensation (such as bonuses or equity, or sometimes even continued employment) that make them willing to compromise their claims. If these covenants are not avoidable, a buyer should be comfortable with the employee benefit covenants to which it agrees and should expect that a court will favor the employees in any close case, including by disregarding arguments perceived as "technical" in nature (such as reliance on "no third-party beneficiary" language or the argument that the employees are not able to enforce the provision).

Sterling also points out that process and documentation matter. For example, it is an open question as to whether a provision in the APA stating that no plan amendment was intended by the employee benefit covenants would have been effective. Transaction documentation should also say (if consistent with the deal negotiations) that the acquiror reserves the right to amend or terminate its employee benefits plans at any time. Finally, it is important to follow the procedures for amending plans for purposes of reflecting employee benefit covenants. Sterling would have had a more compelling argument if (1) it had clearly delineated that the agreement as to the post-closing level of benefits and premiums was solely an agreement between it and Cytec, and (2) the plan documents had reflected that distinction. ■

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Del Monte: Staple Remover? (cont. from page 1)

buyers through proposed leverage ratios, which may have the effect of setting a price floor in an auction. Offering stapled financing may attract more buyers to a sale process by decreasing the costs associated with sourcing financing, particularly in the early rounds of an auction, and by ensuring (even in difficult financing markets) that financing is available to all bidders that need it. A staple may also provide a floor on non-price terms that will be available from other lenders, creating a more robust auction and ultimately a better price for the selling stockholders.

A staple can also provide a seller with access to market knowledge and visibility into leverage levels and pricing that it might not otherwise have. This can help a seller initially assess bids. Stapled financing may shorten the bidding process and the time to signing because the staple lender can complete its diligence and get comfortable with the credit very early in the auction process. Because the seller's financial advisor will have a good chance of earning buy-side financing fees, a seller may even be able to negotiate a lower fee for the sell-side M&A advisory work.

There may also be good reasons to allow a sell-side advisor to offer buyer financing outside the context of a staple. For example, the participation of an additional lender may, given the lender's balance sheet or market expertise, facilitate and expedite closing to the seller's benefit, or facilitate execution in a difficult market by decreasing the individual exposure of the other committing banks.

Understanding the Risks

Of course, whenever a sell-side advisor participates in buy-side financing, including by way of a staple, there are potential conflicts of interests – an issue that was highlighted by the Delaware Chancery Court in *Del Monte* and in the 2005 *Toys "R" Us* decision. The key issue is that the sell-side advisor's possibility of earning fees from the buy-side financing creates the risk that the advisor will seek to influence the process so that the deal goes to a particular buyer (or particular type of buyer, such as a private equity sponsor) that is most likely to utilize its financing. This risk is heightened because the fees that can be earned on the financing are often larger than the sell-side M&A fees. A financing source's interests are also in some other respects potentially adverse to sellers. For example, a financing source might want a buyer to pay less so that leverage levels are lower, and may even seek to scuttle the deal or negotiate concessions (including purchase price reductions) if any conditions to funding arguably have not been satisfied, such as in the case of a material adverse effect arising prior to closing.

There are risks for the buyer too. First and foremost, because of exculpation and indemnification provisions contained in bankers' typical engagement letters and debt financing commitments, the lion's share of any litigation liability is likely to be borne by the portfolio company and its purchaser. In *Del Monte*, the target agreed to pay about three-quarters of the settlement. Further, while the complaint in *Del Monte* alleged improper behavior by the bidder, in that case the court stated that the plaintiffs had established a reasonable probability of success on a claim against the purchasing sponsors for "aiding and abetting" actions that allegedly injured the company's shareholders, which materially increased the sponsors' potential exposure. In addition, if conflicts of interest are not properly managed, sponsors risk losing the benefit of valuable and negotiated-for deal protections. For example, in *Del Monte*, the buyers were stripped of their right to a termination fee and matching rights with respect to topping bids when the court reopened the auction.

These risks are greatest in transactions where the company being sold is publicly held, since shareholder litigation is nearly inevitable in such transactions – and the plaintiffs' bar is now more focused than ever on potential conflicts related to sell-side advisors. Private transactions raise less litigation risk (although sellers will nonetheless wish to manage potential conflicts carefully), but those risks will not be eliminated where there are management and other non-controlling shareholders with differing interests who could bring a claim.

Getting it Right

The most important step for any seller considering the possibility of allowing its financial advisor to offer or provide buy-side financing is to make sure that the board is fully informed and carefully considers its options. Before agreeing to permit its financial advisor to offer buyer

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The most important step for any seller considering the possibility of allowing its financial advisor to offer or provide buy-side financing is to make sure that the board is fully informed and carefully considers its options.

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financing, the board must come to a reasoned decision that the arrangement will advance the interests of its stockholders, including a discussion of steps that will be taken to mitigate the potential conflicts of interests.

Such measures might include some or all of the following:

- Requiring sell-side advisors to disclose all relationships with potential buyers, especially any pre-engagement discussions with potential buyers regarding a possible acquisition of the target and financing.
- Including a provision in the sell-side engagement letter that the advisor cannot participate in buyer financing without the board's prior approval.
- Ensuring that the advisor establishes independent teams to advise the seller and to assist potential buyers with financing, including information barriers to prevent communication between these teams.
- Particularly in a public transaction, engaging a second financial advisor to participate in or co-manage the sales process, give a fairness opinion and run any post-signing "go shop" marketing process, and advise the target when conflicts arise such as a buyer's assertion that a material adverse effect has occurred.
- Seeking to negotiate a lower sell-side fee to recoup the fees paid to a second advisor.
- Carefully reviewing the indemnification provisions in commitment papers and engagement letters, to understand who bears the risk of any litigation exposure.
- In considering whether a sell-side advisor should be permitted to participate in a winning bidder's financing outside of a formal staple process (as was the case in *Del Monte*), make any such decision only after price and other principal terms have been agreed to so that the financial advisor cannot be argued to have tainted the sale process.

What's next?

While there have been relatively few recent sponsor-led acquisitions of public companies as a result of a slowdown in M&A markets generally, we have seen a meaningful shift in public transactions away from sell-side advisors offering a staple and from sellers allowing sell-side advisors to participate in winning bidder financings generally. We are also seeing some sponsors on the buy-side take the position that, based on the facts of a given transaction, they will not permit sell-side advisors to participate as a lead arranger, or at least not as lead-left, in their financing. These trends are more difficult to assess in private company sales and carve-out transactions, but we believe the lower risk of litigation in these transactions is resulting in fewer changes in market practice. While caution is appropriate, even in public transactions we think it is premature to announce the death of stapled financing, at least in the right circumstances. ■

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Bank Investment Under the Volcker Rule (cont. from page 10)

and numerous public comments on the Proposed Rules certainly will be submitted.

At present, the period for public comment is scheduled to end on January 13, 2012, although certain industry participants have already requested additional time to submit comments. However, the statutory deadline for the Volcker Rule to become effective remains July 21, 2012. Between now and then, we'll be following developments closely and will report back in future client updates or issues of this publication. ■

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Covering the Capital Structure: The Seller Note (cont. from page 4)

notes. Certain seller notes (*e.g.*, demand notes and readily tradable notes) are not eligible, and, in any event, the deferral is not free: If a seller holds over $5 million face amount at the end of a year, the Internal Revenue Code generally requires the seller to pay interest on the deferred tax liability. Moreover, if payment dates and amounts are contingent on matters such as the earnings of the target, which is often the case, Treasury Regulations provide complicated rules for the calculation of installment gains and OID.

Special Features for Multiple Sellers. When multiple sellers are involved, as may be the case with the sale of a family business or a company with significant management equity, seller notes may be appropriate and even preferred for some (such as those who may be able to use the installment sale method to defer taxes) but may be unsuitable for others (such as disgruntled minority holders). In such circumstances, it may be possible to structure the transaction so that only some of the sellers receive seller notes. Alternatively, if some unhappy holders are likely to be uncooperative going forward, a buyer may wish to consider whether such holders will ever be in a position to block amendments and whether voting arrangements can be made to assure that the holders most likely to be constructive in the future will control such voting rights. Correspondingly, sellers should review voting arrangements to know whether changes can be made to the terms of the seller note without their consent. In any event, particularly when multiple sellers are individuals who may not be "accredited investors," care should be taken to insure compliance with the securities laws through, for example, use of the safe harbor in Regulation D.

Compromises and Challenges

While never entirely out of season, the seller note is not fit for all occasions. When valuations are easily ascertainable and debt markets readily accessible, use of a seller note may present unneeded compromises and challenges: the compromise, for example, of a seller's preference to exit an investment entirely, or of a buyer's preference for more flexibility than the terms of the seller note permit, and the challenge, for example, of devoting time, effort and attention to the negotiation points, the tax issues and the intercreditor issues described above.

Nevertheless, when valuations are murky and debt is scarce, as in today's markets, the seller note, with its multiple variations and customizable features, can be a very useful device for stitching up the capital structure for an LBO. ■

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Making the Most Out of Distressed Asset Sales (cont. from page 14)

few courts that have considered this issue have held that credit bidding constitutes an exercise of remedies, which typically requires the consent of lenders holding a majority of the debt.[6] Although the language in the relevant contract will govern, courts have rejected the argument that a credit bid is tantamount to a release of collateral requiring unanimous consent of the lenders. Thorough diligence on all of these points is critical.

Conclusion

Section 363 sales now follow a well-beaten path, particularly in busy bankruptcy jurisdictions like the Southern District of New York and Delaware. These sales offer considerable advantages to potential purchasers in the form of protection against undisclosed and other pre-closing liabilities and the certainty of a relatively well-defined process. The appeal of credit bidding to control-oriented investors offers new opportunities but also new complexities for buyers, and underscores the importance of understanding the perspective of key creditor groups to structure one's bid in the most optimal way possible. Finally, in weighing the pros and cons of acting as a stalking horse, buyers should be mindful of the few Delaware cases where disgruntled bidders have successfully challenged break-up fees. ■

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6 *See, e.g., In re Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), aff'd In re Chrysler LLC, 576 F.3d 108 (2d Cir. 2009).*

A Primer for Due Diligence in Each BRIC Country (cont. from page 8)

the granting of concessions or permissions to operate, the transfer of such concessions or permissions and the acquisition of any participations in the regulated companies are subject to the approval of the federal, state or municipal authority, as the case may be. While, subject to the foreign investment restrictions described above, there are no legal restrictions on the participation by foreign investors in most regulated industries, foreign investors must comply with the same requirements imposed on Brazilian investors.

- *Tax:* The Brazilian tax compliance system is considered one of the most complex in the world. As a result, business entities in Brazil are frequently involved in many lawsuits and administrative proceedings that challenge the interpretation and application of the tax framework. Frequently, entities within the same industrial sector are involved in lawsuits and administrative proceedings challenging the same taxes and on the same grounds.
- *Labor litigation:* Brazilian laws grant employees extensive social security and labor rights and benefits, the costs of which are mostly borne by the employer. Additional rights and benefits may also be established by collective bargaining agreements between labor unions and employers. Employees in Brazil frequently file suits against their former employers claiming unpaid rights and benefits, as well as damages; however, upon settlement of the disputes, the amounts actually due by employers tend to be considerably lower than the amounts claimed by the employees. Calculations of a company's exposure to labor liabilities often include considerations of the average amount claimed in lawsuits of the same nature and the company's historical rates of loss.

Financial Due Diligence

- *Accounting records:* Brazil is currently implementing a public digital bookkeeping system, which will also include a digital accounting bookkeeping system and electronic invoices, all subject to digital certification. The integrated public digital bookkeeping system aims to improve the level of monitoring by Brazilian tax authorities and the transparency of accounting records. A significant example of this trend is the SPED Project currently being implemented by the Brazilian Federal Tax Authorities.
- *Financial Audit:* Independent audits of financial statements are mandatory only for public companies, financial institutions, investment and private equity funds, and insurance companies; however, creditors commonly require independent audits of other companies as well. Most large Brazilian companies, whether public or private, are audited by the "big four" auditing firms or a reliable Brazilian accounting firm. Some local accounting firms in Brazil may be less credible and impartial in performing audits, as they may feel pressured to win engagements or maintain relationships with the companies for whom they are providing the audits.
- *Accounting standards:* Brazilian companies are required by law to prepare audited financial statements under Brazilian GAAP; however, financial institutions, insurance companies and listed companies are required to prepare their financial statements in compliance with the IFRS. Following multiple rounds of revisions, the current version of the Brazilian GAAP is substantially in line with the IFRS, although differences still exist between the two standards.
- *Related party transactions:* Private companies in Brazil tend to have extensive, and sometimes messy, related-party transactions or arrangements. These transactions generally result in tax and labor liabilities to the companies involved.

* * *

While the investment opportunities in Brazil are, in many cases, extraordinary, it is important to keep in mind that the vagaries associated with making investments and operating businesses in the rapidly developing economic and legal systems of Brazil can make it, like each of its fellow BRICs, fertile ground for corruption issues. This, of course, increases the importance of due diligence for foreign investors. Still, the role played by private equity in Brazil is growing rapidly as new funds have made successful investments in the country in the last few years. Given all of its unique strengths, it seems likely that well-advised investors will increasingly find prudent ways to navigate the Amazon. ■

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