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Tender Offers Poised to Become an Acquisition Structure of Choice for Private Equity Buyers

Every so often the Delaware legislature adopts a change to the Delaware General Corporation Law (DGCL) that has far-reaching consequences in the practice of mergers and acquisitions. Everyone in the deal community, and especially those in the private equity world, should be tracking an anticipated amendment to the DGCL that will make acquisitions structured as tender offers more inviting. The amendment will greatly simplify the deal process once a bidder acquires more than 50% of the outstanding shares of the target by permitting the use of a short-form, squeeze-out merger to acquire the remaining shares, without a stockholder vote. Under current law, a bidder must reach a 90% threshold in order to consummate this type of squeeze-out merger. Last year, less than 40% of large ($500 million +) U.S. LBOs of public companies were effected via tender offer. We expect this number to increase significantly upon adoption of the amendment.

The Benefits of Two-Step Tender Offers

As is commonly known, a tender offer followed by a back-end merger provides acquirers of public companies with several advantages as compared to one-step, long-form mergers, accelerated timing being chief among them. The primary reason for the timing advantage is that a bidder does not need to file the disclosure documents with

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"I'm afraid I have some bad news. The company has been taken over by the little kid who sells lemonade down the street."

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Letter from the Editors

The past few months have seen a flurry of court decisions, legislative proposals and administrative pronouncements that impact private equity dealmakers. In this issue, we round up the most noteworthy of these developments.

Two recent developments in Delaware spell good news for private equity firms. First, on our cover we explain proposed changes to Delaware law, which will level the playing field for sponsors seeking to utilize the speedier tender offer structure to acquire public Delaware companies by making this structure easier to execute in a leveraged transaction. In addition, a recent decision by the Delaware Chancery Court provides added comfort to private equity buyers who partner with controlling stockholders or other insiders to acquire publicly-traded Delaware companies by reducing their exposure in the now nearly inevitable shareholder litigation that accompanies public to privates.

Elsewhere in this issue, we review the spate of recent rulings and announcements by the IRS on topics ranging from spin-offs to management fee waivers to the medicare tax, and report on the status of the long-running class action litigation challenging club deals and other practices on antitrust grounds. We also update you on two ongoing European legislative initiatives impacting private equity funds. First, we follow up on our extensive previous reporting on the European Alternative Investment Fund Managers Directive (AIFMD), which is to be implemented by July 22, 2013, with a more detailed discussion of its impact specifically on fund managers based outside the EU and on the marketing within the EU of funds organized outside the EU. We also update you on some recent changes to the UK Takeover Code that will affect acquisitions of UK companies subject to the Code.

Dividend recaps became prevalent once again in 2012 and their popularity continues. We review the factors that are driving this trend, as well certain ways to mitigate the risks that these transactions pose for the company, its shareholders and its officers, and directors. Another trend is interest among private equity fund investors in a fund's environmental, sustainability and governance practices, so-called ESG programs. We review what is driving such initiatives and argue how developing a program in advance of your next fundraising could be advantageous.

In our Guest Column, Michael Elio, a Managing Director at ILPA, discusses the changing role of the Institutional Limited Partners Association over its ten-year history, growing from an informal sounding board for institutional investors into a sophisticated advocate for its LP members in promoting best practices, developing research and benchmarks and creating industry leading education programs.

In other news, as part of our ongoing effort to make the *Private Equity Report* the most relevant and useful resource for up-to-date information and analysis for private equity professionals, we are revamping the electronic version of the Report to make it more user friendly, whether viewed online, on your tablet or on your other mobile devices. We hope to launch this new product with the next issue and look forward to your feedback.

Kevin A. Rinker
on behalf of the Editorial Board

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Dividend Recaps: Used With Care, a Useful Tool

Dividend recaps are all the rage. 2012 saw a record volume of recap transactions (over $60 billion, according to data provider S&P Capital IQ LCD), and 2013 is shaping up to be another big year in the U.S. and abroad. A recent report from Thomson Reuters noted that the dividend recap volume in 2Q 2013 ($18.4 billion completed and $5.4 billion currently in the market as of the June 17 report) may exceed the previous market high of $19.3 billion seen in the last quarter of 2012. This frenzy of activity isn't surprising, as dividend recaps have turned out to be a powerful tool for private equity firms focused on returning capital.

As with all power tools, however, there are certain precautions that anyone involved in a recap transaction will want to take to help reduce the inherent risks.

Dividend Recaps Are Prevalent for Good Reasons…

Many attributed the record number of recaps in 2012 to looming changes in the U.S. tax code that caused private equity firms to want to realize profits before the end of the tax year. But even as 2012 recedes into memory, there is a near-continuous flow of such deals in the U.S., and the activity has been spreading worldwide. In Europe, despite a traditional reluctance toward dividend recaps, the market in 2013 has already witnessed several major transactions, including loan-funded dividends for Pets-at-Home and Mivisa. And PE fund Investcorp recently announced that it would scrap sale plans for its portfolio company, Armacell, in favor of a dividend recap. Even Asia, where this financing mechanism had been almost unheard of, has recently seen a handful of dividend recap transactions, led by the recent offerings of Nord Anglia Education that were used, in part, to channel funds to sponsor Baring Private Equity Asia.

There are good reasons for these developments. With prevailing interest rates at near-historic lows, dividend recaps offer an attractive opportunity for funds to obtain a return of – or even a profit on – invested capital, without giving up the potential for future equity upside. Thus, this tool allows a fund to accelerate returns to a point early in the business cycle, at a point when a full exit might not be attractive because business growth or improvements have not yet been fully realized.

The recently robust credit market has allowed borrowers to access more money at lower interest rates and with lighter covenants than is typical in tighter credit environments. This means that many portfolio companies have been able to increase their leverage and pay a dividend even as, in some cases, they have improved their covenant position and kept their debt service costs constant. Companies have also been able to insulate against unexpected cash flow hiccups by taking advantage of re-emergent PIK toggle features in dividend recap financing (in which interest may, at the borrower's option, be paid in the form of additional debt instead of in cash).

…But There Are Still Associated Risks

While a dividend recap can provide clear benefits for shareholders and financial sponsors, there are still risks for the company, its shareholders, and its officers and directors. If the debt-funded dividends are too large relative to the company's earnings and available capital, the company will be vulnerable after the transaction to downturns, as it may be left without the ability to adequately fund day-to-day working capital needs. The company also risks devoting so much of its working capital to debt service that future growth opportunities are impaired.

Ultimately, if the company is unable to comply with its covenants, meet its interest obligations or repay its debt at maturity, it may find itself in a workout or bankruptcy scenario. In that case, creditors who are not being paid in full may, with the benefit of 20/20 hindsight, blame the dividend recap for having caused the problem and may sue directors, officers and shareholders in an attempt to recoup some of their lost investment.

This creates distinct risks for the various constituents:

- Directors and officers are at risk if disgruntled creditors argue they breached their fiduciary duty by over-levering the company–thereby rendering it insolvent–in order to pay an unlawful dividend to shareholders. These claims can raise the specter of personal liability for directors and officers: even if they ultimately are unsuccessful, they are an unpleasant and expensive distraction.

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Dividend Recaps: Used With Care, a Useful Tool (cont. from page 3)

While D&O insurance will generally cover such claims, private equity firms and individual directors are well-advised to ensure that they can overcome exclusions in the policies (including for willful misconduct or improper personal benefit from the transaction).

- PE funds and other shareholders are at risk if creditors attempt to claw back the dividend payment on the theory that it was "constructive fraud" that left the business insolvent. With a lookback period that can extend to ten years or more, clawback actions can be filed against both shareholders that received a dividend and any follow-on recipients, raising the possibility that PE funds, their LPs, and individual shareholders such as management teams may be pursued for return of a dividend years

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U.S. Tax Considerations Relating to Leveraged Recaps

Basic Rules. The tax consequences specific to a leveraged recapitalization can have a significant impact on how much of the proceeds the investors (including the sponsor) are able to keep. Where the recap is structured as a distribution from a corporation, an ordering rule in the tax code determines how the distribution is taxed for U.S. purposes. Specifically, the distribution is taxed as a "dividend" to the extent of the corporation's current or accumulated earnings & profits ("E&P"). (E&P is somewhat like retained earnings but computed on a tax basis.) To the extent the distribution exceeds the E&P, it can be received tax free up to the tax basis in the share. Finally, to the extent the distribution exceeds both the E&P and the tax basis, it is taxed as capital gain.

U.S. individuals. Where the distribution is from a Delaware (or other U.S.) corporation, the dividend portion is generally treated as "qualified dividend income" ("QDI") and therefore eligible for the favorable 20% tax rate in the hands of a U.S. individual. Where the distribution is from a non-U.S. corporation, the dividend portion is generally treated as QDI only if the class of stock is publicly traded or the corporation is eligible for the benefits of a tax treaty with the U.S. If the dividend portion is not treated as QDI, it is generally taxed at a 39.6% tax rate in the hands of a U.S. individual.

Non-U.S. Investors. In the case of non-U.S. investors, the U.S. generally does not tax distributions paid by U.S. companies that exceed E&P and distributions paid by non-U.S. companies regardless of E&P. However, the U.S. imposes a 30% withholding tax (which may be reduced by a treaty) on a non-U.S. investor's share of any dividend income received from a Delaware (or other U.S.) corporation.

Importance of E&P (or the lack thereof). Given the significance of E&P to the tax treatment, it is important for sponsors to understand the amount of a corporation's E&P before effecting a leveraged recap. In many cases, deductions for interest (even PIK interest) and other items will eliminate a target company's current E&P. Moreover, since the structure used by a fund to buy a target corporation can impact whether the target's historic E&P survives, it is important to consider the possibility of a future leveraged recap in structuring a portfolio company acquisition.

Redemptions and Share Buybacks. In some leveraged recaps, the portfolio company buys back stock from all (or a group) of the investors instead of making a distribution. Since the transaction is in form a sale of stock, one might think that the tax consequences would follow and the selling stockholders would have gain (or loss) equal to the difference between the sale proceeds and the tax basis in the stock. However, the tax code includes a special rule that recharacterizes a sale of stock to the issuer corporation as a distribution (subject to the rules described above), unless the selling shareholder's percentage interest in the company (by vote and value) goes down by a significant amount.

Leveraged Recaps by LLCs Taxed as Partnerships. A completely different set of rules applies to leveraged recaps by portfolio companies (such as LLCs) that are treated as partnerships for tax purposes. In many such cases, it is possible to structure a leveraged recap so that there is no current tax at all. (Of course, where an investor holds an interest in such an investment through a blocker corporation, the distribution by the blocker corporation is subject to the rules described above and may be subject to current tax).

Fund and GP Level. In any leveraged recap, it is important to understand how the proceeds will be shared (and be allocated for tax purposes) under the terms of the fund agreement. Moreover, where the proceeds of a leveraged recap do not give rise to current tax to the fund (*e.g.*, because the portfolio company did not have E&P), the distribution of the proceeds by the fund to a partner or by the general partner to its individual partners may give rise to current tax if the proceeds exceed the partner's tax basis in the fund (or the general partner). ■

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GUEST COLUMN

ILPA Ten Years On: Our Focus in 2013

Investing in any institutional market is perplexing. Investing in the global private equity arena – with limited transparency, benchmarking and guidance – is downright challenging.

The Institutional Limited Partners Association (the "ILPA") just celebrated ten years of working to make private equity investing less mystifying. Originally an informal gathering of senior investors, the organization has become an even more sophisticated association that continues to provide a global platform for its members to collaborate and access institutional quality education and research.

Today the ILPA is the only global, member-driven organization dedicated solely to advancing the interests of private equity Limited Partners through industry-leading education programs, independent research, best practices, networking opportunities and global collaborations. The ILPA has over 280 institutional member organizations that collectively manage over $1 trillion of private equity assets.

In the remaining months of 2013, the ILPA will be focusing on four main areas:

- *Standards:* Further evolution of the ILPA's industry best practices initiative to include development of a Standardized Due Diligence Questionnaire;
- *Tools:* Further adoption of tools to assist the ILPA's members in applying ILPA Private Equity Principles 2.0 — in the areas of alignment of interests, governance and transparency — to their own investment strategies;
- *Benchmarking:* The release of an institutional benchmark relevant to private equity investors; and
- *Outreach:* The continuation of our education initiatives to external constituents that impact our industry

Standards

The release of the ILPA Principles and their resulting Best Practices in reporting continue to find their way into the mindset of General Partners. We are pleased with the response received to these new standards and now have over 283 official endorsers with additional endorsements coming weekly.

We have heard from across our membership, which has embraced the adoption of the ILPA Principles and Best Practices, and also from many in the industry, including General Partners, service providers, consultants and others. We will continue to be a resource for those looking to strive for Best Practice in their own organizations.

The next step in the evolution of the ILPA's best practices initiatives was to minimize the administrative burden and increase efficiencies in the due diligence process. The ILPA reached out to General Partners, Limited Partners, placement agents and other interested parties to develop the recently released Standardized Due Diligence Questionnaire. The DDQ was released for a trial period to improve its efficiency and coverage, and it is available for download and review at ilpa.org/standardized-ddq/. We welcome comments and revisions, because we believe that feedback from interested parties can only produce a better product.

Tools

To assist members in applying the ILPA's Best Practices to their workflow, we have developed an online rating model that members can use to note the presence (or absence), on a weighted basis, of key partnership agreement terms and provisions.

With over 70 questions highlighting 13 key areas within the alignment and governance areas of the ILPA Principles, the model not only provides members the means to rate the compliance of the partnership agreements of the funds in a member's portfolio against the ILPA Principles, but also a tool to highlight areas of concern for future monitoring.

This tool is not a substitute for due diligence and document negotiation, but does provide a flexible model for the varying needs of a global and diverse membership.

Benchmarking

Properly benchmarking private equity investments has been a challenge since the first successful portfolio company exit. Though recent years have shown a slow transition to absolute and public-market-equivalent benchmarks within the private equity community, there will always remain the need for relevant benchmarking. The ILPA announced last year that it had partnered with Cambridge Associates to create a measure that more accurately benchmarks the performance of institutional funds in the marketplace. Over the last year, the content and scope of this benchmark has been refined and several quarters have been produced to further assess the results.

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ILPA Ten Years On: Our Focus in 2013 (cont. from page 5)

The ILPA recently released the Q4 2012 results to its members and in the balance of this year, with the help of our members and the participation of the institutional fund community, we will focus on broadening coverage of the benchmark from the 2,000+ funds currently included to the over 5,000 funds in the portfolios of our members.

Outreach

Education has always been a cornerstone of the ILPA's mission. Over the last few years, the discourse on private equity has expanded from our small sphere to common dialogue in financial and political circles. This greater conversation highlighted the need for expanding the education platform to combat the negative press and misinformation about private equity circulating among global news desks.

We have been to Beijing several times to deliver customized seminars on private equity to local LPs and insurance companies and to meet with regulators in order to understand the nuances of investing in China for our members. In Washington, we meet on an ongoing basis with regulators, members of the media and key government officials. Our expectation is to continue this education in the best interest of our members and the asset class at large.

* * *

Private equity is built on partnerships and strong relationships between General Partners and Limited Partners. The ILPA will continue to focus its efforts on education, benchmarking and advocating the importance of private equity within a diversified portfolio. We encourage the continued participation of General Partners and Limited Partners in the industry's march to standardization and widely accepted best practices. ■

Mike Elio
Managing Director, Industry Affairs
ILPA

Michael Elio joined the ILPA in 2012 as its Managing Director, Industry Affairs. Mr. Elio leads the ILPA's programs around research, standards and industry strategic priorities. Prior to joining the ILPA he was a Managing Director and Partner at a private equity advisory firm where he served as the lead consultant to North American and European institutional investors committing in excess of $5 billion annually. For more information please visit ilpa.org or email Mr. Elio at melio@ilpa.org.

Looking for a past article?

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

Delaware Court Decision Could Reduce Litigation Exposure in Going Private Transactions

As a result of a recent decision of the Delaware Chancery Court, private equity buyers who partner with controlling stockholders may now be entitled to important new protections when acquiring publicly traded Delaware companies. If not overturned on appeal, the Delaware Chancery Court's May 29 decision would permit such transactions to be reviewed under the business judgment rule so long as certain procedural safeguards are used. Obtaining the benefit of the business judgment rule can substantially reduce the risk that the transaction will be subject to a pre-closing injunction, and lower the cost (in terms of both legal expenses and settlement value) of the shareholder litigation that now accompanies nearly every going private deal.

The recent decision, by Chancellor Strine in a case entitled *In re MFW Shareholders Litigation*, held that a going private merger with a controlling stockholder will be subject to the business judgment rule, rather than the far more rigorous test of entire fairness, if the transaction is conditioned from its inception on approval by (1) a special committee of independent directors <u>and</u> (2) a majority of the shares held by persons unaffiliated with the controlling stockholder (a so-called majority-of-the-minority vote). The case arose from a transaction in which MacAndrews & Forbes, owner of 43% of M&F Worldwide ("MFW"), offered to buy the rest of MFW's equity for $24 per share. In its initial proposal, MacAndrews & Forbes said it would not proceed with any going private transaction that was not approved by a special committee <u>and</u> by a majority-of-the-minority vote. The special committee negotiated a $1 per share price increase, and the merger was approved by holders of 65% of the shares not owned by MacAndrews & Forbes. Chancellor Strine, finding that the special committee was independent and functioned properly and that the unaffiliated stockholders were fully informed, granted defendants' motion for summary judgment, applying business judgment review.

Although Chancellor Strine found that the case presented an unresolved question of Delaware law, it is a question that the deal community has discussed for many years: namely, whether all going private mergers with controlling stockholders must be subject to the test of entire fairness (which reviews fairness of process and fairness of price, and is a much tougher test for defendants to satisfy), or whether some combination of procedural protections could cause such a merger to be subject to business judgment review (which would respect a decision of independent and informed directors unless it was irrational). The Delaware Supreme Court had previously held that going private mergers with controlling stockholders were subject to entire fairness review, but that the burden would shift to the plaintiff to show that the merger was not entirely fair if the transaction was approved <u>either</u> by a special committee of independent directors or a majority-of-the-minority stockholder vote. That holding has invited the question of whether entire fairness should be the test where <u>both</u> procedural protections are present. Chancellor Strine found that despite broad language contained in previous Delaware Supreme Court rulings the issue had not been previously decided by the Delaware Supreme Court, because both protections were not present in those situations.

The logic underlying the Chancellor's decision is persuasive, particularly the court's focus on incentivizing transaction planners to include both protections by applying the business judgment standard, compared to the modest benefit resulting from merely shifting the burden of proof under the entire fairness standard. But it is not clear whether it will be embraced by the Delaware Supreme Court if the decision is appealed. As recently as last summer, that court, in its *Southern Peru* decision, called entire fairness "the only proper standard of review" for an interested cash-out merger and stated that because fair process usually results in fair price, it has "no doubt" that the use of special committees and majority-of-the-minority conditions will continue to be "integral parts of the best practices that are used to establish a fair dealing process." However, as Chancellor Strine acknowledged, "rational minds can disagree about this question."

While the *MFW* decision constitutes a potentially ground-breaking development in Delaware law relating to take-private transactions, given the tension between the Court of Chancery's holding and prior rulings of the Delaware Supreme Court, private equity practitioners and controlling stockholders will need to consider carefully whether the potential for improved legal protection outweighs the additional conditionality that results from having both a special committee process <u>and</u> a majority-of-the-minority vote. ■

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The IRS Has Been Busy

Since the beginning of the year, there has been a steady stream of notable and somewhat unanticipated announcements and new rules coming out of the IRS that impact the private equity community, and not all of them relate to the current scandals that have gotten so much attention in the press. Below is a brief round-up of these developments.

Spin-Off Announcement #1

The IRS surprised the tax community on January 3rd by suspending the issuance of private letter rulings that bless three transaction structures frequently implemented in connection with tax-free spin-offs while it studies the issues involved. The three so-called "no rules" cover (1) some intercompany transactions that are commonly undertaken in order to prepare a company for a spin-off, (2) some transactions used by a distributing company to extract cash from the business being spun-off, and (3) the creation of high-vote/low-vote governance structures in connection with a spin-off.

While some tax-free spin-offs are consummated without a private letter ruling, the types of transactions covered by the new "no-rules " have generally been done only with an IRS ruling because of uncertainty as to how the relevant tax rules apply. In some cases, the transaction is central to the spin-off being considered (*e.g.*, an intercompany transaction undertaken in order to get the assets and liabilities in the right place). In other cases, the transaction makes the spin-off more attractive (*e.g.*, the extraction of cash from the spun-off business). As a result, the new no rules are likely to discourage some companies from pursuing a spin-off and make it essentially impossible for some businesses to be spun-off.

Spin-Off Announcement #2

On June 25th, the IRS announced an even more significant curtailment of the private letter rulings it would issue going forward in the spin-off context. Under the revised IRS procedure, the IRS will stop issuing private letter rulings as to the overall tax-free nature of a spin-off and will generally limit its rulings to so-called "significant issues." Since the tax consequences of a spin-off could be catastrophic if it failed to achieve tax-free treatment, taxpayers effecting a spin-off have generally sought the halo effect of a private letter ruling that covered the entire transaction. The new IRS procedure applies to private ruling requests made after August 23rd. The new procedure also applies to certain other corporate transactions.

New Election to Treat a Stock Purchase as an Asset Purchase

IRC Section 338(h)(10) has long enabled taxpayers to elect to treat a stock purchase as an asset purchase for tax purposes, so that the tax basis of the assets of the purchased company is stepped up to fair market value. A variety of requirements must be satisfied in order to make a valid Section 338(h)(10) election, including a requirement that at least 80% of the stock of the target corporation be "purchased" and that the buyer be taxed as a "corporation."

IRC Section 336(e), which was enacted way back in 1986, authorizes the IRS to issue regulations that would create a similar election in other contexts. A few weeks ago, the IRS issued regulations under Section 336(e) that allow the equivalent of a Section 338(h)(10) election, but with slightly liberalized requirements. Specifically, an election is permissible under Section 336(e) where the acquirer is a partnership (or other non-corporate entity) and where the acquisition was not effected by "purchase." (The term "purchase" is narrowly defined in the Section 338(h)(10) context to exclude certain taxable distributions and exchanges, such as transactions involving multiple acquirers or non-corporate acquirers.)

We believe that this liberalization in the requirements will make these elections available in a number of additional transactions and will therefore increase structuring flexibility in the M&A context.

Partial 338(h)(10) Elections Limited

Earlier this year, an IRS private letter ruling blessed what has been described as a "partial" Section 338(h)(10) election. The transaction effectively allowed the buyer to receive a step up in the basis of some (but not all) of the assets of a target corporation *in a manner that did not create any incremental tax to the target corporation or the seller*, resulting in an unusual "tax bargain." (This type of transaction is described in greater detail in the Summer/Fall 2012 issue of the *Debevoise & Plimpton Private Equity Report.*)

Surprisingly, the new section 336(e) regulations prospectively change the result of the private letter ruling for taxpayers engaging in similar transactions going forward. While there are a few alternative methods of effecting a so-called partial Section 338(h)(10) election to which the new section 336(e) regulations do not apply, the alternative transaction may be somewhat more difficult to execute and/or provide for a somewhat reduced tax benefit.

Management Fee Waivers

In the last month, the tax press has reported on statements made by IRS personnel indicating that they are looking at the so-called "management fee waiver" mechanisms used by some private equity funds (there have, of course, been separate reports that the New York attorney general is also analyzing these arrangements). These statements indicate that the IRS understands that management fee waiver mechanisms come in a variety of forms, that the IRS is more troubled by some of the forms than others and that the IRS is planning to

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Social Twist: Emerging ESG Policies Could Present More Opportunities Than Challenges for Private Equity

Background

More Red Tape?

For those who do not know or, like many of the rest of us, who know but can't consistently retain each of the individual components of the acronym, ESG refers in a very general way to the environmental, social and governance practices of sponsors and their portfolio companies. These factors are increasingly being discussed by investors, including labor unions, political pundits, regulators, management teams and other observers, as a potential means of both developing a reasonably uniform set of best practices for the industry and otherwise evaluating more generally the global economic and societal profile of private equity firms and their portfolio companies.

A few years ago, when ESG policies were even more nebulous than they are now, many PE professionals and other free market advocates, may have viewed these kinds of policies as an example of overly aggressive global regulation. In the current geo-political environment; however, particularly following the prominence of private equity in the 2012 U.S. Presidential election, and other related developments, most private equity firms understand instinctively that the kinds of considerations embodied in the development of ESG are likely to intensify and potentially lead to standards that, if not met, could have broader implications for the industry.

A leading private equity advocacy, research and resource organization has adopted a sector framework for ESG to assist industry participants in this regard. The standards adopted by the Private Equity Growth Counsel, known as the Private Equity Growth Guidance for Responsible Investments (the "PEGCC Guidelines"), provide very broad and, in some cases given the early stage of many of these considerations, necessarily incomplete guidance on ESG. While fund managers can begin to demonstrate commitment to ESG integration by adopting the PEGCC Guidelines or similar standards at this time, concerns linger in many corners of the private equity community about a "pandora's box" -type dynamic with respect to the evolution of ever more stringent and return inhibiting standards governing a broad array of non-economic matters.

Silver Lining?

Still, many PE professionals are coming to believe that, at least on balance, the private equity community may ultimately have more to gain than to lose by the ESG initiative, particularly to the extent it can play an active role in cooperating with others in developing policies acceptable to it and the various other interested constituents. These advantages include (1) the proactive PR and practical benefits associated with the industry's active cooperation in the development of the ultimate comprehensive standards in this area, as opposed to the seemingly greater risks associated with adopting a more passive role; (2) maintaining access to those investors who may ultimately demand ESG compliance as a condition of investment, to one degree or another, as these standards continue to evolve and, all cynicism aside; and (3) obviating the lost opportunities associated with being late adopters of the greener, more sustainable and more profitable operating practices associated with ESG programs (at least according to their advocates).

Giving Meaning to ESG

The specific contours of an ESG investment policy will likely vary based on the geography, sectors and asset classes the funds target, and other investment strategy features. Most governance and social criteria may arguably be relevant to all funds to some extent, while environmental issues are more likely to vary with the investment strategy. General operational sustainability practices (water/energy management and recycling practices) will, however, apply to most companies; it is, for example, the funds investing in real estate, infrastructure or taking control positions in commodities or manufacturing companies that will need to consider a much wider variety of environmental issues. Social criteria (*e.g.*, attention to diversity and equal opportunity in employment practices, government and community relations, labor conditions and relations, product safety management and other human rights issues) will come into play in

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Institutional fund investors are … increasingly adopting socially responsible investment philosophies, …[and] there appears to be an expectation among fund managers and the industry more generally that fund investor attention to ESG issues will continue to increase over the next five years.

most investments. From a governance perspective, virtually all fund managers would also consider portfolio company accounting practices, attention to bribery and corruption risks, lobbying practices, political contributions, anti-competitive behavior and executive compensation to mention but a few aspects.

Drivers

As noted above, a number of reasons are driving the development of ESG standards across the industry. These include:

- *Investor Requirements; Fund Raising Edge.* Institutional fund investors are themselves, as part of their investment policy mandates, increasingly adopting socially responsible investment philosophies, such as the UN Principles for Responsible Investment ("UNPRI"), which are geared towards global sustainability and believed to be consistent with the duties they have to their stakeholders and the public. Such fund investors are encouraging, and in some cases requiring, fund managers to adopt ESG policies that incorporate such "SRI" principles. As noted above, there appears to be an expectation among fund managers and the industry, more generally that fund investor attention to ESG issues will continue to increase over the next five years.
- *Reputational Considerations.* U.S. state pension plans and other governmental investors also tend to be especially focused on ESG integration in their investments to manage "headline risk" and to avoid potential public embarrassment for government officials. Fund managers, fund investors and the portfolio companies themselves would seem to be largely aligned in their interests to appropriately manage various reputational ESG exposures.
- *Political Focus.* The private equity industry and its various participants have come under increased political scrutiny during the last few years. Implementing ESG policies, adhering to SRI guidelines and generally acting as good corporate citizens could help the private equity industry improve its public image.
- *Value Enhancement.* While some cynicism remains on the value proposition in certain corners of the PE community, there is a growing awareness that optimizing ESG operational aspects may protect and increase the value of investments, for example through detecting and preventing operational disruptions due to negative ESG factors, reducing legal ESG risks and managing ESG publicity exposures that may otherwise impair a portfolio company's brand. Building better business practices and strengthening management may more generally enhance profitability and create business opportunities, potentially leading to higher returns for fund managers and fund investors alike.

The private equity industry and its various participants have come under increased political scrutiny during the last few years. Implementing ESG policies, adhering to SRI guidelines and generally acting as good corporate citizens could help the private equity industry improve its public image.

Examples of Value Enhancement

Proponents of ESG policies point to a number of recent examples of what they believe to be value enhancements facilitated by ESG policies. These include the adoption by a major U.S. private equity sponsor of a green investment program, introducing environmental initiatives and facility and operational improvements that have allowed its portfolio companies to collectively achieve an estimated $365 million in savings. They also include (1) a portfolio food service company saving a cumulative $70 million and almost 60,000 tons of greenhouse gas emissions over two years by improving routing technology, increasing the amount of product carried per truckload, and training drivers on more efficient driving techniques, such as when to shift gears or how to break in traffic, (2) an on-line retailer saving $40 million and avoiding 300,000 garbage trucks-worth of waste over a two year period by streamlining and centralizing its recycling efforts and (3) a communication infrastructure company reducing its energy consumption by 2.5% and saving over $650,000 in annual costs by reducing high-pressure sodium lighting in manufacturing facilities.

Integration of ESG Policies

If and when ESG policies are eventually adopted by a particular sponsor, these policies will need to be integrated at all levels of fund and portfolio management, including in the due diligence of investment targets, through active

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How Will the AIFMD Impact Non-E.U. Fund Managers? Answers to Frequently Asked Questions

In previous issues of the Debevoise & Plimpton Private Equity Report, we have reported extensively on the European Alternative Investment Fund Managers Directive (the "AIFMD").[1] The AIFMD will regulate, in stages, the managers ("fund managers")[2] of European and non-European private equity funds, hedge funds and other alternative investment funds (simply referred to below as "funds"), whether those fund managers are based in one of the Member States of the European Economic Area (the "EU") or outside the EU.[3] The AIFMD is required to be implemented into national law by EU Member States by July 22, 2013 (the "Effective Date").[4]

In this article we discuss the impact of the AIFMD on one subset of industry players that will be impacted by the AIFMD: fund managers that are based outside the EU (even if they have sub-advisors in the EU) and that will be marketing funds organized outside the EU (such as funds organized as Cayman Islands or Delaware limited partnerships) in one or more of the Member States of the EU.[5]

The bottom line for non-EU fund managers wishing to market non-EU funds to professional investors in the EU is that, for the period from the Effective Date until at least the fourth quarter of 2015 (subject to any transitional relief that may be adopted by EU Member States), the AIMFD will require those managers (1) to comply with new disclosure rules (including extensive reporting to regulators) and "no asset stripping" requirements and (2) to continue to market their funds by complying with national private placement regimes in the relevant EU Member States, as those regimes may be modified from time to time. The impact of the AIFMD's on these non-EU managers is discussed in further detail in the frequently asked questions ("FAQs") and answers below.

A. What are the key steps that non-EU fund managers must take now to prepare for the implementation of the AIFMD?

Non-EU fund managers that may be marketing non-EU funds in the EU in the near future must take five key steps right away, if they have not already done so. The Effective Date of the AIFMD is July 22, 2013.

Specifically, a non-EU fund manager that may be marketing a non-EU fund in one or more of the EU Member States after the Effective Date must:

(1) identify those funds that it may be marketing in the EU after the Effective Date;

(2) identify those EU Member States in which the manager may be marketing funds after the Effective Date (the "relevant EU Member States");

(3) determine whether the private placement regimes in the relevant EU Member States will be retained (or modified) after the Effective Date and, for each relevant EU Member State where the current private placement regime will be eliminated or modified, determine the requirements of the new fund marketing rules;

(4) monitor how the AIFMD is implemented in the relevant EU Member States (including whether a relevant EU Member State provides for a "transitional" regime); and

(5) prepare the necessary compliance procedures, which in most cases (unless a transitional regime applies) will involve satisfaction of new disclosure obligations and compliance with new "no asset stripping" rules.

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1 See "EU Directive on Alternative Investment Fund Managers: Good News at Last" in our Fall 2010 issue and "Alert: UK/EU Developments: More Disclosure, More Regulation and a Potentially Shrinking Pool of Investors" in the Winter 2012 issue.

2 The AIFMD defines the "manager" as the entity performing at least portfolio management or risk management in respect of an alternative investment fund, or "AIF". The concept of "AIF" is very broadly defined and includes almost any investment fund, whether closed or open ended and however structured, other than regulated retail funds.

3 The Member States of the European Economic Area are: the 27 Member States of the European Union (Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom), together with Iceland, Liechtenstein and Norway. Croatia will become the 28th Member State of the European Union on July 1, 2013. References in these FAQs to "EU Member States" (or the equivalent) are references to the Member States of the European Economic Area, from time to time.

4 As many as 16 EU Member States have not yet published draft AIFMD implementing legislation. Some EU Member States (including Italy and Norway) are unlikely to implement the AIFMD into national law by the Effective Date.

5 The application of the AIFMD to EU-based alternative investment fund managers, and to non-EU managers managing funds organized under the laws of an EU Member State (e.g., a private equity fund or hedge fund organized as an English limited partnership) in the EU, differ from those outlined in this article. We would be happy to discuss those rules with interested clients.

B. Does the AIFMD apply to non-EU fund managers that only manage non-EU funds?

Yes, the AIFMD applies to non-EU fund managers marketing non-EU funds to "professional investors" in the EU. The AIFMD applies to fund managers based in the EU, to non-EU fund managers managing EU funds, and to non-EU funds marketing its funds in the EU. These FAQs discuss the application of the AIFMD to non-EU managers marketing non-EU funds to professional investors in the EU Member States.

Professional investors include large pension plans (and other undertakings) and institutional investors. A natural person will only be considered a "professional investor" in limited circumstances. Different regulatory regimes apply to non-professional (retail) investors.

C. Does the AIFMD impose consistent marketing rules across the EU for non-EU fund managers marketing non-EU funds?

No, because each EU Member State has its own private placement regime and its regulator may take a different approach to implementing the AIFMD.

The bottom line for non-EU fund managers wishing to market non-EU funds… in the EU is that, for the period from the Effective Date until at least the fourth quarter of 2015, the AIMFD will require those managers (1) to comply with new disclosure rules (including extensive reporting to regulators) and "no asset stripping" requirements and (2) to continue to market their funds by complying with national private placement regimes in the relevant EU Member States.…

Each EU Member State is required to adopt legislation incorporating the AIFMD's requirements in that country by the Effective Date. Although the AIFMD sets forth certain basic, uniform principles, the details of implementation are left to the Member States. These details can differ from country to country. The Member States and their regulators have adopted–or are expected to adopt, because at the time this article is being published not all EU Member States have adopted AIFMD implementing legislation–somewhat different approaches to implementation. This means that the impact of the AIFMD will not necessarily be consistent across the EU.

D. Initially, how will the AIFMD apply to non-EU fund managers marketing non-EU funds in the EU?

From the Effective Date until at least the fourth quarter of 2015, non-EU fund managers generally will be able to (continue to) market their non-EU funds in the EU in reliance on local private placement regimes, subject to new AIFMD disclosure requirements and "no asset stripping" rules. However, some EU Member States may change their national private placement regimes.

The first stage of the (three-stage) AIFMD regime begins on the Effective Date. In general, from July 22, 2013 until the fourth quarter of 2015 (and possibly until a later date),[6] a non-EU alternative investment fund manager may (continue to) market non-EU funds to professional investors in the EU so long as it complies with the various private placement regimes in effect in each of the relevant EU Member States. If, however, a country changes its private placement regime (which Germany has done), the non-EU fund manager will be required to comply with the new regime in that country.[7] See question E below.

In addition, a non-EU fund manager marketing a non-EU fund in the EU will be required to comply with the AIFMD's new disclosure and "no asset stripping" requirements. See questions F and G below. Even these new AIFMD rules may not apply in limited circumstances where a transitional regime applies. See question H below.

Stages two and three of the implementation of the AIFMD are discussed at question I below.

E. Will non-EU fund managers be able to market non-EU funds in the EU in the same way after the Effective Date as before the Effective Date?

Not necessarily. Under the AIFMD, non-EU fund managers may continue to market their non-EU funds in reliance on national private placement regimes after the Effective Date. However, it is possible for an EU Member State to change its laws to add new and more onerous requirements that

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6 The dates for implementation of stages two and three are not yet known and are dependent on the European Securities and Markets Authority ("ESMA") making a positive recommendation that these stages should be implemented. The earliest that stage two will be implemented is the fourth quarter of 2015. The earliest that stage three will be implemented is the fourth quarter of 2018.

7 In addition, the AIFMD requires that appropriate cooperation agreements, intended to help regulators oversee potential systemic risk, be in place between regulators in the relevant EU Member States and regulators in the jurisdictions in which the fund and the fund manager are established. On May 22, 2013, forms of cooperation agreements were agreed to by ESMA and regulators in over 30 non-EU countries, including the United States and the Cayman Islands. While ESMA negotiated the forms of cooperation agreements centrally, the cooperation agreements are bilateral agreements that must be signed between the regulator in the relevant EU Member State and the regulator in the relevant non-EU country. Theoretically, the regulator of an EU Member State may decide not to enter into a bilateral agreement with a particular non-EU jurisdiction. There is no set date on which the bilateral cooperation agreements will be signed.

Club Deal Class Action Survives Summary Judgment

The long-running antitrust class action litigation challenging club deals and certain other practices was recently downsized, but is still alive. A Boston federal judge's March decision in *Dahl v. Bain Capital Partners, LLC, et al.* (on summary judgment motions) allows plaintiffs to proceed to trial against most defendants but narrows the grounds on which they may attempt to prove their "overarching conspiracy" theory, allegedly involving twenty-seven separate transactions. While allowing that claim to go forward, the court made clear that it did not find anything inherently unlawful in joint bidding by different private equity groups.

Background

Club deals became a relatively common phenomenon during the period from 2003 through 2007. While private equity firms justified them as a necessary element of increasingly large transactions, which were often beyond the capacity of most private equity sponsors to pursue on their own, some observers questioned whether the joint bids were being used to restrict competition and thus reduce the prices paid in acquisitions of public companies. In late 2006, media reports indicated that the Department of Justice was investigating whether joint bids violated the antitrust laws. Although that investigation never led to any criminal or civil government proceedings, the *Dahl* lawsuit was filed by private plaintiffs in Boston federal court. The initial complaint was brought on behalf of former public shareholders of nine corporations that were the subject of joint bids. After several years of discovery, plaintiffs' current complaint challenges twenty-seven proposed acquisitions and seeks damages on behalf of former shareholders of seventeen of the acquired companies. The complaint alleges a single overarching conspiracy among ten private equity firms and JPMorgan to allocate the purported market for large LBOs among themselves.

Plaintiffs contended, in opposing summary judgment, that the alleged conspiracy affected transactions in which the target's board solicited bids in an auction, as well as other "proprietary" deals in which the target negotiated with a single buyer or consortium of buyers, after which better offers were solicited in a go-shop period. Plaintiffs alleged that the anticompetitive agreement was carried out through a variety of mechanisms: (1) "club deals," in which a pre-arranged group of firms bid together in a group; (2) "quid pro quos," in which private equity firms purportedly agreed to allocate acquisition opportunities among themselves to limit competition and ensure that each firm was able to participate in its share of the bids; (3) improper auction conduct, including communicating with each other in breach of confidentiality agreements and sharing price information; and (4) refusing to "jump" each other's proprietary deals. During the second day of hearings on the summary judgment motions, after Judge Harrington expressed skepticism concerning the sufficiency of the evidence offered, the plaintiffs largely abandoned all of their arguments in support of the alleged overarching conspiracy other than the claim of an agreement not to jump a signed deal or a deal where the price reached a pre-agreed level.

The Ruling

The court's ruling on the motions confirmed the wisdom of plaintiffs' decision to focus on the alleged agreement not to jump deals. Judge Harrington rejected plaintiffs' other proffered evidence of an overarching conspiracy, ruling that "joint bidding and the formation of consortiums" [sic] are "established and appropriate business practices in the industry" and are beneficial to bidders "for a number of reasons that are unrelated to any alleged overarching conspiracy, including the fact that such partnerships minimize the cost and risk for each partner." The judge also found that the "occasional inclusion of a losing bidder in a final deal" may have the same benefits and, "on its own, does not support an overarching conspiracy." Similarly, frequent communications and the existence of *quid pro quo* arrangements in terms of bringing a firm into a deal in return for later being invited into one of its deals "does not tend to exclude the possibility that they are acting independently across the relevant market" (the evidentiary standard needed for a conspiracy claim to survive summary judgment).

The court further found that "[e]ven where the evidence suggests misconduct related to a single transaction; there is largely no indication that all the transactions

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The decision provides a renewed warning that private equity firms must take great care in all communications, including emails, not to make statements that may create the impression (whether or not accurate) that they have agreed with competitors not to compete or otherwise to restrict competition beyond a particular transaction.

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were, in turn, connected to a market-wide agreement." Because the court had held, on a previous motion, that plaintiffs were bound by their repeated allegations (through five amended complaints) of a single overarching conspiracy, they were not permitted to go to trial on a changed theory of separate conspiracies relating to individual deals. The one exception is a claim against some defendants concerning the acquisition of HCA, which plaintiffs had alleged in a separate count.

Despite holding for defendants on all of these issues, the court found sufficient evidence to let plaintiffs proceed to trial based on several pieces of evidence: (1) a statement by a TPG executive that "KKR has agreed not to jump our deal [to acquire Freescale Semiconductor] *since no one in private equity ever jumps an announced deal"* (emphasis added); (2) the fact that none of the announced, proprietary deals involved in the litigation were ever "jumped" during the go-shop period; (3) a Goldman Sachs executive's statement that "club etiquette prevail[ed]" in the Freescale transaction; and (4) several other similar statements from which an agreement not to jump announced deals could be inferred. Judge Harrington held that this evidence "tends to exclude the possibility of independent action" and thus enabled plaintiffs to proceed to trial, but "solely on this more narrowly defined overarching conspiracy." He therefore denied all defendants' motions for summary judgment, except the motion of JPMorgan, as to which the evidence did not show that it was in the business of bidding for target companies or had otherwise participated in the narrowed conspiracy.

Because the plaintiffs narrowed their theory following the briefing of the motions, and the court accepted only this narrowed theory, the judge ruled that each remaining defendant could file a separate renewed motion for summary judgment "contending that the evidence does not create a genuine dispute as to their participation in the more narrowly-defined overarching conspiracy." Those renewed motions are still in the process of being briefed, so it remains to be seen whether any of the claims will proceed to trial and, if so, whether the plaintiffs will prevail.

Conclusion

Judge Harrington's decision is consistent with the limited number of other decisions addressing this issue, which have held that joint bids for public companies do not, in themselves, violate the antitrust laws. Such bids can have the procompetitive effect of allowing or encouraging more bidders to participate. However, coordinated activity between competitors, especially agreements not to compete, may also have anticompetitive effects that render them unlawful. The decision provides a renewed warning that private equity firms must take great care in all communications, including emails, not to make statements that may create the impression (whether or not accurate) that they have agreed with competitors not to compete or otherwise to restrict competition beyond a particular transaction.

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The IRS Has Been Busy (cont. from page 8)

address the use of the mechanism through the audit process rather than published guidance.

New 3.8% Medicare Tax

As has been widely reported, a new 3.8% "Medicare tax" went into effect on January 1 of this year. The tax applies to certain types of investment income recognized by U.S. individuals and certain trusts and, in effect, increases their cumulative tax rate on such income. For most private equity professionals, the tax will apply to the professional's share of the carried interest (which typically flows through as capital gain, dividends and interest) but will generally not apply to amounts received from the "manager" (typically ordinary compensation income or an allocation of management fees). In some cases the proposed regulations may encourage hedge funds that do not generate significant amounts of long-term capital gain to restructure their carried interest as a "fee" rather than a partnership "profits interest."

While simple in theory, the proposed regulations exceed 40 pages and raise a host of issues in certain contexts – such as the application of the tax to income flowing from non-U.S. corporations and treatment of various deductions and loss carryovers in computing the net investment income subject to the tax. As a result, there should be plenty for your tax lawyer to talk to you about. ■

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ALERT

New Banking Guidance May Impact Leveraged Lending

In March 2013, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the "Agencies") issued the final version of their new supervisory Interagency Guidance on Leveraged Lending (the "Guidance"). To the extent that the Guidance causes a tightening in underwriting policies at regulated banks, it could ultimately lead to a relatively smaller role in the leveraged finance market for loans by regulated banks and a larger role for less regulated products and providers, including private funds.

To Whom Does the Guidance Apply?

The Guidance is applicable to banks and other financial institutions that are regulated by the Agencies and engage in leveraged financing activities, and is intended to update the Agencies' standards in light of the financial crisis and the many changes in the leveraged loan market in recent years. It replaces the Agencies' prior guidance in this area, which had been issued in 2001, and is the final version of proposed guidance first released a year ago, having been revised in response to numerous comments submitted by industry participants.

The definition of "leveraged lending" under the Guidance would pick up most acquisition financing provided in connection with private equity buyouts. Specifically, the Guidance indicates that a leveraged loan would commonly contain some combination of the following elements:

- the proceeds are to be used for buyouts, acquisitions or capital distributions;
- total Debt to EBITDA would exceed 4x, or Senior Debt to EBITDA would exceed 3x, in each case without netting cash against debt, or other defined levels appropriate to the industry or sector;
- the borrower is recognized in the debt markets as a highly leveraged firm, characterized by a high debt-to-net worth ratio; and
- the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.

The Guidance covers asset-based loans that "are part of the entire debt structure of a leveraged obligor."

While obviously relevant for banking institutions (which will need to review and update their risk management policies and underwriting standards in light of the criteria established in the Guidance), the Guidance also is likely to have broader implications for the leveraged lending market, and for financial sponsors and their portfolio companies, which should note a few aspects of the Guidance in particular.

What Does the Guidance Require?

Notably, the Guidance requires lenders to consider a borrower's de-leveraging capacity as part of the lender's risk rating analysis, including whether the borrower has the ability to fully amortize its senior secured debt, or repay a significant portion (*e.g.*, 50%) of its total debt, over the medium term (*i.e.*, 5-7 years) using free cash flow. The Guidance also takes the position that an acceptable leverage level is 6x total debt to EBITDA or less, saying that a higher level "raises concerns" for borrowers in "most industries." Loans that do not meet these criteria would be subject to additional scrutiny and potential criticism by the applicable regulating Agency and, thus, lending banks are apt to treat these standards as bright line rules going forward.

In contrast to the Agencies' proposed guidance, the final Guidance clarifies that diligence and evaluation of financial sponsors is not mandated in all instances but instead only when sponsors actually provide financial support for a transaction (a relatively rare occurrence). If a sponsor does provide such support, the Guidance requires lending banks to analyze and monitor the financial condition and historical performance of the particular sponsor in transactions where the sponsor has provided a guarantee of a leveraged loan that is relied on as a secondary source of payment.

Conclusion

The date for banks and other regulated financial institutions to be in compliance with the Guidance was May 21, 2013, although we expect that there are

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ongoing discussions with the Agencies regarding the exact timing of implementation to allow for the necessary changes to internal processes, such as revising credit and underwriting standards. While the full implications of the Guidance and the resulting changes that will be made by regulated lending banks in response remain to be seen, it is possible that the Guidance could lead to an increased role in the leveraged lending market for unregulated (or less regulated) providers of financing, such as private funds, as well as for less regulated financing products, such as high yield bonds. Such providers and products may become a relatively more attractive alternative to bank-provided leveraged loans in future leveraged financing transactions, both in new transactions, and in refinancings of existing transactions, particularly those existing transactions that do not meet the financial criteria outlined in the Guidance. ■

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Social Twist: Emerging ESG Policies (cont. from page 10)

ownership and engagement of portfolio companies on ESG issues, by monitoring the implementation of the ESG policy both at the fund level and with portfolio companies, and via reporting to fund investors and maybe even the public on ESG initiatives, accomplishments and compliance.

Still, successful ESG integration is unlikely to be achieved if no further work is done beyond just the formal adoption of a policy and the taking of the concrete steps noted above. Rather, the highest substantive impact of ESG integration will likely be achieved by senior management with a fund manager tailoring an ESG policy appropriate for the relevant funds and ensuring that such policy is adhered to at all stages of the investment process. Some fund managers that are at the forefront of these matters designate a special ESG committee or an ESG compliance officer to oversee implementation of the ESG policy and train their investment professionals in ESG evaluation.

Looking Forward

While perhaps not surprising given all the regulatory and political attention currently directed at the industry, including SEC registration, SEC presence examinations and on-going challenges associated with implementing Dodd-Frank, FCPA and UK anti-bribery requirements, a relatively small number of fund managers, outside of a few market leading private equity houses, have devoted a lot of resources to date to ESG considerations. Still, while not necessarily at the very top of the industry's "to do" list at the moment, the current status of the evolution of ESG standards seems to us to create a unique opportunity for the industry to burnish its image by working cooperatively in the development of sensible and palatable standards in this sensitive area. Indeed, we are increasingly seeing fund managers starting to think about these issues in connection with upcoming fundraisings. We suspect it may become increasingly advantageous in the future for fund managers to adopt a formal ESG policy in advance of entering into negotiations with fund investors on terms, because in the absence of a pre-existing policy (and perhaps even when a policy exists), certain fund investors may try to impose compliance with their policy upon the fund manager. Such policies would not be tailored to the specifics of the particular fund investment program. In addition, as a fiduciary to a fund with many investors that may have differing views on ESG matters, a fund manager may find itself in a conflict position trying to comply with different investor policies. Plus, broadly speaking, we have found fund investors to be amenable to reviewing a fund manager's existing ESG policy and taking comfort from the manager's undertaking to use commercially reasonable efforts to comply with such policy. ■

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UK Take Privates: Recent Changes to the Takeover Code

The UK Takeover Panel (the "Panel") has recently announced two sets of changes to be made to the City Code on Takeovers and Mergers (the "Takeover Code") (which is the principal source of regulation for UK take private transactions). The first change, which came into force on May 20, 2013, requires a bidder to provide more disclosure of the impact of a proposed offer on the target company's defined benefit pension schemes, and allows the trustees to take a public position on the offer and obliges the bidder to follow through with its statements of intent. These will be followed on September 30, 2013 by an extension of the jurisdiction of the Panel to cover a broader range of public companies *i.e.*, companies that are incorporated in the UK, the Channel Islands or the Isle of Man and whose securities trade on a UK trading facility (such as AIM), in addition to such companies whose securities trade on a regulated market.[1]

Changes to Pension Scheme Trustee Rights: Key Points

These changes to the Takeover Code apply only to defined-benefit schemes (not to money purchase or defined contribution schemes) and are designed to provide a target company's pension scheme trustees with similar rights to those of the target company's employee representatives. The Panel intends the changes to create a framework in which the effects of an offer on a target's defined benefit pension schemes can become a negotiated point during the course of an offer.

The key impact of the changes to the Takeover Code for private equity bidders is that a bidder is now required to disclose its plans for employer contributions to the target's defined benefit pension schemes, including the current arrangements for funding any scheme deficit. A bidder also has to state its intentions for the accrual of benefits for existing members and the admission of new members. Where a bidder does not intend to make any changes in relation to the schemes, it is required to make a statement to that effect. The Panel may hold a bidder to these statements for at least a year after the end of the offer period.

Any agreement between a bidder and the pension scheme trustees on future scheme funding arrangements will need to be summarized in the firm offer announcement and in the offer document. The agreement will not need to be published on a website unless it falls within the definition of a material contract of the bidder under the Takeover Code, in which case publication will be required.

The bidder and the target are required to make all documents that have to be provided to the target's employee representatives also available to the pension scheme trustees, and pension scheme trustees have the right to have their opinion on the impact of the offer on the pension schemes published.

It is worth noting that these changes do not give the pension scheme trustees or the Pensions Regulator (the UK statutory body with responsibility for all work-based pension schemes) the right to approve or disapprove of the offer. These and various other changes that would have strengthened the negotiating position of the pension scheme trustees were considered but not implemented.

Changes in the Companies Subject to the Takeover Code – Key Points

The Takeover Code applies to any offer for a public company that has its registered office in the UK, the Channel Islands or the Isle of Man, if any of its securities are traded on a regulated market in the UK (such as the London Stock Exchange) or on any stock exchange in the Chanel Islands or the Isle of Man. The Takeover Code currently also applies to any offer for a public company that has its registered office in the UK, the Channel Islands or the Isle of Man (but does not have its securities admitted to trading on a regulated market in the UK, Channels Islands or Isle of Man) where the company is considered by the Panel to have its place of central management and control in the UK, the Channel Islands or the Isle of Man. This central management and control test is often referred to as the "residency test." Of particular importance to private equity bidders was that many public companies listed on AIM fell outside the jurisdiction of the Takeover Code because they did not satisfy the residency test.

The Panel has now announced that changes to the Takeover Code, to come into force on September 30, 2013, will remove the residency test in respect of companies with their registered office in the UK, the Channel Islands or the Isle of Man whose securities are admitted to trading on a multilateral trading facility in the UK (such as AIM or the ISDX Growth Market). Companies which meet the registered office requirement but whose securities are not admitted to trading on any market in the UK will continue to use the residency test to determine whether or not the Takeover Code applies.

This will also mean that private equity funds listed on AIM, which have in some cases been able to take the view that they are not subject to the Takeover Code, will no longer be able to do so once these changes come into force. ■

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1 A regulated market is one that has been designated as such under certain European legislation and included on a list maintained by the FCA. These include, amongst others, the Main List of The London Stock Exchange, Main Board of the ICAP Securities and Derivatives Exchange ("ISDX") and the London Metal Exchange. Other UK-based markets or trading facilities, such as AIM or the ISDX Growth Market, which are not on this list, are not "a regulated market."

the SEC prior to launch of a tender offer, whereas the acquirer in a one-step merger must pre-file a proxy statement, often wait 30 days or more for SEC comments, then provide responses and sometimes rinse and repeat several times. Once the review process is over, a merger proxy must be mailed to stockholders at least one month in advance of the stockholder meeting. By comparison, once launched, a tender offer is required to remain open for just twenty business days, and the waiting period under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, which is generally thirty days, is shortened to only 15 days. Thus, a successful bidder in a tender offer can usually acquire control of a target in a little over a month, whereas a typical one-step merger can take three or four months, during which time the pending transaction is exposed to competing bidders who can disrupt or derail the deal. Other risks, such as those associated with financing and MAE, can be eliminated in the two-step structure if the back-end merger can be closed at the same time as the tender offer.

Section 251(h) would allow a sponsor to launch a financed tender offer conditioned on valid tenders of only a majority of the target's stock without worrying that the margin rules would prevent it from closing the offer if it cannot reach the 90% threshold.

Another benefit of the tender offer structure is that the disclosure documents are generally less burdensome to prepare than a proxy statement. For instance, full audited financial statements of the target are required in a proxy statement, but are not typically required in a tender offer where the consideration is all cash. Not surprisingly, this faster and more streamlined process also tends to result in lower transaction costs.

So What's the Rub?

You may now be asking yourself why anyone would ever choose the one-step merger structure. Well, the answer is that, historically, there was a real stumbling block with the tender offer approach, which was the need to acquire at least 90% of the outstanding shares in order to effect a second-step, short-form merger to squeeze out the remaining stockholders of the target. This can be a difficult threshold to reach even in a deal with broad stockholder support due to the fact that it is often hard to get the attention of retail stockholders, never mind that achieving such a high threshold can be quite challenging where there is any stockholder ambivalence about the deal. If a bidder does not reach the 90% threshold, it then has to proceed with all of the steps that would have been needed to effect a long-form merger, including filing a full proxy statement and calling a stockholder vote, which of course results in an even longer transaction timeline than if the parties had simply begun with a long-form merger. And it is all somewhat meaningless because the bidder will have already obtained control of the target (and thus the stockholder vote) through the tender offer, so the outcome of the second-step merger is a foregone conclusion.

Despite the benefits of speed and lower costs, private equity buyers, unlike strategic acquirers, have often been reluctant to pursue two-step financed acquisitions of public companies due to concerns relating to the federal margin rules, which prohibit loans to a shell acquisition vehicle if directly or indirectly secured by margin stock with a value in excess of 50% of the amount of the loan. If the sponsor was able to close the back-end merger simultaneously with the closing of the tender offer by reaching the 90% threshold, the loan would not be deemed secured by margin stock, but rather by the assets of the surviving company. But if it did not reach the 90% threshold, and thus had to pursue a long-form back-end merger, the sponsor would run a real risk of violating the margin rules, because the margin stock would be the only available collateral for the loan. Although some workarounds have been developed over time, they present a number of complications and are not available in all circumstances.

While tools such as top-up options and dual track structures have been developed to mitigate some of the issues presented by the tender offer approach, they are clunky and imperfect. A top-up option allows the bidder to buy shares directly from the target in an effort to "top up" the bidder's post-tender offer ownership to 90%. However, because of the way the math works, the target may not have enough shares authorized under its charter to move the needle significantly. For example, if a bidder in a tender offer obtains 70% of the outstanding shares at the completion of the offer, the target would need to issue to the bidder twice as many shares as the total outstanding in order for the bidder to reach the 90% threshold. See "The Tender Offer Returns: What Does It Mean for Private Equity" in our Winter/Spring 2007 issue and "Speed

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Tender Offers Poised to Become an Acquisition Structure of Choice (cont. from page 18)

is King: Pointers and Pitfalls on Sponsor-Led Tender Offers" in the Spring 2011 issue for background on the use of tender offers by sponsors.

In a so-called dual track structure, the bidder runs a tender offer and a one-step merger process in parallel, so that if the 90% threshold is not reached, it can drop the tender offer in favor of a one-step merger process that is already well along. However, there are, of course, incremental costs to this approach, and it is not clear that the SEC is fully comfortable with it. Moreover, this structure will obviously not allow the bidder to gain control of a target as quickly as a tender offer followed by a short-form merger in the event that the 90% threshold is not reached.

Section 251(h) to the Rescue

Many of these issues would be swept away by proposed Section 251(h) of the Delaware General Corporation Law, which is expected to be adopted and made effective as of August 1st of this year. If adopted, a bidder for a public Delaware corporation would be able to consummate a short-form merger without a stockholder vote if the following criteria are met:

- the bidder completes a tender offer for any and all outstanding stock, and following completion, holds at least the number of shares required to approve a merger (a majority of the outstanding shares, unless the target's charter specifies a higher threshold);
- the merger agreement expressly provides that the merger will be governed by the new rule and that the back-end merger will be effected as soon as practicable following the completion of the tender offer; and
- the bidder is not an "interested stockholder" under Delaware law, which generally means that the bidder does not already own 15% or more of the target's stock.

Thus, Section 251(h) would allow a sponsor to launch a financed tender offer conditioned on valid tenders of only a majority of the target's stock without worrying that the margin rules would prevent it from closing the offer if it cannot reach the 90% threshold. The new rule would therefore help level the playing field for sponsors competing for assets with strategic buyers and make tender offers a more attractive acquisition structure generally.

Have We Seen the Last of One-Step Mergers?

Adoption of the new rule does not mean, however, that tender offers will all of a sudden become the weapon of choice for sponsors in all circumstances. For one thing, by its terms, Section 251(h) would not be available to buyers who own, together with their affiliates, 15% or more of the target. This limitation could have consequences in particular in the context of a management buyout where management and the bidder together hold more than 15% of the target's stock. In addition, where lengthy periods of time may be required to obtain regulatory approvals, tender offers do not provide much, if any, benefit to the bidder, since the deal cannot close within the twenty business-day period in any event.

Indeed, in a deal where a long period between signing and closing is expected (either due to regulatory reasons, holiday financing blackouts or otherwise), a one-step merger may be preferable to a tender offer. A tender offer would need to be extended again and again until regulatory approval was finally obtained permitting the bidder to close the offer. During that extended period, stockholders who tender would continue to have the right to withdraw their shares at any time, allowing more time for interlopers or activists to appear. By contrast, there is no such need to wait to conduct a stockholder vote, which, if successful, would effectively cut off any further opportunity for a third party to upset the deal or for the stockholders to change their minds, as the "fiduciary out" would fall away at that point. The deal could then close as soon as regulatory approval is obtained.

Another timing concern relates to the acquisition financing itself. It may simply not be feasible to complete the contemplated financing process within the twenty business-day period that the tender offer remains open, particularly where the financing is marketed. However, it may well be possible to complete the process within a period that is shorter than the 2-3 months required for a one-step merger process. In this case, the parties might pursue a tender offer, but negotiate the circumstances under which the offer is automatically or voluntarily extended to accommodate the financing. While an abbreviated transaction timeline may limit the buyer's ability to manage entry into the financing markets, even with a long-form merger there is often a limited window in which to conclude the marketing period (unless the financing is closed into escrow, which presents its own complications and costs).

* * *

Ultimately, Section 251(h) will go a long way in making tender offers a more attractive deal structure for private equity buyers of public Delaware companies. However, sponsors should not discard long-form mergers from the toolkit altogether as regulatory approvals and financing considerations may make that old standby preferable in certain cases. ■

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after it was originally paid.

Applicable Legal Standards . . . Why It All Boils Down to "Solvency"

Challenges to Officer and Director Decision-Making

To successfully sue directors and officers over a dividend recap, creditors must generally show as a threshold matter that the company was insolvent at the time of, or was rendered insolvent by, the dividend recap. Under the laws of most states, this is a factual predicate for alleging that a dividend was illegal or improper. For example, Delaware law requires that corporations pay dividends to their shareholders only from capital "surplus": in essence, the fair value of assets less liabilities, less stated capital (this last item is often a *de minimis* amount).

Insolvency or near-insolvency at the time of the transaction is also a requirement for creditor claims that directors and officers breached fiduciary duties. Courts in most U.S. states hold that directors and officers have no duties to creditors, unless and until the corporation is insolvent or, in some states, near-insolvent. Similar solvency-based constructs apply in many jurisdictions outside the United States.

To defend against these types of claims after the fact, it is therefore crucial that directors and officers be able to demonstrate solvency at the time of the transaction.

Clawback/Fraudulent Conveyance Challenges

Creditors may also attempt to unwind a dividend recap transaction – thereby clawing back the dividend – by alleging it was a fraudulent conveyance under the United States Bankruptcy Code, applicable state laws (*i.e.*, the Uniform Fraudulent Conveyance Act) or equivalent provisions under non-U.S. law.

Under U.S. law, to claw back a payment, the creditor must show that (a) the company was insolvent at the time of, or rendered insolvent by, the transaction, and (b) the transfer in question was made for less than reasonably equivalent value. Because shareholders receiving a dividend get cash without making an equivalent transfer to the company (satisfying the second element), the only real U.S.-law defense to a clawback challenge is to prove that the company was solvent at the time of the dividend. While standards outside the U.S. may be more forgiving, it is fair to say under most jurisdictions that the ability to prove solvency at the time of transfer is a key element of defending a dividend.

What is the Best Way to Demonstrate Solvency?

In evaluating solvency, courts generally consider:

- Whether the fair value of a company's assets exceeded its liabilities (including stated liabilities and identified contingent liabilities);
- Whether the company should be able to satisfy its debt obligations—related to existing debt as well as to any new debt incurred as a result of the transaction—as those debts mature; and
- Whether the company should have a reasonable level of surplus capital following a leveraged transaction to provide downside protection in the case of deteriorating business conditions.

An unfortunate reality in defending litigation claims related to dividend recaps is that lawsuits occur only after something has gone unexpectedly wrong. If all goes as planned and the portfolio company performs as projected, it will repay or refinance its funded debt and honor other creditor claims in the ordinary course, and the dividend recap will never be challenged. It is only if there is a problem – *e.g.,* the company's asset value declines to below book value; EBITDA fails to grow as anticipated; the macroeconomic situation deteriorates; or unexpected litigation or other claims arise – that the portfolio company will enter a bankruptcy or workout, which in turn may spur unsatisfied creditors to pursue litigation.

As a matter of law, courts generally should evaluate both director decision-making and questions related to fraudulent conveyance from the perspective of what was known or anticipated *at the time of the transaction*. Practically speaking, however, it can be difficult for a court to ignore the very fact of the portfolio company's failure in evaluating whether it was solvent at the time of a dividend recap. Hindsight bias is not limited to Monday mornings. For example, if projections were not met, that may influence a judge's view as to whether they were reasonable in the first instance, or whether they were properly stress-tested. Similarly, if asset values at the time of challenge are below book value, the judge may question whether the fair value was overstated at the time of the transaction. For this reason, when planning a dividend recap, the parties should be sure to construct a careful factual record, designed to withstand later litigation scrutiny, demonstrating that the transaction was appropriate at the time it was entered into.

Best Practices for Director, Officer and Shareholder Protection

While there are no silver bullets in this context, there are a few simple steps that directors, officers and shareholders can take to mitigate the risk of a court second-guessing a dividend recap transaction.

Make a Clear, Contemporaneous Record of the Decision-Making Process

If a dividend recap is challenged in hindsight following a restructuring, it will be invaluable for defensive purposes to have a clear record that the directors and

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Dividend Recaps: Used With Care, a Useful Tool (cont. from page 20)

officers engaged in a careful, deliberative process before approving the transaction. Board minutes should reflect that directors considered the company's solvency both before and after the transaction, articulated a clear business purpose for the action, and determined, based on contemporaneously available information including well-vetted projections, that there should be a reasonable level of surplus capital following the dividend recap to provide downside protection in event of a downturn. Directors and officers will be best protected if the record shows they consulted outside professionals, carefully reviewed the available information, asked questions, and had plenty of time to consider the issues (for example, by receiving board materials well in advance and by holding more than one meeting to discuss the transaction).

Get a Solvency Opinion

Although a solvency opinion cannot in and of itself ensure against future financial distress (or provide a complete litigation shield if such distress ensues), it can support—with the imprimatur of a well respected outside expert—the officers' and directors' decision to enter into the transaction. A contemporaneous solvency opinion is a foundation for the directors' belief that the dividend was paid from the company's balance sheet surplus, thus deflecting illegal-dividend claims. A solvency opinion also provides important contemporaneous evidence that the company was solvent at the time of the transaction, thus helping to defeat clawback claims and fiduciary duty claims for the reasons described above.

Cover Every Borrower/Guarantor Subsidiary

In most dividend recap transactions, multiple corporate entities will be involved, whether as borrowers or as guarantors of the new debt obligations or as entities through which the dividend will pass. Litigation claims may arise with respect to not only the primary corporate holding company, but also any other participating affiliates. Thus, for every participating entity, care should be taken to document the relevant facts and board deliberations as to each entity's solvency, its business purpose in participating in or facilitating the transaction, and the benefit that it will receive for any value (including liens and guarantees) it is transferring as part of the deal.

* * *

While there is no perfect protection against litigation risk if a portfolio company fails after a dividend recap transaction, following best practices at the time of the transaction can significantly improve litigation outcomes. As the current open credit cycle (hopefully) continues, private equity firms will no doubt continue to view divided recaps as attractive partial-exit opportunities, but would be well-advised to use them with care. ■

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How Will the AIFMD Impact Non-E.U. Fund Managers? (cont. from page 12)

must be satisfied before a fund manager may rely on its national private placement regime, and Germany has already done this. Also, a non-EU Member State could withdraw (repeal) its national private placement regime altogether. Subject to any available transitional regimes, non-EU fund managers will also be subject to the disclosure and "no asset stripping" requirements described in the answer to the next question.

The AIFMD allows EU Member States to keep their existing national private placement regimes in place until the fourth quarter of 2018 (or possibly later), although it does not require that they do so. The hope and expectation is that most EU Member States will retain their private placement regimes, in one form or another, at least until such time as non-EU fund managers are able to apply for an AIFMD marketing passport (which would be in the fourth quarter of 2015 at the earliest).

It is possible for an EU Member State to change its national private placement regime, for example by adding new and more onerous requirements, and Germany is an example of an EU Member State that has done so. Germany has used the implementation of the AIFMD into national law as an opportunity to significantly re-write its national private placement regime. The modified German national private placement regime will apply from July 22, 2013 (or July 22, 2014, for certain fund offerings if the German transitional regime applies). The new German regime will make marketing of funds by non-EU fund managers to professional investors in Germany more difficult than is currently the case. Because the AIFMD does not require EU Member States to retain their national private placement regimes, it is also possible for an EU Member State to withdraw its national private placement regime completely before the date when non-EU fund managers are able to apply for AIFMD marketing passports (in the fourth quarter of 2015 at the earliest). Were an EU Member State to do this, non-EU fund managers would not be able to market their

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funds in that country at all (as compared to AIFMD authorized EU fund managers, which may obtain marketing passports as early as the Effective Date).

F. In addition to possible burdens that might be imposed by changes to national private placement regimes, what are the most important new requirements that the AIFMD imposes on non-EU fund managers?

Subject to any available transitional regimes, beginning on the Effective Date non-EU fund managers marketing non-EU funds in the EU will be subject to new disclosure requirements and to new "no asset stripping" requirements applicable to control investments in EU portfolio companies.

Subject to any transitional regimes (see question H below) and beginning on the Effective Date, non-EU fund managers will be subject to new disclosure obligations if they market funds in the EU. These new disclosure obligations are summarized as follows.

First, the fund manager must prepare an annual report for each fund that was marketed in the EU after the Effective Date no later than six months following the end of the fund's financial year. The annual report must be provided to investors on request and made available to the regulators in the relevant EU Member States. Most importantly, the annual report must contain certain prescribed information, including disclosure of certain compensation information. See question G below.

Second, the fund manager must provide specified information to prospective investors prior to their investment in the fund, typically in the private placement memorandum (or a supplement thereto) of the fund being marketed. A standard offering document ordinarily contains most of the information that will be required by the AIFMD, although there may need to be enhanced disclosure around certain matters, including in respect of side letter arrangements.

Third, the fund manager must regularly report certain matters, such as information on aggregate assets under management, fund-level leverage and the main categories of assets in which its fund is invested, to the regulators in the relevant EU Member States. These reporting obligations will require fund managers to gather and report a significant amount of detailed information to EU regulators and, at least initially, are likely to be the most onerous of the AIFMD disclosure requirements.

Fourth, where its fund acquires control (greater than 50% of the voting rights) of an EU portfolio company, the fund manager must disclose certain matters (such as information on the financing of the acquisition of the portfolio company) to the regulators in the relevant EU Member States and to the EU portfolio company (with the request that information be passed on to the company's shareholders).

In addition to these disclosure requirements, non-EU fund managers will be subject to certain "no asset stripping" requirements. In broad terms, when a fund acquires control (greater than 50% of the voting rights) of an unlisted EU portfolio company, the non-EU fund manager will be required to use its best efforts to prevent distributions, capital reductions, share redemptions and/or the acquisition of its own shares by the portfolio company, unless (1) any resulting payments to effect a distribution to shareholders will be made out of distributable profits and (2) after giving effect to the distribution, the portfolio company's net assets would remain at or above the level of subscribed capital plus non-distributable reserves.

Note: Once authorized as an "alternative investment fund manager" (on July 22, 2013 at the earliest), an EU fund manager that manages one or more EU-based funds will be subject to greater regulation than non-EU managers. Such EU fund managers will be required to comply not only with the disclosure and "no asset stripping" rules described above, but also with additional AIFMD duties and obligations including the appointment of depositaries meeting specified standards (per fund), obtaining independent valuations (per fund), meeting regulatory capital requirements and implementing certain systems and controls (including with respect to compensation of employees).

G. Will non-EU fund managers be subject to the remuneration provisions of the AIFMD?

Only in part. Non-EU fund managers initially will be required by the AIFMD to disclose certain compensation information in their annual reports. Fortunately, non-EU fund managers will not be subject, initially, to the AIFMD's guidelines and requirements concerning compensation (including deferral of a portion of variable compensation).

Until a non-EU fund manager obtains an AIFMD marketing passport (in the fourth quarter of 2015 at the earliest), the only impact of the AIFMD's remuneration provisions will be to require the fund manager to disclose certain compensation information if it markets a fund in the EU after the Effective Date.

Specifically, a non-EU fund manager will be required to disclose in its annual report (see question F above) the following information:

(1) the total remuneration for the financial year, split into fixed and variable remuneration, paid by the fund manager to its staff,[8] and the number of staff who received such remuneration;

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8 The concept of "staff" has been broadly construed by ESMA and is not limited to employees of the fund manager. The concept extends to those individuals whose services are made available to the fund manager and includes the staff of entities to which portfolio management or risk management activities have been delegated by the fund manager.

(2) to the extent that the information exists or is readily available, whether the total paid remuneration relates to the entire staff of the fund manager or only to those staff who are fully or partly involved in the activities of the fund, as well as the total remuneration paid to the staff of the fund manager that is attributable to each fund;

(3) the total remuneration for the financial year, split into fixed and variable remuneration, paid by the fund manager to senior management and members of staff of the fund manager whose actions have a material impact on the risk profile of the fund;

(4) where relevant, any incentive allocation or carried interest distributed by the fund; and

(5) a general description of the financial and non-financial criteria of the fund manager's compensation policies and practices for relevant categories of staff, so that investors may assess the incentives created.

Aside from disclosure and until such time as it obtains an AIFMD marketing passport, a non-EU fund manager is not required to have any particular compensation policies or procedures in place.

Note: EU fund managers will be required to comply with the disclosure obligations described above, and in addition will be required to comply with all other AIFMD duties and obligations, including the requirement to adopt remuneration policies that satisfy the AIFMD guidelines. These remuneration policies must be consistent with and promote sound and effective risk management and, in addition of other matters, require at least 50% of variable remuneration to consist of non-cash instruments and at least 40% of variable remuneration to be deferred over at least a three to five year period. Until market practice develops and additional guidance is made available, it is likely to be quite difficult in practice to apply these remuneration guidelines.

H. Have any EU Member States adopted transitional regimes that mitigate the impact of the AIFMD?

Yes, the United Kingdom and Germany are proposing to adopt transitional regimes (transition or "grandfathering" rules) that provide limited relief from the AIFMD's requirements for funds being marketed in certain ways before the Effective Date.

The United Kingdom is proposing to adopt a transitional regime that exempts a non-EU fund manager from the AIFMD's disclosure and "no asset stripping" requirements, until July 21, 2014, with respect to any non-EU fund that the non-EU fund manager has marketed anywhere in the EU prior to the Effective Date. The current position being taken by the UK regulator is that "marketing" of a fund for this purpose begins on the distribution of near final forms of the fund's constitutional documents (*e.g.*, its limited partnership agreement and subscription agreement) to any investor in the EU. Distribution of only a private placement memorandum in the EU is not considered marketing for this purpose.

Germany has its own transitional regime. The proposed German transition rules would permit a non-EU manager to market a non-EU fund in Germany in reliance on the existing German private placement regime (not the more onerous regime that goes into effect on the Effective Date), and without have to comply with the AIFMD's disclosure and "no asset stripping" rules, until July 21, 2014, if the non-EU manager marketed the fund in Germany prior to the Effective Date. In Germany, the current position is that marketing of a fund is considered to have begun as soon as the fund's final private placement memorandum is distributed to a single German investor.

I. Looking further down the road, what should non-EU fund managers know about the second and third stages of the AIFMD?

The questions and answers above relate to the first stage of the AIFMD. It is not too early, however, for alternative investment fund managers to begin to consider with their advisers the impact of the second and third stages of the implementation of the AIFMD.

In stage two, beginning in the fourth quarter of 2015 (or possibly later), the AIFMD provides that a non-EU fund manager has the option to obtain a "marketing passport." The AIFMD marketing passport would allow the fund manager to market its funds to professional investors throughout the EU, without being required to satisfy the different requirements of the national private placement regimes that apply in the countries where the funds are being marketed. To hold a marketing passport, a non-EU fund manager would be required to comply in full with the requirements of the AIFMD. These requirements include appointing depositaries meeting specified standards (per fund), obtaining independent valuations (per fund), meeting regulatory capital requirements and implementing certain systems and controls (including with respect to compensation of the fund manager's staff). Alternatively, a non-EU fund manager that does not wish to satisfy the requirements imposed by the AIFMD as a condition to obtaining a marketing passport may continue to rely on the national private placement regimes until the fourth quarter of 2018 (or possibly longer), but only to the extent that national private placement regimes are retained in the EU Member States where the fund manager will be marketing its funds.

In stage three, beginning in the fourth quarter of 2018 (or possibly later), a non-EU fund manager will only be able to market its

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How Will the AIFMD Impact Non-E.U. Fund Managers? (cont. from page 23)

funds to professional investors in the EU if it holds an AIFMD marketing passport.

J. Should non-EU fund managers restructure themselves or their funds in light of the AIFMD?

For most non-EU fund managers, the answer at this stage is likely no, although the business objectives and structure of a particular fund manager may lead to a different answer. Also, restructuring may become a more attractive option in the future when, for example, acquisition of an AIFMD marketing passport (and full compliance with the AIFMD) becomes necessary or desirable (see question I above). It is possible that, after implementation of the AIFMD, some European investors may show a bias towards investing in EU-based funds (although these investors are most likely to be the same group of investors that already raise concerns about investing in Cayman Islands and Channel Islands funds). If this pattern emerges (and depending on the types of investor and the size of their likely investments), consideration may need to be given to incorporating an EU-based fund (potentially managed by an EU-based fund manager) into the overall fund structure.

Other forms of restructuring – including, for example, the establishment of a parallel fund structure, with one fund being managed by the existing manager (and not being marketed to EU investors) and the other fund being managed by a new manager (and being marketed to EU investors pursuant to the AIFMD) – seem premature for most non-EU fund managers, given the added complexity and cost, and the limited advantage, of modifying existing structures. Restructuring may become a more attractive option from 2015, however, when the acquisition of an AIFMD marketing passport would have the consequence of requiring full compliance with the AIFMD. ■

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Recent and Upcoming Speaking Engagements

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Matthew D. Saronson
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GP Masterclass: Fundraising and Best Practices
African Private Equity and Venture Capital Association
Cape Town

April 24, 2013
Stephen R. Hertz
David Innes
Choices of Law in Acquisitions Agreements: U.S. vs. UK
Practising Law Institute
New York

April 26, 2013
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"Private Equity Investing and Beyond"
American College of Investment Counsel
Spring Investment Forum
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May 8, 2013
David A. Brittenham, Co-Chair
"Leveraged Financing Today"
Jeffrey E. Ross
"Drafting in Leveraged Finance"
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May 16, 2013
Raman Bet-Mansour
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May 20, 2013
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Christopher L. Tahbaz
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Judith L. Church
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