

DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT

Winter 2013 | Volume 13 | Number 2

When the SEC Knocks on Your Door, Will You Be Prepared?: Practical Steps PE Firms Should Take to Prepare for an SEC “Presence” Examination

Until recently, the likelihood that an investment adviser to a private equity fund would face an examination by the Securities and Exchange Commission (the “SEC”) was low. The situation today is dramatically different. We anticipate that most advisers to private equity funds (as well as hedge funds and other private funds) will be examined by the SEC over the next two years. While the precise consequences of these examinations have yet to be established, the consequences, both legal and reputational, of an SEC examination that uncovers material compliance issues could be severe. The implementation and testing of strong compliance policies, rigorous preparation and proactive remediation of any weaknesses identified by management prior to an

examination are a firm’s best protection against any negative impact of an examination.

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required that all but the smallest private equity fund advisers and other private fund advisers (such as hedge fund managers) register with the SEC as investment advisers by March 30, 2012. These newly registered firms are now subject to a more extensive compliance regime and to SEC inspection to ensure compliance with that regime.

In light of its new responsibilities, late last year the SEC’s Office of Compliance, Inspection, and Examinations (“OCIE”) publicly launched a plan to examine a

significant percentage of registered advisers to private funds over the next two years. The OCIE has made clear that these so-called “presence” examinations are part of a coordinated national examination initiative designed for the SEC to establish a meaningful presence with respect to newly-registered private fund advisers. A “presence” exam allows the staff to review one or more

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*“You’re not in material breach,
but you’re not in full compliance, either.”*

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Letter from the Editors

Until the financial crisis, the private equity industry faced little scrutiny from securities regulators and private equity bidders were easily distinguishable from their strategic competitors. Today, private equity firms face heightened scrutiny in the U.S., in Europe and around the world. At the same time, the lines have blurred between strategic and private equity deal structuring.

Since enactment of Dodd-Frank, many private equity firms have been required to register as investment advisers, and a significant number of firms now face the prospect of an SEC “presence” examination. In our cover article, we explain the rationale behind the SEC’s focus on private equity firms and provide some practical guidance on how firms should ready themselves for the SEC’s “presence.”

In previous issues we have described how some classic private equity deal mechanics have crept into strategic deals. In this issue, we focus on PE firms taking advantage of synergies by backing their portfolio companies in add-on deals that look remarkably like the deals their strategic competitors might strike. In particular, we outline some of the ways in which the financing, management, contractual, antitrust and deal structuring issues that private equity firms considering add-on acquisitions by portfolio companies are different than those they face in stand-alone transactions.

While a restrictive regulatory regime and the absence of currently viable exit opportunities have put a damper on the private equity outlook in China, there is still much room for optimism in the region. We have two articles that shed light on the future of private equity investment in Asia. First, members of our Hong Kong office review the highs and lows of the past year for private equity investment in China and suggest that challenges in the PRC have shifted investors’ focus to South East Asia where rapidly growing economies are ripe for deal

activity. We also note that recent regulatory developments in China are evolving so Chinese insurance companies will eventually be permitted to invest in offshore private equity funds and are poised to be a likely significant new source of capital for the global private equity community.

Risk management is important to all businesses, especially those as driven by performance as private equity companies. We outline two recent transactions in which companies with significant defined pension liabilities were able to remove historic pension liabilities from their balance sheets by purchasing annuity contracts and suggest how private equity firms might use that technique to make acquiring businesses with large historic pension liabilities more attractive. We also note that private equity firms with pension plan investors need to be aware of transactions of this sort because the transactions are structured to require the transfers of the pension plans’ interests in private equity funds to the issuer of the annuity contracts. Private equity firms are always interested in innovative ways to enhance returns.

We highlight a recent transaction in which Citigroup transferred credit risk from its balance sheet using credit default swaps and explain why the enhanced capital requirements facing banks might provide opportunities for private equity funds to deploy capital in new ways.

We are always looking at ways to make the *Private Equity Report* more useful to our readers. In the coming months we will be making some changes to the electronic version of the Report to make it easier to access, to find particular articles of interest and to search for past articles. Please let us know what you think and if there are any topics of particular interest you would like addressed in a future issue.

Franci J. Blassberg

on behalf of the Editorial Board

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The Year of the Snake: What Does China's Lunar New Year Suggest for Private Equity Activity in Asia?

When private equity observers assessed the Year of the Dragon, which ended recently, they found it to be the “best of times and the worst of times” for private equity investment activity in China. The year featured a number of headline grabbing buy-outs and exits and a number of notable fundraising highlights among private equity managers with strong China franchises. However, it also saw a number of equally deflating developments that serve as powerful reminders of the challenging issues and growing pains associated with private equity activity in China.

Although private equity professionals in the region remain confident about the long-term opportunities in China, it is difficult for some of them to be particularly optimistic about the shorter term opportunities in the just commenced Year of the Snake. Notably for the broader Asia Pacific region, however, the challenges facing the private equity market in China have increasingly caused many global and regional private equity professionals to evaluate the investment

opportunities available in nearby South East Asia in a more favorable light.

PE Activity During the Year of the Dragon

Among other bullish developments, the Year of the Dragon witnessed the largest ever buyout in China in which a Carlyle-led consortium agreed to a US\$3.7 billion buyout of Focus Media Holding Limited. Carlyle also completed a spectacular US\$5 billion exit from China Pacific Insurance Group – an investment with approximately a 7x return in less than seven years. China-focused funds also raised US\$15.4 billion in the aggregate during the Year of the Dragon, further positioning themselves with significant amounts of dry powder for deals.

Still, there has been enough negative news with respect to Chinese businesses in the last year to remind sponsors of the risks of investing in the PRC. Caterpillar's recent US\$580 million write-down of its US\$700 million investment in ERA Mining Machinery Ltd. (a Chinese maker of mine safety equipment) due to “deliberate, multi-year, coordinated accounting misconduct” is a particularly extreme example. Private equity firms are understandably troubled by this scenario impacting a respected international player like Caterpillar as well as by other significant fraud incidents, including the iconic case of Sino-Forest's overstated revenue (and missing trees). The concern runs deeper than the damper that the specter of such accounting issues may place on exit sales to strategic buyers because it also may impact the availability of future capital commitments from LPs wary of the Chinese business environment.

The international regulatory environment is now also intensely focused on Chinese companies. For example, the U.S. Securities and Exchange Commission has now deregistered more than 50 Chinese issuers for accounting irregularities and brought fraud charges against more than 40 individuals and companies. China's securities regulator, the CSRC, is also cracking down on issuers and potential issuers and has stressed the importance of truthfulness and accuracy of an issuer's financial information. In Hong Kong, the Securities and Futures Commission and the Hong Kong Stock Exchange are in the midst of adopting a number of reforms meant to improve the quality of companies that list in Hong Kong, including the well-publicized possibility of potential criminal liability for underwriters. While these developments should eventually help stabilize the investment environment in China, they are currently inhibiting interest in Chinese acquisition opportunities.

As would be expected, these headline grabbing fraud cases have also significantly dampened interest among investors in U.S. stock markets for new offerings of Chinese businesses. Perhaps even more troubling is that they appear to have helped solidify a complete freeze on IPO exits for Chinese portfolio companies. Historically, the Chinese private equity market has relied almost exclusively on IPOs for exits, either domestically or via an offering in Hong Kong or the United States. Today, it is estimated that some 7,500 PRC investments are held by private equity funds with limited alternative exit opportunities, even as the IPO market in mainland China essentially ground to a halt during the fourth quarter of 2012 when the CSRC stopped approving new listings. As of January 2013, there were over

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What Does the New Year Suggest for Private Equity Activity in Asia? (cont. from page 3)

850 companies in the queue for listing approval in mainland Chinese markets, a number that probably represents at least a five-year backlog of listing applications.

Since the vast majority of PRC private equity investments are minority investments, many PE firms have limited effective means of forcing an alternative exit to an IPO. Even where minority investors benefit from sale or put rights, the regulatory overlay makes it very difficult to force a transaction that is not fully supported by the majority shareholders. In addition, there are significant additional obstacles to M&A exits in the PRC because few domestic buyers have the cash or shares to use as currency and foreign buyers are subject to extensive regulatory scrutiny.

Go South East, Young Emerging Market Funds

In light of the challenges discussed above, a number of PE firms have shifted at least some of their focus away from China and towards South East Asia. This has resulted in a number of global PE firms opening offices in Singapore and elsewhere in South East Asia. At the same time, a number of global PE firms have ramped up the hiring

of local deal teams and announced intentions to allocate increased amounts of capital to South East Asia.

If China's staggering demographics have made her a belle of the private equity ball in recent years, South East Asia is certainly no wall flower. The ten ASEAN nations¹ have an aggregate population of more than 600 million (more than either North America or the European Union). Collectively, these countries have rapidly growing economies with an aggregate GDP in excess of US\$3 trillion on a purchase power parity basis (more than either Brazil or Russia). In addition, the countries within the bloc—some with large domestic markets, others export-focused, some with significant natural resources, others with developed technology industries—represent a mix of economies with an increasing potential for integration as a result of the ASEAN Economic Community's goal of a tariff-free, integrated South East Asian market by 2015. Finally, given the extensive trade some of these countries have with China, these markets offer indirect investment exposure to China from offshore.

South East Asia also enjoyed robust M&A activity last year as compared to a relatively flat to down year for China. M&A deals with an aggregate value of approximately US\$90 billion were announced in 2012 in South East Asia, representing nearly a 90% increase from 2011 levels. Moreover, each quarter of 2012 saw South East Asia recording increasing amounts of deal activity, with the fourth quarter alone representing more than US\$35 billion of deal activity.

In addition to a growing M&A market, South East Asia has demonstrated a number of viable exit routes. For example, in 2012, more public money was raised through the

Malaysia stock exchange (approximately US\$7.6 billion) than on the Shanghai (approximately US\$5.3 billion) or London (approximately US\$4.6 billion) stock exchanges. In addition, there are a number of successful private equity managers in the region who are able to regularly consummate control transactions as a result of South East Asian legal and regulatory regimes that permit certain types of control transactions as well as the presence of entrepreneurs and family-controlled conglomerates that are receptive to control sales of a target business to fund their other business activities. The ability of these managers to execute control transactions affords them significantly more power to pursue a trade sale or other alternative exit for a portfolio investment.

Fundraising activity during the Year of the Dragon provides additional evidence of the sharpened focus of the private equity community towards investment opportunities in the broader Asia Pacific region, including South East Asia, and not just China. During the year, LPs allocated US\$14.5 billion to pan-Asia funds, or a 74% increase in such allocations compared to 2011, whereas, as noted above, LPs allocated US\$15.4 billion to China-focused funds during this period, a 47% decrease compared to 2011. Amounts raised for pan-Asian funds during the Year of the Dragon, including KKR's record-breaking US\$6 billion Asia fund, have contributed to an aggregate fund pool for the Asian private equity market that now exceeds US\$400 billion.

The Value of Diversification

Of course, private equity opportunities in South East Asia and China are not mutually exclusive and China's position in the region should not be understated. Indeed, many private equity professionals with successful track records in the PRC are quick to state

¹ Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Myanmar, Cambodia, Laos and Vietnam.

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...[T]he drama in the Chinese market during the Year of the Dragon serves as a timely reminder of the enduring wisdom of investment (and exit) diversification and the benefits of flexible investment mandates.

Pension Derisking: New Ways to Manage Old Pension Liabilities

Otherwise attractive businesses with significant defined benefit pension liabilities are often "off limits" for private equity firms understandably concerned about future pension payment obligations and their financial statement impact. However, if there were techniques to reduce or even eliminate future pension payment obligations and their volatile financial statement impact without breaking promises to retirees, private equity buyers might find a number of transactions more viable.

Private equity buyers may be able to adopt some of the approaches used recently by General Motors and Verizon, whose large ongoing pension obligations under legacy defined benefit plans, were adversely affecting their strategic direction. Each of these companies used pension plan assets (in addition to cash) to purchase group annuity contracts from The Prudential Insurance Company of America that covered a portion of their pension obligations.

In representing Prudential in each of these transactions, which were the two largest derisking transactions ever completed, the Debevoise team found a number of implications for private equity firms. As noted above, these transactions could be used to manage the pension plan liabilities of potential acquisition targets with legacy defined benefit plans as well of existing portfolio companies. Second, since defined pension plans have historically been significant investors in private equity funds, such transactions will involve simultaneous transfers of a substantial number of interests in private equity funds owned by the pension plans involved to the counterparty selling the annuity contract.

What Is Derisking?

The term derisking, of course, refers to reducing risks, which in the pension world

means finding ways to reduce an employer's exposure to volatility, whether due to underfunding or changes in key assumptions such as interest rates and longevity. Derisking can be achieved by tightly matching payment obligations to investments, reducing obligations by buying out retirees or by purchasing annuities to cover the payment obligations, effectively shifting payment and longevity risks from the pension plan to the insurance company.

What Did General Motors and Verizon Do?

Both General Motors and Verizon derisked portions of their pension obligations through purchases of group annuity contracts. The group annuity contracts cover all future pension liabilities for qualifying retirees who are already receiving retirement payments from the pension plans, *i.e.*, qualifying retirees who are "in pay status." Payments required under the pension plans will be made by the insurer directly to the retirees covered by the group annuity contracts. Retirees not covered by the group annuity contracts will, of course, continue to participate in the company plans. The group annuity contracts purchased by GM and Prudential did not cover employees not "in pay status," and the pension obligations to those employees were, accordingly, not derisked.

What Were the Differences in the Transactions?

General Motors and Verizon took different approaches to derisking. The General Motors plan did a "buy-out" transaction. This involved, first, splitting the salaried employee plan into two: one that will continue more or less unchanged, primarily for active employees, and the other for salaried employees who were already in pay status (the "buy-out plan"). Participants in the buy-out plan who met certain other

criteria were offered an opportunity to receive a lump-sum payment in exchange for their pension. For those who either did not qualify for or did not elect a lump-sum, the buy-out plan purchased a group annuity contract. Following the purchase and after completion of various administrative steps, the buy-out plan will be terminated and General Motors will be permanently relieved of responsibility for future payments for participants in the buy-out plan.

Verizon, by contrast, did a "lift-out" transaction. Verizon purchased a group annuity contract for the qualifying retirees who were in pay status in exchange for certain plan assets but without terminating the plan, which will continue with respect to retirees whose pensions were not "lifted out." As a consequence of the purchase, the obligation to pay the retirees covered by the annuity is shifted to Prudential and Verizon's plan will continue for the employees not covered by the group annuity contract.

What Is the Difference to Retirees?

The retirees whose pensions were annuitized should not notice any difference in the amount of their payments or otherwise. Indeed, the only difference should be that their pension checks should now say "Prudential" on them instead of the name of their former employer.

Pensions that have been derisked through annuitization may not be subject to oversight of the Department of Labor or benefit from the Pension Benefit Guaranty Corporation insurance (which is similar in concept to the FDIC insurance on bank deposits). This may matter in the event of an insurer bankruptcy. However, state insurance laws provide oversight, and the

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Pension Derisking (cont. from page 5)

use of a separate account to support the annuity payment obligations is an added level of protection. Although there have been criticisms to the approach used in these transactions and requests for a moratorium on derisking transactions until further study is completed, there has not yet been any regulatory movement on this issue.

Do General Motors and Verizon Still Have Pension Plans?

Yes, both companies still have significant pension obligations that have not been annuitized.

What was Unique about These Transactions?

Although employers have long had the ability to derisk their pensions by purchasing annuities, the scale of these transactions made them unique. GM and Verizon transferred approximately \$25 billion and \$7.5 billion of pension liabilities, respectively, in connection with their purchases of these guaranteed annuity contracts.

Secondly, GM and Verizon used their plans' assets, plus cash to make up the underfunding shortfall in the plan, to pay the annuity premium. This is an innovation, as traditionally in a derisking transaction the pension plan would have liquidated its portfolio and purchased the annuity for cash. When using an existing portfolio as currency, the transferred assets must conform to the insurer's target portfolio allocations and duration as closely as possible, with deviations increasing the dollar value of the premium. Pricing is also determined by the actuarial characteristics of the participants in the plans (*e.g.*, age, gender and similar factors). Obviously, pricing is critically important to the insurance company, because once the insurer has

assumed the obligation to pay the pension obligations, it has also assumed the risk for market performance of the assets and actuarial variations in the actual retiree population. Unlike the pension plan, which could require contributions from the employer, the insurer will not have recourse to the company for additional funds if expectations differ from actual results.

Why Are These Transactions of Interest to Private Equity Firms?

Private equity firms may find annuitization transactions attractive as a tool for managing the pension risks of both existing portfolio companies and potential acquisition targets.

Secondly, private equity firms should be conscious of these transactions because pension plan and insurance company limited partners are likely to seek consent from fund general partners to transfers of limited partnership interests in future annuitization transactions. Because of the nature of the transfer, several terms considered "market" in normal transfers of interests in private equity funds may present challenges.

General partners often request, as a condition to granting their consent to a typical transfer, that the transfer close only at the end of a quarter (or month), that the transferor and the transferee be jointly and severally liable for damages arising out of the transfer, and certain assurances relating to the publicly traded partnership rules are made. The parties in the GM and Verizon transactions resisted these and a number of other routine requests from the general partners whose consents to transfer were being sought. While solutions were found to all of these (and other) challenges, we expect that insurers will push harder in the future to avoid

taking on additional risks beyond the investment and to have the timing of the transfers more closely align with the closing date of the annuity purchases. Further, we expect that pension funds that are anticipating future annuitizations may start to request, at the time they invest in a fund, side letter provisions intended to facilitate those transactions.

Can Private Equity Fund Managers Use Derisking Techniques?

Private equity owners of businesses may not have the same level of defined pension liabilities that GM and Verizon carried, but they may well be able to use the derisking approach to boost the value of existing portfolio companies and to structure transactions that may not otherwise be compelling. However, derisking transactions raise complex legal questions in a variety of areas, including ERISA's rules regarding fiduciary duty and prohibited transactions, qualified plan rules and insurance regulation. ■

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Time for Private Equity to Relax About ERISA-Controlled Group Liability?

“Controlled group” liability under ERISA—the risk that pension liabilities might spill out of one portfolio company of a private equity fund and be enforced against another portfolio company of that fund, or against the fund itself—is a risk that has long presented uncertainty for private equity professionals due to the absence of any definitive authority on the point. For years, however, many sponsors took comfort from favorable analogous case law with respect to general tax principles to conclude that the risk of controlled group liability under ERISA being imposed on them or any other portfolio company of the fund was modest, albeit not non-existent.

But amid the disruption of the recent downturn, novel arguments have been made successfully in the bankruptcy and insolvency context to enforce ERISA claims against healthy sister portfolio companies of private equity funds and against the funds themselves on the basis of controlled group liability theories, thereby engendering additional unease within the community about these potential exposures. These claims arise in two contexts—the first (and less frequent) is in the termination of single-employer pension plans by the Federal pensions regulator, and the second (and more frequent) is in claims made by union-sponsored “multiemployer” pension plans to enforce liabilities when a portfolio company stops contributing to (or “withdraws” from) the plan.

In what we hope will be a positive direction for private equity sponsors in this area, however, a Federal district court in Massachusetts has recently rejected the two principal adverse precedents for private equity funds to emerge during the downturn. While certainly not the last word on this issue, fund sponsors can again be cautiously optimistic that this decision will establish that controlled group liabilities can *not* be enforced against a private equity fund.

Background on Controlled Group Liability

ERISA, the Federal pensions statute, imposes joint and several liability for certain pension liabilities not only on the employer that sponsors the plan, but also against each member of its “controlled group.” For this purpose, the controlled group of a contributing employer generally includes any parent or subsidiary that is a “trade or business” and that sits in an 80% or greater ownership chain (measured, in the case of a corporation, by vote or value, and, in the case of a partnership, by capital or profits).

For example, if Holding Company “H” has two wholly-owned operating subsidiaries, “S-1” and “S-2,” and S-1 incurs a withdrawal liability under a multiemployer (*i.e.*, union) pension plan because S-1 stops contributing, that liability could be enforced not only against S-1 but also against S-2, H and essentially anywhere else within the H controlled group that assets can be found to the extent that the owner of the assets is engaged in a “trade or business” under ERISA. The policy behind the controlled group liability statute is anti-abuse in nature, namely to prevent an employer from shielding its assets away from the plan’s enforcement reach.

Historically, even in the absence of any definitive controlling authority on this question, most private equity funds have taken the position that they are not part of an employer’s controlled group because they are not engaged in a “trade or business” for purposes of ERISA. This view has been based largely on the fact that courts have historically relied on general case law and authority regarding the existence of a “trade or business” for tax purposes to determine whether a fund’s activities constitute a “trade or business” for non-tax purposes. Since the law is viewed as reasonably clear for general tax purposes that, absent unusual

circumstances, a private equity fund’s investment activities do not result in a fund being a “trade or business,” it was generally assumed prior to 2007 that funds were not exposed to controlled group liability under ERISA.

2007—The PBGC Advisory Letter

The viability of this assumption first came under pressure in 2007 when an internal appeals board at the Pension Benefit Guaranty Corporation (or PBGC) concluded that a private equity fund could be considered a “trade or business” for ERISA controlled group purposes. The decision was issued in connection with the PBGC taking over a bankrupt portfolio company’s underfunded pension plan. The PBGC arrived at its decision under an agency theory,

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Unlike the PBGC in its 2007 advisory letter and the court in *Palladium*, the court [in *Sun Capital*] respected the separate entities of the general partners and management company and...concluded that the activities of the Sun Capital funds did not constitute a “trade or business” for purposes of assessing withdrawal liability.

ERISA-Controlled Group Liability (cont. from page 7)

by attributing to the fund all of the activities of the fund's general partner, which, in the view of the PBGC, had "full control" over the fund's business and affairs, including the management of the portfolio companies. In the PBGC's view, these management activities, coupled with: (1) the receipt of management fees and other fee income by the related management company; (2) the fund's stated purpose of effecting operational improvements at its portfolio companies, and (3) certain customary shareholder rights held by the fund, made the fund a "trade or business" under ERISA. Since 2007, this decision has certainly given members of the private equity community pause, but has by no means been viewed as conclusive, due to skepticism that a court would accept an interpretation of "trade or business" under ERISA that diverged from a general tax analysis as well as skepticism that the PBGC would be willing to test that proposition in a Federal court.

2010—The *Palladium* Decision

Nonetheless, in 2010, a Federal district court in Michigan issued a decision, *Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*, that adopted the PBGC's view, not on the merits but for purposes of denying motions for summary judgment. Although the case arose in the context of enforcement of withdrawal liability under a union pension plan, the controlled group issues were the same as in the PBGC decision, and the resulting court decision was the first judicial endorsement of the position that a fund could constitute a "trade or business" for ERISA purposes, regardless of the general tax analysis.

In *Palladium*, two multiemployer pension plans sought to impose ERISA liabilities against a family of private equity funds and their related management

company. The plaintiffs argued that the limited partnerships and the management company were trades or businesses and thus liable, and that the court should treat them all as a single entity for purposes of calculating the 80% threshold necessary to form a controlled group. (Otherwise, no entity would meet the 80% ownership threshold and so there would be no controlled group liability even if the fund were deemed to be engaged in a trade or business.) The case was subsequently settled without further litigation of these issues.

Although it is a published decision of a court, *Palladium*, like the PBGC advisory letter, was perceived as weak authority within the private equity community because: (1) as noted above, it was not a decision on the merits, and its conclusions were never tested on appeal; (2) although it endorses the PBGC position on the "trade or business" issue, its conflict with general tax principles results in an analogous departure from historical precedent; (3) its disregard of the separate entity status of the different limited partnerships in the fund family runs contrary to well-established tax and corporate authority on which practitioners rely in structuring and operating private equity funds, and (4) its inclusion of an affiliated investment manager in a controlled group was perceived as just plain wrong, as it runs directly contrary to the express provisions in the controlled group rules, which are based on control resulting from equity ownership.

2012—The *Sun Capital* Decision

Like *Palladium*, *Sun Capital* involved an effort by a union multiemployer pension plan to assert a withdrawal liability claim against private equity funds, in this case managed by Sun Capital. In summary,

two different Sun Capital funds (Fund III and Fund IV) acquired Scott Brass, a manufacturer. Scott Brass eventually went bankrupt, and around the time of the bankruptcy Scott Brass ceased contributing to the pension plan. Setting their sights on the only deep pocket available, the plan asserted that the Sun Capital funds were members of the Scott Brass controlled group in an action brought in Federal court in Massachusetts.

Analyzing the tax authority on the issue of whether investment activities can result in a "trade or business," the district court concluded that the activities of the Sun Capital funds did *not* constitute a "trade or business" for purposes of assessing withdrawal liability. The court noted that the funds had no employees, did not own office space, did not make or sell any goods and had no income other than passive investment income. The court in *Sun Capital* attached no weight to the fact that (as is nearly always the case) the activities of the funds, of the general partner and of the affiliated management company could be traced to a small number of individuals (in this case, two individuals). The district court expressly gave no weight to the 2007 PBGC decision, which it found to be "unpersuasive" and "incorrect" and to reflect a "misunderstand[ing of] the law." Unlike the PBGC in its 2007 advisory letter and the court in *Palladium*, the court respected the separate entities of the general partners and management company and refused to impute their activities to the funds under any agency or similar theory.

Separately but equally importantly, the district court respected the division of the investment among different members of the fund family. The district court noted

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ERISA-Controlled Group Liability (cont. from page 8)

that Sun Capital's Fund III purchased 30% of the Scott Brass equity, while Fund IV purchased 70%. This bifurcation was made in part for the express purpose of breaking the 80% controlled group chain and thereby avoiding exposure to any risk of withdrawal liability if the investment were to fail (as it ultimately did). The district court in *Sun Capital* concluded that this kind of structuring did not violate a separate veil-piercing provision of ERISA. Although allocating investment opportunities among different funds can create very challenging conflict issues and other potential issues for sponsors, under the right circumstances sponsors may consider this type of structural defense when evaluating acquisitions of "old-economy" targets that sponsor pension plans or contribute to multiemployer plans.

While we hope that the *Sun Capital* decision is the beginning of the end of the

risk that a private equity fund can be viewed as a "trade or business" under ERISA, it will certainly take some time for the law to be classified on these issues. A starting point will be future activity in the *Sun Capital* case itself, as the decision is currently being appealed to the First Circuit. In our view, future battles are most likely to arise in the same manner as in the *Sun Capital* decision—in the multiemployer plan context. This is so for two reasons. First, withdrawal liability is by far a more common way in which controlled group issues tend to arise. Second, the administrators of the multiemployer plans are fiduciaries to plan participants and, thus, separately liable under ERISA for failure of duty, and their perceived failure in chasing all available assets could open them to fiduciary claims by plan participants. (The PBGC is not subject to the same fiduciary scrutiny in the plan termination

context, and so is likely to have more flexibility in a negotiation.)

Consequently, for the time being at least, private equity sponsors should continue to view the risk of controlled group liability under ERISA as a meaningful component of their diligence, and, where appropriate, may wish to consider structural risk-reduction mechanisms such as were used by Sun Capital. ■

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What Does the New Year Suggest for Private Equity Activity in Asia? (cont. from page 4)

that reports about the scope of accounting and other frauds in the PRC are overblown and that a well-qualified local team that picks its partners and advisors wisely can still avoid most pitfalls. In addition, many LPs still seek exposure to the larger Chinese private equity market and continue to invest with private equity managers with a strong position in the PRC market. Still, Chinese companies will likely need the benefit of time and, in some cases, reformed business practices, to reverse the image and related problems arising from the adverse market developments that emerged during the Year of the Dragon.

At least one Fengshui expert in Hong Kong has already promised in the *South*

China Morning Post that things are going to get better soon and that the IPO markets will reopen in the Year of the Snake because "Snakes are skin shedders, [which] signifies radical change." A decision by the CSRC to significantly increase the pace at which it has been permitting companies to list in the PRC would be one such radical and welcome change. The expansion of alternative exit opportunities would be another beneficial change, which seems poised to happen as a more sophisticated market for secondary buy-outs develops.

Still, the drama in the Chinese market during the Year of the Dragon serves as a timely reminder of the enduring wisdom of investment (and exit) diversification and the

benefits of flexible investment mandates. While there will always be room for investment specialization (*e.g.*, country funds), particularly as individual private equity markets grow and mature in the Asia Pacific region, for the moment at least, it appears that many PE firms with flexible mandates in the Asia Pacific region may be in a position to buck the headwinds currently facing China and ride the tailwinds powering South East Asia. ■

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ALERT

First Year Review of the UK Takeover Code in Action

The first review by the UK Panel on Takeovers and Mergers (the “Panel”) of the so-called Cadbury reforms to the UK Takeover Code concluded that the reforms had been largely successful in protecting target companies from being placed under siege by protracted bid periods. Observers of the UK deal scene will recall that the reforms were adopted in September 2011 following the political controversy surrounding Kraft’s offer for Cadbury plc. The changes were intended to shift the balance of UK takeover regulation in favor of target companies and, among other things: (1) tightened the rules on announcement of potential public deals by requiring that leak announcements name all potential bidders; (2) revised the so-called “Put Up or Shut Up” regime to require bidders to either launch an offer or walk away within 28 days of the first announcement of the talks; and (3) imposed more onerous disclosure requirements on bidders. In addition, break-up fees and related deal protection measures were banned, other than in certain limited circumstances. These reforms were hardly welcomed by the private equity community.

The review by the Panel, which published its findings in November of

2012, indicated that it had no immediate plans to revise or reverse the Cadbury reforms. According to the Panel, in the year ended September 18, 2012, there were 81 “firm” proposals to make a takeover offer, 65 of which resulted in the change of control of a target company. About half of these offers were subject to a “Put Up or Shut Up” deadline, though the Panel granted an extension to that deadline in the fifteen cases where the target company consented. Those critical of the reforms have suggested that this data might be more a reflection of a generally slow M&A market rather than the impact of the rule changes themselves—UK takeover activity in 2012 was about 10% down compared to 2010 and 2011 and significantly down compared to the heady days of 2006 and 2007, which saw 151 and 144 such deals, respectively.

In any event, it is fairly clear that the Cadbury reforms are here to stay, regardless of whether their effectiveness was dependent on the deal climate. As discussed in the 2012 Summer/Fall edition of the *Debevoise & Plimpton Private Equity Report*, the Panel has proposed a series of more minor changes to “tidy up” some of the anomalies currently in the Code, but is not proposing any rule changes which

would dilute the Cadbury reforms. The Panel has also recently announced rule changes which will give enhanced rights to trustees of defined benefit pension plans with respect to the treatment of such plans in a takeover and require bidders to disclose details of any deficit reduction arrangements they propose in respect of a target’s pension scheme.

It is premature to reach any definitive conclusions about the impact of the changes to the Code on private equity activity in the UK, though there is some anecdotal evidence that private equity bidders in the UK market have been deterred from approaching target companies by both the prohibition on deal protection measures and inducement fees and the possibility that leaks and rumors about those talks could trigger a requirement to announce their identity and start a 28-day “Put Up or Shut Up” period. It is also possible that the new rule changes around pension trustee rights could have a chilling effect on private equity bidders, who may be particularly sensitive to the precedential impact of the disclosure of their deficit reduction arrangements with particular targets and trustees. ■

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**Have Questions About
Topics Covered in the
Private Equity Report?**

Partners in the Private Equity Group are available to our Clients to discuss these issues and answer questions in depth.

Contact Angeli Saijwani at +1 212 909 1915 or asaijwani@debevoise.com to arrange a PER follow-up call or e-mail.

Tax Reporting Gone Wild: Getting Ready for the New FATCA Rules

Although FATCA (“Foreign Account Tax Compliance Act”) has a laudable goal—establishing an information reporting regime that prevents U. S. taxpayers from evading U.S. tax through offshore accounts—it will create many headaches and administrative burdens for private equity, hedge and other investment funds and their investors. Fund sponsors should be preparing now for the implementation of the FATCA rules because the deadlines are approaching: FATCA registration for non-U.S. funds will begin later in 2013 and the 30% FATCA withholding tax on certain types of U.S. source income will go into effect on January 1, 2014.

While dividends, interest, rents and certain other types of income from U.S. sources that are paid to non-U.S. persons are already potentially subject to 30% U.S. withholding tax, the 30% FATCA withholding tax has a substantially broader scope because, in addition to U.S. source income, it applies to gross proceeds from the disposition of U.S. stock and debt instruments on or after January 1, 2017. It will also apply to so-called “foreign passthru payments,” which the final regulations issued by the IRS earlier in the year (the “Final Regulations”) reserve on, but which may eventually pick up certain types of non-U.S. source income.

There is some good news lurking in the FATCA scheme. Because it is designed as a reporting regime, no withholding tax will apply to payments if recipients comply with the FATCA information reporting rules. The other good news is that the withholding tax rules are being phased in gradually. Although the 30% FATCA withholding tax on U.S. source income begins for payments made on or after January 1, 2014, sponsors and funds have more time to address withholding on gross proceeds from the disposition of U.S.

stocks and debt instruments, which will not apply to dispositions occurring before January 1, 2017. In addition, under a grandfather rule, the 30% withholding tax on gross proceeds will not apply in relation to debt instruments and certain other obligations that are outstanding on January 1, 2014. Withholding on foreign passthru payments will certainly not begin earlier than January 1, 2017, and may well be delayed further.

The painful news, however, is that the rules are extremely complex and some funds and investors may face practical difficulties complying. Since the administrative burdens on funds and fund sponsors will likely be substantial, sponsors should be preparing now in order to deal with the new rules. The Treasury Department is implementing an alternative approach to FATCA based on intergovernmental agreements (“IGAs”) that is significantly less burdensome than the regular FATCA rules in certain respects and, therefore, may provide relief to many non-U.S. funds and portfolio companies. However, the IGA rules are in an early stage of development and are still evolving. The private equity community is hopeful that once these IGAs are in place, the administrative burden on non-U.S. funds and portfolio companies will be substantially reduced. Discussions with more than 50 governments are now underway.

Key Takeaways of the New Rules

A U.S. fund will be required to withhold a 30% withholding tax on any payments to its investors of dividends, interest, rents and other fixed and determinable income from U.S. sources, and gross proceeds from the disposition of U.S. stock and debt instruments (“withholdable payments”) unless the fund obtains appropriate information and certifications from their

investors establishing an exemption from FATCA withholding.

A non-U.S. fund generally will be treated as a “foreign financial institution” (“FFI”) and, as a result, will need to register with the IRS in order to avoid being subject to the 30% withholding tax on any withholdable payments and foreign passthru payments that are made to the fund, when such withholding rules are in effect. In addition, unless a non-U.S. fund is subject to an IGA, in order to avoid being subject to withholding, the fund or its sponsor generally will need to enter into an agreement with the IRS (an “FFI Agreement”) to undertake diligence procedures and to report information regarding the fund’s direct and indirect U.S. investors to the IRS. The FFI Agreement will require the non-U.S. fund to withhold on withholdable payments to investors that do not comply with the FATCA rules or qualify for an exemption in a manner that is similar to a U.S. fund. In addition, non-U.S. funds will be required to withhold on foreign passthru payments when those rules come into effect.

Regardless of where a fund is located, the fund should determine the extent to which its portfolio companies are included in the category of FFIs comprising non-U.S. holding companies, which under the Final Regulations include any non-U.S. holding company “formed in connection with or availed of by” a private equity fund, a hedge fund or similar investment vehicle. All funds should also ascertain the extent to which their portfolio investments include such non-U.S. holding companies or are otherwise subject to the FATCA rules to avoid unexpected withholding.

Under the IGA approach, payments to a non-U.S. fund or other FFI that is resident in a country that has entered into an IGA with

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Getting Ready for the New FATCA Rules (cont. from page 11)

the United States generally will not be subject to FATCA withholding if the FFI satisfies identification and reporting rules regarding U.S. accounts adopted by the FFI's country of residence. The United States has announced that it is engaged with more than 50 jurisdictions regarding an IGA, including the Cayman Islands and other offshore jurisdictions. An IGA has already been signed or initialed with the United Kingdom and several other countries. The IGA approach may offer significant relief for non-U.S. funds and non-U.S. portfolio companies that are resident in countries that have entered into an IGA. However, because only a modest number of IGAs have been signed or initialed and the non-U.S. jurisdictions subject to the IGA must enact implementing legislation, the extent to which funds and fund sponsors will benefit from the IGA approach is not yet clear.

Application of FATCA to U.S. Funds

A U.S. fund will be required to withhold 30% of any withholdable payment made to its investors and other payees (beginning in 2014 or, in the case of gross proceeds from the disposition of stock and debt instruments, 2017), unless the fund establishes that the recipient qualifies for an exemption from FATCA withholding. A FATCA grandfather rule may afford protection for debt instruments and other obligations held by a fund that are outstanding on January 1, 2014, but there is no grandfather treatment for equity investments in portfolio companies.

To avoid withholding on payments to investors of U.S. source dividends, interest and other withholdable payments, U.S. funds must establish procedures to identify their investors' FATCA status and to collect relevant supporting documentation. The IRS is currently revising the Form W-8 series to enable withholding agents to

identify the FATCA status of a non-U.S. investor.

Although a U.S. fund will be subject to the FATCA rules as a withholding agent, and not as an FFI, U.S. fund sponsors should consider the effect of the FFI rules on any non-U.S. parallel funds, feeder funds and alternative investment vehicles, which generally will be treated as FFIs, and on their non-U.S. holding companies and portfolio companies which, as discussed below, also may be treated as FFIs under the Final Regulations. If, and when, IGAs are in effect, the complications arising from fund entities that are resident in IGA jurisdictions may be mitigated.

Application of FATCA to Non-U.S. Funds and Non-U.S. Fund Managers

A non-U.S. fund generally will be treated as an FFI. As a result, unless an IGA applies, the non-U.S. fund generally will be required to enter into an FFI Agreement, in order to avoid being subject to 30% withholding tax on any withholdable payments (beginning in 2014 or, in the case of gross proceeds from the disposition of stock and debt instruments, 2017) and on any foreign passthru payments (beginning no earlier than 2017) to the non-U.S. fund. Although the IRS has not released a model FFI Agreement, the Final Regulations set forth the substantive requirements applicable to an FFI Agreement.

In order for a non-U.S. fund that has entered into an FFI Agreement to avoid FATCA withholding on any withholdable payments and foreign passthru payments to its investors, the fund must obtain appropriate information and certifications to identify its direct and indirect U.S. investors and to establish the identity of other investors under the FATCA rules, and also must obtain waivers of foreign law that would prevent information from being reported to the IRS. As in the case of U.S.

funds, it is anticipated that fund sponsors will collect this information using the revised Form W-8 series.

In addition to diligence, reporting and withholding obligations, there are several other requirements for maintaining an FFI Agreement that a non-U.S. fund should take into account. In order to maintain its FFI Agreement, a fund must reduce over time investors that (1) fail to comply with information requests or fail to waive foreign laws preventing FATCA reporting or (2) are FFIs that do not comply with FATCA. If foreign law prevents an FFI from satisfying its information reporting requirements, the FFI must seek a waiver of such law or otherwise close or transfer the account. As a result, funds should consider including in their partnership agreements appropriate provisions requiring investors to provide information, certifications and waivers required for the fund and its affiliates to comply with FATCA, as well as provisions to protect the fund against investors that do not comply with FATCA.

To facilitate compliance with the registration and certification requirements for FFIs, the IRS will establish an online portal system where an FFI can register its FATCA status with the IRS and where a responsible officer will certify compliance with the FFI Agreement. Treasury and the IRS have stated that the portal should be available by no later than July 15, 2013, and that the last date to register with the IRS to ensure inclusion on the December 2013 list of FATCA-compliant FFIs is October 25, 2013.

The Final Regulations add an option for a fund manager to be a "sponsoring entity" for some or all of its non-U.S. funds. As a sponsoring entity, a fund manager performs the FATCA diligence, withholding and reporting obligations on behalf of some or all of its funds. The Final Regulations also

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ALERT

Offshore Private Equity Funds and Chinese Insurers: Coming Soon?

The prospect of offshore private equity funds being permitted to market their funds to deep-pocketed Chinese insurance companies is quite alluring to the global private equity community. In an exciting development for the industry, this prospect took a significant step forward in October 2012 when the Chinese Insurance Regulatory Commission (“CIRC”) promulgated regulations which, subject to certain important conditions and requirements, permit Chinese insurance companies, for the first time, to invest in certain qualified offshore private equity funds sponsored by qualified sponsors. Although the legal regime under which these investments in global private equity funds will be permitted is still a work in progress, with many details and uncertainties yet to be sorted out, this Alert sets out the highlights of the CIRC’s actions to date.

Qualified Fund Sponsors

Investments will be permitted only in funds that are sponsored by “qualified” sponsors and satisfy certain conditions, including:

- The sponsor has no less than US\$15 million in paid-in capital or net assets and cumulative assets under management of no less than US\$1 billion;
- The sponsor has a mature investment team and an established track record;
- The fund has at least US\$300 million of committed capital and focuses on growth-stage or mature businesses; and
- No financial institution or any subsidiary thereof can have *de facto*

control over the management or operations of the fund and no financial institution or any subsidiary thereof can hold any general partner interest in the fund.

Qualified Chinese Insurance Companies

Any Chinese insurance company proposing to invest in a qualifying offshore private equity fund will need to comply with certain requirements, including:

- A solvency adequacy ratio of not less than 120%; and
- A limit of 15% of its total assets in overseas interests, including the proposed fund investment.

Implementing Mechanics

Despite these encouraging developments, there are still a number of important issues that must be clarified before qualifying offshore fund sponsors should plan on welcoming Chinese insurance companies to their limited partners meetings. Among those issues are:

- How the regulatory approval of specific fund investments will operate in practice;
- The development through further regulatory processes or practices of detailed definitions for certain critical concepts, including those in determining qualifying status for sponsors such as “net assets” and “cumulative assets under management;” and
- Of particular importance, whether Chinese insurance companies will be

required to make any investments in a qualified offshore private equity fund through an “offshore fiduciary.” This type of requirement currently applies to certain other permitted offshore asset classes for Chinese insurance companies. The qualification standard for an “offshore fiduciary” in general is fairly high, *e.g.*, having assets under management of no less than US\$30 billion. This requirement, if applicable to fund investments, will have the effect of limiting the range of intermediaries that Chinese insurance companies may use and may limit the ability of private equity sponsors to have the kind of direct access to Chinese insurance companies they might like in order to fortify relationships.

The CIRC’s rule-making is an encouraging development for the private equity community and has the potential to enhance the fundraising opportunities for non-Chinese private equity firms. However, any rejoicing would be premature as there is still much work to be done before Chinese insurance companies will be able to supply offshore fund sponsors with a new source of capital. ■

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Strategic Thinking: Special Considerations for Private Equity Sponsors Contemplating Add-on Acquisitions

“Topped again” is a frustrated refrain often heard from PE firms these days when attractive targets in this competitive market slip into the hands of rival bidders. With many firms sharing similar IRR expectations, the economic difference between a winning and losing bid among sponsors can be quite small, so every dollar of additional purchase price could prove decisive.

Strategic buyers present a different profile in competitive auctions. Sellers may perceive that strategics present some disadvantages as potential buyers—potential antitrust issues, confidentiality and poaching concerns—but their ability to realize synergies often justifies superior financial offers. Taking advantage of synergies need not be unique to strategic acquirors, however. Just as strategic buyers have been lifting techniques from the private equity playbook to utilize in their deals (see “Imitation is the Sincerest Form of Flattery: Continued Use of Private Equity Technology in Acquisitions by Strategic Buyers” in the Summer/Fall 2012 issue of the *Debevoise & Plimpton Private Equity Report*), some sponsors are seeking to grow existing portfolio companies through bolt-on acquisitions in order to replicate some of the dynamics enabling strategic buyers to pay higher prices in deals.

Buying a complementary business through an existing portfolio company can present a sponsor with additional deal considerations that do not exist in most private equity transactions. The most fundamental of these, of course, is that in addition to courting management of the target, the sponsor must ensure that the existing portfolio company’s management team is fully supportive of the deal. This article discusses some of the other considerations in deals of this type, including some that may present additional execution risk and suggests some ways to mitigate those risks.

Buyer Self-Diligence

In add-on deals, a sponsor should work closely with its portfolio company in performing self-diligence to confirm the validity of any synergies or other financial benefits built into its pricing model.

Financing Agreements. One of the first areas for serious diligence should be the portfolio company buyer’s existing debt agreements. If the sponsor intends to finance the acquisition under the portfolio company’s existing debt agreements, the threshold issue, of course, will be whether sufficient borrowing capacity exists to permit the acquisition (discussed in greater detail below). But the sponsor and the portfolio company’s management also need to ascertain whether the post-closing combined entity can comply with the existing covenants applicable to the portfolio company and still operate the combined business as anticipated. If the answer to these questions is not clearly affirmative, and if refinancing or amendments to the debt agreements at the portfolio company level is not attractive, the sponsor may want to acquire the new business, at least initially, in a separate silo, and then share personnel and functions through a services agreement with the existing portfolio company. Of course, the economics of this services arrangement would need to pass muster under the affiliated party transaction covenants in the separate debt agreements of each company. Another approach, which may be necessary, especially if the portfolio company’s debt agreements have only a few years before maturity, is negotiating an “amend and extend” transaction.

Management Arrangements. Another key area of focus should be the portfolio company buyer’s arrangements with management. Do those agreements provide flexibility to adjust titles, roles and responsibilities in order to

integrate key members of the target’s management as officers and as directors as desired? Or, will such changes give rise to a right on behalf of one or more of the portfolio company’s managers to terminate his or her employment with “good reason?” Also, if the sponsor has put in place a traditional incentive arrangement at the portfolio company, with units vesting over time as well as based upon exit hurdles, will the plan need to be recalibrated to incorporate the new members of the management team as well as the scale of the combined business? The sponsor will need to be particularly sensitive to any covenants requested by the seller to maintain the target’s existing benefit arrangements for a period of time following the closing as it may not be feasible to operate two different regimes within the newly combined company.

Contractual Concerns. Other areas that should be reviewed with particular care include long-term leases for sites that may be rendered redundant, exclusivity arrangements with sales agents and representatives and material supply and IT services agreements that the combined company may seek to renegotiate in light of the increased post-closing purchasing volume. Preclusive provisions in any one of these agreements are unlikely to be a deal killer, but a number of thorny obligations, in the aggregate, could negatively impact value. Any of these agreements could also present consent issues that would need to be disclosed in the “no conflicts” representation that the portfolio company buyer will likely be asked to provide in the purchase agreement.

Target Diligence

Diligence undertaken on the target in transactions of this kind needs to cover all of the same areas as any other buy-out transaction, but also needs to focus on

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Strategic Thinking (cont. from page 14)

limitations on the ability of the combined business to realize anticipated synergies and other cost savings. These can arise by virtue of any non-competition or exclusivity arrangements that purport to be binding upon affiliates as well as collective bargaining agreements at facilities that may be combined or closed following the closing.

Deal Conditionality—Allocating Antitrust Risk

Of course, to the extent a sponsor chooses to act like a strategic buyer by pursuing an acquisition through an existing portfolio company, it will face some of the risks confronted by strategic buyers, especially the antitrust risks associated with combining businesses in the same horizontal or vertical space. Acquisitions of significant size must be reported to the U.S. antitrust enforcement agencies (and possibly other countries' antitrust regulators) prior to consummation, thereby potentially delaying a closing if a U.S. enforcement agency seeks additional information about the acquisition's competitive implications by issuing a (highly burdensome) "second request," and even potentially imperiling the deal if the agency brings suit to have the transaction enjoined. In many instances, non-U.S. antitrust regulatory authorities can also delay the closing and request additional information about the transactions and the business' markets.

Private equity deal makers may not be accustomed to doing transactions in which there is a substantive antitrust issue and may need to be closely advised about the process. Prior to entering into a transaction with meaningful antitrust issues, the parties generally assess the risk of government action and, in negotiating the purchase agreement, allocate the risk, including by negotiating the following two key issues:

Undertakings by the Buyer to Facilitate the Transaction's Approval. Generally, the buyer undertakes to take steps to seek and achieve

the antitrust enforcement agencies' approval of the transaction. These efforts are often described in various transactions as "Best Efforts," "Reasonable Best Efforts," "Commercially Reasonable Best Efforts" and the like. There is no definitive court precedent detailing what each of these efforts standards may require, although some contracts include "hell or high water best efforts clauses" that are generally thought by practitioners to mean what they say.

An alternative attractive to buyers, albeit also imprecise, is to provide that in no event will the buyer be required to take any steps that would have a material negative effect on its business. Another, more precise alternative, is for the parties to stipulate with some or detailed specificity what the buyer is required to divest if necessary to accomplish the transaction. This undertaking can take various forms, such as the obligation to divest manufacturing plants responsible for a particular percentage of sales, particular named plants or particular subsidiaries. (The parties might also agree that divestitures above a certain level will result in a purchase price adjustment.)

Although this approach has the quality of greater precision, the purchase agreement must be submitted to the antitrust agencies with the notification filing. Accordingly, a contractual clause requiring the buyer to take substantial measures to satisfy government regulators, including divesting substantial assets if necessary, may signal to the enforcement agencies that the parties likely concluded that the transaction raises troublesome competitive issues and how far the buyer is willing to go to facilitate the transaction.

Antitrust Termination Fees. Like the reverse termination fee payable by a buyer to a seller (RTFs) in the event a transaction fails to close due to a failure of financing, buyers, particularly in deals with genuine substantive antitrust risk, are increasingly agreeing to pay

the seller a fee if the deal falls apart for failing to clear antitrust review. Some antitrust-related RTFs are modest. Two high-profile deals from 2011, however, had sizable RTFs: AT&T—T-Mobile (cash, assets and spectrum totaling approximately US \$6 billion) and Google—Motorola (US \$2.5 billion). This represents approximately 15% and 20% of the total values of the deals in question, respectively.

Whatever their size, RTFs compensate the seller for losses suffered by its business during the disruptive sale period and, perhaps most importantly, they provide an incentive for the buyer to secure regulatory approval. Indeed, in a deal with a sufficiently large RTE, it is fair for the buyer to question whether an affirmative covenant is even necessary.

Deal Conditionality—Financing Risk

Whether the acquisition will be financed under the portfolio company's existing debt facility or through a new debt financing, a sponsor will confront financing issues that would not arise if the buyer were a Newco. Under an existing facility, the portfolio company will need to confirm it will be able to meet incurrence tests and leverage ratios, which are typically (but not always) measured as of closing. Therefore, the initial portfolio company borrower will have performance risk during the period between signing and closing for itself as well as the business to be acquired. Similarly, if a new facility is contemplated, the debt commitment papers will likely include requirements for solvency certificates and offering or syndication documents with respect to the entire business. Each of these elements will involve significant administrative work and could present increased execution risk.

The sponsor will also need to keep in

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New Opportunities for Private Equity to Help Financial Institutions Address Basel III Capital Requirements?

A recent transaction between Blackstone Group LP (“Blackstone”) and Citigroup may well signal future opportunities for capital providers including private equity firms. While that particular transaction appears most appropriate for diversified asset management firms, it may suggest ways for private equity firms to utilize committed capital to provide targeted credit support. It also is another variation of the type of derisking transaction we discuss on page 5 of this issue in the article “Pension Derisking: New Ways to Manage Old Pension Liabilities.” We discuss the transaction and its implications for private equity firms below.

The Transaction

According to public reports, Citigroup transferred a portion of the credit risk relating to a \$1.2 billion pool of shipping loans on its balance sheet to an affiliate of Blackstone through an insurance arrangement. Blackstone provided this insurance through a synthetic securitization structure: Citigroup entered into a credit default swap (“CDS”) with a separately capitalized Blackstone entity as counterparty, with the CDS insuring a portion of the credit risk of the loan pool. Under its regulatory capital rules, Citigroup used the CDS to reduce the amount of capital it was required to hold against the loan pool, thereby allowing it to deploy existing capital more efficiently.

Implications and Future Opportunities

The key motivator for Citigroup was its desire to secure capital relief under the so-called “Basel III” capital rules, which will be phased in over a multi-year period and are expected to substantially increase regulatory capital requirements for U.S. banking organizations, particularly those with significant trading activities.¹ Given the sizeable costs associated with these increased capital requirements, U.S. banking organizations must consider not only whether transaction structures achieve underlying economic and tax objectives, but also whether they are capital efficient under Basel III. It is, therefore, not surprising that other U.S. banking organizations are actively considering these types of transactions: indeed, other major U.S. banking organizations have structured similar deals. For example, we recently advised an insurance company that proposed to issue an insurance policy to a banking organization specifically to secure capital relief under the Basel framework (the transaction was never consummated). In that proposed transaction, the underlying policy and the risks it insured were structured to meet

¹ For more information on implementation of the Basel III capital requirements in the United States, see *Debevoise & Plimpton Client Update, The New Capital Framework Proposals: Enhanced Burdens Across the Banking Industry* (June 13, 2012).

specific requirements under the regulatory capital rules.

It appears likely that these types of risk transfer transactions will become more popular as the Basel III capital requirements come into effect. The Blackstone transaction, as well as our own experience, demonstrate that these transactions can accommodate a variety of counterparties (e.g., insurance groups or funds) and structuring options (e.g., tailoring risk transfer arrangements to specific provisions of the regulatory capital rules). These transactions appear to be particularly good opportunities for funds to generate revenue by providing targeted credit support, while retaining the ability to actively deploy capital as needed.

While it remains to be seen if transactions of this type can be structured in ways that are appropriate and attractive for a traditional private equity fund, it is yet another example of the innovative emerging opportunities for capital providers to make effective use of balance sheet capital as banking organizations adjust to the post-crisis regulatory paradigm. We will keep you updated on future developments in this area. ■

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When the SEC Knocks on Your Door, Will You Be Prepared? (cont. from page 1)

areas of the business and operations of the adviser that are viewed by the SEC staff as presenting higher risks (as contrasted, for example, with examinations prompted by specific allegations of improper conduct or routine exams that may involve a deeper dive into all of an adviser's operations).

For the uninitiated, the prospect of these examinations can be intimidating. Most private equity firms and their management and employees now face a level of regulatory scrutiny and oversight that is significantly more rigorous than they have previously experienced. Even fairly limited presence examinations can be time consuming and detailed. Examination teams are likely to ask challenging and targeted questions, and frequently ask firms being examined to provide proprietary or quantitative information that the firms have historically kept strictly confidential. In addition, while these examinations may turn out in many or most cases to be mostly fact-finding

exercises, private equity firms should be aware that an examination could lead to a firm being criticized for perceived deficiencies and, possibly, further SEC investigation and enforcement activity.

Firms selected for an exam should expect the process to move quickly. Registrants are often asked to respond to the initial requests for information from the examination team within two weeks, and field work (including site visits) usually commences shortly thereafter. Field visits generally include interviews with a firm's senior management and investment professionals, as well as the firm's compliance staff.

The balance of this article identifies a number of practical actions that we recommend each investment adviser consider in order to be prepared for a presence examination.

Preparation Step One: Foster a Culture of Compliance

Private equity firms should create a strong

ethical culture in their organizations from top to bottom. They should evaluate the overall attitude of management towards compliance obligations and risk management, both generally and compared to their peer firms. Conflicts and risk management should not be relegated to junior personnel only but should be handled or supervised, as appropriate, by senior personnel.

Preparation Step Two: Assess Firms' Risks in Areas that the SEC is Likely to Prioritize

Based on the concerns that the SEC staff has expressed publicly, as well as our experience over the past several months advising a number of private equity firms already being examined, we believe that the staff will likely focus on one or more of the following high-risk areas: fund marketing practices and

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SEC Examination Priorities for Private Equity Firms in 2013

On February 21, the OCIE published a report outlining its examination priorities for 2013. Highlights of the priorities identified in the report that apply to registered advisers to private equity funds include the following:

- **Corporate Governance and Enterprise Risk Management.** The staff will meet with senior management and internal auditors to understand firms' approach to enterprise risk management, evaluate firms' tone at the top and to initiate a dialogue on key risks and regulatory requirements.
- **Conflicts of Interest.** The staff will focus on conflicts of interest, steps the firm has taken to mitigate conflicts, the processes that the firm has in place to manage conflicts on an ongoing basis, and the sufficiency of disclosures made to investors concerning conflicts.
- **Compliance with the Pay to Play Rule.** The staff will review compliance with the recently adopted and amended pay to play rule.
- **Undisclosed Fee Arrangements.** The staff will review financial and other records to identify transaction fees, placement agent fees and other fee arrangements that have not been disclosed to investors—particularly fees paid to affiliated entities.
- **Marketing/Performance Presentations.** The staff will focus on the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized and related disclosures and compliance with record keeping requirements. Advisers should note that the staff considers aberrational performance a potential indicator of fraudulent or weak valuation procedures or practices.
- **Allocation of Investment Opportunities.** The staff will examine the allocation by the firm of investment opportunities between funds that do not pay carried interest and funds that do pay carried interest, particularly if the funds share similar investment objectives and the same portfolio manager is responsible for making investment decisions for both accounts.

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materials (including presentation of past fund performance), conflicts of interest, valuations and the safety of client assets.

In addition, the SEC staff has emphasized that it will be particularly interested in reviewing, in the case of private equity firms: fees charged to portfolio companies; whether expenses are being inappropriately shifted by the private equity firm to the funds that it manages or to their portfolio companies; the allocation of expenses among funds; the allocation of investment opportunities between or among funds managed by the same firm (and between or among funds and co-investors); related-party transactions; so-called “zombie” funds (funds at the end of their terms that still hold portfolio investments); and insider trading.

The sidebar on page 17 of this issue of the *Debevoise & Plimpton Private Equity Report* sets out with more specificity the areas that the SEC staff has identified, in an Alert published on February 21, 2013, as its examination priorities in 2013.

We recommend that every private equity firm proactively and carefully consider how best to respond to questions that an examination team might raise in the areas that the SEC has indicated are its key areas of concern, and whether the firm’s policies and practices should be modified to ensure it is in compliance with the relevant laws, regulations and recommended best practices in those areas. Every private equity firm should document its compliance policies and procedures and monitor and test the effectiveness of those policies and procedures. If a firm identifies a problem requiring remediation, we recommend that the firm (after consulting with counsel) address the problem now, before the SEC arrives. The SEC is likely to view these kinds of remediation efforts much more favorably than remediation done at the end of the examination process at the urging of the

OCIE staff.

Specific steps to take to address areas of particular SEC concern include the following:

- *Cross-check investor-facing disclosures for consistency.* Review performance presentation and marketing representations in offering documents, pitch books, RFPs and due diligence questionnaires and compare them to the current and historical performance of the funds managed by the firm and their portfolio investments. Are the performance presentations correct? Are net performance numbers disclosed? Do disclosures to investors adequately describe fees charged by the firm to the funds and, especially, to portfolio companies? Is the disclosure of management fee offsets and deal and expense allocation policies clear and accurate? How robust are the firm’s processes to ensure compliance with the policies that it has told investors it will follow?
- *Evaluate conflicts in the allocation of investment opportunities.* Conflicts can arise between funds that have similar investment strategies (including different vintages of a single family of funds) or funds that may invest in different parts of an issuer’s capital structure. How are such conflicts disclosed and managed? What disclosures does the firm make regarding co-investment opportunities? Does the firm disclose the basis on which it presents co-investment opportunities to proprietary vehicles or strategic partners? How do these arrangements compare to those offered to limited partners generally?
- *Assess expense allocations between (and among) the funds and the firm.* How are expenses (including broken-deal expenses) allocated across feeder funds under

common management, affiliated entities, and co-investment funds? Do fund disclosures describe the common types of expenses charged to funds and clearly describe the firm’s allocation methodology? Have expenses been allocated as disclosed and provided for in the relevant fund partnership agreement or other documentation? The staff is likely to evaluate whether firms have in place procedures to ensure that funds are not being overcharged for expenses and are not bearing expenses that contractually should be borne by the private equity firm or other parties.

- *Assess the firm’s valuation processes.* Is the firm following the valuation procedures that it has told investors it will follow? Is the valuation process robust, fair and transparent? Should the firm use a third-party valuation firm in some circumstances? Have there been unexplained changes to the methodology used to value an investment? Historically, did valuations fall off after the firm finished marketing a fund? Were the values actually realized in exits significantly lower than valuations previously provided to investors?
- *Test the firm’s compliance procedures and staffing.* Are there strong processes for ensuring compliance with the fund’s partnership agreement, side letters and other governing agreements and formation documents? Are compliance and other key risk management and back office functions sufficiently staffed?

Preparation Step Three: Prepare “Day One” Materials Now

We recommend that private equity firms consider preparing, now, narrative presentations discussing the firm’s key policies and procedures in high-risk areas of

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focus, even before the OCIE initiates an examination. Also, firms should think carefully about which employees are the right employees to make available to the exam staff if an examination is commenced and should ensure that those employees are prepared to address the staff's questions and concerns. Firms should also be prepared to demonstrate that they have set the right "tone at the top" by making senior executives available to exam staff to discuss the firm's culture and compliance profile.

In addition, we recommend that firms keep readily available certain documents that are consistently requested by the examination team (even though some of these documents may not be required to be maintained under the SEC's books and records rules), including:

- a current organizational chart;

- a schedule of threatened, pending and settled litigation or arbitration involving the fund adviser or any supervised person;
- current compliance policies and procedures, any records of noncompliance with such and a record of the steps taken to address those events; and
- the firm's risk matrix or other documents that were prepared as part of an evaluation of the firm's risk management process.

Conclusion

As discussed above, a significant number of private equity firms will likely be subject to an OCIE "presence" examination over the next two years. While the precise consequences of these examinations have yet to be established, fallout and reputational damage from an SEC examination "gone wrong" could potentially be severe. As in

many other compliance areas, the adoption of strong compliance policies (and taking steps to test and ensure that those policies are in fact being followed), rigorous preparation for a possible examination and proactive remediation of any weaknesses identified by management in advance of any examination are a firm's best protection against the unknowns that might arise during an examination. ■

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Strategic Thinking (cont. from page 15)

mind that if asset divestitures are required to obtain antitrust approval, ratio compliance will need to take into account the divestitures and the divestitures (which may need to be undertaken as quickly as possible) will need to comply with asset sale limitations in the existing debt agreements.

Sponsor Support

Because an operating portfolio company will generally be the contracting party in these transactions, the private equity sponsor could reasonably take the position that the portfolio company's commitment should be sufficient and the sponsor should not be obligated to provide seller with any guaranty of the portfolio company's obligations under the purchase agreement. This may or may not be a winning position depending on the facts and circumstances. If the deal is dependent upon new equity

financing, an equity commitment letter will likely be requested. Moreover, if new debt financing is contemplated and the sponsor and/or the portfolio company buyer is seeking the benefit of an RTE, seller may argue that sponsor should provide a limited guaranty of that fee given that the transaction is being structured with deal technology more often used in the private equity world. (For a possible rejoinder to this position, again see "Imitation Is the Sincerest Form of Flattery: Continued Use of Private Equity Technology in Acquisitions by Strategic Buyers" in the Summer/Fall 2012 issue of the *Debevoise & Plimpton Private Equity Report*.) Of course, the sponsor could decide that it (and its portfolio company) would be willing to forgo an RTE limitation on liability even where one might otherwise be appropriate in exchange for the sponsor not being

required to guarantee a termination fee.

* * *

The opportunity to be a "strategic thinker" in a bidding process is understandably appealing for sponsors. But, sponsors focusing on add-on acquisitions need to adjust their typical acquisition mindset to take into account the additional complications that, if anticipated and addressed, could well result in a winning bid and a smoothly integrated business combination. ■

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Getting Ready for the New FATCA Rules (cont. from page 12)

revise the definition of “financial institution” so that non-U.S. fund managers are also treated as FFIs, although equity interests in such entities generally are not treated as financial accounts subject to the FATCA diligence and reporting requirements.

Application of FATCA to Portfolio Companies

The Final Regulations provide that a non-U.S. holding company that is “formed in connection with or availed of by” a fund is treated as an FFI. While the exact scope of this requirement is unclear, it appears that certain non-U.S. holding companies that are owned directly or indirectly by funds will need to register with the IRS. As in the case of a sponsored non-U.S. fund, a fund manager can undertake the registration, diligence, reporting and withholding requirements for a non-U.S. holding company as a “sponsoring entity.” The

Final Regulations provide a limited exception to FFI status for certain non-U.S. holding companies that are members of a participating FFI group and that do not maintain financial accounts or make or receive payments outside of such group.

A non-U.S. holding company or portfolio company that is treated as an FFI but does not comply with FATCA may be subject to adverse consequences unless an IGA applies, including 30% withholding on withholdable payments and on foreign passthru payments paid to the company by other FFIs. In addition, dividends and interest paid by a non-U.S. company that is a participating FFI could be subject to foreign passthru payment withholding. In light of these issues, sponsors should review the FFI status of their non-U.S. holding companies and portfolio companies to determine whether these companies may be treated as FFIs that are required to register

or enter into an FFI Agreement, and whether an IGA may apply.

With careful planning and clear communications with investors, fund sponsors should be able to satisfy the requirements of FATCA, although compliance with the FATCA rules will vastly increase the amount of administrative effort expended by both the fund sponsors and their investors. Funds not organized in the U.S. will want to stay abreast of the progress of IGAs in their jurisdiction of organization, which may alleviate some of the particular burdens placed on non-U.S. funds by FATCA. ■

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