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Strange Bedfellows:
Private Equity and Strategic Alliances

Economic crises make strange bedfellows. Historically, private equity firms and strategics have vied for acquisition targets, with private equity firms becoming increasingly competitive when financing markets were vibrant. One of the many consequences of the financial crisis and liquidity crunch has been a renewed interest of private equity firms teaming with strategic investors (and visa versa) to acquire even medium-sized targets. Although these types of alliances are not new (see our prior article, "Mixed Clubbing: Do Private Equity Firms and Strategics Make Good Dance Partners" in the Fall 2007 issue of *The Debevoise & Plimpton Private Equity Report*), with the financing markets being closed for many potential transactions, PE firms are looking at strategic investors both for deal sourcing and sector expertise as well as capital, while strategic investors are viewing PE firms as significant sources of capital as well as having deal execution expertise. The advantages of the PE firms/strategic investor alliance are now more evident than ever with respect to regulated industries, where having a strategic investor may provide comfort to the regulators that the target company will be operated prudently and in accordance with industry standards.

Every PE firm and strategic investor contemplating a joint bid for a deal has wondered what "market" is for private

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"Strategics, if you can't buy them, join them."

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Letter from the Editor

Private equity firms are known for flexibility, ingenuity and seeing value where others do not. Never have these skills been more relevant than during the current economic crisis with leading private equity portfolios being divested at huge discounts, financing for new (and committed) deals nearly non-existent and portfolio companies facing hard economic challenges notwithstanding, in many cases, forgiving capital structures. On the other hand, the conventional wisdom is that the best private equity investing is done in uncertain times. We are believers!

In this issue, we take a look at how these difficult times are impacting the private equity world from a variety of perspectives. On our cover, we note that economic crises make strange bedfellows. Since private equity firms and strategics have a renewed interest in partnering rather than competing for transactions, we examine the key issues inherent in these partnerships.

In our guest column, Mark O'Hare, a founder and Managing Director of Preqin, a leading source of data and analysis of the alternative assets industry, summarizes the findings of his firm's recent informal survey of over 100 institutional investors. Mark concludes, despite some interesting cross currents in his findings, that many private equity investors are "cautiously optimistic," notwithstanding the current economic turmoil.

Throughout this issue, we report on legal issues of special concern to the private equity community in these uncertain times. Heidi Lawson advises private equity professionals serving on the Boards of portfolio companies to make sure the insurance policies designed to protect them will actually do so if the portfolio company goes bankrupt. And, members of our workout team remind directors of the scope of their fiduciary duties in the troubled company context.

Although you have all read about the Huntsman-Hexion dispute in the business press, we reprise the story to focus on the lessons to be learned for the "new deal" age.

Because deal activity will actually resume one of these days, our tax team reminds you to be cautious under some new tax regulations to avoid unintended consequences if you are buying a consolidated subsidiary where the seller is recognizing a loss. We also suggest that you review the compensation plans in any of your portfolio companies that are organized as partnerships, LLCs or foreign corporations to make sure that the new draconian rules on deferred compensation hidden in the bail-out bill do not create some nasty surprises for unsuspecting employees.

In addition, we discuss a roadmap of steps to take if you are a buyer in a sales process where there is not enough time to diligence potential Foreign Corrupt Practice issues of the target. These steps may reduce the risk of FCPA related enforcement actions post-closing, notwithstanding the possible existence of pre-closing breaches.

We also highlight some proposed legislation in the EU impacting private equity as well as some recent German developments and provide some insight into the recently-adopted Santiago Principles relating to Sovereign Wealth Funds.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of

Debevoise & Plimpton LLP

919 Third Avenue
New York, New York 10022
1 212 909 6000

www.debevoise.com

Washington, D.C.
1 202 383 8000

London
44 20 7786 9000

Paris
33 1 40 73 12 12

Frankfurt
49 69 2097 5000

Moscow
7 495 956 3858

Hong Kong
852 2160 9800

Shanghai
86 21 5047 1800

Please address inquiries regarding topics covered in this publication to the authors or any other member of the Practice Group.

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Franci J. Blassberg
Editor-in-Chief

Stephen R. Hertz
Andrew L. Sommer
Associate Editors

Ann Heilman Murphy
Managing Editor

David H. Schnabel
Cartoon Editor

The Private Equity Practice Group
All lawyers based in New York, except where noted.

Private Equity Funds
Marwan Al-Turki – London
Kenneth J. Berman – Washington, D.C.
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One (Small) Step for PE Firms:

Fed Loosens Restrictions on Minority Banking Investments

In September 2008, the Federal Reserve Board issued a new policy statement on minority equity investments in banks and bank holding companies that was designed to make non-controlling banking investments more attractive to private equity funds by loosening the restrictions on such investments in a number of important respects and clarifying how the Fed would interpret certain of its existing regulations. However, the September policy statement did not change the basic thrust of the Fed's regulatory regime applicable to minority banking investments, which significantly limits the attractiveness of the banking sector to most private equity firms. Thus, while helpful in some circumstances, it seems unlikely that the adoption of the September policy statement will impact fundamentally how private equity investors look at potential investments in banking organizations or lead to a significant increase in the level of such investments in the near term, especially in light of current market conditions.

The Federal Reserve Board, pursuant to the Bank Holding Company Act (the "BHC Act"), regulates companies that control a bank or a bank holding company (a "banking organization"). The BHC Act defines control as the power (1) to vote 25% or more of the voting securities of a banking organization, (2) to elect a majority of the directors of a banking organization, or (3) to exercise a "controlling influence over the management or policies" of a banking organization. An entity that controls a banking organization may be required by the Fed to provide additional capital or management resources to the banking organization. This potentially open ended commitment creates a particular problem for private equity funds. In addition, the BHC Act limits the extent to which a company that controls a banking organization can also control non-banking, commercial businesses. As a result, private equity investors wishing to invest in banking organizations have, with very few exceptions, sought to do so only on a non-controlling basis.

Although the first two prongs of the BHC Act's definition of control would appear to provide a clear path to avoid control—keep your ownership of voting stock below 25% and don't control a majority of the board—the Fed has historically imposed a much more restrictive view of control through its interpretation of the third prong of this definition—the prohibition on exercising a "controlling influence." For example, prior to the adoption of the most recent policy statement the Fed has generally not permitted a non-controlling investor to have *any* representation on the board of directors of a banking organization if it held more than 10% of the organization's the voting stock. Even where the investor has no representation on the board, the Fed has generally limited non-controlling investments to less than 25% of a bank organization's total equity (rather than solely voting equity).

Under the new guidance set forth in the September policy statement, the Fed has indicated that it will not object to a non-controlling investor having up to *one third* of the total equity of a banking organization, provided that the investor's *voting* interest does not exceed 15%. Generally, a non-voting equity security that is convertible into a voting security, such as a non-voting preferred instrument that is convertible into common stock, will be considered to be non-voting if it cannot be converted in the hands of the original investor (or an affiliate of the investor) and may be transferred only (1) to an affiliate of the investor, (2) to the issuer or an affiliate of the issuer, (3) in a widespread distribution, (4) in transfers of blocks representing less than 2% of the issuer's outstanding voting securities, or (5) to a person that already controls 50% or more of the issuer's voting securities.

More significantly, the Fed has indicated that it will allow an investor who owns more than 10% of the voting stock of a banking organization to have a single representative on the organization's board of directors without being deemed to have control. A second director will be permitted provided that the banking organization has another, larger shareholder that controls the organization and is regulated by the Fed and the proportion of the entire board represented by the two directors appointed by the non-controlling investor is not in excess of the lesser of 25% and such investor's total equity interest. The representative(s) of the non-controlling investor can be a member of board committees, but they cannot act as the chair of a committee or of the entire board. The September policy statement also contains helpful guidance as to the ability of an investor to express its views to the management of the banking organization

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Paul D. Brusiloff
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Pierre Maugüé
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A. David Reynolds
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Tax
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Buyer Beware:

Purchasing Stock of a Consolidated Group Member Recognizing a Tax Loss

Selling stock of a subsidiary at a loss is regrettably more common these days than any of us would like. That sad fact turns out to be important not only to the seller of a subsidiary in a consolidated group, but also to an unsuspecting buyer.

In September, the IRS issued new regulations that apply to the sale of stock of a member of a U.S. consolidated tax group in cases where the selling group recognizes a tax loss. The rules (commonly referred to as the "loss disallowance rules" or "LDR") make it easier for the selling group to claim a tax loss in such a case (whereas prior law made it extremely difficult to claim such a loss). Unfortunately for buyers, however, the new rules may adversely impact the tax attributes of the purchased subsidiary (*e.g.*, NOLs and tax basis of the subsidiary's assets) unless the selling group agrees to make an appropriate election under the new regulations.

Simple in Concept but Difficult in Application

When the selling group has a tax loss in the shares of a subsidiary (a "stock loss") and the tax attributes of the subsidiary exceed the value of the subsidiary (an "inside loss"), the new rules liberalize the ability of the selling group to claim the stock loss but require a reduction in the tax attributes of the subsidiary to avoid a "doubling up" of the loss. Accordingly, the attributes of the subsidiary may be reduced by the lesser of the amount of the stock loss and the amount of the inside loss.

…[T]the new rules liberalize the ability of the selling group to claim the stock loss but require a reduction in the tax attributes of the subsidiary to avoid a "doubling up" of the loss.

While simple in concept, the new regulations are spectacularly complicated and extremely fact intensive to apply (so much so that some have questioned whether they will be administrable). As a result, in many cases it may be difficult for buyers (or selling consolidated groups) to know with complete confidence whether or how the new rules apply or whether the rules require a reduction in the tax basis of the target company's assets or the target's other tax attributes. Moreover, even post-closing IRS adjustments or challenges to the tax returns of the target for taxable years through the closing date can impact the analysis.

Electing out of the New Rules

Fortunately, the regulations allow the selling consolidated group to elect to reduce the loss it claims upon the sale of stock of a member and thereby preserve the target company's inside tax attributes. We expect that buyers from consolidated groups will begin requesting selling consolidated groups to make such an election (including on a protective basis), particularly where the buyer is unable to quantify the potential attribute reduction. Of course, sellers may now ask to be compensated for foregoing the benefits of the new regulations.

Effective Date

The new rules are effective for sales closing on or after September 17, 2008, except for sales made pursuant to a binding agreement between unrelated parties that was in effect prior to the effective date. If an existing agreement is amended on or after the effective date, it may be subject to the LDR Rules. Therefore, along with seeking elections in purchase agreements now being negotiated, purchasers that amend existing agreements should take care to ask the seller to make the election described above.

Still Not Out of the Woods

Regardless of whether the new rules apply to reduce the attributes of the target, those attributes may be impacted by other rules. For example, section 382 of the tax code reduces the ability of a target company with NOLs or built-in losses to use those attributes after an ownership change. ■

David H. Schnabel
dhschnabel@debevoise.com

Peter F. G. Schuur
pfgschuur@debevoise.com

Michael Bolotin
mbolotin@debevoise.com

GUEST COLUMN

Cautious Optimism Amid the Turmoil

Amid the uncertainties of the current financial crisis and liquidity crunch, GPs, LPs and the general public all are curious about private equity's future. We asked Mark O'Hare, founder and Managing Director of Preqin, a leading source of data and analysis for the alternative assets industry, to share with us the results of his firm's recent survey of institutional investors views of the future.

As financial advisors, Yogi Berra and John Maynard Keynes may not seem to have much in common, but consider the following quotes:

- "Predictions are difficult, especially as regards the future."
- "Economists set themselves too easy a task if all they say is that once the storm is passed the sea will be calm again."

(Sorry, no prizes for the correct attribution.)

The current dislocation in the global economy is obviously having a huge impact on the private equity industry: what is the medium-term outlook, and how can we expect the landscape to change?

During October, Preqin completed a survey of the views and strategies of 100 institutional investors, representing $1.5 trillion of AUM, and $93 billion of allocations to private equity. More recently, I have had the privilege of participating in several private equity conferences to gauge sentiment across several geographies and market segments:

- Global LPs and GPs (SuperReturn Middle East, Dubai, October 14th)
- US General Partners (FRA Client Servicing Conference, New York, October 20th)
- US Lower Mid-Market PE Firms (NASBIC, Palm Beach, October 27th)

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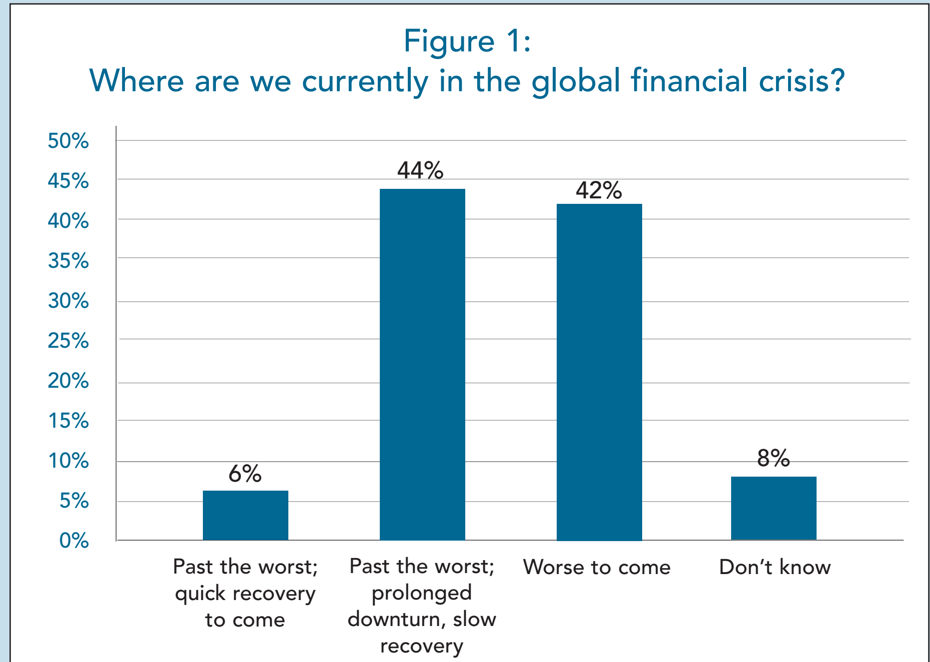
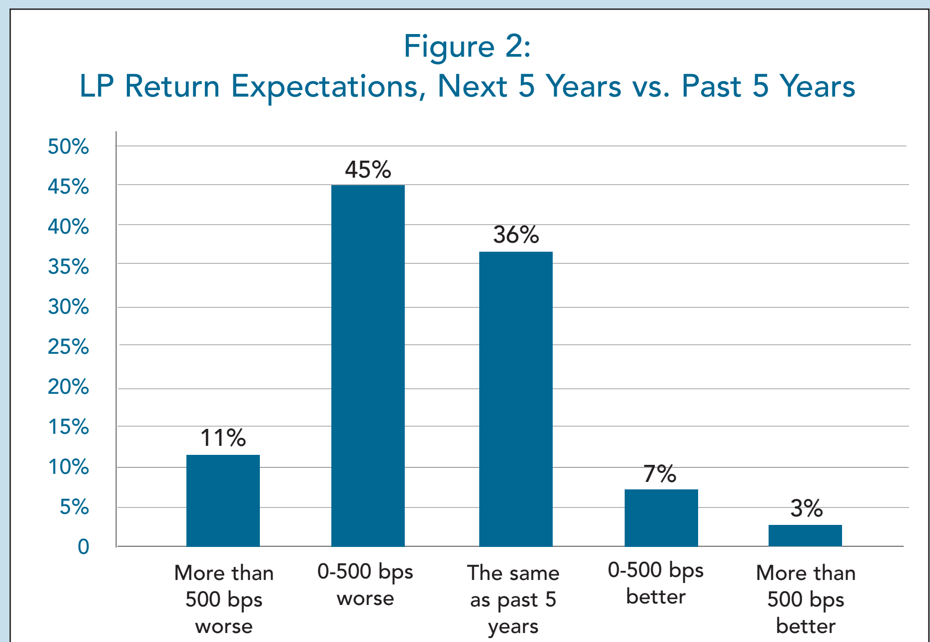


Source: Audience poll, PE World MENA, Dubai, November 2008



Source: Preqin LP survey, October 2008

Guest Column: Cautious Optimism Amid the Turmoil (cont. from page 5)

- French LPs and GPs (Private Equity Exchange, Paris, November 13th)
- Middle East LPs and GPs (Private Equity World MENA, Dubai, November 18th)
- Global LPs and GPs (SuperInvestor, Paris, November 20th)

In addition, we continue to track fundraising trends and fund returns data. What are the LPs and GPs saying, and what can we infer about the next few years?

Where Are We in the Crisis?

LPs and GPs have few illusions on the severity of the situation (Dubai, November 18th, see Fig. 1, page 5). The LPs and GPs at SuperInvestor in Paris (November 20th) felt much the same, with a consensus for a global recession of two to three years.

Return Expectations

Well before the credit crunch hit, LPs and GPs recognized that the preceding five years were a period of unusually high returns for private equity investors, and many cautioned this couldn't be expected to continue indefinitely. Unsurprisingly, a majority of the institutions in Preqin's poll expect returns to be somewhat lower over the next five years (see Fig. 2, page 5).

Despite this, and a recognition that many investments made during 2006 and 2007 may prove to be very difficult, there is also a widespread appreciation that historically funds that have had their investment periods during market downturns have often been among the best-performing vintages.

With stockmarkets currently on multi-year lows, and sellers' price expectations declining, there is widespread recognition among GPs and LPs that we may be entering a very attractive time for making private equity investments.

This is not lost on LPs who, despite recognizing that it may be difficult to match the returns of recent years, are nevertheless reasonably bullish about prospective returns from private equity investments over the coming five years (see Fig. 3, below).

The median expected gross IRR is in the 15%–20% range, and the average expectation among LPs polled is for 17.4%.

Future Fund Commitments

Private equity's growth has benefited from the steady increase in LPs' percentage allocations to the asset class over recent years. Will this trend continue? The fact that LPs expect reasonable returns from their private equity investments over the coming five years augurs well, and the audience poll in Dubai on November 18th confirmed this (see Fig. 4., below).

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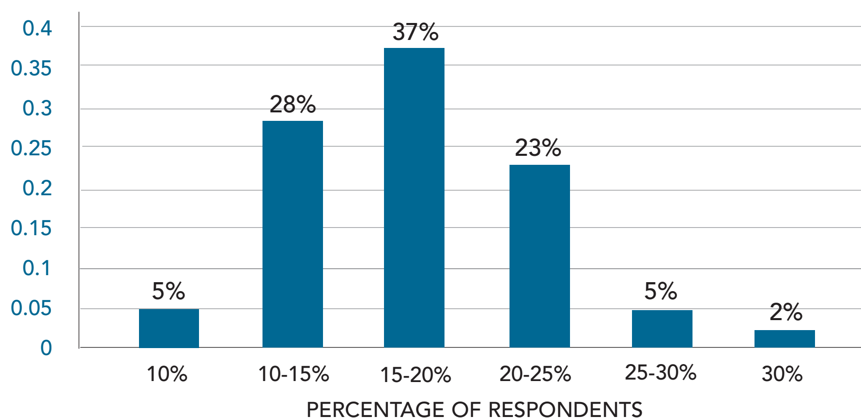
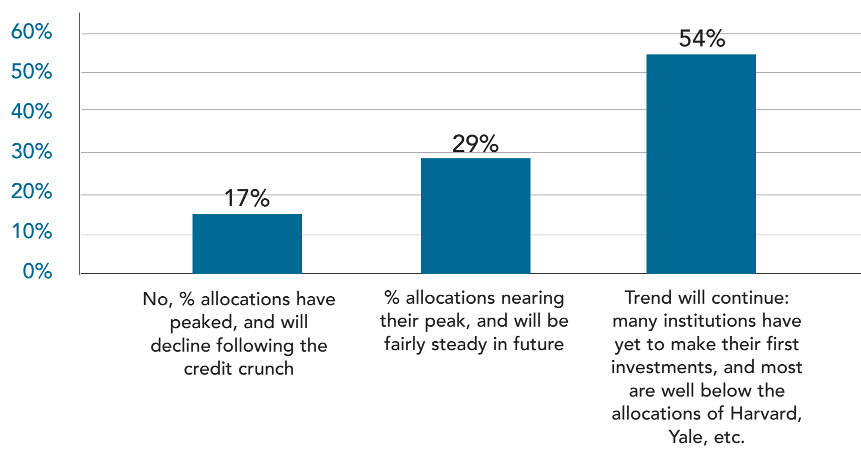
Figure 3: LP Return Expectations—Gross IRR for Next 5 Years



Source: Preqin LP survey, October 2008

Figure 4: Over recent years institutions have consistently increased their allocations to PE. Will this trend continue?



Source: Audience poll, PE World MENA, Dubai, November 2008

More Deferred Compensation Legislation—Will It Ever End?

Hidden in the bail-out bill was a new draconian rule that applies to traditional deferred compensation arrangements of partnerships and foreign corporations, and some performance and management fee arrangements of hedge funds. Deferred compensation that is subject to the new rule, §457A of the Internal Revenue Code, must be included in income when the compensation will no longer be subject to a so-called "substantial risk of forfeiture" (meaning that the tax deferral will not be respected and the service provider may have phantom income). However, if the amount of the deferred compensation cannot be determined at that time, the amount will continue to be deferred until the amount is determinable, at which time the service provider will include the amount in income *and* be subject to a 20% penalty tax, plus interest.

Private equity fund sponsors should immediately determine whether this new rule applies to them or any of their portfolio companies and, if it does, should begin formulating their compliance strategies.

Who, Me?

Section 457A applies to deferred compensation arrangements of "non-qualified entities." The first step in a private equity fund sponsor's inquiry will be to determine whether there are any "non-qualified entities" in its universe. The term is potentially very broad: unless expressly excluded, a "non-qualified entity" includes any partnership, whether foreign or domestic, and any foreign corporation.

In general, a *partnership* will be a non-qualified entity unless "substantially all" of its income is allocated to taxable partners. Taxable partners generally do not include (1) tax-exempt organizations and (2) non-U.S. persons whose income is not subject to a "comprehensive foreign income tax." A foreign corporation will generally be a non-qualified entity if its income is not effectively connected with a U.S. trade or business or is not subject to a comprehensive foreign income tax. We do not yet know how Treasury will interpret the "substantially all" requirement or the term "comprehensive foreign income tax."

Private equity fund sponsors have for many years invested in portfolio companies organized in partnership form, including operating partnerships and limited liability companies. These entities will be "non-qualified entities" unless substantially all of their income is allocable to taxable partners, which may not be the case where the partnership or LLC is owned by a fund with a substantial number of tax-exempt or "offshore" limited partners, or where a "blocker" company in place is in a tax haven jurisdiction. Similarly, foreign company portfolio investments may be "non-qualified entities." The deferred compensation arrangements of these portfolio investments are subject to §457A.

In addition, many private equity funds will themselves be non-qualified entities if, for example, they have a substantial number of tax-exempt or "offshore" limited partners. The management and performance fee arrangements of such funds may be subject to §457A. However, we believe that a partnership profits interest issued by a non-qualified entity is not subject to §457A.

What Arrangements Are at Risk?

Once the non-qualified entities are identified—be they portfolio investments, the fund manager, or the fund itself—the next task will be to identify whether they have any problematic deferred compensation arrangements. "Deferred compensation" is very broadly defined for this purpose to include any "legally binding right"—that is, any promise—to a service provider to receive compensation

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Hidden in the bail-out bill was a new draconian rule that applies to traditional deferred compensation arrangements of [many] partnerships and foreign corporations....Deferred compensation that is subject to the new rule...must be included in income when the compensation will no longer be subject to a so-called "substantial risk of forfeiture"....

More Deferred Compensation Legislation—Will It Ever End? (cont. from page 7)

that is payable to the employee in a later year for services performed in an earlier year. Many private equity fund sponsors are familiar with the types of deferred compensation arrangements that are subject to §409A. Well, think of §457A as §409A on steroids —while the same types of deferred compensation arrangements are subject to §457A, §457A also affects certain equity-based awards and performance-based compensation that are exempt from §409A's reach. (The good news is that we expect that §457A will not apply to partnership profits interests, and thus most private equity carried interests should not be subject to §457A.) On its face, §457A appears broad enough to include,

- at the private equity fund and manager level, phantom carry arrangements and deferred management fee arrangements, including so-called "side pocket" fee arrangements, and
- at the portfolio company level, stock appreciation rights, options, other performance-based compensation, severance agreements and other items of compensation not traditionally understood as deferred compensation.

The good news is that we expect that §457A will not apply to partnership profits interests, and thus most private equity carried interests should not be subject to §457A.

What Are the "Outs"?

The main exception from §457A is compensation that is paid shortly after it ceases to be subject to a "substantial risk of forfeiture" (that is, it becomes vested). However, the only vesting restriction that works for this purpose appears to be the performance of substantial services; it appears that vesting based on the achievement of performance conditions will *not* be a sufficient vesting condition to rely on this exception. Under this exception, payments made within 12 months after the end of the service recipient's year during which vesting occurs are not treated as deferred compensation for purposes of §457A. The Treasury may issue guidance in the future that will provide additional exceptions.

When Do the New Rules Apply?

Section 457A applies to deferred amounts which are "attributable" to services performed after December 31, 2008. Deferred amounts which are "attributable" to services performed before January 1, 2009, will not be subject to §457A, *provided* that such amounts are included in income no later than (1) 2017 or (2) the taxable year in which the amount is no longer subject to a "substantial risk of forfeiture." The Treasury Secretary is charged with issuing, by February 2009, transition rules that will permit service providers and service recipients to conform their arrangements which are "attributable" to services performed before January 1, 2009 to these requirements without violating §409A.

Note that §457A is not intended to replace the other draconian deferred compensation statute, §409A, and it remains to be seen how Treasury will integrate the two statutes (and, in particular, whether regulatory exceptions under §409A final regulations will be imported into the §457A regime).

What Should You Do Now?

The new rules leave many questions unanswered. While the IRS is expected to provide guidance on §457A soon, it is important to remember that §457A goes into effect January 1, 2009, so there is no time to delay. If you are potentially subject to §457A, we encourage you to immediately take stock of your compensation arrangements and perhaps the structure of the relevant partnership or foreign corporation to consider any changes that may be warranted or desired to comply with the new rules. ■

Peter A. Furci
pafurci@debevoise.com

Jonathan F. Lewis
jflewis@debevoise.com

David H. Schnabel
dhschnabel@debevoise.com

Charles E. Wachsstock
cewachsstock@debevoise.com

Sovereign Wealth Funds: The Santiago Principles

Policymakers' frantic search for capital to prop up ailing financial institutions has led to a more welcoming environment for sovereign wealth funds ("SWFs") in Washington and the capitals of Europe alike. Beneath this uneasy embrace, however, concern lingers over SWFs' lack of transparency and the possible use of their investment clout to further the geopolitical ambitions of their sponsor countries.

In the hope of addressing these concerns, the IMF's International Working Group of Sovereign Wealth Funds ("IWG") recently published its Generally Accepted Principles and Practices for Sovereign Wealth Funds. Known as "The Santiago Principles" or "GAPP," which establish voluntary practices and principles for SWF governance and transparency that are designed to demystify SWFs while ensuring that they invest on the basis of economic and financial risk and return, rather than political considerations.

The IWG was established on May 1, 2008 with a mandate to draft generally accepted principles and practices for SWFs and is comprised of representatives of the 26 member countries of the International Monetary Fund with SWFs. Given the divergent structure and purpose of the various SWFs and the varying interests of their member countries, which include several Gulf states, China, Norway, Russia, Singapore and the United States, this was no easy task.

The Santiago Principles consist of 24 principles and practices falling into three main areas: legal framework, objectives, and coordination with macroeconomic policies; institutional framework and governance structure; and investment and risk management framework. In each of these areas, the objective is to promote accountability, transparency and independence, and in doing so, reduce the risk of political influences on investment decisions of SWFs.

GAPP principles most prominently focused on these aims include:

- GAPP 6, 7, 8 and 9, which are intended to delineate a clear line of demarcation between SWF owners (*i.e.,* the sovereign sponsor) and SWF managers, and to establish principles for SWF governance. They require:
  - an effective division of roles and responsibilities to facilitate operational independence of SWF management;
  - that the SWF owner set the objectives of the SWF and appoint members of its governing bodies in accordance with clearly defined procedures;
  - that the governing bodies operate in the best interests of the SWF, and have clear authority to carry out their functions; and
  - that management implement SWF strategy in an independent manner and in accordance with clearly defined responsibilities.
- GAPP 16, 17, 18, 19, and 21, each of which is directed in part to ensuring transparency by requiring public disclosure of:
  - the SWF's governance framework and objectives and of the manner in which management is operationally independent from the SWF's owner;
  - relevant financial information to demonstrate the SWF's economic and financial orientation, including asset allocation, benchmark information where relevant, and rates of return over appropriate historical periods;
  - the investment policy of the SWF, including qualitative statements on investment style, investment themes and objectives, and strategic asset allocation;
  - the extent to which investment decisions are governed by other than economic and financial considerations (*e.g.,* social, ethical, religious or environmental factors); and
  - the SWF's general approach to voting securities of public companies, including the key factors guiding its exercise of ownership rights.
- GAPP 15, 18, 19 and 20, which all establish norms of behavior for SWFs that are designed to limit political influences on, and the use of political influence in, SWF investments, including requirements that:
  - SWF operations and activities in host countries be conducted in compliance with local laws (including local disclosure requirements);
  - SWF investment policies be clear and consistent with defined objectives, risk tolerance and investment strategy, and be based on sound portfolio management principles;
  - SWF investment decisions aim to maximize risk-adjusted financial returns in a manner consistent with an SWF's investment policy and based on economic and financial grounds; and
  - a SWF not take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.

The GAPP principles are voluntary, but according to the IWF report, "members of the IWG support and either have implemented or aspire to implement" the principles. Although the SWFs themselves and many observers argue that they have always been economic and not political actors, the Santiago Principles, if widely adopted, should go a long way towards allaying residual fears about the political motivations of sovereign wealth funds. ■

Andrew L. Sommer
alsommer@debevoise.com

Liam F. Timoney
ltimoney@debevoise.com

Electronic Filing (and Tracking) Comes to Reg D Private Placements

Mandatory electronic filing has entered the world of private placements. Although this seems like a positive development, private funds in particular should be aware that their placement activities will be easier to track than in the past.

Form D should be familiar to private equity sponsors as the notice required to be filed with the Securities and Exchange Commission for a nonpublic issuer offering in reliance on Regulation D under the Securities Act of 1933, as amended. Beginning March 16, 2009, every Form D filed with the SEC must be filed electronically on new Form D.[1]

This new electronic filing requirement will require some issuers unaccustomed to electronic filings to get up the learning curve. Issuers filing electronically must first obtain EDGAR (the SEC's Electronic Data Gathering, Analysis and Retrieval System) access codes from the SEC, generally by filing a Form ID electronically, and within the next two days faxing the SEC a notarized authenticating document. While one-stop filing is the goal and state regulators intend to develop a system to electronically interface with EDGAR, even after March 15, 2009 it is likely that paper filings will be required by some (or all) states for some time, and some states may not accept new Form D even in paper format.

Private fund issuers in particular may be unhappily surprised by the public's easy accessibility to their Form Ds. Form Ds electronically filed with the SEC will be accessible from any computer with Internet access and the SEC will capture and tag data items to make them interactive and viewable in an easily-read format. To skirt the issue of general solicitation and advertising arising from easy access to Form D, the SEC has created a safe harbor if the issuer makes a good faith, reasonable attempt to comply with Form D requirements. Filers concerned about news coverage and general accessibility of their filings should note this issue will only intensify and may want to consider carefully whether structuring placements of securities under the Reg. D exemption is the right approach.

When to File New Form D: When Is the "Sale"?

If you are using new Form D either in paper or electronically, the period for timely filing will be the 15th day after the first sale, or the next business day if that falls on a weekend or holiday. The date of first sale is an informational item on new Form D so it will be obvious if the federal filing is late (although there is no specific penalty for a late federal filing); a state may separately request date of first sale in the particular state (some states have imposed additional fees or other penalties or measures for late filings). The SEC is interpreting "sale" as the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check and not necessarily as late as the closing date. Because practitioners who have generally treated the closing date as the trigger date are concerned about rolling admissions, incomplete subscriptions, and missed deadlines that might result from the SEC's interpretation, the Committees on Federal Regulation of Securities and State Regulation of Securities of the American Bar Association have asked the SEC to reconsider and instead make the trigger the closing date, and we will stay tuned for possible future developments.

Changes in Information Required by New Form D

There are a number of differences in the informational requirements of new vs. old Form D. Thankfully, some of the requirements, such as the disclosure of net asset values for investment funds, are subject to opt out. The new disclosures required with respect to sales commissions and finders fees is likely to flag the use of unregistered placement agents and finders for regulators. In addition, private funds must disclose the exemption they rely upon under the Investment Company Act of 1940.

Amendments to Form D

Currently, under old or temporary Form D there are no explicit requirements as to when and under what circumstances to amend Form D. New explicit requirements for filing amendments to Form D now apply to all filings on new Form D and, beginning March 16, 2009, to continuing offerings that had been filed on old or temporary Form D. Amendments will be required, if the offering is continuing, (1) annually, (2) to rectify a material mistake of fact or error, and (3) to report any change in information (whether or not material) subject to certain specific exclusions. For example, any new executive officer, a decrease of more than 10% in the minimum permitted investment, an increase of more than 10% in the total offering amount, or a new placement agent or finder, will require amendment as soon as practicable.

Also on the SEC Agenda

The SEC in separate releases had also proposed substantive changes to Reg. D including a new exemption, across-the-board bad actor disqualification provisions, changes in the definition of "accredited investor" and changes in the treatment of accredited investors in private pooled investment vehicles. Those proposals have not been finalized but remain on the SEC's agenda. The nation's economic crisis and the anticipated departure of Commissioner Cox seem to have pushed those agenda items off the front burner, at least for the moment. ■

Ellen Lieberman
elieberman@debevoise.com

[1] *During the transition period which began September 15, 2008, issuers have the option to file the new Form D electronically or in paper with the SEC or to file the "temporary" Form D in paper with the SEC ("temporary" Form D is basically the old Form D with a few minor, non-substantive tweaks).*

Are New Private Equity and Hedge Fund Regulations on the Horizon in the EU?

European Union regulation of the private equity and hedge fund sectors is likely on the horizon, but only after what will be a relatively long gestation period. The EU Parliament, which is the elected body that oversees the work of the EU's legislative branch (the EU Council) and executive branch (the EU Commission), voted in late September to adopt a report of the EU's Committee on Economic and Monetary Affairs calling for stricter disclosure standards for, and limits on, excessive borrowing by private equity and hedge funds.

Relying on its power to propose new legislation projects to the Commission, the Parliament has formally requested that the Commission prepare a draft bill by the end of this year. But both the timing and the content of any resulting EU legislation are hard to predict. The swift passage of the legislation, as it winds its way through the EU Parliament and Council, is by no means certain, particularly since difficult economic times have presented more pressing problems.

More importantly, the current report, which essentially does not distinguish between private equity and hedge funds, is vague enough that even those deputies who supported the recent resolution are likely to find much to disagree about in the coming months.

The EU Parliament's official "resolution with recommendations to the EU Commission" (which incorporates word-for-word the committee's report) is only seven pages long and conspicuously vague. Its brevity, however, belies the extent of the work and discussions surrounding its publication. In its final form, the resolution includes far fewer and less onerous proposals than did previous drafts of the underlying report, due largely to input from private equity groups and inevitable compromises among the Parliament's socialist, liberal and conservative members.

It took approximately six months to finalize the report from the time its author, Parliament member Poul Nyrup Rasmussen, penned his first draft. Those who are familiar with Mr. Rasmussen, the president of the Party of European Socialists and a former Prime Minister of Denmark, will appreciate that his personal perspective on private equity may not be particularly objective. (Rasmussen is well known for authoring a recent book in Denmark entitled *grådighedens tid* (which translates as "In the Age of Greed") and for being a vocal critic of pension fund investment in private equity, most notably in connection with the takeover of TDC, Denmark's largest telecom operator, where a consortium of five private equity groups (Apax, Blackstone, KKR, Permira and Providence) acquired the company but were unable to de-list it due to the refusal of ATP, a large Danish pension fund, to tender its 5.5% interest in the tender offer.)

After the publication of Rasmussen's first draft of the report, representatives of the European private equity industry, including Javier Echarri, secretary general of the European Private Equity and Venture Capital Association, spoke out against the rush to regulate the industry, highlighting the numerous benefits arising from private equity investment in Europe, such as job creation, the strengthening and revival of foundering businesses and the provision of funding for startups.

The final version of the report calls for the following regulatory initiatives for the private equity and hedge fund industries in Europe:

- Heightened transparency and disclosure requirements concerning debt exposure, risk-management systems, portfolio valuation methods, general investment strategies, fee policies, source and amount of funds raised, as well as disclosure of high level executives' compensation "systems."
- The implementation of unspecified measures to limit the incurrence of excessive debt and asset stripping, as well as a general call for a requirement in the private equity sector that leverage be sustainable for both the target company as well as for the acquiring firm.
- A review of the main EU directive covering employees' rights in order to ensure that it sufficiently protects employees' rights to be informed and consulted when the control of a business is transferred by owners who are private equity and hedge funds, as well as the review of the main pension fund directive to ensure that employees or staff representatives are adequately informed about the nature of their pension investments and the associated risks. It is not clear from the report whether this review might lead, for example, to the EU extending the obligation to inform and consult workers' councils about certain transactions (which is common in some parts of continental Europe, but not in the United Kingdom or Ireland), beyond its current scope.

In earlier incarnations, the report had called for extensive disclosure of compensation of managers, directors and other staff of private equity and hedge funds, and specific disclosure requirements regarding debt exposure, managers' past performance,

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Are New Private Equity and Hedge Fund Regulations on the Horizon? (cont. from page 11)

valuation methods for portfolio companies, and the amount of fund managers' investments in the funds. It remains to be seen whether the deletion of these recommendations ensures that they will not reappear when the legislature puts pen to paper.

At this point, any new regulations are likely to be delayed several months by policymakers' competing agendas, the mechanics of the EU legislative process, or both. The EU Commission must now decide the terms of any draft legislation based on the Parliament's recommendations, but the process is not universally supported. Interestingly, the European Commissioner for the Internal Market and Services, Charlie McCreevy, has recently appeared to be trying to slow any rush to regulate. Among other things, McCreevy has emphasized that the regulation of private equity should move at a controlled pace and be carefully examined in light of the many contributions the sector has made to the European economy. McCreevy recently observed, for example, that "all known regulatory concerns relating to the impact of hedge funds and private equity on the financial and economic system are already addressed—either in European or national legislation."

For the moment, it's still too early to anticipate the timing or the content of any resulting new legislation and how it might affect private equity in Europe. However, it is clear from the report and the EU Parliament's interest in the subject that, for better or for worse, private equity and hedge funds are now officially on the EU regulators' radar and agenda. Stay tuned for an update as the legislative process unfolds. ■

E. Drew Dutton
eddutton@debevoise.com

Gabriel Weiss
gweiss@debevoise.com

One (Small) Step for PE Firms (cont. from page 3)

without being deemed to exercise a controlling influence. The Fed has made clear that a non-controlling investor may advocate changes to the bank organization's policies and operations. The Fed's policy statement gives examples of the types of things that the investor may permissibly seek to have input on, including changes to the organization's dividend policies, financing strategies, acquisition or divestiture proposals, management changes, and change of control transactions. While the investor may give its views on such matters, and even initiate proposals, the ultimate decision must remain with the bank organization's management, board, or shareholders as a whole. The banking organization cannot give a non-controlling investor specific consent rights as to such matters or its policies generally. In addition, the non-controlling investor may not threaten to sell its shares or to sponsor a proxy solicitation if its recommendations are not adopted.

As a result, while the September policy statement gives private equity investors somewhat greater flexibility in making minority investments in banks—for example, by allowing director representation at investment levels above 10%, and by allowing total equity investments of up to 33% (albeit with a substantial portion being in the form of non-voting shares)—it doesn't allow the investor to take the type of ownership position, or to exercise the level of control, that private equity firms traditionally expect to obtain in respect of their portfolio company investments.

In certain circumstances, a private equity investor may be able to utilize a "silo" structure to effect an investment in a banking organization in a manner that gives the investor control for BHC Act purposes without subjecting its associated fund to the financial commitments and investment restrictions applicable to bank holding companies. It may also be possible to structure contemporaneous minority investments by multiple investors in a manner that avoids attributing control of the bank organization, and hence bank holding company status, to any member of the group. Given the importance of control rights to most private equity funds, these approaches may provide a more promising path to private equity investment in the banking sector. However, the Fed's September policy statement specifically declined to address the issues raised by these structures.

Thus, while the September policy statement may make banking investments marginally more attractive to private equity investors, a significant increase in such investments is likely to await further Fed guidance on structures to accommodate controlling investments by private equity firms. ■

Gregory V. Gooding
ggooding@debevoise.com

Paul L. Lee
pllee@debevoise.com

How Bad Is "Bad Faith?" New Delaware Perspectives

It is not uncommon for directors to be nervous these days. The Delaware Chancery Court's recent decision in *Ryan v. Lyondell Chemical Co.* exacerbated those jitters.

The case is troubling because it finds that independent directors, acting without conflicts of interests, could be held personally liable for approving a high-premium cash merger with non-coercive, customary deal protection terms, which was overwhelmingly supported by stockholders. The decision, if upheld, could have far-reaching consequences for private equity buyers and sellers alike, including an increased level of overcautiousness by skittish directors, greater reliance on pre-market checks, and in the event exigencies preclude a pre-market check, more extensive post-market checks. Luckily, there are some even more recent cases and the opportunity for a reversal on appeal that may alleviate the concerns over the Chancery Court's decision in the *Lyondell* case.

More than 20 years after the term "Revlon duties" first came on the scene, the Delaware courts continue to analyze precisely what those duties entail, sometimes with unexpected results. It was only a little over a year ago that we published an article in the Summer 2007 *Debevoise & Plimpton Private Equity Report* about a trio of Revlon cases that had just been decided ("Applying Revlon to Private Equity Transactions: Lessons from Recent Delaware Chancery Court Decisions"). Recently, another trio of *Revlon* cases—in addition to the Lyondell decision, *McPadden v. i2 Technologies, Inc.* and *In re Lear Corp. Shareholder Litig.*—has been added to the burgeoning body of *Revlon* case law.

As we noted in our earlier article, "there is no single formula for satisfying *Revlon*" duties. Directors must take care to analyze the complete array of relevant facts and circumstances in each case and tailor the sale process, including deal protection measures, to meet *Revlon's* command to directors to act reasonably to obtain the highest price reasonably available. Moreover, directors' *Revlon* duties are likely to evolve with changes in markets and perceptions. Today's market environment, for instance, may call for different fiduciary measures—such as greater scrutiny of financing conditionality—than may have applied before the current liquidity crisis. The three cases highlighted in our earlier article principally addressed the Revlon implications of management's potentially conflicted role in the diligence and negotiation process.

The newer cases—*Lyondell, McPadden* and *Lear*—focus on whether the directors of the target companies in those cases violated their *Revlon* duties to such an extent that they could be said to have acted in "bad faith." Bad faith, as compared to mere negligence or gross negligence, implicates a director's duty of loyalty. This is significant, because many Delaware companies have in their charters a provision permitted under Section 102(b)(7) of the Delaware General Corporation Law eliminating personal liability for directors for breaches of the duty of care. This exculpatory provision, however, can not extend to breaches of the duty of loyalty. Thus, while the negligent (or even grossly negligent) director may be protected from personal liability, the disloyal director—including the director who acts in bad faith—may not.

Ryan v. Lyondell

In April 2006, the Board of Lyondell, a healthy company not looking to be sold, turned down an unsolicited offer from Basell AF for $26.50 to $28.50 per share as inadequate. A little over a year later, a Basell affiliate put the company "in play" by acquiring an 8.3% stake and filing a Schedule 13D indicating an intent to discuss various transactions with Lyondell. Lyondell's Board met to consider the 13D, but decided that an immediate response was not required. In early June, 2007, Lyondell's CEO suggested to Basell that a price of $48 was justified. Only one other party had approached Lyondell since the 13D filing, and its offer was rebuffed. Then, on June 26, Basell agreed to acquire Huntsman Corporation. When Basell's bid for Huntsman was topped, Basell's CEO, under time pressure to decide whether to continue to bid for Huntsman, met with Lyondell's CEO.

At a meeting on July 9, Basell initially proposed a $40 price, but, during the

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...[D]irectors' *Revlon* duties are likely to evolve with changes in markets and perceptions. Today's market environment, for instance, may call for different fiduciary measures—such as greater scrutiny of financing conditionality—than may have applied before the current liquidity crisis.

How Bad Is "Bad Faith?" (cont. from page 13)

meeting, raised the price to $44 to $45. When Lyondell's CEO said he doubted the Board would support a deal in that range, Basell responded with a "best" offer of $48 per share, conditioned on signing a merger agreement in seven days with a $400 million break-up fee. Basell said it needed a firm indication of interest from Lyondell by July 11, the deadline for making a new bid for Huntsman.

As diligence and merger agreement negotiations proceeded, Lyondell's Board met and authorized the CEO to negotiate for a higher price, a "go-shop" provision allowing Lyondell to solicit alternative bids for 45 days after signing a merger agreement with a 1% break-up fee during the go-shop period, and a reduction in the $400 million post-"go-shop" break-up fee. Lyondell's CEO raised these points on July 15, but Basell flatly refused, agreeing only to reduce the break-up fee to $385 million (which represented approximately 3.0% of the equity value of the deal) and refusing to agree to a "go-shop" provision. Believing $48 to be a "blowout" price, Lyondell agreed to the deal, on July 16 and its stockholders overwhelmingly approved the merger.

While...there is "no single blueprint" for fulfilling a board's *Revlon* duties, the court said that "in most instances" the board will be required to engage actively in the sale process, and that the exclusive sale processes previously endorsed are limited exceptions to the general rule....

The court used harsh language to describe the conduct of the Lyondell Board both before and after the Basell offer. It called the Board "indolent" for "languidly" awaiting overtures in the wake of the 13D filing and not hiring a banker or otherwise taking active steps to prepare for a takeover bid. The court criticized the Board, among other things, for having "avoided an active role" in the merger negotiations, which were conducted by the Lyondell CEO; for not having conducted a pre-signing market check; for failing successfully to negotiate a go-shop provision; for agreeing to a 3% break-up fee, a no-shop provision and matching rights; and for considering, negotiating and approving the deal in less than seven days.

While the court acknowledged the concept that there is "no single blueprint" for fulfilling a board's *Revlon* duties, the court said that "in most instances" the board will be required to engage actively in the sale process, and that the exclusive sale processes previously endorsed are limited exceptions to the general rule, applicable only where the board has "a body of reliable evidence with which to evaluate the fairness of the transaction."

The court questioned the adequacy of the Board's knowledge and efforts, despite finding that the Board was "active, sophisticated and generally aware of the value of the Company"; that it had solid reasons to believe that a competing bidder would not emerge; that it was presented with detailed analysis from management and its financial adviser indicating that the Basell price was fair and that the likelihood of a topping bid "was slight, if not non-existent"; that, although the filing of the 13D had put the company in play two months before Basell made its offer, no other viable proposals were received; and that the most knowledgeable director —the CEO—believed that $48 was the best price then available.

Similarly, although it found that the deal protections may have been "typical," the court was not satisfied that Lyondell's acceptance of them, or its decision not to conduct a market check, was justified by the record. In particular, the court was not convinced that the Board made any serious effort to resist Basell's deal protection demands or that Basell would have walked away if it had not received all the protections it demanded.

The court concluded that the Board may have breached not only its duty of care, but also its duty to act in good faith, because the directors failed "to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities." The court found that Lyondell's exculpatory charter provision could not protect the defendants at the summary judgment phase, because "the Board's apparent failure to make any effort to comply with the teachings of *Revlon* and its progeny implicates the directors' good faith and, thus, their duty of loyalty."

On September 15, the Delaware Supreme Court agreed to hear the Lyondell directors' appeal, and it is possible that the lower court's decision will be reversed, although that appeal will not be decided until early 2009. Moreover, the Chancery Court's decision is not a decision on the merits: it is a procedural decision not to dismiss the litigation before the actual facts can be established at trial. It is certainly difficult to see how the Lyondell directors' behavior was so egregious as to rise to the level of bad faith. Indeed, the court's

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Recent Legal Developments in Germany

This article focuses on some recent legal developments in Germany that will be of relevance to the private equity community once the deal making climate improves.

German Corporate Law Reform—MoMiG

On November 1, 2008, following extensive discussion over the past few years, a fundamental reform of Germany's corporate laws went into effect. The reform is laid out in the *Law for the Modernization of the Law on German Limited Liability Companies and the Prevention of Mispractice* (generally known under the acronym "*MoMiG*").

Among other things, *MoMiG* eases capital maintenance rules and introduces a new regime for intra-group cash pooling. In the past, admissibility of intra-group upstream loans in connection with a cash-pooling system had become legally questionable due to a restrictive interpretation of the relevant capital maintenance rules by the German courts. MoMiG introduces changes that are likely to facilitate cash management within the target group as part of the day-to-day operations and that could also reduce the need for bank financing in an acquisition context because cash that was previously "trapped" in German subsidiaries, may now be used to satisfy the working capital needs of other members of the target group.

Moreover, *MoMiG* includes new rules for the subordination of shareholder loans, provides for a simplified incorporation process and facilitates share purchases.

Takeover-Related Squeeze-Out

Going private transactions in Germany could become more expensive if a recent decision of a Frankfurt Regional Court is a good prognosticator. The subject of the decision is the "squeeze-out" of Deutsche Hypothekenbank's remaining shareholders after NordLB's acquisition of a 97.4% stake through a public takeover bid. In implementing the squeeze-out, NordLB relied on a special takeover-related procedure that was introduced in implementation of Art. 15 of the EU Takeover Directive.

That procedure has several distinct advantages: First, it can be launched upon simple request by the main shareholder following completion of a takeover bid, once at least 95% of the voting rights belong to the bidder without requiring a resolution adopted at the target's shareholders' meeting. The remaining shares are then be transferred to the bidder by operation of law upon order of the court.

Second, if a bidder has acquired at least 90% of the target's securities as a result of the takeover bid, the consideration paid in connection with the takeover bid is also deemed adequate compensation for the minority shareholders in the subsequent squeeze-out. Prior to the Regional Court's decision, the prevailing opinion in Germany had been that the adequacy of the compensation to the minority shareholders is *irrefutably* presumed. The Regional Court broke with the prevailing view and held that the presumption is merely a rebuttable one, citing a decision of the German Federal Constitutional Court regarding the minority shareholders' constitutional rights to get full (market) value for the shares.

The Regional Court's decision is widely criticized as opening the floodgates for protracted shareholder litigation and for relegating the decision as to the adequacy of the consideration to be received by minority shareholders in a squeeze-out to valuation experts. The decision has been appealed.

Cash-Settled Equity Derivatives

Germany's financial supervisory authority, the BaFin, recently confirmed that cash-settled (as opposed to physically-settled) equity derivatives may be used to acquire significant positions in public German issuers without triggering disclosure obligations.

Generally, the German Securities Trading Act requires any person who acquires 3% or more of the voting rights of a public German issuer to file a disclosure notice. Such a notice must also be filed when a person acquires other financial instruments that give it the right to acquire at least 5% of the voting rights. The term "financial instruments" is broadly defined and includes physically-settled equity derivatives, but does not include cash-settled options or cash-settled equity swaps.

Cash-settled options were used in Porsche's building a stake in Volkswagen

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MoMiG introduces changes that...reduce the need for bank financing in an acquisition context because cash that was previously "trapped" in German subsidiaries, may now be used to satisfy the working capital needs of other members of the target group.

Recent Legal Developments in Germany (cont. from page 15)

and cash-settled equity swaps in Schaeffler's takeover of German DAX-company Continental. Cash-settled equity swaps are derivative instruments that perfectly mirror the economics of the underlying shares. In the case of Continental, the swaps were backed by a number of investment banks, none of which held more than 2.999% of the underlying shares, thus avoiding the banks' own disclosure requirements. In its decision, *BaFin* blessed Schaeffler's strategy, arguing that Schaeffler did not have the legal right to direct the voting of the shares and that there was no evidence of any further agreements with the investment banks on the basis of which the underlying Continental shares could have been attributed to Schaeffler.

It remains to be seen whether the recent events surrounding Porsche and Volkswagen will generate new momentum for plugging what many perceive to be a disclosure loophole. Note that the German Finance Ministry, after earlier statements to the contrary, recently hinted that the German Federal Government was considering new legislation concerning this issue.

Foreign Investment Restrictions

Germany is planning new restrictions on foreign investments by investors based outside the EU and European Free Trade Association (EFTA), which may hamper investment activity. If enacted, the new rules would expand existing legislation focusing on the defense and encryption industry, which was enacted following the 2003 takeover of Howaldtswerke-Deutsche Werft, the world's leading conventional submarine-maker, by a U.S. private equity firm.

The main elements of the proposed bill are:

- Any direct or indirect acquisition of a stake of at least 25% of the voting rights in a company resident in Germany by a non-EU or non-EFTA investor may be subject to a formal investigation by the Federal Ministry for Economics.
- There is no restriction to specific industry sectors and the size of the deal is irrelevant.
- Investigations by the Ministry must be initiated within three months after signing.
- The Ministry is entitled, within two months of having received the requested information, to impose restrictions, in particular, to prohibit the acquisition, if the transaction is considered to be a "threat to public order or security."

Until the above time periods have elapsed or a decision has been taken, the acquisition remains subject to a condition subsequent. While the proposed bill does not contemplate an express obligation on the part of the acquiror to notify the Ministry, the bill entitles the German Federal Cartel Office to share merger control information with other authorities. As a consequence, acquirors may voluntarily apply for a review prior to the signing of the transaction.

The proposed bill, on its face, applies to any non-EU or non-EFTA acquiror. Nonetheless, it is believed that the primary targets of the bill are sovereign wealth funds that attempt to acquire public infrastructure, such as telecom and energy networks. The low market capitalization of many public German issuers due the current financial crisis is expected to accelerate the adoption of the bill. Whether and how the bill would be enforced vis-à-vis private equity sponsors remains to be seen, though German Economics Minister Michael Glos hastened to assure that "Germany is and remains open to foreign investments" and that "the majority of foreign investments will not be affected by the proposed legislation."

The proposed bill has already attracted heavy criticism. The German Federal Council (*Bundesrat*) has asked for a shortening of the review and decision periods. Moreover, concerns have been voiced that the proposed legislation may violate the EC Treaty's provisions on the free movement of capital. The EU Commission has already requested additional information from the German Federal Government. The bill must still pass a vote in the German Parliament (*Bundestag*). ■

Thomas Schürrle
tschuerrle@debevoise.com

Peter Wand
pwand@debevoise.com

Avoiding FCPA Anxiety:

A Roadmap to M&A Due Diligence and Post-Acquisition FCPA Compliance

Many deal processes simply do not allow adequate time or access for customary legal due diligence. This is particularly true in some processes involving public targets, especially in Europe. Not only are these facts of deal life frustrating, but they also can require private equity and other buyers to make judgments about potential enforcement risks without sufficient information. In a cross-jurisdictional setting, this can be particularly acute because the jurisdiction in which the target business is located may not prohibit activities which are outlawed under the U.S. Foreign Corrupt Practices Act ("FCPA") when the business is owned by U.S. persons. The U.S. Department of Justice ("DOJ") has issued guidance on what U.S. acquirors, including private equity firms, need to do to avoid having the DOJ take enforcement action if it proceeds with an acquisition of a business with FCPA issues where appropriate anti-corruption due diligence cannot be completed before closing.

The DOJ guidance was issued through its opinion review and was prompted by Halliburton Company's ("Halliburton") request for an opinion regarding the DOJ's intention to take enforcement action where it has insufficient time and inadequate access to information to complete appropriate FCPA and anti-corruption due diligence pre-closing with respect to a UK public company.[1] DOJ made explicit its expectation that acquirors include thorough FCPA-specific due diligence in their pre-acquisition activities and heed the roadmap offered for situations when appropriate pre-acquisition due diligence and remediation cannot be negotiated or are otherwise impracticable.

[1] *Op. Proc. Rel. 08-02 (June 13, 2008), available at http://www.usdoj.gov/criminal/fraud/fcpa/opinion/2008/0802.html ("the Halliburton Opinion").*

Application of the FCPA to Private Companies

By way of background, FCPA applies to broad general categories of entities and individuals: (1) "issuers" (for conduct that occurs anywhere in the world in the case of U.S. issuers, and for conduct that involves use of the mail or any means or instrumentality of interstate commerce in the case of non-U.S. issuers); (2) U.S. citizens, nationals and residents and entities with a principal place of business in the U.S. or organized under U.S. laws (for conduct that occurs anywhere in the world); and (3) any individual or entity who engages in prohibited conduct "while in the territory of the United States." The DOJ prosecuted two private companies—Paradigm B.V. and Omega Advisers, Inc.—in 2007 and we expect the trend in the prosecution of domestic concerns to continue.

Opinion Procedure Releases

FCPA Review Opinion Procedure Releases are important pronouncements in an area of law with few litigated cases and scant formal guidance from government regulators. Although, as standard practice, the releases disclaim their applicability to anyone other than the requesting party (in this case, Halliburton), it is widely accepted that the DOJ intends for all companies subject to the FCPA to act within the parameters set forth in the opinion procedure releases.

The Halliburton Opinion

Halliburton requested assurances from the DOJ that its planned bid for Expro International plc would not result in FCPA liability. Halliburton represented that it was unable to complete appropriate FCPA and anti-corruption due diligence because of United Kingdom legal restrictions inherent in the bidding process for a public U.K. company, and offered to implement a rigorous post-closing plan instead. Halliburton specifically requested answers from the DOJ to the following questions: (1) whether the acquisition itself would violate FCPA; (2) whether Halliburton would be held liable for pre-acquisition violations by Expro; and (3) whether Halliburton would be held liable for post-acquisition violations by Expro prior to Halliburton's completion of its FCPA and anti-corruption due diligence, where such conduct is identified and disclosed to the DOJ within 180 days of closing.

The DOJ responded that, in exchange for Halliburton undertaking and successfully completing the extensive post-

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DOJ made explicit its expectation that acquirors include thorough FCPA-specific due diligence in their pre-acquisition activities and heed the roadmap offered for situations when appropriate pre-acquisition due diligence and remediation cannot be negotiated or are otherwise impracticable.

Avoiding FCPA Anxiety (cont. from page 17)

closing plan, it would not take any enforcement action for the acquisition of the target itself or for any pre-acquisition or post-acquisition unlawful conduct of the target that was disclosed, terminated and remediated within 180 days after the closing, or within a reasonable time period (in the judgment of the DOJ). Though it is important to note that the detailed post-closing steps listed in the Halliburton Opinion are not "requirements" for anyone other than the requestor, Halliburton's post-closing plan does merit attention, as it provides insight into the DOJ's due diligence expectations and serves as a roadmap for any private equity firm considering the acquisition of a company with operations outside the United States.

> **...[I]n exchange for Halliburton undertaking and successfully completing the extensive post-closing plan, [DOJ agreed] it would not take any enforcement action for the acquisition of the target itself or for any pre-acquisition or post-acquisition unlawful conduct of the target that was disclosed, terminated and remediated....**

Halliburton Post-Closing Plan

The key aspects of Halliburton's approved post-closing plan can be categorized into four sections: (1) due diligence; (2) disclosure; (3) compliance; and (4) remediation:

1. Due Diligence

Halliburton was required to present the DOJ with a comprehensive, risk-based FCPA and anti-corruption due diligence work plan within ten business days of the closing. The plan was expected to address, among other things, the use of agents; dealings with state-owned customers; any joint venture, teaming or consortium arrangements; customs and immigration matters; tax matters; and any government licenses and permits. The due diligence was to be organized into high risk, medium risk, and lowest risk categories, and each category carried a different time frame for completion.

Halliburton was expected to retain external counsel and third-party consultants, including forensic accountants, to conduct the due diligence, and the due diligence process was required to include examination of relevant records and interviews with relevant individuals.

The due diligence and remediation, including investigation into any issues that were identified, was required to be completed within various time periods. The plan required Halliburton to report on high-risk due diligence within 90 business days of closing; medium-risk within 120 business days of closing; and low-risk within 180 days of closing. Any issues that required more extensive investigation had to be completed within one year of closing.

2. Disclosure

Immediately following the closing, Halliburton was required to disclose whether any pre-closing information learned by Halliburton suggested that any FCPA, corruption, or related internal controls or accounting issues existed at the target company. Halliburton was also required to disclose any issues uncovered during the course of its post-closing due diligence.

3. Compliance

Halliburton was required to immediately impose its own Code of Business Conduct and specific FCPA and anti-corruption policies and procedures on the target company, including effectively communicating the policies and procedures to employees within defined deadlines.

4. Remediation

Halliburton was required to take appropriate remedial action, including terminating or suspending third party agreements and/or disciplining employees where necessary, within one year of closing.

As long as the post-closing plan was implemented and completed within one year of closing, the DOJ assured Halliburton that it would not take enforcement action against Halliburton for any pre-acquisition violations of the target or any violations that occurred within 180 days after closing that Halliburton disclosed to the DOJ, assuming no Halliburton employee or agent was knowingly involved in the violation. However, the DOJ did reserve the right to take enforcement action against the target company for any FCPA violations, regardless of disclosure, and Halliburton was required to maintain the target company as a wholly-owned subsidiary for so long as the DOJ was investigating.

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Best Planning for the Worst:

Assuring Insurance Coverage for Private Equity Sponsors and Portfolio Company Directors in Bankruptcy

Introduction

In the current environment, there is little doubt that there will be more companies entering bankruptcy proceedings in the next year or two, including private equity portfolio companies. Insurance can be a very valuable asset in a bankruptcy, amounting to millions of dollars, potentially protecting the private equity sponsor, the portfolio company, and the funds managed by the PE sponsor. Historically, PE sponsors have often relied on the D&O coverage purchased by their portfolio companies to address their D&O insurance needs. Even so, many private equity sponsors have not actively managed this coverage in ways best designed to ensure this coverage is always available to it in a bankruptcy scenario. As a result, some sponsors, as described below, have been blocked from accessing this coverage when it may well be most needed: upon the bankruptcy of its portfolio company.

Recently, it has become more common for some private equity sponsors to protect against this risk by purchasing insurance at the sponsor level to cover their own activities and those of the funds they manage. While such coverage may well provide additional protection to a sponsor and its managed funds, it too, if not properly structured, can be subject to important limitations on coverage in the event of the bankruptcy of a portfolio company. As a result, sponsors are well advised in the current environment to review the scope of their current coverage to make sure there are no gaps or conflicting terms between the insurance coverage at the portfolio company level, on the one hand, and any such insurance at the fund level, on the other hand.

Unfortunately, many private equity firms take their first close look at their own coverage and the coverage at the portfolio company level only once a bankruptcy is imminent. In some cases, PE sponsors find that any coverage they have purchased at either the portfolio company level or fund level is not appropriately tailored for bankruptcy exposures. As a result, some private equity sponsors are finding themselves financially exposed at a stage when it is too late to take remedial action.

Here are some of the questions that private equity sponsors should be asking about insurance when it comes to protecting themselves and the funds they manage from just such a fate.

Is the Portfolio Company Directors and Officers Insurance Policy an Asset of the Bankruptcy Estate under the Bankruptcy Code?

Pursuant to Section 541(a)(1) of the Bankruptcy Code, assets of a debtor's bankruptcy estate are subject to the automatic stay. The automatic stay acts to preserve the estate and prevents distribution of estate assets without bankruptcy court approval. In the insurance context, to the extent a policy and the proceeds of a policy are determined to be assets of the estate, the insurer is not permitted to pay defense costs, settlements or judgments under the policy. Directors, who most likely cannot get indemnification from the financially troubled portfolio company, could find themselves exposed.

For this reason, the first question that a private equity sponsor should be asking is whether or not the portfolio company directors and officers insurance policy will likely become an asset of the bankruptcy estate. The determination as to whether a directors and officers policy and/or the proceeds belong to the estate is very fact-specific, and may vary depending upon the jurisdiction and the policy language. The types of coverage (Sides A, B and C)[1] as well as the terms of the policy are crucial to the determination. The fact-specific nature of the inquiry results in some uncertainty regarding how a bankruptcy court would decide these issues.

For example, a policy may be an asset of the bankruptcy estate while the proceeds

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1 *Side A: Provides coverage for directors and officers in cases when the company cannot indemnify the individuals (e.g., because the claims are not indemnifiable under applicable law). Side A coverage has no retention.*

Side B: Provides coverage for the company when the company indemnifies the directors and officers. Side B coverage usually has a significant retention of e.g., $1,000,000+.

Side C: Provides coverage for the company for liability arising out of certain types of claims made against the company, such as claims brought by shareholders or creditors under the securities laws. Side C coverage also usually has a significant retention of e.g., $1,000,000+.

…[T]he first question that a private equity sponsor should be asking is whether or not the portfolio company directors and officers insurance policy will likely become an asset of the bankruptcy estate.

thereof are not. The policy is frequently deemed an asset of the estate because it is in the debtor's name and the debtor paid for it. On the other hand, if the policy is solely for the benefit of the directors and officers and the debtor has no interest in the proceeds of the policy (*e.g.*, a policy that provides Side A coverage only), bankruptcy courts generally hold that the proceeds do not belong to the estate. The distinction gives directors and officers the ability to access policies solely for their benefit despite the bankruptcy of the company.

A majority of the case law on this issue analyzes Sides A and B coverage, resulting in relative clarity that proceeds of policies with Sides A and B coverage only, are not assets of the bankruptcy estate. For almost a decade, however, most directors and officers policies have provided Side A coverage for the directors and officers, and Side B and Side C coverage for the company, with one aggregate limit for all three types of coverage. This complicates the analysis regarding "ownership" of the proceeds because any payment on account of Side A coverage reduces the availability of the Side B and, in particular, Side C coverage—which has the effect of diminishing the property of the estate.

Based on the distinction between "ownership" of the policy and "proceeds" of the policy, depending upon the policy language, some courts have held that the policies with Sides A, B and C coverage and the proceeds thereof are assets of the estate, leaving the D&O claims of directors subject to the automatic stay. On the other hand, some bankruptcy courts have taken a more practical view and considered the distinction both in the context of defense costs and settlement. For example, some courts have allowed reimbursement of expenses (frequently up to a specified amount), reasoning that directors and officers may be irreparably harmed if reimbursement is denied. Other courts have allowed settlements when the debtor has not made a claim on the policy, reasoning that a contingent right of the debtor should not preclude access by the directors and officers because the proceeds are not assets of the estate unless the debtor has the right to recover the proceeds.

It should be noted that the courts look at the language in the policy very closely and well-advised sponsors can negotiate for the inclusion of certain provisions to a D&O policy to make it clear to the bankruptcy court that the policy is intended to protect the individual directors and officers and that coverage for such individual directors and officers takes priority over any other coverage provided.

…[W]ell-advised sponsors can negotiate for the inclusion of certain provisions to a D&O policy to make it clear to the bankruptcy court that the policy is intended to protect the individual directors and officers and that coverage for such individual directors and officers takes priority over any other coverage provided.

Will the Private Equity Sponsor Policy Be Deemed an Asset of the Portfolio Company's Bankruptcy Estate?

Intuitively, one would think that D&O-related claims made by a PE sponsor under any insurance policy purchased and owned by such PE sponsor (as opposed to a policy at the level of the portfolio company) would not be subject to the automatic stay under Section 541(a)(1) of the Bankruptcy Code in the event of a bankruptcy of such portfolio company. The last thing that a private equity sponsor expects is to have its own policy 'hijacked' and made a part of the portfolio company's bankruptcy estate, leaving the private equity sponsor and the funds potentially uninsured. However, due to problematic wording in the underlying polices, some policies of this kind have indeed been deemed to be assets of the estate of the bankrupt portfolio company, thereby making claims by the sponsor under that policy subject to the automatic stay.

One of the ways that the private equity sponsor policy can get dragged into the portfolio company's bankruptcy estate is through poorly drafted definitions of certain terms, *e.g.*, 'insured entity.' Often, in an attempt to cover all entities connected to the private equity sponsor under the private equity sponsor policy, the definition of what entities are covered is inadvertently too broad. If the portfolio company is covered, by definition, under the private equity sponsor's policy (intentionally or not), then the private equity sponsor policy can be accessed by the portfolio company and arguably seized by the bankruptcy court, inasmuch as the portfolio company is deemed an 'insured entity' under the private equity sponsor policy.

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The Good, the Bad and the Ugly: *Hexion v. Huntsman*

Private equity firms approaching the closing of a public company acquisition agreed to before the current credit crisis have sometimes found themselves in three-way standoffs worthy of *The Good, the Bad and the Ugly*: target companies have tight contracts with no financing outs; buyers have firm commitments from lending sources (subject to the absence of a "Material Adverse Effect" (MAE)); and lenders seeking to rely on the MAE out have strong leverage over buyers and targets because the deal cannot close without their funding. M&A practitioners have engaged in spirited debates about the rights and remedies of the parties in these situations, but have shown a marked reluctance to explore them judicially—probably because the stakes are high and the outcome uncertain.

One buyer, however—Hexion Specialty Chemicals, Inc., which had agreed to a $10.6 billion merger with Huntsman Corp. —decided (to paraphrase Eli Wallach) to shoot, not talk. In the ensuing litigation,[1] the Delaware Chancery Court, rejecting Hexion's effort to back out of the deal, took the opportunity to shed light on several of the topics that have absorbed the M&A community, including: how to determine whether an MAE has occurred, and which party must prove it; what constitutes a "knowing and intentional" breach of a merger agreement; what is required by an agreement to use "reasonable best efforts" to complete a transaction; and what are the consequences for failing to close a deal.

Like everyone in the private equity community, you have probably been riveted by the press reports at each stage of this dispute, but we thought it might be helpful to reprise the story to focus on the lessons to be learned.

Hexion's Agreement with Huntsman

Hexion, a portfolio company of the private equity firm Apollo Global Management, agreed in July 2007 to acquire Huntsman for $28 per share, topping Huntsman's prior agreement to be acquired by Basell for $25.25 per share. Hexion had financing commitments requiring a solvency certificate from the Chief Financial Officer of Hexion or Huntsman or from a valuation firm, but the merger agreement did not include a "financing out" excusing Hexion from closing if financing was unavailable. The merger agreement required Hexion to use its "reasonable best efforts" to consummate the financing, provided for uncapped damages for Hexion's "knowing and intentional breach of any covenant" and for liquidated damages of $325 million for other breaches and entitled Huntsman to obtain specific performance of Hexion's obligations under the agreement, other than the ultimate obligation to close the deal.

After Huntsman reported disappointing earnings, Hexion hired a valuation firm which opined that the combined company would be insolvent. Hexion went public with the opinion and sought a declaratory judgment that Hexion was not obligated to close because the combined company would be insolvent and because Huntsman had suffered an MAE, and that Hexion's potential liability was limited to $325 million. The court disagreed with Hexion and found, as Huntsman claimed, that Hexion knowingly and intentionally breached its obligations under the merger agreement.

Insolvency Opinion Found Unreliable

The court found the insolvency opinion to be "unreliable" because it was produced without consultation with Huntsman management, with a view toward its use in litigation, and was based on a "series of pessimistic assumptions," resulting in "skewed numbers." In the court's view, rather than embark on a "carefully designed plan to obtain an insolvency opinion," Hexion's board had a duty "to explore the many available options for mitigating the risk of insolvency while

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In the court's view, rather than embark on a "carefully designed plan to obtain an insolvency opinion," Hexion's board had a duty "to explore the many available options for mitigating the risk of insolvency while causing the buyer to perform its contractual obligations in good faith."

1 *Hexion Specialty Chemicals, Inc. v. Huntsman Corp., C.A. No. 3841-VCL (Sept. 29, 2008).*

causing the buyer to perform its contractual obligations in good faith." In any event, solvency was not a condition of the merger.

MAE Remains a High Hurdle in Delaware

Turning to the question of whether Huntsman had suffered an MAE, the court preserved the Delaware courts' streak of never having found an MAE to have occurred in the context of a merger agreement—a streak the court said was "not a coincidence." The court rejected Hexion's argument that the court could find an MAE by comparing Huntsman's performance with that of peer companies, an argument based on the exclusion from the MAE definition of changes affecting the chemical business generally except to the extent they disproportionately affected Huntsman. Such an argument would put the cart before the horse: first, the court must find an MAE to have occurred; only then should it consider the "disproportionate impact" provision.

Instead, the court analyzed the MAE question under the framework set forth in *In re IBP, Inc. Shareholders Litig.*, considering "whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." According to the court, for a decline in earnings to constitute an MAE, it "must be expected to persist significantly into the future." The court noted that buyers face a "heavy burden" in invoking MAE clauses, with the burden of proof, absent clear language to the contrary, falling on the party seeking to excuse its performance.

Ultimately, the court decided there had been no MAE. Although Huntsman's earnings per share (EPS) had decreased substantially, the court felt that EPS was the wrong benchmark because it was dependent on capital structure. Instead, the court compared EBITDA with the prior year's equivalent period and found the declines to be relatively modest. Similarly, the court rejected Hexion's argument that Huntsman's results should be compared to its forecasts. The merger agreement expressly disclaimed representations and warranties as to Huntsman's projected results, and at least one Apollo partner testified that Hexion never fully believed Huntsman's forecasts. The court also noted that Hexion's own models at the time the merger agreement was signed contained EBITDA forecasts for 2009 in line with analysts' current projections. The court agreed that future performance was also relevant to the MAE analysis, but found that Hexion's projections for Huntsman's decreasing EBITDA were "overly pessimistic."

...[T]he court preserved the Delaware courts' streak of never having found an MAE to have occurred in the context of a merger agreement—a streak the court said was "not a coincidence."

Knowing and Intentional Breach Exposes Hexion to Uncapped Damages

The court next considered whether Hexion had engaged in a "knowing and intentional breach" of the merger agreement, meaning that its liability for breaches of the merger agreement would not be capped at $325 million. Hexion argued that a "knowing" breach would require Hexion "not merely to know of its actions but to have *actual knowledge* that such actions breach the covenant." The court said this was "simply wrong," observing that "if a man takes another's umbrella from the coat check room, it may be a defense to say he mistakenly believed the umbrella to be his own," but it is "no defense to say he had not realized that stealing was illegal" or that "it was not his 'purpose' to break the law."

The court held that Hexion knowingly and intentionally violated its duty to use reasonable best efforts to consummate the financing and its duty to avoid taking actions that could reasonably be expected to materially impair, delay or prevent consummation of the financing. Hexion did so by failing to contact Huntsman to discuss its concerns about solvency, by publicly claiming in a complaint and a press release that the combined entity would be insolvent, and by sending the lead lending bank a copy of the insolvency opinion obtained by Hexion—actions the court found were intended to scuttle the financing. The court put particular emphasis on Hexion's failure to confer with Huntsman, stating that it "both constitutes a failure to use reasonable

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The Good, the Bad and the Ugly: *Hexion v. Huntsman* (cont. from page 22)

best efforts to consummate the merger and shows a lack of good faith." The court also found that Hexion was "dragging its feet" in obtaining regulatory clearances in a deal with a "hell or high water" antitrust approvals covenant.

Finally, the court considered whether specific performance was available. The court noted that the merger agreement contained a provision generally permitting a non-breaching party to obtain specific performance, but that in "virtually impenetrable language" that provision went on to prohibit Huntsman from specifically enforcing Hexion's obligation to consummate the merger. The court ordered Hexion specifically to perform its other obligations under the merger agreement, including its obligation to use reasonable best efforts to obtain financing, which, the court noted, both lending banks had recently stated they were prepared to provide "if a customary and reasonably satisfactory solvency opinion could be provided." The court observed that Hexion would remain free not to close, but "if Hexion's refusal to close results in a breach of contract, it will remain liable to Huntsman in damages." Those damages could be substantial: the merger agreement expressly provided that Huntsman's damages for a knowing and intentional Hexion breach would be "based on the consideration that would have otherwise been payable to stockholders of the Company."

What Next?

After the decision, the parties resumed negotiations and Huntsman shareholders chipped in another $217 million to try to bridge the funding gap while Apollo agreed to put up an additional $730 million – but, the day before the scheduled closing, the lenders announced they would not fund because they believed that Huntsman's proffered solvency opinion and certificate were not "customary and reasonable." The following day, Hexion sued the banks in New York State court seeking specific performance of the banks' obligations on an expedited basis. Hexion also sought a ruling preventing the expiration of the financing commitments, which was denied. Huntsman has litigated in Texas, pursuing multi-billion dollar tortious interference claims against Apollo (including claims against certain of its executives personally) as well as against the banks. The parties reportedly have been in talks to re-price the deal, but, at the time of this writing, the stand-off continues. ■

Paul S. Bird
psbird@debevoise.com

William D. Regner
wdregner@debevoise.com

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equity/strategic bidding groups. Unfortunately, unlike the 2005-2007 period when most players on the private equity scene could articulate the market terms for private equity "club" arrangements in large-cap transactions, our review of about a dozen recent private equity/strategic bidding group arrangements confirms that there has yet to develop any clear pattern of terms that govern the relationship between the PE firm and the strategic investor in these transactions. While we know that new market terms will eventually develop with respect to other PE transactions in this cycle, we are less certain that standard market terms will become discernible in the arrangements between private equity firms and their strategic partners, because each team is comprised of a strategic investor and one or more PE firms joining forces for different reasons.

…[W]hat [is] "market" for private equity/strategic bidding groups[?] …[T]there has yet to develop any clear pattern of terms that govern the relationship between the PE firm and the strategic investor in these transactions...because each team is comprised of a strategic investor and one or more PE firms joining forces for different reasons.

There are, however, several key issues that need to be addressed before contemplating any such partnership. These include material issues relating to governance, exit, additional investment, commercial relationships and the role and incentivization of management.

Governance

The composition of the Board of Directors and consent rights for major decisions set the framework for the allocation of governance rights. Usually, each significant investor, whether strategic or private equity, has representation on the board of the joint enterprise, often on a basis roughly proportionate to its equity investment. In addition, the composition of committees is often negotiated to be proportionate to board representation. The Board also generally includes the CEO. In many instances, a quorum for Board meetings is not met unless representatives of each of the investors are present, providing additional comfort for strategic and private equity investors alike.

Board rights are often subject to sell-down provisions, pursuant to which the number of directors to which an investor is entitled decreases as the investor reduces its investment. In some instances, the parties provide that independent directors nominated by each (or a subset) of them (and as to which consent is not to be unreasonably withheld by the others) will serve on the Board even while it is a private company. The hiring and/or firing of the CEO is sometimes allocated to the majority or lead partner and sometimes requires a super majority vote. The minority investor (or sometimes each investor) often has consent rights to certain fundamental matters such as merger, liquidation, material asset acquisitions and dispositions, issuance of equity securities, option plans, incurrence of material indebtedness and affiliate transactions and, sometimes, such matters as approving operating budgets. One of the more subtle issues is whether the right to appoint directors is transferable with any permitted transfer of shares.

Exit Issues

As would be expected, exit issues can dominate negotiations between a private equity and strategic teammates. PE firms generally focus on medium-term investment horizons, while strategic investors may be more focused on building a long-term asset with connectivity to its core business. Although PE firms will often view the strategic investor as a potential acquiror of the business, the strategic investor may be more interested in keeping the asset out of the hands of the competitor than in owning 100% of the business itself. In some transactions, in fact, PE firms and strategics join forces to acquire a previously wholly-owned subsidiary of the strategic partner.

There is usually some period following the closing of the transaction (*e.g.*, ranging generally from two to seven years) during which neither investor may sell its investment without the consent of the other investor. Even after that time, there may be restrictions on sales to the strategic partners' competitors or other parties. After the "no transfer" period has elapsed, in transactions involving strategic acquirors and PE firms from different jurisdictions, there may also be restrictions on private sales to a non-U.S. entity in order to avoid making the company a "controlled foreign corporation" (with its attendant deemed dividend issues) for U.S. strategics or PE firms organized in the U.S.

Any sale of shares is often subject to a right of first offer (or, in some instances, a right of first refusal) by the other investor

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Strange Bedfellows: Private Equity and Strategic Alliances (cont. from page 24)

or the company. Drag-along and tag-along rights with respect to share sales are almost always a feature of this type of transaction, with some negotiation about when either party can be forced to sell out or be dragged along if it is not willing to match or jump the offer.

Although only a few transactions give one party the ability to put a business up for auction, it is fairly common for a significant minority investor to have the right to require the Company to effect an initial public offering after the absolute prohibition on sales without consent has expired. Other demand and piggyback registration rights are common as well, with the ability to demand one or more registrations (after the IPO) often granted to each major investor with the requirement to include the other investors' shares on *pro rata* basis.

PE firms sometimes are attracted to strategic investors because they believe the strategic investor will grant them certain liquidity with a put right. Such provisions are more frequently proposed than agreed upon, but are sometimes included. In other instances, the strategic investor may have a call right that may or may not be coupled with the put right. The key issue in both of these circumstances is obviously pricing. Some of the most common options include independent valuations at fair market value, the application of fixed multiple formulas to EBITDA or some other metric and a fixed multiple of capital invested. We have also seen at least one transaction that includes a somewhat novel feature that might help bridge the gap when a PE firm wants a put right and the strategic investor is less inclined to grant one. In that transaction, the PE firm had the right, after a specified period of time, to swap its stock in the company on tax free basis for the publicly-traded stock of its strategic partner during a three-year period. While this approach may help address the strategic partner's concern regarding liquidity demands, it does not resolve the pricing issue. In addition, depending on the size of the investment related to the strategic partner's equity float, the strategic partner may require limitations on sales of its stock in order to protect its stock price.

Generally, investors do not have an obligation to provide additional capital or make additional investments in the company. However, they generally do have the opportunity to participate *pro rata* in any future equity issuances, often through pre-emptive rights.

Commercial Relations

Commercial contracts between the company and the strategic investor are sometimes a key part of the investment thesis.

In some instances, the strategic investor is guaranteed a distribution channel which would not be available if the business were sold to another party and is therefore willing to offer advantageous pricing and/or exclusivity arrangements in order to achieve that goal. Favorable distribution and other commercial arrangements can often provide the acquired business a guaranteed revenue stream for its products through requirements or even "take or pay" contracts. In other circumstances, a strategic partner may assume distribution responsibilities for the acquired business and may be compensated for doing so through the issuance of junior securities or other non-cash economics which may be particularly attractive when debt financing is scarce.

Management Equity

Many private equity transactions include incentivizing management with significant equity participation. Since this model is less customary in the corporate environment, agreements between strategic and private partners about the design of management equity arrangements are essential. If the strategic partner is contemplating acquiring the private equity investor's share of the business rather than exiting alongside the private equity investor via an IPO or eventual sale of business, it may be less inclined to adopt the type of private equity management ownership model to which private equity investors—and the management teams that work with them—have become accustomed. Private equity investors, of course, may argue that the more traditional corporate approach to management incentivization is less effective in aligning the interests of management and its owners. While this debate may sound philosophical and cultural, it has important economic ramifications for both types of investors as well as the business's management.

* * *

Although strategic investors and private equity firms are more typically competitors than partners in acquisitions, it is expected that they will increasingly join forces to acquire businesses in the current economic climate. In doing so, they will need to face important decisions relating to governance, exit, commercial relationships and incentivizing management, where their perspectives may be different but where reasonable accommodation can result in productive partnerships. ■

Franci J. Blassberg
fjblassberg@debevoise.com

Michael W. Blair
mwblair@debevoise.com

Guest Column: Cautious Optimism Amid the Turmoil (cont. from page 6)

Most LPs Approaching Target Allocations

The tremendously strong fundraising markets of 2004 to 2007 benefited from the rapid pace of distributions from previous vintages: LPs committed to new funds in an attempt to reach their target allocations, but because of the pace of distributions back to them from their existing funds, they were generally not getting any closer to their targets. As a result, many LPs increased their rate of commitments, fuelling the fundraising boom.

This virtuous circle obviously could not last indefinitely, and in 2008 it has clearly ground to a halt. Distributions have slowed to a trickle, and many LPs are now approaching or, in some cases, above their targets. Fig. 5, below right, shows how LPs' commitments vs. target allocations have evolved over the past 12 months to October 2008. In 2007, just over half of all LPs (53%) were under their target commitments to private equity, while in 2008 that figure has declined to only 36%. A year ago only 29% of all LPs were at or above their target commitments, now nearly half of them (48%) are.

This shift in actual vs. target allocations will clearly have major implications for private equity fundraising over the medium term, with the clear result being a relative decline in the market over the next couple of years. This was confirmed at the SuperInvestor conference in Paris – most LPs will still be making new fund commitments, but more cautiously than before.

Sovereign Wealth Funds

SWFs have historically been relatively modest investors in private equity, with typical allocations of 2-3% of AUM. However, SWF's generally have long time horizons, and do not need to match a specific liability profile—in other words, they are 'natural' investors in private equity. Combine this with the rapid growth of AUM, and it is clear that SWF's will become the leading source of funding for the private equity industry:

- ***2008:*** SWF's have around $3.6 trillion AUM, so 2-3% gives a current private equity investment of $70 -100 billion, or 3.5% to 5% of total funding for the $2 trillion global private equity industry.
- ***2013:*** SWF's are projected to have $10-15 trillion AUM by 2013, and allocations to private equity should reach 5% to 6%—in other words, a total private equity investment of $500-800 billion, or 20-25% of a $3 trillion global private equity industry.

Most leading global private equity firms have SWF LPs and anticipate increasing allocations from them—and few of them expect that 'burnt fingers' from recent investments made in financial services firms (*e.g.*, ADIA's 2007 investment in Citigroup) will halt this trend.

Growth Areas

The LP survey highlighted several market segments where LPs plan to increase their allocations in future. Some of these are the obvious beneficiaries of the changed market environment: distressed debt, mezzanine, and secondaries funds. Others were more of a surprise —*e.g.*, LPs plan to continue investing in real estate funds, despite the current market difficulties. Funds of funds continue to enjoy strong support.

There is widespread belief that emerging markets private equity will continue to grow, focused primarily upon growth capital.

Fundraising in 2008-2010

Fundraising will be depressed in 2008 and 2009, but we expect a good recovery thereafter. Total private equity funds raised in 2007 reached $644 billion (all fund types, including fund of funds), while 2008 looks like it will come in around $550 billion. We forecast 2009 to be in the range $400 billion to $500 billion.

Unfortunately, none of this means that

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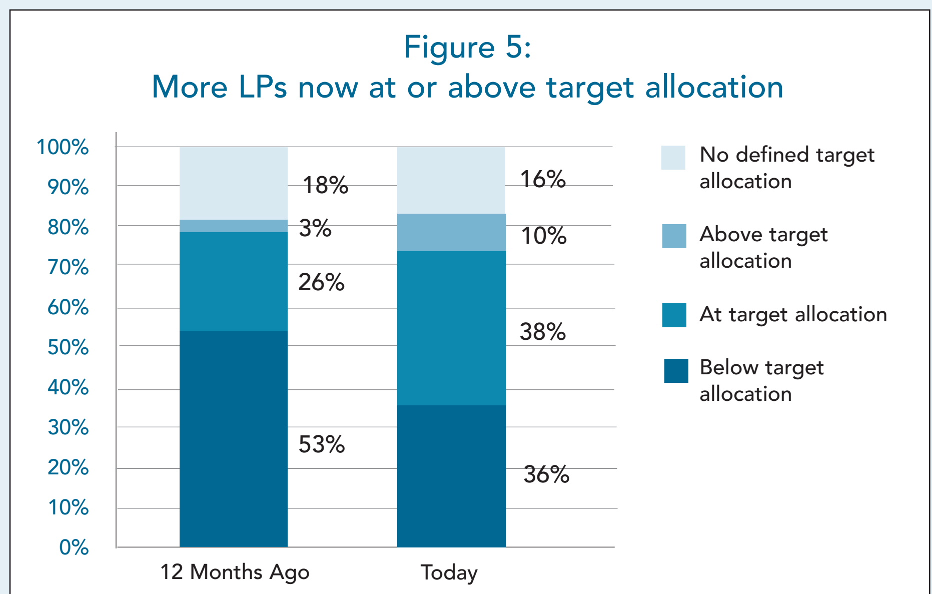


Source: Audience poll, PE World MENA, Dubai, November 2008

Guest Column: Cautious Optimism Amid the Turmoil (cont. from page 26)

fundraising will be easy for GPs: 2008 and 2009 will clearly be difficult, and even after that the record number of new funds on the road will make things extremely competitive for GPs raising their funds.

Changes in the LP/GP Relationship

Investing in a private equity fund requires a remarkable commitment from LPs—something akin to marriage. Our survey gave clear indications of what LPs look for in their relationships with their GPs: after the *sine qua non* of a good track record, it was issues like trust and alignment of interest that scored highest.

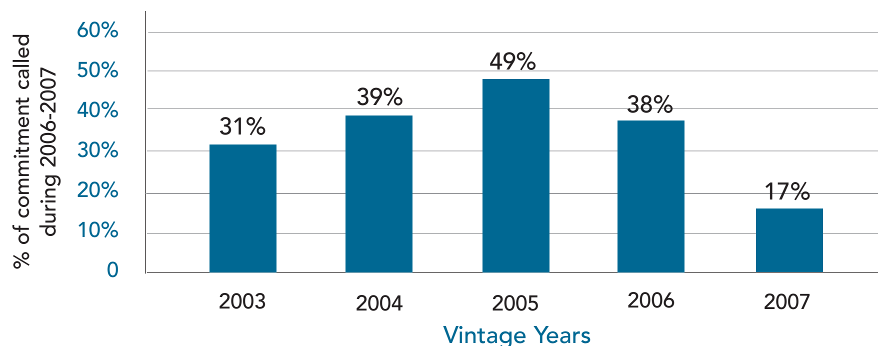
Fund terms migrated in the GPs favor during the heady fundraising markets of 2004 to 2007. There is widespread expectation that the pendulum will now swing the other way: the LPs who are still investing have many funds to choose from, and fund terms will inevitably move in the LPs' favor, with GPs seeking to gain a competitive advantage through favorable fund terms.

Fallout from 2005 and 2006 Vintage Funds

While private equity firms should see good investment opportunities looking forwards, there will clearly be major problems among portfolio companies acquired during the height of the boom in 2006 and 2007. How big is the problem likely to be? Using our Performance Analyst database, we calculated the proportion of buyout funds' commitments that were called up and invested during 2006 and 2007 (Fig. 6, below.). With the obvious caveat that every investment is unique, and that some companies acquired during 2006 and 2007 will be doing very nicely, thank you, it is clear that 2005 vintage funds look very exposed, and the 2004 and 2006 vintages will also have problems. (For further details, please see Preqin's November Spotlight newsletter availabe on Preqin's website at www.prequin.com.)

The mood at the SuperInvestor conference was very pessimistic, with some speakers saying that 25% of private equity firms could disappear. Whilst there will of course be a fallout, we do not expect a figure anything like as high: the PE firms will work through many of their portfolio problems, and default rates are likely to be lower than for the economy at large. Furthermore, PE funds have a lot of dry powder available—currently in excess of $450 billion—and so are well-placed to take advantage of attractive investment opportunities over the medium term.

What is the 'medium term'? The simple—and uncomfortable—answer is "Not yet." Most GPs at SuperInvestor are taking a cautious approach, and do not feel that the time to invest has come yet.



Source: Audience poll, PE World MENA, Dubai, November 2008

Conclusions

LPs fully understand the challenges facing markets generally, and private equity in particular. Despite this, they are cautiously optimistic on the prospects for private equity, and appear set to continue the longer-term trend of making increased commitments to the asset class. GPs see great investment opportunities ahead, but are adopting a cautious 'wait and see' approach.

We forecast 2008 fundraising to be 15% down on the 2007 peak, with 2009 a further 15-20% down. The longer-term growth trend will reassert itself in 2010. 2005 vintage buyout funds could see negative median IRRs, and the 2004 and 2006 vintages will also struggle. There will inevitably be some spectacular disasters, and some firms may not survive—but the vast majority will work through the problems and come out the other side. We'll see strong growth in areas like distressed private equity, mezzanine funds and emerging markets.

2007, 2008, and 2009 vintages should perform well, delivering excellent returns to the LPs that are able to invest in them. The winning firms will be those that stay close to their LPs—and move towards more LP-friendly fund T&C's.

Most importantly, private equity will come through with its most valuable asset intact: the ability to deliver superior returns through most market environments. ■

Mark O'Hare
Managing Director
Preqin

How Bad Is "Bad Faith?" (cont. from page 14)

decision is difficult to square with the other two recently decided *Revlon* cases.

McPadden and Lear

In *McPadden v. i2 Technologies, Inc.*, the plaintiff alleged that i2's board acted in bad faith when it approved the sale of a subsidiary to its management team for $3 million. Six months after the deal closed, that same team turned down an offer of $18.5 million for the business, and the team eventually sold the business 18 months later for over $25 million. In *In re Lear Corp. Shareholder Litig.*, the plaintiffs alleged that Lear's board acted in bad faith when it approved an amendment to a merger agreement adding a termination fee, payable if Lear's stockholders simply voted down the merger, in exchange for a $1.25 per share increase in the merger price.

Both i2 and Lear had exculpatory charter provisions, eliminating personal liability of directors for breaches of the duty of care as long as the directors acted in good faith. Therefore, in each case, the plaintiffs could recover only if they proved that the directors acted in bad faith.

The i2 court found that the directors had been grossly negligent: they put the eventual management-buyer in charge of the sale process, even though they knew of his interest in buying the subsidiary; they failed to oversee the sale process, which did not include contacting the most obvious potential buyers; they knew their financial adviser was using projections prepared at the direction of the eventual buyer; and they agreed to a price at the lowest end of the valuation range determined using the least favorable set of projections. All of this seems to be extremely irresponsible behavior and significantly more egregious than the actions or inactions of the Lyondell board.

Nevertheless, the court held that the plaintiffs failed to state a claim against the directors in light of the exculpatory provision in i2's charter. Chancellor William Chandler stated that gross negligence "cannot be an example … of bad faith conduct." While the intentional dereliction of duty or the conscious disregard for one's responsibilities may constitute "bath faith," the court found that the plaintiffs failed sufficiently to allege that the directors acted in this way. Instead, the plaintiff's pleadings indicated that the directors acted with gross negligence or reckless indifference—both of which were exculpated by the charter provision.

In *Lear*, the court rejected an argument that the defendant directors acted in bad faith by agreeing to a $1.25 per share price increase in exchange for a no-vote termination fee representing 0.9% of the total deal value, knowing that it was improbable that shareholders would approve the sweetened deal. Vice Chancellor Leo Strine concluded that directors "cannot be faulted for being disloyal simply because the stockholders ultimately did not agree with their recommendation."

Even if the directors' decision was unreasonable or grossly unreasonable, Lear's exculpation provision required plaintiffs to allege "facts that support a fair inference that the directors consciously acted in a manner contrary to the interests of Lear and its stockholders." The plaintiffs alleged that Lear's Board took "no care" and approved in "bad faith" a merger agreement almost certain not to be approved, but they failed to plead particularized facts supporting these "inflammatory and conclusory charges of wrongdoing."

Vice Chancellor Strine went further. In contrast to the *Lyondell* decision, Vice Chancellor Strine acknowledged that boards "may have to choose between acting rapidly to seize a valuable opportunity without the luxury of months, or even weeks, of deliberation—such as a large premium offer—or losing it altogether." According to the Vice Chancellor, it takes a very extreme set of facts to sustain a disloyalty claim premised on the notion that disinterested directors intentionally disregarded their duties. He concluded that since the Lear board and special committee met frequently, and since the special committee hired reputable advisors, the plaintiff could not sustain the disloyalty claim.

Lessons

While no director wants to be caught up in litigation, the risk of significant personal liability is likely more persuasive in shaping a director's actions and giving rise to skittish and overcautious behavior. For the

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…[B]oards are permitted to act quickly in appropriate circumstances to avoid losing a good deal; grossly negligent behavior (which may be exculpated) is not the same as bad faith (which may not); and only a very extreme set of facts demonstrating a conscious disregard of one's responsibilities or the dereliction of duty will allow a plaintiff to sustain a claim of bad faith against a target's directors.

How Bad Is "Bad Faith?" (cont. from page 28)

acquiring sponsor, this could mean facing target boards that will insist on more extensive pre-signing market checks, particularly in light of the *Lyondell* court's insistence on the importance of the pre-signing market check in satisfying a board's *Revlon* duties. It could mean that the target board will take more time before signing a deal to make sure it has done everything possible to ensure that it has obtained the best price for the target—the "*reasonably* available" qualification will likely be overlooked. And to cover themselves further, target boards may well insist on broader post-signing marketing opportunities.

This increased risk of personal liability may also affect the willingness of the best qualified people to serve as directors on the board of both public companies and sponsors' portfolio companies. And none of this will come as welcome news to the partners in private equity firms who serve on a portfolio company's board, particularly if the firm is looking to sell.

On the other hand, the *McPadden* and *Lear* cases provide some welcome comfort for sponsors and directors alike: boards are permitted to act quickly in appropriate circumstances to avoid losing a good deal; grossly negligent behavior (which may be exculpated) is *not* the same as bad faith (which may not); and only a very extreme set of facts demonstrating a conscious disregard of one's responsibilities or the dereliction of duty will allow a plaintiff to sustain a claim of bad faith against a target's directors.

These cases are difficult to harmonize with *Lyondell*, and so long as *Lyondell* is good law, there will continue to be uncertainty as to what conduct may constitute "bad faith" in the context of a sale of control of a target. If, however, the Delaware Supreme Court reverses *Lyondell*, many will let out a sigh of relief, and the courts' understanding of the realities of modern deal practice as evidenced by *McPadden* and *Lear* will let everyone breathe a little easier. ■

Andrew L. Bab
albab@debevoise.com

Avoiding FCPA Anxiety (cont. from page 18)

Implications

The Halliburton Opinion certainly reinforces the concept that thorough FCPA due diligence is best conducted pre-acquisition. Where practicable, private equity firms and funds should fully investigate and resolve any potential issues discovered during pre-acquisition due diligence prior to closing and, in certain situations, consider making disclosures and seeking an opinion from the DOJ in the event that the acquiror thinks it may inherit FCPA liability upon closing. Acquiring firms looking to avail themselves of the DOJ opinion procedure review will be wise to note the DOJ's statement in the Halliburton Opinion discouraging companies from entering into agreements that limit the information that can be provided to the DOJ. The DOJ's request may be entirely unworkable in a transactional world that often operates narrowly within confidentiality agreements, but it bears noting that the ability to receive a DOJ opinion may be adversely impacted by an acquiror's inability to disclose. In the appropriate circumstance, we would expect that the DOJ might exercise some flexibility where the impracticality of obtaining such a confidentiality agreement is demonstrated. On the positive side, the Halliburton Opinion shows that the DOJ recognizes some of the realities of the bidding process and acknowledges that situations exist where it is impossible, or impracticable, for an acquiror to complete FCPA due diligence before closing. The DOJ exhibited flexibility in accepting Halliburton's proposed remedy in such a situation and its opinion offers a roadmap for a successful due diligence and post-closing planning. Private equity firms faced with similar circumstances, where the completion of FCPA-related due diligence prior to closing is not possible, can minimize their legal risks by conducting intense post-closing FCPA due diligence, disclosing and remediating any issues, and imposing their compliance policies and procedures upon the target immediately upon closing. ■

Paul R. Berger
prberger@debevoise.com

Christopher J. Cestaro
cjcestaro@debevoise.com

Erin W. Sheehy
ewsheehy@debevoise.com

Bankruptcy Court Authority to Make Payments

Regardless of whether a policy provides Side A, B and/or C coverage, insurers regularly require authority from the bankruptcy court before making any payments under any insurance policy which may be deemed to be an asset of the bankrupt's estate, including policies held at the level of the portfolio company and the PE shareholder. As a result, well-advised portfolio companies and sponsors should ensure that specific bankruptcy clauses are added to their policies in order to facilitate their ability to get this authority from the bankruptcy court. The next few sections describe some of these bankruptcy clauses.

Does the Insured v. Insured Exclusion Exclude Claims by the Bankruptcy Trustee and Other Parties?

D&O insurance policies generally include an exclusion—called the "insured v. insured" exclusion—to coverage for claims brought by other insured parties. The purpose is to prevent collusion between the insured entities to the detriment of the insurer. In a bankruptcy, the "insured v. insured" exclusion is problematic because if a trustee or other party is representing the interest of the company (an insured) when it brings a claim against the directors and officers (insureds), the exclusion may be triggered.

Therefore, most insureds insist on an exception to the insured vs. insured exclusion to allow coverage for claims brought by a bankruptcy trustee, an examiner or their respective assignees. Careful attention to the wording of this exception is necessary to make sure all possible claimants are excepted out of the exclusion. If a portfolio company has operations in various foreign jurisdictions, the type of parties that may bring claims in all jurisdictions should be specifically excepted.

Does the Portfolio Company Policy Have a Financial Insolvency Exception?

In general, Side A coverage for non-indemnifiable loss usually has no retention (deductible), thereby allowing the directors and officers to access the coverage for their first dollar of loss. Side B coverage for indemnifiable loss usually has a retention, frequently a significant one, *e.g.*, $1,000,000+. Absent a properly worded financial insolvency clause, in the event a claim is 'indemnifiable,' *i.e.*, falls under Side B coverage, the insurer will presume that the directors and officers have been indemnified by the company where it is required or permitted by law, regardless of whether the directors and officers have actually been indemnified.

This 'presumption' can be very costly for a director or officer when the company is financially unable to provide indemnification and the director or officer must immediately look to the insurance policy for protection. As a result of the presumption, the director must first pay a significant retention because the claim is treated by the insurer as an 'indemnifiable loss,' even though no actual indemnification has occurred. To make matters worse, some policies have additional conditions that could require that the portfolio company (*i.e.*, the trustee) make a 'good faith' application to the court on behalf of the director, formally seeking a determination on indemnification, before the director can access the insurance policy.

It is very unlikely that a director or officer could personally fund such a large retention, or that a trustee could be compelled to go to court to seek indemnification on behalf of the director. (Indemnification rights become more complicated once a portfolio company is in bankruptcy, which is something that should be discussed further with bankruptcy counsel.) This leaves the individual director in a very precarious position since the director may not be able to meet the conditions under the policy to access coverage. Unfortunately, this leaves the individual director or officer exposed.

A properly worded financial insolvency provision should effectively eliminate the presumption. This would then make any claim by a director or officer a Side A claim in the event that the portfolio company enters into a court-supervised reorganization or bankruptcy proceeding. Again, Side A gives the directors and officers direct access to coverage under the policy for their first dollar of loss.

Does the Portfolio Company Policy Continue to Cover Claims After a Portfolio Company Files for Bankruptcy?

It comes as a surprise to most private equity sponsors that insurance policies generally do not cover acts committed after a change of control. What's worse, in many policies, sometimes buried deep within a series of definitions, a bankruptcy is included as an event meeting the definition of "change of control." This means that once a bankruptcy is filed, coverage under the terms of the policy automatically ceases. While claims could be covered for a short period of time, *e.g.*, until the end of the policy period, the board may be immediately exposed inasmuch as their insurance protection ceases for any wrongful acts, once a bankruptcy filing is made. Obviously, the insured should seek to have this wording

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Best Planning for the Worst (cont. from page 30)

changed, or else at the very moment coverage may be needed the most, it may well be unavailable.

Conclusion

This article highlights just a few of the issues that may arise in the context of a bankruptcy of a portfolio company which may result in a principal of a sponsor, sitting on the board of a portfolio company in financial distress, finding out that he or she can't access the portfolio company policy or the private equity sponsor policy. Of course, coverage always depends upon the policy wording in light of the applicable facts and circumstances. As a result, it is hard to predict, with certainty, whether or not there will be coverage in advance of an event. With that said, a careful review of policy wording now, at both the portfolio company level and private equity sponsor level, could make a difference amounting to millions of dollars. ■

Heidi A. Lawson
halawson@debevoise.com

Recent and Upcoming Speaking Engagements

October 10, 2008

Heidi A. Lawson
A Comparative Review of D&O Liability and Coverage Issues in the United Kingdom, Brazil, China, India and Russia C5
Third Annual European D&O Liability Insurance Conference
London

October 15, 2008

Andrew N. Berg
Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations, and Restructuring 2008
Tax Strategies for Private Equity
Practicing Law Institute
Crown Plaza Hotel, New York

October 23-24, 2008

Franci J. Blassberg, Program Co-Chair
Twenty Fourth Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions
October 23rd
Special Problems When Acquiring Divisions and Subsidiaries
October 24th
Negotiating the Acquisition of the Private Company
ALI-ABA Committee on Continuing Professional Education
New York

November 5, 2008

Katherine Ashton
Recent UK and US Legal Developments in International Corporate Restructurings
Corporate Restructuring Conference
Redcliffe Training
London

November 11, 2008

Thomas M. Britt III
Successful Investment Strategies in Emerging Markets (Focusing on China, India and Vietnam)
2008 KVIC Partners Forum
Seoul

November 17, 2008

Elisha Raman Bet-Mansour
Opportunities and Challenges for Private Equity Bidders in the Current Deal Market

Franci J. Blassberg, Program Co-Chair
Corporate Governance for Private Equity
IBA Conference
on International Leveraged Buyouts
London

December 3, 2008

David H. Schnabel
Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations, and Restructuring 2008
Tax Strategies for Private Equity
Practicing Law Institute
Los Angeles

December 9, 2008

Rebecca F. Silberstein, Panel Chair
Private Equity in 2009: What You Need to Know Now—Major Trends in Large and Mid-sized Funds
West Legalworks (Thomson Reuters)
New York

December 10, 2008

Dr. Thomas Schürrle
International Aspects of Corporate Compliance: Importance of the U.S. FCPA for German Companies
Euroforum
Berlin, Germany

December 10, 2008

Mark P. Goodman
Massive Redemptions, Poor Performance and Fund Closures: The Key Issues Surrounding the Global Financial Crisis and your Directors' and Officers' Liability
Maloy Risk Services and Debevoise & Plimpton LLP
CCO University Outreach Program/Webex

ALERT

Duties of Directors of Distressed Companies: An Update and Refresher

In light of current economic conditions, private equity professionals serving as directors of portfolio companies may want to re-familiarize themselves with the law concerning the impact of a corporation's financial distress on their fiduciary duties. Decisions in Delaware since the last economic downturn have changed some of the rules of the game.

Refresher on Fiduciary Duties

As all corporate directors are repeatedly reminded, directors of corporations have two primary fiduciary duties, the duty of care and the duty of loyalty. The duty of care requires that each director exercise the degree of care that an ordinary and prudent person would use in similar circumstances. The duty of loyalty requires that a director act in good faith in the best interests of the corporation and its shareholders and prohibits self-dealing.

The decisions of directors are generally protected by the "business judgment rule," which presumes that in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the decision was in the best interest of the corporation. Decisions of "interested" directors, however, are subject to the more onerous "intrinsic fairness" test, which examines whether the action of the board was both substantively and procedurally fair.

Fiduciary Duties When a Company Is in Distress

In a solvent corporation, the board of directors owes its fiduciary duties to the corporation's shareholders. Creditors are only entitled to the benefit of their contractual rights only as set forth in the financing or other agreements to which they are party. When a corporation is in distress, the focus of the board's obligations expands to include not only the interests of shareholders, but also those of creditors. With respect to many board decisions, this change in focus will not be significant and directors should think in terms of the best interests of the "community of interests" constituting the corporation. But in some instances, the interests of creditors and shareholders will diverge. When this occurs, the corporation's directors need not slavishly follow the demands of its creditors. However, the directors should not subject the corporation and its creditors to undue risk in pursuit of a recovery for shareholders.

The "Zone of Insolvency"—Is It Irrelevant?

Until recently, restructuring professionals generally advised clients in distress that the constituency to which a board of directors owes fiduciary duties expands to include creditors when the corporation is in the vicinity or "zone of insolvency." In recent decisions, however, the Delaware courts have moved toward a bright-line test, suggesting a duty to creditors does not arise until the corporation is actually insolvent. Courts in many jurisdictions, such as New York, have not yet spoken clearly on this issue. But the Delaware courts are highly influential in the field of corporate governance, and other jurisdictions are likely to follow Delaware's lead.

This change in Delaware law may mean less in practice than in theory. It is often impossible or, at least, impractical to determine when a corporation actually becomes insolvent. The two traditional tests of solvency – the balance sheet test (*i.e.*, whether the liabilities of the corporation exceed its assets at fair valuation) and the equity test (*i.e.*, whether the corporation can pay its debts as they come due)—can be difficult to apply. Consequently, in most instances, a board should start thinking in terms of maximizing value for everyone rather than just shareholders once the company is in financial distress.

Good News for Directors

It is important to remember that in many respects a director's fiduciary duties do not change when a corporation is insolvent. As before, the director's principal obligations are the duties of care and loyalty and most decisions of the board are still protected by the business judgment rule.

Further, since the last economic downturn, the Delaware courts have confirmed that the rules applicable to directors of solvent corporations apply in other important respect when a corporation is insolvent. In recent decisions, the Delaware courts have held that creditors (like shareholders) have no direct right of action against a corporation's directors for breach of fiduciary duty and are subject to provisions in a corporation's charter that limit the liability of directors for breaches of the duty of care. (As all directors should know, however, a director's liability for breaches of the duty of loyalty cannot be limited by the corporation's charter.)

Directors of distressed portfolio companies, however, may face special challenges if they are "interested" (whether as a result of the sponsor's shareholdings, purchases of debt or otherwise), as the intrinsic fairness test may then be applicable to the directors' actions. We will examine this subject in more detail in the next issue of the *The Private Equity Report*. ■

Richard F. Hahn
rfhahn@debevoise.com

Hilary Sokolowski
hsokolowski@debevoise.com

Jasmine Powers
jpowers@debevoise.com