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Sponsored Spin-Offs: The Private Equity Fund as Anchor Investor

In these times of tight financing, finding a buyer for a non-core line of business presents real challenges for a corporate parent. A spin-off may be an attractive structure to facilitate a private equity fund's interest in such an investment. Unlike a cash sale of a subsidiary or a division, if the spin-off qualifies as a tax-free investment, the parent will not incur any tax cost in disposing of the target business. As a result, the spin-off may create an investment opportunity that would otherwise not be available to the private equity fund. This article discusses the structural, legal and tax issues that must be carefully analyzed in structuring a spin-off for a private equity investment, including the new guidelines on structuring constraints contained in the so-called "Anti-Morris Trust" rules issued by the IRS in 2001.

Structure of Transaction

In order to effect a tax-free spin-off in anticipation of an investment by a private equity fund, parent typically would first distribute all of the stock of an existing or newly created subsidiary to its shareholders on a *pro rata* basis in the form of a special dividend. If the target business is held in a separate subsidiary or constitutes a relatively small portion of parent's value, parent generally would spin off the target business. The distribution would be followed by a pre-arranged investment by the private equity fund in the spin-off company. As described below, however, in some situations, parent and the fund may prefer that parent spin off all of the non-target businesses so that the fund can acquire shares in the parent (containing only the target business) after the spin-off. As used in this article, "Spinco Target" refers to the business in which the private equity fund will make its investment, and "Parent" refers to the spinning or spin-off company, as the case may be.

For a spin-off to qualify as a tax-free transaction, generally the private equity fund's investment must be structured as a primary investment (that is, a purchase of newly issued shares) and the fund must acquire less than 50% by vote and value of the shares of Spinco Target. If the spin-off fails to qualify as tax-free, both Parent and its shareholders may be subject to significant taxes in connection with the distribution.

Advantages/Disadvantages

There are a number of reasons why a spin-off to facilitate a private equity fund's investment may be advantageous to both the fund and Parent. From the fund's perspective, the target business may be an attractive investment opportunity because it is not correctly valued by the market (for example, because Parent trades at a lower P/E ratio than the appropriate ratio for the target business). From Parent's perspective, the spin-off may free Parent to focus on its core business while preserving for Parent's shareholders a share of any future increase in value that the private equity fund brings to Spinco Target. The investment by the private equity fund may also enhance

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"Don't think of it as losing a daughter, think of it as a sponsored spin-off."

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letter from the editor

In this issue of The *Debevoise & Plimpton Private Equity Report*, we focus on two broad themes of interest to private equity investors in the current economic climate: how to tackle the European market for private equity investment and how the shrinking pool of financing available for acquisitions is affecting deal structures and subsequent financing rounds.

On our cover, Paul Bird, the Co-Chair of the firm's Mergers and Acquisitions Practice Group, and Peter Schuur, a Tax Partner in our London office, discuss how a structured spin-off of a non-core line of business to a private equity investor can unleash the unrealized value of such a business for the corporate parent and the private equity investor alike. David Schwartz, a Partner in our Private Equity Funds Group, also discusses how private equity and venture capital investors can protect themselves against future uncertainty in the event of later stage lower priced financing tranches, so-called "down rounds."

Our Guest Columnists for this issue, Geoffrey Cullinan, Tom Holland and Simon Baines of Bain & Company's global equity practice warn that while Europe presents opportunities for private equity investment, there is room for caution, and address some of the misconceptions that investors contemplating entering the European market may have. In another article, we review the tax and regulatory issues that U.S. fund managers contemplating setting up operations in London should be familiar with to avoid ugly surprises and unanticipated delays. Also, in this issue, Maurizio Levi-Minzi, a Partner in our Corporate practice, and Giancarlo Capolino Perlingieri, an International Counsel in our London office, report that recent developments in Italian corporate law should make Italy more hospitable to leveraged acquisitions in the future.

This issue's Trendwatch column analyzes how the terms of funds with non-U.S. sponsors differ from their American cousins and reveals that the gap is narrowing as the non-U.S. marketplace matures.

As usual, we also focus in this issue on U.S. legal developments impacting private equity funds and their portfolio companies. Stuart Hammer reminds private equity firms returning to investments in "old economy" businesses of the potential for firm exposure to Superfund liability, but also highlights new federal legislation limiting environmental liability for purchasers of property. We also report on how the new anti-money laundering legislation adopted in the aftermath of September 11 has created a new era of regulation and oversight for financial institutions, including private equity funds, and we remind fund managers of the dangers marketing and press activities can pose to their private placement exemption.

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Down Rounds: How to Protect Against Future Uncertainty

In sharp contrast to the recent boom years, subsequent rounds of venture financing are now generally priced lower – substantially lower – than the prior rounds. In reaction to this change of climate and in anticipation of potential future "down rounds" investors are *(i)* insisting on stronger contractual protections, such as milestones, "full rachet" anti-dilution protection and senior liquidation preferences, *(ii)* finding that protective provisions negotiated by investors in earlier higher-priced rounds may impose impediments to structuring the down round and *(iii)* facing additional legal issues. This article will explore these provisions and highlight the issues savvy investors should focus on when investing in this climate.

Contractual Protections.

Milestones. Rather than invest all committed funds at one closing, many investors now insist on dividing a financing into several tranches or stages and funding only after agreed-upon milestones have been met by the Company. The milestones are generally tied to more objective standards, such as revenues or governmental approvals, and are sometimes tied to more subjective standards, such as stage of product development.

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Milestones help investors limit their exposure if the Company fails to meet its plans. Companies, however, often resist milestones since they limit flexibility and if an investor defaults on its obligation to fund a tranch, the Company generally has neither the time nor resources to pursue legal remedies. One alternative to serial funding based on milestones is automatic adjustment of the conversion price (effectively lowering the purchase price) if the Company fails to meet a milestone. This gives the Company comfort that all funds will be invested and the investor price protection in the event the milestone is not reached.

Liquidation Preferences. Investors typically purchase convertible preferred stock which returns to investors, in preference to any junior securities, their original cost (or, as discussed below, a multiple thereof) in the event of a liquidation, sale or change of control of the Company and are convertible into common stock at the option of the investor. In the boom years, the liquidation preference of later rounds was generally *parsi passu* with earlier rounds of preferred stock. However, in a down round the liquidation preference of the existing preferred stock is by definition over-priced, and the new investor usually insists that the liquidation preference of the new money be senior to the liquidation preference of existing preferred stock. Furthermore, as additional compensation, the new money may insist upon a liquidation preference equal to a multiple (2x or more) of the original cost and/or participating preferred. (Participating preferred entitles the investor to its liquidation preference plus the amount it would have received in a liquidation had it converted its preferred stock into common stock.) Holders of the existing preferred stock and common stock, who will only participate in the proceeds of a liquidation event after payment to the preferred stock issued in the down round frequently resist these provisions. However, often the only choice is between approving the issuance of senior preferred stock with a multiple liquidation preference or bankruptcy.

Price Anti-Dilution Provisions. Investors often protect themselves against subsequent down rounds with "weighted-average" or "full rachet" anti-dilution provisions. Weighted average anti-dilution reduces the initial conversion price of the preferred stock (and increases the numbers of shares of common stock into which the preferred stock is convertible) to a weighted average price based on the numbers of shares outstanding and the number of shares issued in the new round. Full rachet anti-dilution reduces the conversion price all the way down to the dilutive issuance price. Often investors in down rounds insist upon full rachet anti-dilution provisions to fully protect themselves against subsequent down rounds.

Companies generally object to full rachet anti-dilution. Since an investor's conversion price will adjust to the lowest price of any subsequent financing, it has less incentive to participate in a subsequent down round. Therefore, companies often insist on a "pay-to-play" provision as a compromise. In order for an investor to take advantage of the full rachet anti-dilution protection in a subsequent down round, it must purchase its *pro rata* share of securities in such down round.

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Europe: Finding the Sweet Spots for U.S. Investors

Europe has traditionally been seen by U.S. private equity investors as a market rich in opportunities. While it remains true that the European private equity market is less mature than in the U.S., the market is becoming increasingly competitive. Operating as a U.S. private equity investor in Europe is complex, requiring an understanding of multiple national markets. Notwithstanding the fact that interesting opportunities for U.S. investors do exist, it is still too early to tell whether the initial U.S. entrants have been successful. This article will address the top questions that U.S. investors contemplating a European investment are posing.

Is there lots of low-hanging fruit for private equity investors in Europe?

No, the European private equity market is at least as competitive as the U.S., with more deals conducted by investment bank auction and fewer proprietary deals.

The last few years have seen a surge in European LBO activity. In 2001, the value of deals done in Europe outstripped the U.S. market for the first time. However, despite growing opportunities in Europe, the private equity market has become highly competitive.

On the one hand, the flow of funds into private equity has risen dramatically as institutional investors continue to increase allocations to private equity. One result of this is that the market has seen major European players, such as Apax, Candover, Doughty Hanson, Cinven and CVC Capital Partners, raising billions of dollars for Europe-focused funds.

Added to this has been the growth in auctions as a means of conducting acquisitions. Auctions are particularly prevalent in the UK market. But they are increasingly being used to increase the efficiency of the acquisition process elsewhere. Across Europe, virtually all large deals are now conducted by auction.

This has made it harder for private equity funds to find proprietary deal flow. The auction process, often conducted by the large U.S.-based investment banks, has made it very difficult to find deals below fair market price, and has pushed prices up and expected returns down. As a result, the focus of private equity funds has shifted strongly toward how to add value to their transactions rather than merely relying on financial engineering to generate returns.

Europe is one market these days, right?

Wrong. Europe is still a multitude of different country markets each providing differing opportunities and requiring local knowledge and networks.

Europe is not really one market for private equity, despite the launch of the single currency and growing harmonization of legislation. Opportunities differ considerably by country, with the private equity market at varying stages of maturity across Europe.

The UK market has traditionally been the most advanced, and accounted for 50% of all European deals by value 1997-2001. However, recent growth has been stronger in Germany, Italy and Sweden, and much of the current effort of European private equity investors has shifted toward such markets.

European governments and the European commission have realized the great potential economic benefits of private equity. As a result, structural reforms are in progress in the major markets and at the EU level, for example Germany's removal of capital gains tax on the sale of shareholdings and recent corporate law reforms in Italy. (See "German Tax Reform: A Primer for Fund Managers," *The Debevoise & Plimpton Private Equity Report*, Summer 2001 and "Italian Corporate Law Reform Promises Friendlier Deal Environment" elsewhere in this issue.) These reforms will prove beneficial in the medium term by increasing deal flow and flow of capital into the asset class, but in the short-term significant differences exist in legislation between countries which will continue to mean that market dynamics differ between states.

Furthermore, the competitive situation and key success factors required within each market create different levels of opportunity for private equity investors. For example, the Italian market is much less penetrated by private equity than comparable countries, but is very difficult for foreign funds to operate in part due to the importance of strong domestic political and business contacts. Scandinavia, on the other hand, has opened up rapidly to external private equity investors, with external investors' share of deals by value rising from 28% in 1997 to 61% in 2001.

The key to operating in Europe is to understand that private equity is predominantly a local business. Some of the larger deals can be conducted on a pan-European basis from one location. But for mid-market deals it is critical to have a local presence, a local network, local advisors who understand national and European industry structures and trends and a familiarity with language, customs and culture – this takes time to build.

So where's the angle?

Opportunities exist in Europe to create value by restructuring acquisitions. However, this can be difficult to achieve given government regulation, employ-

ment legislation and union strength in some countries, and the pool of European turnaround management is small.

Compared to the U.S., European labor laws generally afford a far greater degree of employee protection. This can be problematic for private equity funds hoping to create value from restructuring their investments.

Legislation differs across Europe. One example of legislation making restructuring very difficult exists in France. There, layoffs must follow a strict procedure, which takes not less than 180 days before they can finally be implemented. If changes are made to the proposed retrenchments during the period, the 180-day period restarts.

Another problem facing private equity investors in Europe is scarcity of managerial talent available to execute turnarounds. First, the talent pool is small overall, and, second, for any given deal there exist national, language and geographic barriers to accessing that talent. Some U.S. investors have resorted to bringing in U.S. management, but there have been high-profile cases where this has failed to work due to a clash of management styles and culture.

When the talent is available, incentivizing that talent appropriately can be tricky. UK managers typically respond to U.S.-style incentives, like stock options. But continental managers do not always. For example, in Germany, management tends to put a higher priority on community standing and cooperation at the work place than on financial incentives. Furthermore, some U.S. private equity investors have provoked a strong negative reaction in the business community in some countries by announcing U.S.-style management compensation packages that are viewed as excessive compared to local norms.

Despite the difficulties, there are some examples of U.S. private equity investors taking a value-added approach and successfully improving performance of their acquisitions in Europe. For example, Texas Pacific Group is in the process of driving growth and increasing EBITDA ahead of the industry at its UK pub chain, Punch Taverns.

What's the opportunity for taking public companies private?

Taking public companies private is a rapidly growing source of deals, with the advantage initially of allowing "quasi-proprietary" deal flow for private equity funds.

Historically, public to private deals in Europe have been rare given complex legislative requirements and corporate control rules. But transactions of this type are growing. European stock market sentiment has moved away from smaller stocks, and this has led to a growing perception among private equity investors that many smaller stocks are undervalued. This has fueled public-to-private transactions, which rose from less than 4% of European deals by value in 1997 to 20% by 2001.

Public-to-private deals can allow a private equity investor to understand the company better and potentially develop an advantageous relationship with an incumbent management team before they bid, after which management is required by law to disclose the bid and thereby open up the acquisition to other players.

Are there any interesting exit opportunities?

The secondary market (sales of companies from one private equity investor to another) is providing a greater opportunity for exit.

The secondary market provides a growing source of potential exit for European private equity investors. From 1997-2001 approximately 8% of European private equity deals were secondary market sales, and this is likely to increase as long as IPO market conditions remain difficult.

Are there many privatization opportunities left?

Interesting state privatization opportunities still exist; however, networks and political connections are key.

Following hectic activity in the late 1990s, the rate of privatization in Europe is slowing, with $47 billion raised from privatizations in the EU in 2000 vs. $60 billion in 1999. This drop can be attributed partly to a reduction in the number of assets left to be privatized, but also to unfavorable equity markets that have caused states to postpone privatization plans.

However, attractive opportunities do still exist, particularly in Eastern Europe and in sectors where liberalization is incomplete, such as telecoms and energy. And there is evidence that private equity investors will play a bigger part in privatizations going forward, with governments increasingly seeing private equity as an alternative to the IPO.

One of Europe's high-profile private equity investors, Guy Hands, former head of Nomura's Principal Finance Group, has recently set up his own firm, Terra Firma Capital Partners. Terra's goal is to invest about 40% of its new fund in German government privatization projects.

The major U.S. private equity players have already been successful in Europe, haven't they?

It is too early to tell whether any of the major U.S. players have been successful in the European market, as there have been few exits. Those that have not yet entered are behind the game, particularly given barriers to entry.

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Private Equity Funds Abroad: Establishing a London Office

For many fund managers, there comes a time when establishing a London office begins to make sense, whether to increase the firm's visibility and be closer to UK and other European investment opportunities, to support the monitoring of existing portfolio investments, or to launch a European-based initiative, such as a new fund with a predominantly European investor base. Setting up operations in London, however, is not as simple as it is in the U.S. and can result in surprises for U.S.-based managers unfamiliar with the regulatory and tax issues involved. We review below some of the issues that U.S. fund managers should be aware of when preparing to open a London office.

For most managers, establishing an office in the U.S. is almost a non-event: the manager may need to qualify to do business in the local state (normally satisfied by a routine filing and, in some cases, also by a publication requirement) and, in some states, may have to comply with local registration requirements, but is exempt from registration with the SEC under the Investment Advisers Act of 1940 (the "U.S. Act") as long as the manager has no more than 14 clients in any 12-month period and does not hold itself out generally to the public as an investment adviser. For purposes of determining the number of clients, each fund is generally regarded as one client; however, the client counting rules are complex and often parallel funds and co-investment vehicles count towards the 14-client limitation. Thus, a newly established firm can begin fund raising and making investments without first registering as an investment adviser. In fact, many managers may never need to register with the SEC.

In contrast, a fund manager establishing an office in the UK will in almost all cases be required to obtain authorization from the Financial Services Authority (the "FSA") before undertaking investment-related activities. The Financial Services and Markets Act 2000 (the "UK Act") requires persons carrying on "regulated activities" in the UK to be authorized by the FSA. Most activities that a fund manager would want to conduct are regulated activities, including raising an investment fund, providing investment advice and structuring portfolio investments. Although there are many technical exemptions that allow certain regulated activities to take place without FSA authorization, most fund managers establishing a permanent London office find it impractical and too restrictive to rely on operating exclusively within the exemption system. Furthermore, engaging in regulated activities in the UK without FSA authorization or an exemption is a criminal offense and can render transactions voidable at the option of the other party.

U.S. fund managers contemplating a London office should bear in mind that the process can be time-consuming and that FSA authorization can take three to six months.

The structure of a fund manager's London office must also be carefully vetted from a UK and U.S. tax perspective, with a view to minimizing the double taxation of the manager's earnings and structuring the London operations so that the manager and its principals do not become subject to UK tax on income that is unrelated to the London office's operations.

Structuring the London Office

Subsidiary or Branch Office. To establish an office in London (or elsewhere in the UK), a U.S.-based manager will typically form an English limited company as a subsidiary and apply for authorization from the FSA. The alternative to forming a subsidiary is opening a branch office. Either alternative requires FSA authorization, but for the reasons described below a U.S. manager will in most cases prefer a subsidiary to a branch.

If the fund manager undertakes investment advisory activities in its London office through a UK subsidiary, the manager typically retains the subsidiary under an advisory agreement between the manager and the subsidiary. That way the subsidiary acts for only the fund manager.

Limited Liability. One advantage of establishing the London office as a subsidiary of the U.S. firm is that the U.S. firm is normally insulated from the liabilities that the London office may incur in the course of doing business. Under English law, a parent company is generally not liable for the debts and obligations of its subsidiary beyond the amount of the parent's unpaid shares in the subsidiary. If the London office is established as a branch office of the U.S. firm instead of a subsidiary, there is no structure to insulate the U.S. firm from the liabilities of its London branch. As a result, the assets of the U.S. firm remain exposed and potentially available to satisfy those liabilities. To maximize the likelihood that the limited liability and separate legal identity of a UK subsidiary will be respected by the English courts, U.S. firms and their UK subsidiaries are well advised to

adopt good corporate "housekeeping" practices when conducting and documenting their business activities (in particular board meetings) and to consult with in-house or outside counsel as appropriate.

UK Tax Considerations. The UK tax consequences of operating a London office through a subsidiary or a branch are generally similar. Profits attributable to the subsidiary or branch will be subject to 30% UK corporation tax; no UK tax will be imposed on dividends from the subsidiary to the fund manager or on repatriations of earnings of the branch to the U.S. One significant advantage of operating through a subsidiary rather than a branch is that only the UK subsidiary will be required to file a tax return with the UK tax authorities, which tends to insulate the fund manager from UK tax scrutiny. A branch, on the other hand, may be required to supply information concerning the fund manager's overall operations and income in addition to the branch's own income.

To preserve the UK tax advantages of operating a London office in a subsidiary form, the fund manager must avoid creating a taxable presence in the UK other than through the subsidiary. In particular, the fund manager should not have its own UK office. Employees of the manager should not enter into agreements on behalf of the manager while they are present in the UK. In addition, the employees of the UK subsidiary generally should not have the power to enter into agreements on behalf of the fund manager or on behalf of private equity funds that are advised by the manager.

Under the UK transfer pricing rules, transactions between the fund manager and its UK subsidiary must be on an arm's-length basis. Care must be taken in structuring the advisory agreement between the parent and subsidiary to ensure that the subsidiary receives adequate remuneration for the services it renders and can operate profitably in the UK. In order to minimize the value that can be ascribed to the subsidiary's services for UK tax purposes, it is best to avoid transfers of potentially valuable assets to the subsidiary, such as long-term contracts or the right to use the manager's name in the UK, unless they can be revoked by the fund manager at any time.

U.S. Tax Considerations. From a U.S. tax perspective, operating a London office through a branch may be more appealing than a subsidiary for the reasons described below. Fortunately, under the U.S. "check-the-box" rules, a fund manager can get the best of both worlds and elect to treat a wholly-owned UK subsidiary as a branch for U.S. tax purposes. The principal advantages of making the check the box election are that (i) U.S. transfer pricing requirements will not apply to transactions between the manager and the subsidiary, which will prevent the manager from being whipsawed by the U.S. and UK tax authorities' taking inconsistent transfer pricing positions; (ii) the subsidiary will not be subject to separate U.S. tax reporting requirements under the U.S. "controlled foreign corporation" rules; and (iii) if the fund manager is owned by U.S. individuals and is structured as a pass-through for U.S. tax purposes, making the election will enable the individuals to claim U.S. foreign tax credits in respect of the subsidiary's UK income tax.

Regulated Activity in Other European Jurisdictions. Another potential advantage of a U.S. firm choosing to establish a UK-domiciled subsidiary instead of a branch is that the subsidiary, if authorized to conduct regulated activities in the UK, benefits from the Treaty of Rome and certain European directives that may allow it to conduct regulated activity elsewhere in Europe. This means that the subsidiary may, for example, provide investment advice or engage in other regulated activities in these jurisdictions without having to obtain local authorization, although certain formalities may need to be observed. The treaty and the directives do not operate in favor of the London branch of a U.S. firm because the branch remains part of a U.S. entity.

Filing of Accounts. One potential disadvantage of establishing a UK subsidiary instead of a branch is that a subsidiary company must prepare and file its own audited accounts in accordance with the requirements of the Companies Act of 1985. A branch office, on the other hand, can file audited accounts prepared in accordance with the practices of the U.S. firm, although for UK tax purposes the branch is also required to produce unaudited accounts for the UK operation only.

Employee-Related Taxes. The fund manager's UK branch or subsidiary generally will be required to withhold UK income and employment taxes from compensation paid to UK-based employees, and to remit the withholdings to the UK tax authorities. The branch or subsidiary will also have an independent obligation to pay the employer's portion of UK employment

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U.S. fund managers contemplating a London office should bear in mind that the process can be time-consuming and that FSA authorization can take three to six months.

Protecting Shareholders from Superfund Liability

This is Part 2 in a two-part series on environmental issues of critical importance to private equity investors. In Part 1, we addressed the inadequacies of traditional Phase 1 Environmental Site Assessments as a due diligence tool. In this article, we address the liability of shareholders under the federal Superfund law.

As private equity firms increasingly recalibrate their investment mix in favor of traditional, "old economy" businesses, they need to ensure that their interaction with these businesses does not expose the firm to environmental liabilities. Of particular concern is the firm's potential liability under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), the federal Superfund law, whose broad liability scheme has in the past burdened shareholders with multimillion dollar cleanup obligations. As discussed below, shareholders that engage in certain activities can subject themselves to CERCLA liability. This issue's "Alert" focuses on recent amendments to CERCLA which have expanded the exemptions from liability for certain purchasers of contaminated businesses. These changes do not impact shareholder liability under CERCLA discussed herein.

CERCLA. CERCLA empowers the federal government and private parties to recover costs incurred in cleaning up a facility. While cleanup costs are generally sought from the parties that owned or operated the polluting facility, shareholders are also often sued, even where they had little or no connection to the polluting facility. Shareholders have been particularly susceptible to CERCLA suits in situations where a company no longer exists or is incapable of paying its share of cleanup costs due to insolvency or bankruptcy.

For many years, courts were divided as to the circumstances under which shareholders could be held liable under CERCLA. Most courts held shareholders liable under CERCLA where plaintiffs demonstrated that the shareholders were "actively involved" in managing the activities of a corporation. These courts would consider various factors, including whether the shareholders controlled a corporation's daily operations, supervised its financial decisions, approved significant transactions or placed its personnel in management positions. Other courts held shareholders liable under CERCLA where the shareholders merely had the authority to control a corporation's operations, even if such authority went unexercised. Still other courts refused to hold shareholders liable unless the requirements necessary to pierce the corporate veil were met.

United States v. Bestfoods. A 1998 decision by the U.S. Supreme Court helped bring clarity to the issue of shareholder liability under CERCLA, and in the process, helped slow the tide of CERCLA lawsuits brought against shareholders. The Court's decision in *United States v. Bestfoods* limited the circumstances under which shareholders and corporate parents could be held liable under CERCLA.

The Court in *Bestfoods* held that there were only two theories under which shareholders and corporate parents could have CERCLA liability:

First, the shareholder/corporate parent could have "direct liability" when it directs the workings of, manages or conducts the affairs of a company's polluting facility. Specifically, a shareholder/corporate parent will be held liable when it manages, directs, or conducts activities at a facility that were specifically related to the pollution, such as operations having to do with the leakage or disposal of hazardous substances or compliance with environmental laws.

Second, the shareholder/corporate parent could have "derivative liability" when the extent of the shareholder's control over the company has destroyed the legal formalities of separateness between parent and company such that the corporate veil is properly pierced under traditional corporate law principles.

As discussed below, *Bestfoods*, and the cases interpreting it, have developed some important principles that shareholders must consider in seeking to shield themselves from CERCLA liability.

Shareholder Activities. *Bestfoods* provided a safe harbor for shareholders to engage in general corporate activities with a corporation without subjecting the shareholders to direct liability under CERCLA. Shareholders will be shielded from CERCLA liability if their activities are consistent with their investor status. Protected activities include monitoring the performance of a company, supervising the company's finance and capital budget decisions and articulating general corporate policies.

However, shareholders can be held directly liable when they involve themselves in the environmental activities of a facility. In this respect, the cases that have interpreted *Bestfoods* have estab-

lished certain guidelines that should help insulate shareholders from CERCLA liability:

- Shareholders should not assume any responsibility for, or oversight over, environmental matters of a facility. Environmental matters include any matters related to waste disposal, cleanup or environmental compliance activities.
- Where environmental regulators or others regard the shareholder as the true operator of the facility, direct liability is likely to be found. In this respect, shareholders should not interact or correspond with environmental regulators or waste haulers on a facility's behalf.
- A facility's environmental permits should not be registered in the shareholders' name. Moreover, the shareholders should not play a role in obtaining environmental permits for a facility and should not liaise with regulators with respect to such permits.
- Shareholders should not retain environmental attorneys, consultants, engineers or contractors to address environmental issues at a facility. While these activities alone may not subject a shareholder to CERCLA liability, they likely will be factors in a court's analysis of direct liability.
- Shareholders should be cautious before advising a facility about issues relating to the facility's sewer system, drainage system and wastewater treatment systems, which often serve as conduits for contamination.
- Shareholders should not require a company to notify the shareholders of any contact the corporation has with environmental regulators.
- Shareholders should not settle the corporation's environmental lawsuits.
- Having an employee of a shareholder/corporate parent serve as an officer of a subsidiary will not in itself subject the shareholder to direct liability. *Bestfoods* recognized that it is entirely appropriate for directors and officers of a shareholder/corporate parent to serve in a similar capacity for a subsidiary. Courts will presume that joint officers and directors have acted properly, and to overcome this presumption, a plaintiff must demonstrate that the joint officers and directors were really acting for the shareholder/corporate parent when they were ostensibly acting on behalf of the subsidiary.
- Where shareholders dominate the activities of a company, but are not involved in the company's environmental activities, direct liability is not likely to be found. However, such activities expose the shareholders to derivative liability.

Veil Piercing. Shareholders will be held derivatively liable when they control a company such that the corporate veil is properly pierced under traditional corporate law doctrines. *Bestfoods* left open the question as to whether federal or state veil piercing law should be used to analyze derivative liability. This void has created a split among courts as to whether federal or state law should be applied. Nonetheless, veil piercing factors likely to be considered under both federal and state law include the following:

- inadequate capitalization of assets,
- extensive or pervasive control by the shareholder,
- intermingling of properties or funds,
- failure to observe corporate formalities and separateness,
- siphoning of funds, and
- the absence of corporate records.

Bestfoods *provided a safe harbor for shareholders to engage in general corporate activities with a corporation without subjecting the shareholders to direct liability under CERCLA. Shareholders will be shielded from CERCLA liability if their activities are consistent with their investor status.*

Whether a court applies federal or state veil piercing law, it will be more inclined to hold shareholders liable when they misuse the corporate form to accomplish some wrongful purpose, such as fraud.

Conclusion. *Bestfoods* was an important decision for shareholders as it limited the circumstances under which they could be held liable under CERCLA. Nonetheless, four years after the *Bestfoods'* decision, shareholders continue to be sued in CERCLA actions. As companies continue to falter and are unable to pay their share of cleanup costs, CERCLA suits against shareholders are expected to increase as plaintiffs seek out "deep pockets" to help pay for cleanup costs. To help prevent such suits, private equity firms should adhere to the guidelines outlined above. ▢

— Stuart Hammer

Recent Developments in Anti-Money Laundering Laws and Their Impact on Private Investment Funds

In the aftermath of the September 11th terrorist attacks, American lawmakers aggressively worked to tighten and strengthen U.S. anti-money laundering laws. On October 26, 2001, President Bush signed into law the USA PATRIOT Act, which is aimed at stemming the flow of illegal funds to terrorists around the world. Among other things, the Act required that "financial institutions" adopt anti-money laundering compliance programs by April 24, 2002. As we reported to our clients and friends in February, the U.S. Treasury Department apparently views the term "financial institution" as used in the Act as encompassing private equity funds, hedge funds and other private investment funds. (Editor's note: As we went to press, the April 24 deadline for putting in place compliance policies and procedures was extended to October 24, 2002.)

Actions That Private Funds Must Take Now. Private funds, which have been largely unregulated in the U.S. until now, have had to act quickly to establish internal anti-money laundering compliance programs by the April 24, 2002 deadline. The Treasury Department is expected to have issued regulations specifying the steps that private funds must take. Private funds are required by the Act to adopt compliance programs, however, even if the regulations are not issued in time, so it has been necessary to develop programs without detailed guidance from the regulators.

We are working with private equity firms and other fund sponsors to put in place compliance programs customized to their particular businesses. In every case, however, the firm must (1) develop internal policies and procedures designed to prevent the laundering of proceeds of criminal acts through the fund, (2) designate a compliance officer, (3) establish an ongoing employee training program and (4) create an independent audit function to test the anti-money laundering program.

These requirements will affect the fund during its capital raising process and throughout the life of a fund. For example, the policies and procedures referred to in clause (1) above could provide that, during the fund-raising process, fund sponsors will: undertake detailed due diligence investigations with respect to the identities of investors, such as obtaining representations and, in appropriate cases, supporting documentation as to the identities of investors; make disclosure in their offering memoranda of the new regulatory regime; and obtain covenants in subscription documents from investors that they will supply information on an ongoing basis as needed to assure compliance with the new rules. (Additional due diligence procedures with respect to certain types of accounts will be required by July 23, 2002.) Once the fund has been formed and is operating, ongoing monitoring of investor activity will be required.

Future U.S. Regulation of Private Funds. Additional direct regulation of private funds is almost certain. The USA PATRIOT Act requires the Secretary of the Treasury, the SEC and the Federal Reserve to recommend to Congress the expansion of the U.S. Bank Secrecy Act to cover investment companies, including private funds. It is possible, for instance, that private funds will be required to file reports of suspicious activity involving fund accounts.

The Act also requires the Treasury Department to promulgate, by October 26 of this year, new regulations setting forth the minimum standards for financial institutions, including private funds, to verify the identity of their customers (their investors). While it is impossible to know exactly what these rules will say, it is likely that the "know-your-customer" rules applicable to other financial businesses will greatly influence the content of the Treasury regulations. Some of our clients – particularly those not now raising a new fund – may decide to wait until the regulations are issued before asking investors for information and documentation verifying their identity. Other clients – particularly those raising a new fund – are asking potential investors now for the detailed information that is expected to be required by the upcoming regulations. Their thinking is that it is preferable to gather the information before bringing an investor into the fund, rather than trying (perhaps unsuccessfully) to chase down the information later and, possibly, discover a problem. Whichever approach fund sponsors decide to take, they should be aware that the anti-money laundering policies and procedures that private funds must have in place as of April 24 require at least some heightened level of due diligence regarding investors.

Regulation of Other Institutions That is Likely to Impact Private Funds. Under the USA PATRIOT Act and NASD rules proposed in January 2002, registered broker-dealers, like private funds, also must establish anti-money laundering compliance programs. In addition, Treasury Department regulations that were proposed in December pursuant to the Act, as well as the proposed NASD rules mentioned above, will

require broker-dealers, like banks, to submit "suspicious activity reports" to regulators.

This regulation is likely to affect private funds that are affiliated with broker-dealers, as well as funds and fund sponsors that hire broker-dealers (placement agents) and even private funds that merely maintain accounts with U.S. financial institutions. For example, private funds should recognize that placement agents are now (or shortly will be) subject to much stricter recordkeeping and reporting requirements. So, a fund sponsor using a placement agent to help raise a fund can expect to receive more (and more detailed) requests from the placement agent about the fund and about the fund's investors (at least, those investors who are not also clients of the placement agent) than was the case in prior years.

Recent Developments in Cayman Anti-Money Laundering Laws. The U.S. is not alone in strengthening its anti-money laundering legislation. For example, last year the Cayman Islands, where a great many non-U.S. private equity funds and hedge funds are organized, greatly strengthened its anti-money laundering legislation. Current Cayman anti-money laundering laws predate the U.S. laws described above, and impose similar requirements, including "know your customer" rules. As part of the Cayman "know your customer" rules, funds are obligated to perform relatively detailed due diligence on investors to establish and verify their identities and sources of funds. This may include obtaining certified copies of passports with respect to individual investors and various organizational and authorization documents with respect to institutional investors; however, the level of due diligence required may be less when an investor funds its capital contributions from a country deemed to have anti-money laundering legislation equivalent to that of the Cayman Islands. Sponsors of funds organized under Cayman Islands law may also be obligated to report suspicious investor activity to the Cayman Reporting Authority, which means that funds will need to establish means of monitoring investor activity. Funds that have employees or a physical presence in the Cayman Islands are also required to designate anti-money laundering compliance officers and to conduct regular employee training.

Priorities and Some Suggestions.

1. Compliance Program. As stated at the beginning of this article, U.S. private fund sponsors are required to have in place anti-money laundering compliance programs for their funds as of April 24, 2002. Any such program should be crafted to fit the circumstances, policies and procedures of each fund. As part of this program, any fund seeking investors should include language in its subscription documents that requires that its investors (limited partners) provide to the fund's general partner all information that the general partner deems necessary in order to comply with anti-money laundering or anti-terrorist laws or regulations. We have updated the form of subscription agreement that we prepare for clients accordingly.

2. Know Your Customers. As part of its compliance program, and in anticipation of the "know-your-customer" rules to take effect later this year, fund sponsors should begin considering new procedures designed to verify the identities of existing and prospective investors in their funds.

3. Investment Activity. During due diligence on potential portfolio investments that are subject to these regulations (e.g., investment by a fund in a brokerage firm) or that are expected to be subject to these regulations (e.g., investment by a fund of funds in other private funds), the fund considering the investment should seek information about the target's anti-money laundering compliance efforts.

4. Dealing With Other Regulated Entities. Private funds should consider including appropriate provisions in their contracts with placement agents and with acquisition targets that are in financial services businesses, regarding anti-money laundering compliance. For example, in an acquisition agreement where the target is a financial services business, a fund should consider obtaining a representation from the seller or target that it is in compliance with anti-money laundering and anti-terrorist laws and regulations.

5. Non-U.S. Funds. Fund sponsors should consult local counsel for information regarding the impact of Cayman Islands, EU or other anti-money laundering legislation on non-U.S. funds.

Conclusion. Recent developments in U.S. anti-money laundering legislation may well have ushered in an era of regulation for private funds. At a minimum, these developments have imposed new burdens on private investment funds that, in many cases, are unaccustomed to regulatory oversight. The next year will bring a series of regulations and recommendations that could have additional effects on the ways in which private equity funds raise and invest their capital. Private funds and fund sponsors need to be aware of these regulations not only because of the need to comply with the law, but also because of the reputational risks associated with such matters.

— Kenneth J. Berman, Michael P. Harrell, Shannon Conaty and Jennifer Spiegel

Italian Corporate Law Reform Promises Friendlier Deal Environment

In the past, Italy has not been a very friendly environment for mergers and acquisitions in general and particularly leveraged acquisitions. It seems, however, that this environment is about to change. In the late fall of 2001, the Italian legislature adopted a series of changes to its corporate law to facilitate investment. These changes, known broadly as the Reform Project, are expected to, *inter alia*, make LBOs easier when the rules implementing the Reform Project are announced in the next six months. In the meantime, private equity investors considering investments in Italy should be aware of two significant innovations promised by the Reform Project: a more favorable treatment of leveraged acquisitions and the broader array of choices of corporate governance mechanisms that will become available to Italian companies.

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Leveraged acquisitions

In the past, Italian law imposed severe restrictions on LBOs. Article 2357 of the Italian Civil Code (the "Civil Code") provides that an Italian corporation may only purchase its own shares through distributable profits and reserves. The financial assistance rules in Article 2358 of the Civil Code provide that an Italian corporation may neither subsidize nor provide any guarantee for the acquisition or subscription of its own shares. Both provisions were used to void LBOs in a number of cases in the early 1990s.

A more encouraging treatment of LBOs emerged from the Trenno case in 1999. Snai Servizi acquired a controlling interest in Trenno though an acquisition vehicle financed with the issuance of equity securities and with certain credit facilities. The acquisition vehicle, which had also acquired from Snai Servizi certain other related businesses, was then merged into Trenno through a reverse merger. The court of Milan, holding that a leveraged merger is not a *per se* violation of the financial assistance provisions of the Civil Code, suggested a case-by-case approach. The court reasoned that such a leveraged acquisition, if part of a broader corporate objective aimed at creating synergies for increasing the cash flow capacities of the companies involved, would be compatible with the financial assistance provisions contained in the Civil Code. The pendulum appeared to swing back, however, in a recent fraudulent bankruptcy case, when the Italian Supreme Court (without providing adequate reasoning) held that leveraged buy out structures violate the financial assistance provisions and are not allowed in the Italian legal system.

Given the scarce and conflicting case law, legal scholars have made significant contributions to the debate over LBOs. Some have defended LBOs on the grounds that they are compatible with the Civil Code because the vehicle is financed long before the acquisition of the target company and the assets of the target company are a generic and hypothetical security for the financing bank. On the other hand, detractors have argued that financial assistance provisions are triggered because the assets of the target company increase the likelihood that the acquisition lender will be repaid on its credit facility. Therefore, leveraged transactions could be viewed as sham transactions circumventing the financial assistance rules.

Against the uncertain background created by these few cases and conflicting opinions of scholars, the Reform Project seems to suggest that the implementing rules to be passed by the Italian government by October should create a safe harbor for LBOs by making it clear that leveraged mergers of companies do not violate the prohibitions against a corporation acquiring its own shares or the financial assistance rules. The text of the Reform Project seems to unconditionally approve leveraged acquisitions, but gives no guidance to the Italian government as to how this principle should be implemented. In light of the conflicting case law and of the divergence of scholarly opinion on this issue, it is likely that the implementing rules will contain restrictive terms and conditions limiting the availability of the safe harbor. While the Reform Project provides powerful evidence of a positive trend towards modernization of Italian corporate law, the full extent of the new legal framework for Italian LBOs will not be clear until the implementing rules are released.

Corporate Governance

The Reform Project also promises significant changes in the corporate governance arena by introducing significant changes to the rules governing corporate organization and director liability.

Structural issues
Under current law, the board of directors (*consiglio di amministrazione*) of an Italian company is responsible for managing and representing the company. In practice, the board of directors delegates many of its powers to one or more managing directors (*amministratore delegato*) and/or to the executive committee (*comitato esecutivo*). The internal board of statutory auditors (*collegio sindacale*) is responsible for supervising the board of directors.

The Reform Project provides that Italian companies will be permitted to choose between the current one-tier board structure and two alternative forms of governance: (i) the two-tier management board (*consiglio di gestione*)/supervisory board (*consiglio di sorveglianza*) structure, and (ii) the board of directors (*consiglio di amministrazione*)/audit committee (*comitato di controllo*) structure.

The management board/supervisory board structure is based on the German corporate governance structure (except that, under the Reform Project, the supervisory board seems to have a lesser involvement in the management, *e.g.*, does not approve the investment strategies of the management board). The duties of the supervisory board differ from the current supervisory duties of the internal board of statutory auditors (*collegio sindacale*) in that the supervisory board will be granted powers currently entrusted to the shareholders. These powers will include the powers to appoint and revoke the members of the executive board, to approve the financial statements and to assert claims against the members of the management board. In the board of directors/audit committee structure, an *ad hoc* audit committee, mainly composed of non executive and independent directors, will be formed as a part of the board of directors. This *ad hoc* audit committee will be entrusted with inspecting powers.

Liability issues
An Italian company's directors may face both civil and criminal liability in connection with the performance of their duties. Directors are subject to civil liability for a breach of (i) the duty of care, (ii) the duty of loyalty, (iii) duties contemplated in *ad hoc* provisions of the Civil Code, for example the duty to prepare the financial statements. With respect to the duty of care, directors are subject to the reasonable person standard of care, according to case law, a higher than average standard of care by reason of their position. Directors are subject to criminal liability in certain limited circumstances such as, for example, making misrepresentations in the financial statements in the company, divulging confidential information about the company or causing the company to distribute illegal dividends.

A civil action may be brought against directors by (i) the company (*azione sociale*), if approved by the majority of the shareholders; (ii) the creditors (*azione dei creditori*), if the directors' acts or omissions have depleted the company's assets; and (iii) third parties (including minority shareholders), if they can prove they were directly affected by directors' acts or omissions (for example, if minority shareholders subscribe to a capital increase because the directors have misrepresented the financial statements). In practice, the necessary approval for the *azione sociale* is rarely obtained and the *azione dei creditori* is filed by the trustee in bankruptcy proceedings.

Directors are jointly and severally liable to third parties but, within the company, liability is shared among directors and depends on the particular director's degree of negligence. A company may take out insurance policies to cover directors' liabilities. Such insurance policies, however, cannot cover directors' gross negligence, willful misconduct and criminal offenses. Even in the case where the directors delegate their powers, the directors maintains supervisory powers and responsibilities.

The Reform Project provides that companies may specify in their by-laws certain qualifications for their directors (*e.g.*, good standing, relevant skills, independency requirements). Such qualifications are currently mandatory only in certain businesses, such as insurance and banking. Although case law has already developed in this respect, directors may be subject to a higher standard of care if the practice develops for Italian companies to require certain qualifications for directors.

The new legislation will provide certain qualified minority shareholder access to the company's civil action (*azione sociale*) against directors.

Under certain circumstances, however, establishing a director's criminal liability will be harder than under current legislation. For example, under the new legislation directors may be criminally liable for misrepresentations in the company's financial statements only upon proving the directors' misrepresentations, including by means of omitting facts, were material and aimed at deceiving shareholders or third parties with the intention of making unlawful profits.

The exact ramifications of the Reform Project will be clear only after the release of the implementing rules. For the time being, however, private equity investors can take some comfort from the fact that the Italian lawmakers appear interested in dealing with some of the perceived difficulties that face foreign investors in Italy. ▢

— Maurizio Levi-Minzi and Giancarlo Capolino Perlingieri

Marketing Guidelines in Private Placements

You are a senior principal of a private equity fund sponsor about to launch Fund IV. *The Wall Street Journal* calls and wants to interview you. You gladly grant the interview and extol the virtues of past fund performance and cheerfully announce you are looking forward to closing your fourth successful fund. Things never looked better. Not so fast! When the article appears the next day, you get an urgent call from counsel who explains that your marketing of Fund IV will have to be delayed to allow for a cooling off period. What just happened? You have just come close to losing your private placement exemption. This article will explain how the exemption works, the steps fund sponsors need to take to preserve it and how to avoid the pitfalls of a significant delay in marketing or closing a fund.

Private equity funds are typically formed by offering investors partnership interests in a limited partnership (a "Fund") with the fund sponsor as general partner. Such an offering requires registration under the Securities Act of 1933 (the "Securities Act"), unless an exemption from registration is available. Private equity funds generally avoid a registered offering by relying on Section 4(2) of the Securities Act, (which exempts from the registration requirements of the Securities Act all "transactions by an issuer not involving any public offering") and on Regulation D, the safe harbor for private placements promulgated under the Act by the Securities and Exchange Commission (the "Commission").

Counsel will typically provide at the Fund's closing a legal opinion that the Offering was not required to be registered under the Securities Act, and that the Fund will not be required to be registered under the Investment Company Act of 1940 (the "Investment Company Act").[1] Counsel will not be able to provide this opinion, which is required as a condition to closing the Fund by the Fund's limited partners, absent representations from the client and the placement agent that the offer was made in accordance with the requirements of Section 4(2) of the Securities Act and Regulation D, including that no form of general solicitation or general advertising occurred.

The Exemptions

Most funds qualify for the safe harbor under Regulation D. Rule 506 of Regulation D requires that the Fund, as issuer of the limited partnership interests, "reasonably believe" that there are no more than 35 purchasers who are not "accredited investors." Therefore, assuming that all the other requirements of Regulation D are met, an unlimited number of accredited investors may invest in the limited partnership interests without jeopardizing the availability of the Regulation D exemption. Accredited investors include natural persons whose individual or joint net worth with their spouse, exceeds $1 million or who had an individual income in excess of $200,000 or $300,000 with their spouse in each of the two most recent years, and has a reasonable expectation of reaching the same income level in the current year.

Under both Section 4(2) of the Securities Act and Regulation D, the requirement that the offering not involve "any public offering" means that during the course of soliciting investors (the "Offering"), no general solicitation or general advertising has occurred, including, for example, any advertisement, article, notice or other communication published in any newspaper, magazine or similar media, or broadcast over television or radio; or any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Avoiding the Pitfalls

So why was your counsel so perturbed? At the upcoming closing, the Fund sponsor and placement agent will need to make representations to support counsel's opinion as to the private placement exemptions. The making of such representations by the Fund's representatives and reliance thereon by counsel would be difficult if the client is quoted by the press discussing the Offering or the new Fund it is in the process of raising. Equally problematic would be a section of the client's Web site devoted to the Fund it is in the process of raising – we have seen Web sites with a link for investors to contact the fund sponsor for more information (it might as well say "widows and orphans, send money here!").

In these situations, counsel will typically propose a cooling-off period prior to continued marketing and/or the first closing of the Fund. Additionally, if the Commission believes the conduct of the sponsor has constituted a general solicitation, the Commission could impose a significant cooling-off period (such as six months) to follow the general solicitation. We know of at least one instance where the Commission has imposed a six-month cooling-off period after an article appeared quoting an executive discussing fund raising. We, have, on occasion, also imposed cooling-off periods on our own clients (e.g., of 60 days) prior to continued marketing or, in some cases, actual closing of the fund.

Most clients ask "but really, how can this be? Our target market consists of major institutional investors, and the individuals we target are so high net

1 The requirement that the private placement not involve any public offering is a critical component of the exemptions from registration under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, on which many private funds rely to avoid registration. Fortunately, the test under the Investment Company Act is satisfied by a private offering under the Securities Act. In other words, satisfying the private offering requirements under the Securities Act will also satisfy the private offering requirements of the relevant Investment Company Act exemptions.

worth that they meet the accredited investor test. These investors are sophisticated enough to ask detailed questions about our track record and engage their own advisors. They are not going to invest in our Fund just because we were quoted in the newspaper. The press is reporting our Offering based on information from third parties and existing limited partners – and not all of it's accurate. How can we not at least correct the misinformation? And the widows and orphans who logged on to our Web site and e-mailed us, well, we certainly aren't going to allow them to invest."

What's the answer? That may be true, but it doesn't matter. Unfortunately, this is one of the few areas on which the law is clear. And as individual high net worth investors comprise an increasingly significant part of the investor base for many private equity funds, it is becoming more of a possibility that advertising and press coverage may increase awareness and actually condition the market for some in that class of investor.

Perhaps the most critical advice? When in doubt, consult with counsel who will be providing the private placement legal opinion. Of course, if the Fund sponsor typically makes public statements regarding its business or activities unrelated to marketing the Offering (for example, an acquisition or disposition made by a prior Fund, or a change in the Fund sponsor's investment professionals), it may continue to do so. (A common analogy is that when a company has a stock offering, whether public or private, it continues to advertise its products in the same manner as before the offering.) But we advise that any press release or other public document or statement mentioning the private equity business of the Fund's sponsor should be reviewed by counsel to ensure that it does not contain statements that might be construed as an attempt to "hype" or condition the market for limited partnership interests (e.g., disclosure of prior fund performance data) or otherwise publicly solicit interest in investing in the Offering.

Guidelines

So the stakes are clear: to avoid a potentially significant delay in raising your Fund, avoid any form of general solicitation during the Fund's marketing period.

In addition, we recommend the following guidelines:

1. The fund sponsor and placement agent should only contact entities known by them to be accredited investors on the basis of previous experience (i.e., "cold calling" of accredited investors is generally prohibited, as is a broad mailing, even if limited to institutional investors, in the absence of a prior substantive relationship).

2. There should be no press releases, press conferences, publicity or advertising (in any publication, on radio or television, or over the Internet) mentioning the Offering.

3. Inquiries from reporters regarding the Offering should be met with a "no comment" response.

4. Participation in any panel or conferences open to the general public, or at seminars where not all invitees are institutional or accredited investors with whom the speaker has a prior substantive relationship, should not mention the Offering or make statements that might be construed as an attempt to "hype" or condition the market for the partnership interests.

5. There should be no attempts to obtain feature articles or other coverage by U.S. newspapers or other media, either in respect of the Fund, its investment strategy or the Offering.

6. Be even more conscientious in the case of dual U.S./international offerings.[2]

The Do's and Don'ts of Press Relations

How does the Fund sponsor manage compliance within its organization when dealing with the press and ongoing public communications about its business and ongoing activities? The following "do's and don'ts" might be helpful:

1. Do limit the persons authorized to talk to the press to a small number of professionals who have been fully briefed by counsel.

2. Don't embark on a public relations campaign during the marketing period, but do continue within the scope of your current communications without any reference to any specific fund in the market;

3. Don't mention specific facts about existing funds that might be of interest to prospective investors, such as investment returns;

4. Do respond to prior inquiries about the Offering or the Fund in the market with "no comment."

5. Don't be lured into responding to a reporter's question which states an inaccuracy about your prospective fund. Do tell the reporter that the facts he or she has stated are inaccurate but that your lawyers have advised you that your response to such comments must be "no comment."

6. Do limit your communications to those designed to attract deal flow, not investors (e.g., discussing your investment focus, types of portfolio companies in which you would be interested in investing).

7. Do maintain a contemporaneous record of these inquiries for your protection in the event you are misquoted.

8. And most importantly, don't forget to consult counsel before engaging in any questionable conversations or activities.

— Rebecca F. Silberstein

2 It is possible to offer the partnership interests in the U.S. pursuant to Regulation D and outside the U.S. in reliance on Regulation S, and publicity outside the U.S. is generally not restricted under Regulation S. However, because of the difficulty of controlling the flow of information from outside the U.S. to inside the U.S., the Commission has been particularly vigilant about publicity overseas that is picked up by the U.S. media in connection with international offerings involving a U.S. private placement. The fund sponsor must take sufficient precautions to prevent information ostensibly intended for the overseas press from appearing in the U.S. Prior clearance from counsel should be obtained before the Fund sponsor engages in offshore publicity or advertising that might find its way into the U.S.

the ability of Spinco Target to operate as a stand-alone business, thereby allowing Parent to effect the spin-off earlier than it would have otherwise been able to do so. In addition, the spin-off may facilitate a more direct incentive structure for management compensation. Further, the participation of a private equity fund as an "anchor" investor in Spinco Target may serve to validate Parent management's decision to spin off the business and the choice of the management team selected to lead Spinco Target.

There are also disadvantages attendant to a post-spin-off investment by a private equity fund. Under the Anti-Morris Trust rules, if the investment is agreed to prior to or within six months after the time of the spin-off, the private equity investor will not be permitted to acquire 50% or more by vote or value of the shares of Spinco Target. As a result, the private equity investor will not be able to exercise outright control over Spinco Target or its board of directors. As discussed in greater detail below, a subsequent change of control of either Parent or Spinco Target within the two-year period following the spin-off could result in burdensome taxes being imposed on Parent. Spin-offs can also involve significant transaction costs, and Parent and its shareholders receive no proceeds from the distribution of shares. Moreover, unlike a privately held portfolio company, Spinco Target will continue to be subject to SEC reporting requirements, and the value of the shares will continue to fluctuate in the market.

Structuring Considerations

Separation Issues. Unless the spin-off business currently operates autonomously on both an operating and financing basis, a spin-off will raise a series of separation issues, similar to those faced in connection with an asset purchase of a division. Generally, a distribution agreement will allocate assets and liabilities, including contingent liabilities and debt between Parent and Spinco Target. Parent and Spinco Target may also need to enter into transitional service arrangements and intercompany licensing arrangements for shared technology. In connection with a spin-off, Parent and Spinco Target will also enter into a tax sharing arrangement for allocating pre-spin-off tax liabilities and tax benefits, as well as responsibility for any taxes that are imposed on Parent if the spin-off fails to qualify as a tax-free transaction. Although Spinco Target will establish its own management incentive plans, there typically will also be a need for a separate agreement allocating pre-spin-off assets and liabilities relating to employee benefits between Parent and Spinco Target. The private equity firm will want to be actively involved in negotiating the terms of these separate arrangements and any indemnities that accompany them.

Control issues. As mentioned above, if the private equity fund's investment is agreed to in connection with the spin-off, under the tax rules the private equity fund generally will not be permitted to acquire 50% or more by vote or value of the shares of Spinco Target. Since, for tax purposes, voting power is generally measured by a shareholder's power to appoint directors, the fund also will not be able to control Spinco Target's board of directors. The fund may nevertheless be able to obtain practical control if the remaining ownership of Spinco Target is highly dispersed. In addition, the private equity firm may be able to negotiate veto rights, both at the shareholder and board of directors level, although these must be carefully tailored to avoid giving the fund "deemed control" over Spinco Target for tax purposes. Control arrangements, as well as representations relating to the target business and other arrangements relating to the private equity fund's investment, would be set forth in a separate investment agreement.

Debtholder issues. In connection with the spin-off, the existing debt of the group must be allocated between Parent and Spinco Target. A significant due diligence issue is whether the spin-off will violate the terms of the indentures or credit agreements governing the debt of either company. As many indentures and credit agreements restrict the amount of dividends or distributions to shareholders or the disposition of "all or substantially all" or significant portions of a company's assets, a spin-off may be subject to the debtholders' consent.

In order to inject an appropriate amount of leverage into Spinco Target, it may be desirable to allocate a disproportionate amount of debt to the target company in connection with the spin-off. One practical limit on pushing debt into a subsidiary that is to be spun off, however, is the Parent's tax basis in the subsidiary; any excess amount of debt will give rise to corporate tax in connection with the spin-off.

In order to increase flexibility in allocating debt between Parent and Spinco Target, it may be preferable for Parent to transfer all of its non-target business to a new subsidiary, leaving behind the target business together with an appropriate amount of debt. Parent would then spin off the new subsidiary and the private equity investor would acquire shares in Parent containing only the target business. Of course, if the non-target businesses are significantly larger than the target business, this reverse structure may significantly increase transaction costs. Also, since any company-level taxes resulting from the spin-off's failure to qualify as a tax-free

transaction will be imposed on Parent, the private equity fund's investment will be subject to a significant contingent liability. In this situation, a good tax indemnity is critical.

Tax issues. A spin-off must satisfy a number of technical requirements to qualify as a tax free transaction. If a spin-off does not satisfy these requirements, Parent will be subject to tax on the excess of the value of Spinco Target over Parent's tax basis in the shares of Spinco Target. In addition, Parent's shareholders will be treated as having received a taxable distribution from Parent equal to the value of Spinco Target.

The principal requirements for a tax-free spin-off are:

- Parent and Spinco Target each must have been engaged in an active trade or business during the entire five-year period prior to the spin-off;
- Parent must distribute stock that constitutes at least 80% of the Spinco Target's voting stock and 80% of each other class of stock, and generally cannot retain any shares of Spinco Target;
- the spin-off must be undertaken for an IRS-approved "corporate business purpose" (including facilitating an investment in Spinco Target or Parent);
- the spin-off cannot be principally a "device" for distributing earnings to the shareholders of Parent; and
- the shareholders of Parent must retain a continuing interest in both Parent and Spinco Target.

As discussed above, a spin-off that is followed by an investment must also satisfy the Anti-*Morris Trust* rules that generally provide that, if an otherwise tax-free spin-off is part of a plan pursuant to which one or more persons acquires shares constituting 50% or more by vote or value of either the Parent or the spin-off company, the spin-off will be treated as taxable to the Parent company, but not necessarily to the shareholders. A plan will be presumed to exist if a change of control of Parent or the spin-off corporation occurs at any time during the two years prior to, or the two years following, the spin-off.

Recently issued Treasury regulations provide additional guidance on when a spin-off and a subsequent acquisition are considered to be part of a plan for purposes of the Anti-*Morris Trust* rules. The regulations list a number of facts and circumstances that must be weighed in determining whether the acquisition is part of the plan, and also provide for several safe harbors that, if satisfied, prevent a spin-off and an acquisition from being considered as part of a plan. Unfortunately, a spin-off that is followed by a pre-arranged investment in Parent or the spin-off company will not qualify for any of the safe harbors. As a result, such an investment must be limited to less than 50% of the shares of the target company by vote or value. For this purpose, an option granted in connection with the investment will be treated as exercised, unless Parent can establish that, upon the later of the date of the spin-off and the date of the grant, there was a 50% or smaller possibility that the option would be exercised. In the event the private equity investor approaches a spun off corporation after the spin-off has been effected and a six-month "cooling-off" period has occurred, and if the spin-off was motivated by a corporate business purpose other than to facilitate an acquisition, a safe harbor may apply that would permit a private equity investor to acquire 50% or more of the spin-off company or the Parent.

Shareholder Approval

Shareholder approval is not required for most spin-offs. Section 271 of the Delaware General Corporation Law requires shareholder approval only for a sale, lease or exchange of all or substantially all of a company's assets. The relevant cases suggest that a spin-off is not a sale, lease or exchange. Furthermore, in the majority of spin-offs, the assets being spun off will not represent "all or substantially all" of the company's assets. A transaction involving a major reshuffling of the company's subsidiaries or assets, followed by the spin-off of substantially all of the company's assets, may require shareholder approval under Delaware law and other states' law such as New York, which require shareholder approval for a sale, lease, exchange or other disposition of all or substantially all assets.

Securities Law Issues

The federal securities law issues relating to spin-offs are fairly well settled.

In September 1997, the SEC's Division of Corporate Finance (the "Division") released a staff legal bulletin setting forth the factors the Division would consider to determine whether a subsidiary being spun off by its parent company would be required to register the spin-off under the Securities Act of 1933, as amended (the "33 Act"). The Division stated that it would not require registration in cases where:

- Parent's shareholders do not provide consideration for the spun-off shares;
- the spin-off is *pro rata* to Parent shareholders;
- Parent provides adequate information about the spin-off and the subsidiary to its shareholders and to the trading markets;
- Parent has a valid business purpose for the spin-off; and
- if Parent spins off "restricted securities," it has held those securities for at least two years.

The Division explained that the first two factors help satisfy the requirement that the spin-off not involve a "sale" of the securities by Parent by ensuring that shareholders not give up value for the spun off shares. To satisfy the third factor, the subsidiary, if not already a reporting company under the Securities Exchange Act of 1934, as amended (the "34 Act"),

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Sponsored Spin-offs (continued)

is required to file with the SEC on a Form 10 and provide to the shareholders an information statement, which contains essentially the same disclosure as required for a registration statement on Form S-1 under the 33 Act. The fourth factor – the need for a valid business purpose – also addresses the issue of whether the parent company receives value for the spun-off shares. Examples of a valid business purpose are allowing management of each business to focus solely on that business, providing employees of each business stock-based incentives linked solely to his or her employer or business' performance, enhancing access to financing by allowing the financial community to focus separately on each business and enabling the companies to do business with each other's competitors.

For the Division, the fifth factor ensures that Parent will not be deemed an underwriter engaged in a public distribution of "restricted securities." The two-year holding period does not apply where Parent formed the subsidiary being spun off.

Staff Bulletin No. 4 also confirms that the Division will not require 33 Act registration simply because the parent company asks its shareholders to vote on the proposed spin-off. So long as there is a valid business purpose for the spin-off, the Division declared that a vote on the asset transfer that may be involved in the spin-off does not change the overall nature of the transaction.

Form 10 is used to register the spun-off securities under the 34 Act. Much like an S-1 prospectus, the information statement included in the Form 10 describes the spun-off company's business, properties and management, and includes information on executive compensation, employee benefit plans, financial data, management's discussion and analysis of results of operations and financial condition and historical and *pro forma* financial statements. SEC review of a Form 10 registration statement is substantially similar to that for an S-1.

Structuring the sale of a non-core business as a spin-off clearly involves significant and challenging hurdles and will require close coordination with counsel and other advisors; yet it can often be the only good way for a corporate parent and a prospective private equity investor to tap the pent up value in an underutilized line of business. ■

— Paul S. Bird and Peter F.G. Schuur

Guest Column (continued)

Many of the major U.S. players such as Clayton, Dubilier & Rice, Inc.; Texas Pacific Group; Kohlberg Kravis Roberts & Co.; Providence Equity Partners and The Carlyle Group have entered the European market. In most cases, initial offices have been set up in the UK. Some are beginning to venture further onto the continent.

Their presence is reflected in the share of European deal value taken by U.S. investors, which has risen from 4% in 1997 to 13% in 2001, with a further 7% share in 2001 accounted for by syndicates which included U.S. players. U.S. private equity investors have been successful with some European investments made from their U.S. operations, such as Texas Pacific Group's acquisition of Ducati and Bain Capital's investment in SEAT. However, many U.S. players have found entering Europe on their own and expanding across the continent challenging. Several, such as Blackstone and Bain Capital, have been in Europe for several years but have yet to do many deals from their European operations.

There have been some high-profile successes though, such as KKR's acquisition and subsequent IPO of financial services firm Willis Corroon. But other than that, there have been very few exits to date by U.S. investors, and so it is too early to judge success.

Is it too late to get in the game?

U.S. private equity investors that have not yet entered the European market will find themselves behind when they do, particularly give barriers to entry such as the need to build local networks in European markets. U.S. players currently in Europe are trying to build these networks, for example by recruiting senior advisors such as former UK Prime Minister John Major at Carlyle, or senior industry figures as investment professionals. A thorough understanding of opportunities within each market and European industry trends and structures and the strategic issues facing particular acquisition targets will be critical to success. ■

— Geoffrey Cullinan, based in London, and Tom Holland, based in San Francisco direct Bain & Company's global private equity practice. Simon Baines, a London-based consultant, assisted with this article.

Contractual Constraints.

In the old days (the late 1990s), when each subsequent round was higher than the last, investors did not always focus on the divergent interests of each class of preferred. Now they must. Generally, holders of the preferred stock will have the right to approve, among other things, *(i)* the issuance of securities senior to or on a parity with the existing preferred stock, *(ii)* alterations to the rights of the existing preferred stock and *(iii)* the sale or merger of the Company.

Accordingly, the existing preferred stock must approve the financing that will dilute their shares, and the new money investors must not only negotiate a deal with the Company, but also with the existing investors.

When a subsequent round of preferred stock is sold, it is most important to determine whether the existing high priced investors will vote with the new lower-priced subsequent round as a single class or whether each round will vote separately. For example, if the Company proposes a merger netting the early investors a simple return of their investment or less and netting the new down round investors a return equal to a multiple of their money, it is likely these two classes of investors will have divergent views on the transaction. If, after giving effect to the down round, the new money will control a majority of the preferred stock as a class, then the new money will insist that all the preferred stock vote together as one class (as opposed to each series of preferred stock voting separately) so that the higher priced investors cannot veto a transaction favorable to the lower-priced preferred stockholders. If the new lower priced investors do not control the preferred stock as a class, they may require a separate vote for the new money and that the special voting rights of the higher priced preferred stock be eliminated. (If the valuation of the down round is dramatically less than the earlier rounds, the new money may simply insist that the existing preferred stock be converted into common stock in order to eliminate such conflicts.)

In addition to carefully reviewing the list of matters subject to the separate vote of preferred stockholders, it is critical to review a post-closing *pro forma* capitalization table in order to determine the appropriate percentages needed to approve such matters (the Company will generally ask for a simple majority) and whether the holders of preferred stock vote as one class or each series votes separately. Similar reviews should be made of existing Stockholder Agreements, Registration Rights Agreements and other ancillary agreements.

Legal Issues.

Directors have a duty of care and a duty of loyalty to the Company and its stockholders and, in certain cases, to the creditors. (See “Troubling Times for Directors of Portfolio Companies,” *The Debevoise & Plimpton Private Equity Report*, Winter 2002).

If individual directors (or the funds they represent) plan to participate in the down round, the Board must be particularly careful that the terms of the round are fair to the Company and that the process in which the Company approved the transaction was itself a fair process.

It is important for the Company and the Board to solicit as many bids as possible in order to obtain the best possible deal and to create a record of a deliberate and fair process. An investor with no pre-existing interest in the Company leading the down round (as opposed to a group of existing investors with conflicting interests) is particularly helpful. Engaging an investment banking firm to solicit bids and assist the Board in exploring options is often helpful should the Board subsequently need to defend the price of a down round.

Another protection against claims from existing stockholders is to offer all stockholders the right to participate in the dilutive financing. However, any such offering must comply with Federal and state securities laws. If the Company’s existing stockholders include non-accredited investors, an offering of the dilutive securities to all investors in compliance with applicable securities laws may be expensive and time consuming. If timing is an issue, the Company may sell the dilutive securities to the accredited investors and hold a subsequent closing for the non-accredited investors after it has prepared the necessary offering materials to comply with Federal and state securities laws. Even if the costs of complying with applicable securities laws exceed the expected proceeds of an offering to non-accredited investors, many Companies will make such an offering in an attempt to protect itself (and the Board) against subsequent claims from such non-accredited investors.

Boom times will return, but venture capital investors will likely remember the lessons learned from down rounds for several years to come.

— David J. Schwartz

taxes. A UK branch or subsidiary will not be subject to withholding and employment tax obligations in relation to an adviser who is treated as an independent contractor for UK tax purposes. If, however, the relationship between the adviser and the branch or subsidiary too closely resembles an employer-employee relationship, the UK withholding and employment tax rules for employees will apply to the subsidiary or branch, even if the adviser's contract specifies that the adviser is an independent contractor.

Special rules apply to the taxation of non-resident employees who are only present in the UK on a temporary basis and to UK resident employees who are not "domiciled" in the UK for UK tax purposes. Although the definition of "domicile" is very fact-specific, a non-UK national who does not intend to remain in the UK on a permanent basis generally will not be treated as having a UK domicile. Under current UK law, a fund manager may be able to structure compensation arrangements for an employee who has responsibilities both inside and outside of the UK, but who is not domiciled in the UK, so that compensation relating to the non-UK services is not subject to UK tax unless it is "remitted" to the UK. Individuals who are resident but not domiciled in the UK should also be able to shield certain non-UK capital gains from UK tax unless the gains are remitted to the UK. There has been recent speculation in the UK press that the UK Treasury will propose to change the rules described above so that any individual residing in the UK for more than four years will become subject to UK tax on his or her worldwide income. Similar proposals have been rejected in the past, and at present it is not possible to predict whether, or in what form, the proposal will be made or adopted. In any event, compensation arrangements in relation to key UK-based employees and arrangements with respect to any carried interest to be allocated to UK-based employees for private equity funds managed by the U.S. manager must be closely scrutinized to ensure they are structured in a tax-efficient manner from both a UK and U.S. tax perspective.

Authorization Process

The FSA Application. The information required to be provided for authorization pursuant to the UK Act is more intrusive than that required for registration under the U.S. Act.

Subsidiary	Branch Office
FSA authorization required	FSA authorization required
Investment advisory agreement with parent required	U.S. firm exposed to liability for actions of branch
Able to conduct certain regulated investment activities in other European countries	Separate authorization required to conduct regulated investment activities in other European countries
Subject to 30% UK corporation tax	Subject to 30% UK corporation tax
Subsidiary files UK tax return	U.S. firm files UK tax return in respect of branch operations
Audited reports must comply with the Companies Act 1985	Audited reports may be completed in accordance with U.S. firm's reports

The FSA application forms require the firm to provide extensive information about its operations and owners, including a business plan describing the regulated and unregulated activities the firm intends to conduct, details on management and organizational structure, anticipated outsourcing arrangements, budgets (including projections), compliance procedures, control systems and supporting documentation. In addition, the application requires the individuals who control the firm to disclose personal financial information. Although this information is kept confidential, many U.S. fund managers find this level of scrutiny highly objectionable.

Furthermore, as "threshold conditions" to approving the application, the FSA considers the firm's affiliate relationships or "links" (particularly links with entities outside the EU, where financial services may be less regulated), the adequacy of the firm's financial resources, and whether the firm and its senior personnel are "fit and proper" to perform the functions and activities proposed in the application.

After the application is submitted, the FSA may demand additional information, investigate the firm's compliance with other regulatory regimes and agencies, require the firm's representatives to appear before the FSA and answer questions, or visit the firm's place of business. The firm may also have to provide, at its own expense, a report by an accountant or actuary on any matters that the FSA chooses, such as the firm's internal systems and controls.

In general, the FSA authorization process is intended to ensure that only suitable firms and individuals engage

in regulated activities. The FSA has authority to deny authorization to persons it deems undesirable or otherwise unsuitable to engage in regulated activities.

The SEC takes a different regulatory approach, requiring registration of firms that provide investment advisory services to more than the specified number of clients (or that otherwise hold themselves out to the public as providing such services) and then subjecting these firms to regulation under the U.S. Act. The information required in the application for registration with the SEC is more limited. A manager registering under the U.S. Act files a Form ADV with the SEC. This form requires certain identifying and financial information about the firm and its business, including details about the types of clients to which it will provide advisory services, the basis of compensation, investment policies and procedures, and educational and employment background of its owners and officers and certain employees. Registration usually becomes effective by SEC order within 45 days of filing.

Individuals. A UK firm that is itself authorized must also ensure that its individual employees and outside service providers that perform certain "controlled functions" specified by the FSA are also authorized. UK employees who undertake investment management activities, provide investment advice, arrange transactions in securities or oversee back-office functions related to managing investments are required to pass an examination on the rules regulating the particular activity. There is no comparable requirement for a U.S. private equity firm.

Most Americans who work in their firm's London office consider the exams onerous and do not take them, at least not initially. The London office is usually staffed with at least one or two people who have been based in the UK for some time and have already passed the exams. Over the next several years the FSA is expected to revise the examination structure, which currently encompasses many overlapping tests, a vestige from the era before the UK Act when several self-regulating organizations performed the work of the FSA.

Timing. Applications by firms must be decided upon by the FSA within six months of submission, although the FSA is striving for a turnaround time closer to three months. For individuals applying for authorization, the FSA can take up to three months to decide, but generally processes these applications more quickly (usually within a few weeks).

A firm cannot undertake regulated activity until FSA approval is received. During the period between submitting an application and receiving FSA authorization, an applicant may only conduct activities that are exempt from the general prohibition on carrying out regulated activities in the UK. In contrast, from the date a U.S. firm files the Form ADV with the SEC, it operates as a registered investment adviser and is subject to regulation under the U.S. Act.

Application Fees. Application fees vary based on the complexity of the application. Fund manager applications are normally regarded as moderately complex cases and are subject to a fee of £5,000 (about $7,100) per application. There is no application fee for individuals applying for FSA authorization, but there is a small examination fee.

Operating as an Authorized Person

Once a firm obtains the authorization to conduct investment business, it becomes an "authorized person." Authorized persons are subject to separate FSA rules and disciplinary procedures that form an additional layer of regulation and compliance requirements on top of the UK Act. Authorized persons must appoint a compliance and anti-money laundering officer and are subject to detailed rules on the conduct of investment business, including record keeping, marketing to and advising clients, best execution practices, protection of client assets and other requirements. An authorized person should generally expect an inspection by the FSA within its first year of operation and thereafter at least once every three years. There is no client disclosure requirement comparable to the "brochure" rule under the U.S. Act, which requires a registered investment adviser to distribute a copy of Part II of its Form ADV to its limited partners on an annual basis.

Firms may be fined or censured by the FSA for acting outside the scope of their FSA authorization (although acting outside the scope is not a criminal offense). Firms can apply to the FSA to broaden, narrow or cancel their authorizations as business needs change.

A firm cannot undertake regulated activity until FSA approval is received... In contrast, from the date a U.S. firm files the Form ADV with the SEC, it operates as a registered investment adviser...

Before a manager opens a London office and begins marketing interests in a private investment fund into or out of the UK, the manager should consult with counsel on these and other UK regulatory and tax considerations.

— Sherri G. Kaplan, Geoffrey Kittredge and Dale Gabbert

alert

Alert: Recent Amendments to CERCLA Limit Liability for Purchasers

On January 11, 2002, President Bush signed into law the "Small Business Liability Relief and Brownfields Revitalization Act." The Act amends the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" also known as "Superfund") by, among other things, exempting certain purchasers of contaminated property from CERCLA liability, which could be good news for private equity firms refocusing on traditional old economy businesses. The Act also establishes a program to encourage the redevelopment of abandoned or underutilized industrial properties known as "Brownfields."

Highlights of the Act include the following:

- It exempts from CERCLA liability "bona fide prospective purchasers" of contaminated property even if such purchasers were aware of the contamination prior to their purchase. To qualify for this exemption, the new owner must, among other things, have (i) conducted an "appropriate inquiry" into environmental conditions at the property, (ii) not contributed to the contamination, (iii) taken reasonable steps to stop any continuing contamination and prevent or limit exposure to the releases, (iv) cooperated with regulators, (v) provided access to persons conducting investigative and remedial activity, and (vi) complied with land use restrictions.
- It relieves certain owners of contaminated property from CERCLA liability if the contamination resulted solely from contaminants that migrated from a contiguous property.
- It clarifies the so-called "innocent landowner defense" for purchasers of contaminated property who did not learn of the contamination at the time of purchase despite undertaking environmental due diligence with respect to the property.
- It establishes federal grants and loans to state and local agencies for investigating and remediating Brownfields sites.

While it remains to be seen what impact the Act will have on private equity transactions, the following points are worth noting:

The Act only impacts liability under CERCLA and has no effect on a purchaser's liability under state environmental laws, which are often the source of environmental liability in private equity investments. In addition, the Act does not impact potential obligations under other federal environmental laws, such as citizen suits that may be brought under the Resource Conservation and Recovery Act.

Moreover, the Act is not likely to act as a windfall to purchasers of contaminated property. The Act provides that if the property's market value is enhanced because the EPA expends funds remediating the property, the EPA may impose a "windfall lien" on the property for the enhanced market value.

The Act may impact how investors conduct their environmental due diligence. For purchasers to avail themselves of the new exemptions, the Act generally requires that they have conducted an "appropriate inquiry" into the environmental conditions of a property. Purchasers may need to seek advice to help determine whether "appropriate inquiry" has been made. (The Act establishes interim due diligence standards for "appropriate inquiry" and requires the EPA to promulgate regulations within two years that establishes final due diligence standards.) In addition, in order to avail themselves of the new exemptions, purchasers will want to establish a reliable record that releases of hazardous materials occurred entirely pre-acquisition.

Similarly, the new exemptions generally require that the purchasers not take actions post-acquisition that contribute to contamination or hinder cleanup efforts. Investors will need to ensure that their actions do not run afoul of these provisions.

Finally, because of these amendments, investors may find it easier to avail themselves of the new CERCLA exemptions if they structure transactions as asset purchases. As a corollary, sellers may be more aggressive in trying to shift environmental risks to purchasers.

Future EPA guidance or judicial interpretation may help provide clarity to the Act. We will be watching closely as the EPA, state authorities and the courts begin the process of interpreting these new provisions.

— Stuart Hammer and Harry Zirlin

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