

The Sarbanes-Oxley Act's Surprising Impact on Private Equity

Although the Sarbanes-Oxley Act of 2002 (the "Act") was designed to address many of the recent, well-publicized accounting and governance scandals involving large publicly held companies, its impact extends far beyond the members of the S&P 500. The Act has some real (and in some instances, perhaps unintended) consequences on companies that have issued public debt securities but not public equity securities. As anyone who has ever pored over a funds flow memo at 3:00 in the morning knows, many portfolio companies of private equity firms fit that description.

Thus it was with only slight surprise and bemusement that we watched approximately 200 private equity professionals file into our 35th floor conference center on September 25 to hear from a group of panelists including Merrill Lynch's David Webb, PricewaterhouseCooper's Raymond Beier, Clayton, Dubilier & Rice, Inc.'s Kevin Conway, *The Deal's* John Morris and Debevoise partners Peter Loughran, Larry Cagney and Franci Blassberg, regarding the effect of the Act on private equity. As the attendees learned, the Act's internal inconsistencies and the lack of guidance from the SEC on many of its provisions make definitive answers to many questions difficult. However, what is clear is that the impact of the Act may result in significant changes in the way private equity firms do business.

On-Again, Off-Again

The threshold issue that underlies many of the others discussed at the seminar is under what circumstances a "debt filer" is considered an "issuer" under the Act.¹

¹ The Act defines "issuer" as any issuer of securities (1) the securities of which are registered under Section 12 of the Exchange Act (i.e., is listed on an exchange or has over 500 holders); (2) that is required to file reports under Section 15(d) of the Exchange Act because it has filed a registration statement with the SEC; or (3) that has filed a registration statement with the SEC that has not yet become effective and has not been withdrawn.

The answer depends on timing. "Voluntary" filers (i.e., those companies that are no longer required to file periodic reports pursuant to the Exchange Act because they have fewer than 300 holders of their securities, but that are contractually obligated to file reports under their high-yield indenture) are not covered by the definition of "issuer" in the Act. However, a company cannot become a voluntary filer unless it has first filed a registration statement under the 1933 Act, thus making it an "issuer" under the Act. Even after a company becomes a voluntary filer, it will become an "issuer" again if it files another registration statement with the SEC (either for debt or equity). This on-again, off-again status is one of many examples in the Act where the treatment of voluntary filers is not altogether clear. Also, the SEC may decide to hold voluntary filers to the same standard as all other filers, and treat them as "issuers" under the Act. This would not be inconsistent with the SEC's historical position on the treatment of voluntary filers. However, for now, a voluntary filer is not technically an "issuer" under the Act; but

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"Because of the new financial statement certification requirements, we've adopted a more conservative revenue recognition policy."

letter from the editor

Like the business community at large, the private equity sector is facing a new level of public scrutiny. In this sensitized environment, one of the issues receiving focused attention is the public disclosure – and risk of potential future disclosure – by public pension funds of information that has traditionally been treated confidentially by limited partners of private equity firms. The issue potentially goes far beyond disclosure of unrealized or incomplete return data. Although there are many arguments on both sides of this complicated issue, we are concerned that the decision by some public pension funds to disclose such information – and the risk that others will be forced to do so by public pressure and/or by Freedom of Information Act requests – ultimately will lead to less rather than more disclosure by private equity firms.

For example, in reliance on the confidentiality provisions of their limited partnership agreements, many private equity firms have felt comfortable sharing with limited partners material non-public information about their portfolio companies, competitively sensitive business information about portfolio companies and predictions about the timing of potential exit opportunities which could be deemed “gun-jumping” if publicly disclosed. The public disclosure of such information could violate applicable securities laws and harm the competitive positions of portfolio companies. Thus, if limited partners are being required to disclose publicly the information in their files, funds may be less willing to disclose this information to limited partners in the first place. It would be perverse indeed if the focus on transparency were to lead to less disclosure or, if disclosure were made, to harm limited partners (by harming the funds in which they have invested).

In this issue of the *Debevoise & Plimpton Private Equity Report*, we have several articles that address issues arising out of the increasing pressure from regulators and investors for heightened disclosure and monitoring of public companies and private funds. In our cover article, Josh Targoff reviews the surprising ways in which the Sarbanes-Oxley Act can impact private equity funds and their portfolio companies. In the “good news” department, Ken Berman describes how the Treasury Department’s recent rules establishing requirements for anti-money laundering compliance programs recognize that most private equity funds do not attract money launderers. Also, Ann Baker, in our Paris office, describes guidelines recently adopted by the French venture capital association that encourage member funds to employ more transparent and consistent standards for evaluating assets and reporting to investors.

In addition to our recurring Trendwatch column, which this quarter focuses on Funds of Funds, we tackle a variety of topics geared towards investment in a down market, including strategies for acquiring distressed companies, the tax issues to be aware of when buyout funds seek to purchase debt from their portfolio companies, and how to protect private equity professionals from liability for serving as portfolio company officers and directors. In our Guest Column, Connie Kassouf and Keith Macomber, of Heidrick & Struggles International, outline a formula for attracting and retaining talent in private equity firms in a period when the prospect of significant financial rewards may be years away.

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Distressed Company Acquisitions – Section 363 Sales

The Opportunity

Most troubled companies have at least one attractive business unit that will appeal to private equity firms as well as potential strategic buyers. But, while the underlying business is promising, the company may be over-leveraged, perhaps even insolvent. Worse yet, the target may have significant contingent liabilities, such as outstanding litigation, that a private equity buyer won't want to take on. The savvy acquiror's goal will be to buy only the underlying assets and to leave behind all or a significant portion of the liabilities.

If the target business represented only a small portion of a larger enterprise, you would do a classic asset purchase transaction, taking on only those liabilities that you and the seller agree will be assumed. But here, the target business represents most – perhaps even all – of the assets of the distressed seller. How can you get the assets free and clear of the liabilities? How do you avoid the risk of the transaction being characterized as a fraudulent conveyance? How do you avoid negotiating with dozens – or more – creditors, who at this point are (or soon may be) the real owners of the business?

The answer to these challenges may be a Section 363 sale under the U.S. Bankruptcy Code.

What is a Section 363 Sale?

Section 363 of the Bankruptcy Code permits a debtor in bankruptcy to sell its assets outside the ordinary course of business. Importantly, a Section 363 sale can be accomplished on an expedited basis and prior to proposing a plan of reorganization or liquidation. A Section 363 sale can encompass all or substantially all of a debtor's assets, and can also be used by a debtor to sell discrete businesses in a series of separate sales.

From the buyer's point of view, a Section 363 sale is attractive because it allows the assets of the seller to be acquired free and clear of liabilities and encumbrances. Of course the buyer can, and typically will, agree to assume specified liabilities. For example, buyers in Section 363 sales often agree to assume all of the trade obligations related to the business, which has the advantage both of preserving important business relationships and also of eliminating one class of creditor that could otherwise object to the transaction. Buyers should keep in mind, though, that even in Section 363 transactions there are some types of liabilities – notably certain environmental liabilities – that may survive the transaction and become liabilities of the acquiror.

Section 363 sales can take place (relatively) shortly after the seller makes its initial bankruptcy filing. In many cases, the buyer and the seller will have negotiated a deal prior to the bankruptcy filing, which the seller will announce at the same time that it files for bankruptcy. Sellers will often view

this approach as the one most likely to maximize the going concern value of its assets and minimize the damage to the business that can result from the uncertainty of a bankruptcy proceeding.

As a buyer, the downside of a Section 363 transaction is that your deal with the seller is vulnerable to being topped. The contract you just signed, prior to the seller's bankruptcy filing, is unenforceable after such filing until and except to the extent that it has been blessed by the bankruptcy court. Moreover, under Section 363, the seller must demonstrate that it has obtained the "highest and best" price for the assets it is selling. As a result, the bankruptcy court will typically approve the terms of your deal with the seller only if they survive an auction supervised by the bankruptcy court – a second auction, assuming that the seller chose your firm as the purchaser only after an original auction process.

Because your deal remains subject to this additional auction, you as the seller's selected purchaser are often referred to as the "stalking horse."

The Stalking Horse

There are advantages and disadvantages to acting as a stalking horse in a Section 363 transaction. The advantages include:

Due Diligence As the stalking horse, you will have a significantly greater opportunity to conduct due diligence than bidders that emerge later in the process. The compressed timetable of the bankruptcy court auction process simply does not afford other bidders the opportunity for the type of extensive due diligence that private equity firms typically undertake. Because post-closing indemnification rights will be limited or

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Human Capital – A Private Equity Firm’s Greatest Asset

With the world’s leading financial institutions shedding management layers at a record rate, attracting and retaining talent might not – at first blush – appear to be a strategic imperative for private equity firms. Nothing could be more off point.

Next to LP relations and managing the portfolio, the most important priority for leaders of private equity firms is making sure that they are hiring and keeping good people. As the chairman of one major firm recently told his investors, “In the end, this business is all about people. We used to be able to rely on leverage and some financial engineering to produce results. Those days are gone. Now, the quality of a firm’s human capital dictates its ability to produce returns and to raise financial capital.”

He’s right. More than ever before, private equity firms require the right mix of talent to be successful. They need professionals to source investments, conduct rigorous due diligence, negotiate and structure complex transactions, manage companies for peak performance and time exits for maximum realizations.

As an asset class, private equity has reached a new threshold, moving from the opaqueness and obscurity that being “alternative” provided and into the transparency of maturity and respectability that comes with being in the mainstream. Like others that preceded them, private equity *firms* have grown into *institutions*. And as the size of their funds has increased, so too, has their need for a more professional management style. Adding to this pressure are calls for more regulatory oversight and the recent decision by the University of Texas Investment Management Company (UTIMCO) to follow the example set by CALPERS two years ago and report publicly on the condition of its private equity investment portfolio.

There is little doubt that more change is in the offing for the world of private equity. A few firms have responded to these new demands by bringing in professional human resources professionals to oversee the care and feeding of its staff. While it is difficult to fault this approach, more is required. Our experience working with a range of private equity firms of all sizes, shapes and interests indicates that a firm’s ability to recruit and retain the best talent requires the close involvement, support and sincere commitment of the senior partners.

Rich compensation is no longer sufficient to retain talent and, in fact, it is increasingly difficult to provide, given the decline in portfolio values and scarcity of realizations from IPOs or strategic sales. Most estimates put the overhang – the amount of capital raised but not yet invested – as high as \$125 billion. So, in most firms, younger professionals, as well as their more experienced colleagues, face the prospect of waiting years before seeing any real money.

What factors, then, can provide members of firms with sound reasons to remain in place? Our experience in the private equity industry over the past 20 years indicates that there are several actions that firm leaders can take to create an environment that is hard to leave. The most important of these is to establish a *strong culture* – one characterized by a well-defined and clearly articulated value system. Such a value system is useful in helping everyone inside and outside

the organization to understand exactly how the firm will approach a situation and how it will behave in different circumstances.

A second characteristic of the culture should be a sense of *empowerment*, so that members of the organization know what their roles are and feel that they are important. Private equity, by nature, is entrepreneurial and draws people who want to build companies and create value. A successful firm’s culture will build upon this spirit, rather than trying to contain it within a hierarchical management structure.

A third factor is *teamwork*. Several elements contribute to a sense of team, including the value system and empowerment, as noted above, as well as recognition of accomplishments, a *shared sense of purpose* and a willingness to listen to every point of view.

A fourth element is a work environment that provides *intellectual stimulation*, challenge and, above all, fun. Private equity investing is hard work, sometimes involving long hours, travel, stress and strain. People are much more likely to remain engaged in an endeavor if they feel that they are being stretched to full capacity and will develop personally and professionally as result of the challenges they have met head on.

If these elements are present in a firm’s culture, we have found, there is a greater likelihood of there being greater success, as well as lower turnover. The formula, then, for attracting and retaining talent in private equity firms is to:

- Clarify what the firm stands for so that professionals can both identify and affiliate with the culture and its value system.
- Communicate exactly what the culture is – and what the benchmarks are for success.
- Give professionals the freedom and space to expand their experience and develop their talents to the fullest.
- Spell out clearly the career track for partnership, so that staff joining the firm with an expectation of partnership and the rewards it brings understand exactly what is involved in reaching for that brass ring.
- Provide the opportunity for everyone to have a hand in the firm’s successes and to feel that their contribution has had a positive impact.
- Create compensation systems that are based on fairness and reward accomplishments.
- Deliver honest, candid and constructive feedback in formal performance reviews and informally, on an ongoing basis.

Increasingly, the leaders of private equity firms will be called upon to manage their human capital as closely as other assets and will be held accountable by LPs. Firms that use our retention formula should benefit. ■
 — *Connie Kassouf and Keith Macomber are New York City-based partners in the Global Financial Services Practice of Heidrick & Struggles International, an executive search and leadership consulting firm.*

Tax Pitfalls for Buyout Funds Buying Portfolio Company Debt

In the last year or so, a significant number of buyout funds have sought to acquire portfolio company debt (whether bank debt, privately held debt or public bonds) at a discount from an existing lender. When the buyout fund is a partnership that owns more than 50% of the portfolio company, the acquisition can cause draconian tax consequences to both the buyout fund and the portfolio company (even though it is not even a party to the transaction). The good news is that in many cases these tax consequences can be avoided by a bit of tax planning.

This is an area where the tax law invents a lot of deemed transactions that never really happened and then prescribes the actual tax consequences. The acquisition of the portfolio company debt by the related buyout fund is treated for federal income tax purposes as though (1) the portfolio company (the borrower) reacquired the debt for an amount equal to the purchase price paid by the buyout fund and (2) the buyout fund transferred an equal

amount to the portfolio company in return for a “new” note from the portfolio company. The new note is treated as having a face amount and other terms identical to the note actually acquired.

The Problem

For example, suppose that a portfolio company has a \$1,000 note outstanding with a 10% coupon and the buyout fund buys the note for \$600. Under the tax rules, the acquisition is treated as though the portfolio company reacquired the note for \$600 and as though the buyout fund transferred \$600 to the portfolio company in exchange for a new \$1,000 note.

COD Income to the Portfolio Company

Since the portfolio company is treated as having satisfied \$1,000 of debt with \$600, the company recognizes \$400 of “cancellation of debt” income. COD income is, in general, treated like any other type of income (*i.e.*, it is subject to a 35% federal income tax rate at the corporate level). However, if the portfolio company is insolvent at the time

the COD income arises, the portfolio company is permitted to exclude a portion of the COD income – meaning that it doesn’t need to pay tax on that income. For this purpose, a company is considered insolvent to the extent its liabilities exceed the fair market value of its assets (including goodwill). The portion of the COD income that can be excluded is capped at the amount of the insolvency. Thus, if the assets of the portfolio company in our example were worth \$900 and it had no other liabilities, the amount of the company’s insolvency would be \$100 and the company would be required to report only \$300 of COD income (rather than the entire \$400).

The tax code exacts a price for permitting a company to exclude COD income. Specifically, the company is required to reduce favorable tax attributes (like NOLs) by the amount of excluded COD income. Thus, in our example, the favorable tax attributes (if any) of the portfolio company would be reduced by \$100.

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Phantom Income Issue for the Buyout Fund

The buyout fund is essentially treated as having transferred \$600 to the company in exchange for a new note with a face amount of \$1,000 paying 10% interest. The difference between the \$1,000 face and the \$600 “issue price” of new note is treated as “original issue discount.” As the holder of the note, the buyout fund will be required to report this \$400 of OID as interest income over the remaining term of the note – even though it will not receive a corresponding amount of cash until the note is repaid in year seven.¹

Adding Insult to Injury at the Portfolio Company Level

Although the buyout fund is required to report the \$400 of OID as interest income over the remaining term of the note, the portfolio company is not necessarily allowed a corresponding interest deduction. This is because the tax code generally disallows a portion of the interest deduction on debt instruments with “significant” OID where the current cash interest payments are not sufficiently high relative to the OID. This rule was not designed at all for these types of transactions and its application seems particularly harsh since the portfolio company was required to report the \$400 of COD income (or reduce a like amount of tax attributes). But the rule applies nevertheless.

The Fix

Happily, it is possible for a buyout fund to avoid this terrible tax result. All of the deemed transactions discussed above only apply where debt is acquired by a person “related” to the portfolio

company. If the buyout fund is a partnership, it will be treated as related if it owns more than 50% of the portfolio company. Similarly, if the buyout fund is related to the portfolio company but forms a partnership (or an LLC taxable as a partnership) to buy the debt, the partnership (or LLC) will similarly be treated as related to the portfolio company. However, if the buyout fund forms a special purpose corporation (or an LLC taxable as a corporation) to acquire the debt, it is likely that the new corporation will not be considered related to the portfolio company even if the buyout fund is related to the portfolio company. This is an outgrowth of the fact that the rules for determining whether two corporations are related for this purpose are entirely different from the rules for determining whether a partnership and a corporation are related.

Assuming (as will often be the case) that the new corporation is not treated as related to the portfolio company, then none of the adverse tax consequences discussed above will apply. The acquisition should not trigger any COD income to the portfolio company and should not create any OID in the existing note. Rather, the new corporation should be treated like anyone else that buys debt at a discount. Thus, under the “market discount rules” a portion of any gain realized by the new corporation upon the retirement or sale of the note will be recharacterized as ordinary rather than capital gain.

Foreign or Domestic

If the new corporation is organized in the U.S. (e.g., as a Delaware corporation), then the actual cash interest will be subject to corporate level tax as will any gain recognition upon retirement or sale. Thus, if the corporation held

the note until retirement, it would have \$400 of gain (since it bought the note for \$600 and received \$1,000 of proceeds).

However, if the corporation is organized outside of the U.S., then it is possible for a substantial portion of the interest to escape corporate level tax and for all of the gain attributable to the discount to escape corporate level tax. If a foreign corporation is used, the structure must take into account the fact that the current cash interest payments will be subject to 30% U.S. withholding tax unless an applicable tax treatment reduces or eliminates the withholding tax rate. The availability of a treaty depends both on where the new corporation is organized and, in some cases, the makeup of the investors in the buyout fund. Accordingly, the country in which to organize the new foreign corporation must be selected with great care.

It is also worth noting that there are often restrictions imposed by the governing documents of a buyout fund on the ability of the fund to invest outside of the U.S. Specifically, it is fairly common for a buyout fund to be required to obtain advice from local counsel (prior to making an investment in a foreign jurisdiction) that (1) the limited liability of the investors in the buyout fund will be respected in the foreign jurisdiction and (2) income unrelated to the fund will not become subject to tax by the foreign jurisdiction. ■

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¹ Thus, if the remaining term of the note was seven years, the buyout fund would receive \$100 of cash interest each year but would have interest income ranging from \$129 (in the first year) to \$195 (in the seventh year).

The *Pure* Way to Go Private

Conditions (apart from continued tightness in the financing markets) are ripe for going private transactions. The equity markets continue to be soft. The Sarbanes-Oxley Act of 2002 and related SEC and stock exchange rules have made life as a controlled public company more burdensome. Moreover, in a recent decision (*In re Pure Resources Shareholders Litigation*), the Delaware Court of Chancery explains how to effect a going private transaction that avoids the strict entire fairness test.

Going private transactions involve litigation risk because of the inherent conflict of interests between the controlling shareholder (sometimes an exiting controlling shareholder and sometimes the private equity firm itself) and the public minority. The Delaware courts have held that regardless of the procedural protections the parties adopt, such as requiring that a special committee of independent directors approve the transaction or conditioning approval of the transaction on the vote of a majority of the minority's shares, a merger of a Delaware company with a controlling shareholder is subject to a strict judicial review standard of "entire fairness."

In previous decisions, Delaware courts have held that the entire fairness standard does not apply to tender offers, unlike mergers, so long as the offers include full disclosure and are not coercive. Delaware courts have also held that entire fairness review is inapplicable to short-form mergers, which can be effected without a shareholder vote by a parent company owning 90% or more of a subsidiary. Putting these two steps together, a controlling shareholder wishing to avoid the entire fairness test can, instead of negotiating a merger with a special committee, simply launch a non-coercive tender offer conditioned on getting to 90%. In his October 2002 decision in *Pure Resources*, Vice Chancellor Leo Strine shed some more light on this route by explaining what it means for a going private tender offer to be considered non-coercive.

In *Pure Resources*, the court enjoined Unocal Corporation from completing a going private exchange offer to buy out the public float in Unocal's 65%-owned subsidiary, Pure Resources, Inc. A special committee of Pure's independent directors had opposed the offer on the grounds that the price was inadequate. The court found Unocal's offer structurally coercive because, although it was subject to a majority of the minority tender condition, it counted as part of the minority the shares that were held by Unocal directors and officers and also shares held by Pure management who had economic interests in the acquisition because of their employment relationship, their severance agreements, and their put agreements which would be triggered upon the closing of the tender offer.

In his decision, Vice Chancellor Strine bemoans the "possible incoherence" in Delaware law because of the disparity between two lines of cases. One line of cases, emphasizing the importance of protecting minority shareholders from overreaching by the controlling shareholder, holds that going private mergers are subject to an entire fairness review regardless of the procedural protections adopted by the parties. The other line of cases, emphasizing the importance of freedom of contract, holds that non-coercive tender offers by controlling shareholders are not subject to entire fairness review.

Strine seeks to bridge the gap between these different approaches

to essentially similar transactions by beefing up the requirements that a tender offer by a controlling shareholder must meet to be found non-coercive. According to Strine, a non-coercive going private tender offer must:

- be subject to a non-waivable majority of the minority tender condition;
- include a promise by the controlling shareholder to complete a prompt short-form merger if it obtains 90% of the shares; and
- not involve any retributive threats by the controlling shareholder – e.g., to eliminate the dividend or delist the stock – if the offer fails.

Vice Chancellor Strine's formulation can be expected to set a new procedural benchmark for tender offers in going private transactions – even in transactions that have been negotiated with and approved by a special committee of independent directors.

Although the *Pure Resources* decision more clearly marks the trail for a going private transaction that avoids the entire fairness test, private equity investors should bear in mind that even if proceeding by tender offer may appear preferable from a state law point of view, there may be important reasons to use a different route. For example, tender offers, unlike a merger, may raise questions under the federal "best price, all holders" tender offer rule if special arrangements are to be made with the target's management in connection with the transaction. Since such arrangements are typically an important part of transactions

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The *Pure* Way to Go Private (continued)

sponsored by private equity firms, care must be taken to structure the transaction in a manner that avoids running afoul of these restrictions.

A private equity investor should also make sure that a unilateral tender offer, not approved by a committee of independent directors, does not constitute a “hostile” bid that may be prohibited by a fund’s constitutive documents.

Even if a unilateral offer or a transaction not approved by the Target Board is not prohibited, a private equity firm should consider whether avoiding negotiations with a special committee will raise reputational or limited partner relations issues. Private equity firms must also take care to structure going private transactions in a manner that avoids problems under the federal

margin rules, which limit the amount of borrowings that can be secured by publicly traded stock. □

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Covering Your Assets: Indemnification and D&O Insurance

Especially these days, it is hard not to be nervous about personal liability arising from service as a fund partner or as a corporate director or officer. These risks are inherent in each of the roles that private equity principals play:

- Directors, officers or partners of the management company;
- Directors, officers or partners of the general partners or managing members of the investment funds sponsored by the management company; and
- Directors (often the Chairman) and at times officers of the funds' portfolio companies.

In addition, some investors in an investment fund serve on the advisory board of the fund. Unaffiliated executives serve as directors of the fund's portfolio companies, as do some of the companies' officers (generally the CEO). And, of course, executives of the portfolio companies serve as officers of those companies.

How can principals and others protect their assets from claims of shareholders, creditors, employees and other stakeholders made against them personally as a result of their serving as directors and officers (and in similar positions in partnerships and limited liability companies)? Through two mechanisms:

- Indemnification – under state law, under the bylaws or other organizational documents of corporations, partnerships and limited liability companies, and under other contracts with the company or other parties; and
- Directors and officers liability insurance.

This article will focus on the application of these protective mechanisms to directors and officers of portfolio companies. A future article will focus

on indemnification and D&O insurance for investment funds, their general partners or managing members, and the management company.

Indemnification

Directors and officers of a corporation are typically entitled to indemnification from the corporation under state law and the applicable provisions of the corporation's charter and bylaws (or similar organizational documents), and sometimes pursuant to other contractual indemnification arrangements.

Indemnification Under State Law

Assuming that the portfolio company is a Delaware corporation, state law generally provides that the company may indemnify its directors and officers against expenses (including attorneys' fees), judgments, fines and settlement amounts that are actually and reasonably incurred in connection with any proceeding brought by or against the company. In order for indemnification to be available, (1) the individual must have acted in good faith and in a manner reasonably believed to be in (or not opposed to) the company's best interests, and (2) in a criminal proceeding, the individual must have had no reasonable cause to believe that his or her conduct was unlawful. (Under Delaware law, termination of the proceeding by judgment, settlement, conviction or a plea of *nolo contendere* does not, in itself, create a presumption that these standards of conduct have not been satisfied.) Whether these standards have been met may be determined (1) by a majority of the disinterested directors (or a committee thereof), (2) if there are no disinterested directors, or if such directors so direct, by independent legal counsel, (3) by the stockholders, or (4) if the individual has been held liable

to the company, by the Delaware Court of Chancery.

Directors or officers of portfolio companies that are organized as limited liability companies, limited partnerships or other business entities, or under the laws of jurisdictions other than Delaware (particularly non-U.S. jurisdictions), should be mindful that the availability of D&O indemnification and the relevant standards may vary according to the applicable statutory regime.

Indemnification Under Organizational Documents

State law simply authorizes the corporation to provide D&O indemnification. In order to avail its officers and directors of these protections, the corporation should also explicitly provide for D&O indemnification in its charter and/or bylaws (or similar organizational documents). In many cases, the charter may simply state the general proposition that officers and directors will be indemnified to the fullest extent permitted by applicable law. In any event, the bylaws should contain detailed provisions regarding the standards for determining whether and to what extent indemnification is available and the procedures for making indemnification claims. Ideally, these bylaw provisions should track the relevant statutory provisions as closely as possible, and should further provide that the rights granted by these provisions are not exclusive of any other rights to which the directors and officers may be entitled by law, agreement, vote of the stockholders or disinterested directors, or otherwise.

Indemnification Under Contractual Arrangements

Although the bylaws may state that the indemnification provisions are to be

deemed to be a contract between the portfolio company and its directors and officers, it may also be advisable for the directors and officers to enter into separate indemnification agreements with the company. (In the case of an officer of a portfolio company, similar indemnification provisions might also be found in his or her employment agreement.) These agreements not only provide explicit contractual rights on which the individual may rely, but may also be tailored to address related issues, such as the individual's remedies in cases where indemnification is determined not to be available. Again, these agreements should track the applicable statutory law and should provide that the rights granted are not exclusive of any other indemnification rights to which the individual may be entitled. Because the charter and bylaws of the portfolio company may no longer be in place following an exit event, contractual terms should require that the terms of the indemnification agreement will be binding on any acquiror of, or other successor to, the portfolio company. As a further means of protecting their principals who serve as directors and officers of portfolio companies, private equity firms might also incorporate similar indemnification provisions into their consulting or monitoring agreements with their portfolio companies.

D&O Insurance

Although statutory, bylaw and contractual indemnification provisions provide the first layer of protection for those serving as directors and officers of portfolio companies, both individual directors and officers and the portfolio companies themselves generally want – indeed, a well-represented individual about to join the board of a portfolio company will *require* – directors and officers liability insurance:

- Individual directors and officers want protection that does not depend on the financial status of the company (claims for indemnification against the company are generally worthless in a bankruptcy).
- Individual D&O insurance coverage is often broader in some areas than statutory, bylaw and contractual indemnification.
- Insurers may be quicker to advance defense costs than the company itself.
- The company will want to lay off some or virtually all of the risks resulting from its providing indemnification by insuring those risks; and
- Most D&O insurance policies cover certain types of claims – most important, securities law claims – made directly against the company itself, as well as claims made against individual directors and officers.

D&O Policies – the Basics

A D&O insurance policy provides three basic types of coverage:

- For individual directors and officers, coverage for claims made against the individual for any “wrongful act” committed or allegedly committed by the individual in his capacity as a director or officer of the company or otherwise relating to the individual's status as a director or officer, to the extent the individual has not been indemnified by the company (“direct coverage”);
- For the company, coverage for claims made against individual directors and officers for such “wrongful acts,” to the extent the individual *has* been indemnified by the company (“corporate reimbursement coverage”); and
- Also for the company, coverage for certain specified types of claims made directly against the company (“entity coverage”).

Entity coverage has been added to many policies primarily to avoid disputes between the D&O insurer and the company as to what portion of a claim made against both the individual directors and officers and the company itself (a common occurrence for securities law claims) is covered by the D&O policy and what portion must be covered out of the company's assets. For claims covered by entity coverage, the D&O insurer will cover the entire claim, whether made against the individual directors and officers, the company, or both. Although entity coverage avoids these disputes, it has caused other problems – exhaustion of coverage for individual directors and officers by claims against the company, and findings by some bankruptcy courts that the D&O policy is an asset of the company in bankruptcy, resulting in delays in insurance payments (including for defense costs) made to individual directors and officers and sometimes outright disallowance of such payments.

For these reasons – and the losses of D&O insurers in several recent large bankruptcies – entity coverage may be on its way out. Indeed, *individual directors and officers of companies facing financial difficulties may demand that the company purchase a D&O policy that does **not** include entity coverage.*

For the remainder of this article, we will focus on direct coverage and corporate reimbursement coverage.

The Language of the Policy Makes a Difference!

The combination of statutory, bylaw and contractual indemnification with corporate reimbursement coverage and direct coverage should provide seamless protection for individuals serving as directors and officers. Of course, as in any complicated contract, the devil is in the details.

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New Guidelines Signal Greater Transparency for French Fund Managers

As the French private equity industry matures, French funds are adopting greater transparency in how evaluations are conducted and providing more elaborate and consistent reporting to their investors. The AFIC (Association Française des Investisseurs en Capital), the French venture capital association, began a concerted effort to encourage French fund managers to employ more professional, consistent standards and reporting in June, 2001 with the issuance of an Ethics Code for Fund Managers, followed this past September by the publication of a concise yet detailed “Guide on Evaluations and Reporting,” based on the guide published in 2001 by the European Venture Capital Association.

The AFIC is also cooperating with counterpart organizations in other European countries, notably Great Britain, in order to render some of these principles more uniform so that investors will have a more consistent basis on which to invest in funds established in different European countries. While similar efforts at greater transparency are underway in the U.S., including by the recently formed Private Equity Standards Board, no findings are expected until after the New Year at the earliest. Thus, for the time being, the Europeans appear to be farther along in the attempt to make reporting of fund investments more uniform and clear.

The Guide outlines certain fundamental principles that French fund managers are strongly urged to apply when evaluating their fund's assets:

- Preferably, evaluation methods should be prudent and detailed in the fund documents.
- Evaluations should be made at least twice a year. They must be consistent from one investment to another and from one evaluation date to the next.
- Evaluations must take into account the long-term nature of private equity investments and full disclosure must be made to investors as to what methods, data (including data to support IRR calculations) and processes are used for evaluation of the fund's assets.
- The AFIC recommends that an external, independent third party (either the Advisory Committee of the fund if it includes outside experts, or the fund's statutory auditor) review evaluations after they are established by the fund manager.
- In addition to the minimum level of information to be included in periodic reports to fund investors, the Guide sets forth a more detailed level of information that the AFIC strongly recommends fund managers adopt as part of their “best practices.”

The Guide also includes guidelines on making various IRR calculations (*i.e.*, gross IRR of investments sold, gross IRR for all investments and net IRR per investor).

In addition to these basic principals and IRR calculation guidelines, the Guide also establishes general rules for specific valuation issues, including deferred purchase pricing, dilution factors arising from the exercise of price adjustments and options, and the proper methods of valuing listed and non-listed securities.

Deferred Pricing Calculations

For investments sold with a deferred purchase price, the deferred portion of the price should be recorded as realized capital gain only when the payment thereof is certain and should not be taken into account for the calculation of gross IRR until such time as it is effectively received.

Fully Diluted Capital The Guide identifies several dilution factors, including the stock option pool, ratchet provisions, commitments to participate in future capital increases and the existence of convertible debt instruments and gives indications on how these factors can be taken into account to determine fully diluted capital.

Because the calculation of fully diluted capital is a difficult exercise and may not reflect the reality of the terms negotiated, in certain cases the fund manager may decide not to take into account fully diluted capital in evaluations, or to apply different rules to determine fully diluted capital. Nonetheless, investors should be fully informed of the methods used and

While similar efforts at greater transparency are underway in the U.S., including by the recently formed Private Equity Standards Board... for the time being, the Europeans appear to be farther along in the attempt to make reporting of fund investments more uniform and clear.

of any factors that might have an impact on the evaluation of the fund's investment.

Evaluating Non-Listed and Listed Securities

The Guide provides two alternative methods on how to evaluate interests in non-listed portfolio companies. First, it suggests the use of conservative value (at cost) for investments that show neither profit nor positive cash flow. Conservative value can be adjusted under certain circumstances if a significant number of new shares has been issued to a third party at a different price, or if there are indications of a significant and long term decline in the company's situation and prospects.

Alternatively, non-listed companies can also be evaluated at fair market value in those cases where the investment generates profits or a positive cash

flow. Fair market value will generally be determined by taking into account other significant transactions at normal market conditions by independent third parties that have taken place with respect to the share capital of the relevant portfolio company. If no such transactions have taken place, then the Guide recommends using a multiple based on comparable companies, or on companies from the same sector of activity, or using the multiples used for the initial investment. Any investment valued based on multiples must be subject to a discount (of at least 25%) to take into account lack of liquidity.

Evaluations of interests in listed companies should be based on the last quoted price on the date of evaluation, or on a reasonable average (over the

preceding 15 listing days) with a discount (10 % to 20% if the shares are not subject to lock-up, 25% if the shares are subject to lock-up or other transfer restrictions).

The AFIC is strongly urging its members to apply the principles set forth in the Guide, or if they do not, to provide their investors with cogent explanations as to any deviations therefrom. French fund managers have greeted the AFIC Guide with enthusiasm, because of their perception that consistent practices in evaluations and reporting will make their fund vehicles more attractive to sophisticated, international investors. ■

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FTC Welcomes Filings from Multiple Bidders

An auction may have many bidders, but only one buyer. When it comes to sales of businesses, however, antitrust authorities are now prepared to view each bid as the real deal.

Purchases of businesses often require Hart-Scott-Rodino filings accompanied by waiting periods that allow the federal antitrust authorities to consider a proposed transaction's competitive implications before the transaction closes. It has long been government policy that HSR filings will not be accepted for hypothetical transactions. In what might be viewed as a departure from this policy, however, the

FTC staff has recently indicated their willingness to accept a filing from various bidders for the same property. Each filing must simply be accompanied by a certification that the bidder has a good faith intention to complete the transaction if its bid is chosen.

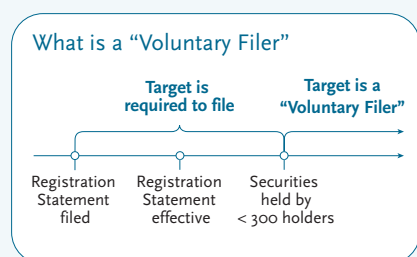
The benefits of this policy for the seller are that it can require each bidder to clear the HSR 30-day waiting period before the seller chooses the winner. This gives the seller assurance that the purchaser will not be stymied by antitrust issues and facilitates a quick closing. The policy works for the antitrust authorities too. Multiple

filings for a single sale means multiple filing fees – good news in a down-deal market.

For bidders, however, a seller that requires an HSR filing raises the price of poker. All but one bidder will waste a filing fee – as much as \$280,000 for a proposed transaction valued at over \$500 million – on a deal it will not have the chance to complete. Bidders should think long and hard before they risk that kind of money. ■

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voluntary filers will have to weigh the risks and benefits in reviewing compliance with the various provisions of the Act, and monitor market and regulatory developments in the area before deciding they are “home free” once they hit “voluntary” status.



If It Smells Like a Loan... It Probably Is One

It has long been considered a crucial ingredient for success in private equity deals for funds to have managers invest in portfolio companies side-by-side with the fund. When members of management do not have enough cash to make meaningful investments, many sponsors allow them to borrow from the company itself. Other sponsors sometimes arrange for the portfolio company's lenders to provide personal loans to the executives, in certain cases having the company guarantee the loans.

Because this practice is so prevalent, the provision of the Act that will be most jolting to the private equity world promises to be the strict prohibition against an “issuer” extending or maintaining credit, or arranging for the extension of credit, to or for any director or executive officer. Not only is the provision vague, but violations of it carry strict criminal penalties. And while a “voluntary” filer technically is not subject

² Any loan existing on July 30, 2002 is “grandfathered” so long as there is no renewal or “material modification” to any term of the loan after such date. Also, loans to an employee who is not an “executive officer” are not prohibited, but will become illegal if the employee is promoted to a top spot.

to the prohibition, a loan provided or arranged on or after July 31, 2002 by a company that is not an issuer at the time, will become illegal the minute the company becomes an “issuer” (e.g., by filing a registration statement).²

Given the broad wording of the provision, the sparse legislative history behind it, and the criminal penalties facing its violators, the challenge will be to find ways to ensure managers have “skin in the game” without having the structure look too much like a loan. Larry Cagney and Franci Blassberg provided a few suggestions:

- Create a holding company structure, have the holding company make the loan, and don't have the holding company guarantee the operating subsidiary's (public) debt.
- Require the manager automatically to use some of his or her annual bonus to purchase deferred stock – at a discounted price. Failure to do so could result in a termination for cause.
- Have the manager purchase as much as possible without borrowing; make up the rest with options.
- Create a limited liability structure and provide managers with “profits interests” in the LLC (while this does not create skin in the game, it does provide managers with capital gains treatment; and the LLC structure allows for maximum flexibility, should the law be clarified).

None of the above suggestions is perfect, and some may be aggressive (or have an adverse accounting impact). Unfortunately, however, unless and until the SEC provides guidance on what constitutes an “extension of credit” for purposes of the Act, given the criminal penalties involved, devices that look and

feel like a loan (such as a put/call structure, or requiring a manager to satisfy a negative capital account in a limited liability company) should be approached hesitantly, to minimize the risk of becoming the first test case on this provision.

Certification “Confusion”

One provision of the Act that clearly applies to all preparers of Exchange Act periodic reports (including voluntary filers) is the certification requirement set forth in Section 302 of the Act.

SEC rules have mandated the inclusion of a number of statements that must be certified in the body of all periodic reports (10-Qs and 10-Ks for domestic companies) by the CEO and the CFO of the filer. Perhaps the most significant is the certification that the financial statements and other financial information in the report “fairly present in all material respects” the company's financial condition, results and cash flows. There are a number of issues that are raised by this requirement:

- While “fairly present in all material respects” is not defined in the Act, the phrase is intended to be broader than “have been prepared in accordance with GAAP.”
- Private equity sponsors may face CEOs and CFOs, recently installed to run newly acquired portfolio companies, who are reluctant to certify personally financial statements for periods of time in which the executives (and the sponsor) had no involvement with the company. This could result in extensive due diligence and maybe even restatements of historical financial statements, an expensive but perhaps unavoidable task, in order to provide the certifying officers the comfort they require to make the necessary certifications.

- While the CEO/CFO certifications are not required for 1933 Act registration statements, a portfolio company filing its S-1 or S-4 should anticipate the certification requirement looming with its first 10-Q, and should make sure that its CEO and CFO are “on board” with the historical financial statements in the 1933 Act filings. Having to restate financials almost immediately after going public could anger investors and embarrass the fund.
- One of the most well-known facts about the Act is that it contains two separate provisions requiring certifications of periodic reports. While the “302” certification applies to any entity that files a report, the additional certification requirement of Section 906 is applicable only to “issuers” (and not voluntary filers). However, we are of the view that the “906” certification does not materially add to the certifying officer’s potential liability, as the “302” certification is essentially the same as the “906” version, and omitting the “906” certification may not be worth the curiosity it could engender with the voluntary debt-filer’s investors.

are a few important issues relating to this provision.

- The first questions are whether the audit committee requirement is now in effect, or is awaiting SEC rules, and whether the requirement applies to all “issuers,” or only to listed companies.
 - We are of the view that the requirement is not yet in effect, will not be in effect until the SEC passes rules on the subject, and in any event will apply only to companies with securities that are listed on an exchange or quoted on NASDAQ.
 - Others have interpreted the provision as effective immediately, and applicable to all “issuers,” including companies with public debt but not public equity.
- Only SEC rulemaking will definitively resolve this debate.
- The Act prohibits “affiliated persons” from sitting on audit committees. “Affiliated person” is not defined in the Act.
 - Unless the SEC creates a specific definition for this purpose, the current definition in the Exchange Act would apply. This definition,

committees of companies in which they may have only a minority investment (a curious result; given private equity professionals’ financial expertise and the alignment of economic interests, public investors should be pleased to have them sitting on their companies’ audit committees).

More to come

Some final thoughts on the Act’s effect on private equity:

- At present, it appears unlikely that purchasers of high-yield debt will be willing to give up registration rights without a fight (they enjoy the liquidity the registered debt provides). And, since there is no way a company that intends to issue public debt can avoid becoming subject to the Act, sponsors may have to consider becoming subject to the Act a “cost of admission” to the relatively inexpensive high-yield market.
- It remains to be seen whether this cost of admission will spawn a new and less expensive mezzanine market. Unless it does, even with the complications of complying with the Act, the high-yield market appears to remain the best alternative for the mezzanine layer of the capital structure for deals of a certain size.
- The SEC eventually will resolve some of the ambiguity in the legislation, and its resolutions will have a major impact on the private equity world. In particular, the SEC’s position on “voluntary” filers will be of special interest, as will its interpretation of the personal loan prohibition and its determination as to whether all “issuers” – or only listed companies – must have a completely independent audit committee.

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Application of Certain Provisions of the Act

Provision	Applies to Debt Issuer (and guarantor) if:
CEO/CFO Certifications:	
§ 302 Certification	Issuer files or submits periodic reports (whether voluntary or required).
§ 906 Certification	Issuer is required to file periodic reports under the Exchange Act.
Loan Prohibition:	
	Issuer is required to file periodic reports under the Exchange Act or has filed a registration statement.
Audit Committee/Independence: The debt is listed on an exchange (or NASDAQ).	

Audit Committees – No Sponsor Need Apply?

One of the more ambiguous provisions of the Act is its requirement of a completely independent audit committee. From a private equity perspective, there

which in turn is the definition used in the Investment Company Act, would pick up holders of as little as 5% of the issuer’s equity, effectively prohibiting sponsors with PIPEs investments from sitting on the audit

non-existent, the stalking horse's ability to conduct meaningful due diligence is extremely valuable. Bidders that arrive late to the party are often forced to take certain matters on faith – or rely on the assumption that the stalking horse has uncovered and priced into its bid any significant problems.

Bid to Beat The stalking horse sets the threshold on price and contract terms, including indemnification (if any) and escrow protections. Because competing bids are compared to the stalking horse contract, other bidders usually propose to alter the stalking horse contract only in ways that will make the competing bid more attractive. As a result, to the extent that the stalking horse has been able to conduct meaningful due diligence, it may be able to accept less onerous contract terms than might otherwise be the case, thereby setting a barrier to entry for competing bidders. Moreover, if there are contractual terms that are important to your firm, such as financing conditions or employee matters, you are unlikely to be able to get them into the contract if you are a competing bidder rather than the stalking horse.

Deal Protection To induce potential bidders to act as the stalking horse, the seller will provide the stalking horse with deal protection covenants in the original sale agreement. While these provisions are subject to approval by the Bankruptcy Court before they become enforceable against the debtor, that approval is typically obtained quickly following the seller's bankruptcy filing (with the bidder being able to terminate the contract if such approval is not promptly granted). While deal protection provisions are often challenged by creditors, experienced practitioners can

advise the parties as to those provisions that are likely to be acceptable to creditors and the court, and help you structure the original contract so that you have something to give away while still maintaining an acceptable level of protection.

Generally, the stalking horse buyer will be able to get the following deal protection terms:

Expense reimbursement, which must be reasonable in relation to the deal size and generally capped;

Break-up Fee, which normally cannot exceed 3% of the deal price; and

Bidding Procedures that set standards for qualifying competing bidders and conducting the auction. These typically include requirements as to the financial ability of competing bidders, the minimum initial overbid necessary to gain entry to the auction, and minimum subsequent overbid requirements.

On the other hand, there are disadvantages to being the stalking horse. Most important of these is the time and expense that can be incurred for a deal that may never be consummated due to a competing bidder. There is also the reputational cost of losing a deal in a very public forum.

Because of the downsides of acting as the stalking horse, there is an obvious temptation to sit back and allow somebody else to smoke out the problems in the business and establish a valuation. However, this is probably not the best strategy for a private equity fund buyer. A bidder that emerges only during the bankruptcy auction will not have the opportunity to conduct significant due diligence – and most private equity firms are highly reluctant to rely upon a due diligence investigation

done by another bidder. Moreover, only by acting as the stalking horse can you negotiate closing conditions and other terms that may be of particular importance to you. Finally, although the limited deal protection that is achievable in a Section 363 purchase contract may be a very small consolation prize for a busted deal, it should be sufficient both to cover the expenses of your advisors as well as compensating your professionals for their time and effort in putting the deal together.

How Long Will it Take?

For anybody who has been through a full-blown reorganization in bankruptcy, a sale under Section 363 is a surprisingly short-track procedure. But from the perspective of those more used to doing deals outside of bankruptcy, it may take longer than you might hope. In large part, the timing will depend upon the jurisdiction in which the bankruptcy case is filed and how busy the bankruptcy court docket is at the time. In Delaware, though, a reasonable timetable – starting from the time that the original acquisition agreement is signed with the seller – might be as follows:

1. Initial Filing. Seller files for bankruptcy, e.g., a day or two after signing your purchase agreement.

2. Initial Motions. Within two business days after the initial bankruptcy filing, seller (now the “debtor”) submits to the bankruptcy court motions for approval of (x) the bidding procedures and the expense reimbursement and break-up fee provisions and (y) the proposed sale.

3. Bidding Procedures Order. Approximately a month after the initial bankruptcy filing, the bankruptcy court

enters an order approving bidding procedures, expense reimbursement and break-up fee.

4. **Submission of Competing Bids.**

Approximately 26 calendar days after the entry of the bidding procedures order, competing bids must be submitted to the debtor. The debtor must promptly provide to the stalking horse and any creditor committees copies of qualified bids.

5. **Auction.** Approximately 28 calendar days after the entry of the bidding procedures order, the debtor will hold the auction for the business, which, if one or more competing bidders emerges, can be expected to take at least a day, perhaps longer.

6. **Sale Hearing.** Immediately following completion of the auction, the debtor will seek approval of the Section 363 sale to the winning bidder at a bankruptcy court hearing at which creditors

and other interested parties can object to the sale.

7. **Entry of Sale Order.** Within two business days after the sale hearing (and within 32 calendar days after the entry of the bidding procedures order), the bankruptcy court will enter the sale order.

8. **Final and Non-appealable Sale Order.** If no objections to the sale order have been made within ten calendar days after the entry of the sale order, the sale order becomes final and non-appealable on the eleventh calendar day after the entry of the sale order.

9. **Closing.** The closing generally occurs either immediately after the entry of the sale order or immediately after the sale order has become final and non-appealable.

On this schedule, and assuming that your stalking horse bid survives the bankruptcy court auction, you should

be able to close your transaction approximately two months following the execution of the purchase agreement with the seller and its initial bankruptcy filing.

Conclusion

The current economic environment presents both opportunities and challenges for private equity firms looking for acquisition targets. There are many good businesses that are burdened by unrealistic debt loads or other significant liabilities. The challenge is to separate the good from the bad in a transaction that is to be accomplished on a reasonable time schedule, while providing an appropriate level of contractual protection to the buyer. In many cases, a sale under Section 363 of the Bankruptcy Code provides a suitable solution. ■

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The Sarbanes-Oxley Act's Surprising Impact on Private Equity (continued)

- How will the high-yield market respond to the Act? Will debt buyers expect full compliance, whether or not the debt issuer is subject to all provisions? It is still too early to tell, but this would be an unfortunate development, and it will be up to sponsors and their counsel to convince the “buy-side” that while requiring compliance with the enhanced *disclosure* provisions of the Act is appropriate, requiring compliance with some of the *substantive*

provisions – particularly the management loans and audit committee independence sections – is not necessary and would not be in anyone's best interests.

- Many “marginal” public companies may decide to give up on being public in the face of the additional burdens placed on them by the Act. Additionally, focus by conglomerates on core businesses may inspire them to off-load more tangential divisions. Buying opportunities for the private equity sector may await.

- In the meantime, we will provide additional updates as SEC rules become effective. Sponsors should consult with legal counsel to determine the appropriate response to the Act by their current – and future – portfolio companies, as the new era of federally mandated corporate governance and enhanced disclosure becomes a permanent feature of the deal-making landscape. ■

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D&O insurance contracts are often presented as boilerplate policy forms that are the same for every policy. Often, no one reviews the policy language before coverage is bound. The broker and risk manager agree on a one- or two-page order setting out the basic coverage details (basically a term sheet), and coverage is bound and the premium paid based wholly on this term sheet. Months later comes the policy – dozens of pages of the insurer’s form policy, plus dozens of endorsements that amend the terms of the form policy. Only when a claim and a coverage dispute relating to that claim arise does anyone read the policy carefully. Then come the surprises.

The terms and language of a D&O insurance contract are as subject to negotiation as any other complicated contract. Although it is true that most insurers write their policies based on the insurer’s standard policy form, (1) policy forms differ – from insurer to insurer and even for a particular insurer, which may have several D&O policy forms, and (2) insurance policy language can be tailored to the needs of the insureds – either through negotiation of the language of endorsements amending the form policy, or through a “one-off” policy known as a manuscript policy. Of course, the degree to which an insured can negotiate policy terms and language will depend on how much market power the insured commands. But private equity firms, with portfolio companies purchasing hundreds of millions of dollars in coverage, should not settle for coverage that does not fit their needs.

Some Things to Watch Out For

What companies are covered? A D&O insurance policy ordinarily covers the directors and officers of the company named on the Declarations page for

the policy (the “named entity” or the “insured company”) and all of its subsidiaries. Subsidiaries are generally defined to include only those companies of which the named entity has majority voting control. Many policies exclude subsidiaries formed as partnerships unless the partnership is specifically included in an endorsement to the policy.

- In complex corporate structures, it is vitally important for the highest-tier company in the corporate chain to be the named entity. Don’t make the mistake of having the primary operating company as the named entity, leaving out the directors and officers of the holding companies formed to acquire the primary operating company (which are not, of course, “subsidiaries” of the primary operating company). If a holding company does not itself have majority voting control of the primary operating company, the highest tier company that does have majority control should be the named entity, and all other holding companies should be listed as additional named entities.
- Even a partnership of which the only partners are two wholly-owned subsidiaries of the named entity will not be covered unless specifically endorsed onto the policy. Beware of subsidiaries formed as partnerships for tax purposes, particularly in foreign countries (which may not contain the word “partnership” or abbreviations such as “L.P.” in their names, but rather abbreviations such as “SC” or “KG”).
- Directors and officers of companies that are not majority controlled by the named entity (such as joint ventures) may be covered as so-called “outside entities,” but only if the company is specifically endorsed onto the policy. Even then, coverage will be limited.

Such companies either should have their own D&O policies, or should be specifically added as additional insured companies (rather than merely as outside entities) onto the policy covering the named entity.

Who is covered? D&O policies generally cover only individuals who are duly elected or appointed as directors or officers of the named entity or one of its subsidiaries. Non-officer employees may be covered for certain types of claims as well.

- Note that representatives of the management company who take direct roles in the management of a portfolio company but who are not elected or appointed as directors or officers may be subjected to claims, but will not be covered under the portfolio company’s D&O policy. If coverage is to be assured, such persons should be endorsed onto the policy as additional insured individuals.
- Coverage of companies formed in civil law jurisdictions with multiple board structures (supervisory board, advisory board, management board) may be unclear. Who is a “director” of such a company? Coverage can be clarified through an endorsement to the policy.

What is covered? Policy definitions and exclusions are important. For example, the entire coverage under the policy depends on the definition of “wrongful act.” Other important defined terms are “claim,” “loss” and “defense costs.” Reviewing these coverage definitions is as important as reviewing the exclusions. And don’t forget that what may be covered in the policy form can be limited or excluded in an endorsement!

- Be particularly wary of every provision dealing with bankruptcy. Make sure that claims made against the individual

directors and officers by the bankruptcy trustee and creditors committees are not excluded as “insured against insured” claims or otherwise.

- The types of exclusions from D&O policies (including exclusions contained in the definition of “loss” covered by the policy) are fairly standard. The language of these exclusions varies markedly from policy to policy, however. It is in this area that the “language makes a difference” rule noted above is most important. The presence or absence of a single word such as “deliberate” (as modifying the type of act that may be excluded from coverage) can make an enormous difference in whether a particular claim will or will not be covered.
- Private equity firms should be particularly vigilant concerning IPO exclusions – exclusions from coverage of claims relating to public offerings of securities of portfolio companies and purchases and sales of securities after a public offering. Consider limiting such exclusions to equity offerings, and defining the term “public offering” as narrowly as possible (for example, specifically to exclude management and other offerings under Reg. D, Rule 701 and other exemptions available under the securities laws).
- The effect of non-U.S. laws on what is covered in a U.S.-based policy (where the named entity is a U.S. company but a major subsidiary is not) should be analyzed and negotiated. For example, most U.S. policies exclude from the definition of “loss” civil and criminal fines and penalties. These exclusions are rooted in U.S. public policy relating to what losses are insurable. In other jurisdictions, however, fines and penalties may be insurable. Consider negotiating special endorsements covering non-

U.S. subsidiaries that expand coverage from what is available for U.S. companies.

- Will a fact pertaining to or knowledge possessed by one director or officer exclude coverage only of that director/officer, or of all directors and officers, even the “innocent”? Every policy should contain “severability” language specifying under what circumstances facts or knowledge will be attributed to other insured directors and officers.

When is a company covered? D&O insurance policies are “claims made” policies, that is, they cover claims made during the policy period, regardless of when the events that gave rise to the claim occurred. The policy period can be cut short if a company undergoes a change in majority voting control (for example, coverage terminates for claims made against a subsidiary after the subsidiary is sold, or under certain circumstances, becomes subject to bankruptcy proceedings). In addition, newly acquired subsidiaries may not be automatically covered unless notice is given to the insurer (and perhaps not even with notice, unless an additional premium is paid).

- Whenever a subsidiary is sold or the named entity otherwise loses majority voting control of a subsidiary, planning must be made for coverage of post-change in control claims relating to pre-change periods. Generally, a special “run-off” policy can be purchased to cover such claims.
- Whenever a new subsidiary is acquired, the D&O policy must be reviewed to determine what notice must be given to the insurer to ensure coverage of the subsidiary, and whether other measures must be taken.

Don’t forget the policy application. Many companies treat the policy application (particularly a renewal application) as a form of relatively little importance. But the policy may be rescinded for a mate-

rial misrepresentation or omission in the application.

- Does the policy application incorporate, by reference, the company’s financial statements and all documents filed with the SEC or other governmental bodies? If so, misrepresentations or omissions in those documents can result in rescissions of the policy.
- Coverage for subsidiaries and directors and officers not named in the application may be denied.
- Beware of attribution language (the reverse of severability language) in the application. Will a misrepresentation or omission in the application result in rescission of coverage for all directors and officers, even those innocent of the misrepresentation or omission?

Principals of private equity firms who serve as directors or officers of their portfolio companies may find themselves exposed to any number of unforeseen claims made by shareholders, creditors, employees and others. In order to protect their principals against such claims – and to better attract other talented individuals to serve as directors or join the management teams of their portfolio companies – private equity firms should put in place the full range of bylaw and contractual indemnification provisions and obtain D&O insurance policies crafted to the particular needs of their principals and other directors and officers of their portfolio companies. ■

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Most Private Funds Will Be Exempt From Anti-Money Laundering Compliance Programs

Congressional activism over the past year in response to corporate malfeasance and threats of terrorism has threatened to impose significant new regulatory requirements on the private fund industry. Fortunately, in one area, successful lobbying by commentators and industry professionals has narrowed the applicability of new anti-money laundering rules to exclude most private equity funds.

On September 18, 2002, the U.S. Department of the Treasury proposed a new rule under the Bank Secrecy Act, the anti-money laundering statute that was amended by the USA PATRIOT Act as a means to respond to terrorism. The rule will establish the minimum requirements for anti-money laundering (“AML”) programs for certain private funds, including hedge funds, commodity pools and real estate funds. Yet, in a significant development, most private equity funds will not be subject to the new requirements. The Treasury, in consultation with the SEC, concluded that private funds that do not provide for redemptions are not likely to be used by money launderers. Here are some FAQs about the proposed rule.

Will all private funds be subject to the rule? No. A private fund will be subject to the rule only if it (1) gives investors a right to redeem their ownership interests within two years after purchase and (2) has total assets of at least \$1 million at the end of the most recent calendar quarter. A fund organized outside of the U.S. that meets this criteria will be subject to the rule if it (1) sells ownership interests to a U.S. person or (2) is organized, operated or sponsored by a U.S. person (e.g., a

fund sponsor or manager located in the U.S.). Most hedge funds and commodity pools will be subject to the rule. Real estate funds that meet the above criteria also will be subject to the rule.

What private funds will not be subject to the proposed rule? Most private equity/venture capital funds do not provide redemption rights and thus will not be subject to the proposed rule. The rule also exempts private funds that are owned by one family, employees’ securities companies and most employee benefit plans.

What will a fund subject to the rule (“Covered Fund”) have to do if the rule is adopted? A Covered Fund will be required to develop and implement a written AML program reasonably designed to prevent the fund from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with the applicable provisions of the Bank Secrecy Act. The program must (1) establish and implement policies, procedures and internal controls reasonably designed to achieve these objectives; (2) provide for independent testing for compliance; (3) designate one or more persons responsible for implementing and monitoring the AML program; and (4) provide for ongoing AML training for appropriate persons. In addition, the Treasury encourages private funds to adopt procedures for voluntarily filing reports relating to suspected money laundering.

How will the regulators track down a Covered Fund to determine if it is complying with the rule? The rule will require a Covered Fund to file a notice with the Treasury’s Financial Crimes Enforcement Network. The notice will include

contact information for the fund, its sponsors and its AML compliance officer, the amount of the fund’s assets under management and the number of fund security holders. The rule also will require a Covered Fund to provide the AML program to the Treasury or its designee upon request.

When must a Covered Fund have an AML program that meets the standards of the rule? Ninety days after the final rule is published in the Federal Register. We therefore expect that AML programs will be required to be implemented during the first quarter of 2003.

Will private funds be subject to additional AML regulation? Maybe. Before the end of the year, the Treasury and the SEC are expected to submit to Congress a joint report recommending additional AML regulations for private funds.

In any event, AML regulation is likely to have an affect on private funds that are not subject to AML regulation. Many private funds not subject to the Bank Secrecy Act deal with financial institutions that are subject to its requirements. These financial institutions may be requesting private funds to provide additional information in order to fulfill their own obligations under the developing regulatory regime. Private funds may need to be in a position to respond to these requests. ■

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