Debevoise & Plimpton

Private Equity Report

Volume 3 | Number 3 | Spring 2003

Securitization of Private Equity Fund Interests: What Every Fund Sponsor Should Know

The possibility of securitizing private equity fund interests has been under discussion for several years now, in both the private equity and asset-backed securities businesses. To date, the institutions that have created securitized pools of interests in private equity funds have done so in order to move these assets off their balance sheets, often to obtain regulatory capital relief. These pools are sometimes referred to as CFOs, which is shorthand for "collateralized fund obligations" and a take off on the abbreviations for "collateralized debt obligation" funds (CDOs) and "collateralized loan obligation" funds (CLOs). In a CFO, as in any securitization, assets – in this case interests in private equity funds – are transferred to a special purpose vehicle (SPV). That vehicle, or another vehicle that owns all or substantially all of the equity in the SPV, issues one or, typically, several series of notes and equity interests to institutional investors. The more senior of these notes often are rated. In a CFO, even more so than in most securitizations, however, the assets being transferred into the SPV are highly illiquid and cash flows are unpredictable – distributions out of private equity funds are "lumpy." These limitations and other business and regulatory concerns, discussed below, raise serious concerns about whether private equity funds are an appropriate asset class to be securitized, and make these transactions difficult to complete. Thus, despite all of the talk about the securitization of private equity fund portfolios, the number of such transactions that has been completed to date can be counted on the fingers of one hand. Nevertheless, interest in CFOs remains strong. Now that more of these transactions are on the drawing board, sponsors of private equity funds ought to be aware of the issues raised by CFOs.

During the past four months, three major financial institutional investors with significant private equity portfolios have notified a number of our private equity sponsor clients that the financial institutions intend to securitize their portfolios of interests in private equity funds, including funds sponsored by our clients. Among other things, these financial institutions have asked our clients to consent to transfers of limited partnership interests in our clients' funds to SPVs formed in connection with the securitizations. While a transfer by a limited partner in a fund to an unaffiliated third party raises certain business and legal issues, generally these issues are easily handled. A transfer in connection with a securitization, however, raises significant additional legal and business issues, including (1) disclosure of confidential fund information, including potentially sensitive portfolio company information, to unrelated third parties, (2) creditworthiness of the new limited partner (the SPV), (3) increased risk of litigation, (4) tax and regulatory considerations, (5) anti-money laundering compliance issues and (6) legal fees and expenses incurred by the fund sponsor in its review of the securitization

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letter from the editor

As we put this issue of *The Debevoise & Plimpton Private Equity Report* to bed, it appears that Spring has finally, at long last, arrived. In celebration of its return, and, undoubtedly, of many of you to the fairways, our Guest Columnist, Joseph F. Coughlin, a Managing Partner at Corporate Risk Solutions LLC, aptly uses a golf analogy to explain how the incredible tightening of the insurance market over the last year-and-a-half necessitates that private equity firms carefully diligence the insurance marketplace as part of their pre-bid processes.

In our cover article, Michael Harrell and Mia Warren discuss the much-touted, but rarely completed, transaction of securitizing private equity fund interests and outline the legal and regulatory constraints that should make fund sponsors think carefully before consenting to a securitization of its funds' interests by institutional investors.

Elsewhere in this issue, David Mason reports that FASB is once again considering making the fair value method of valuing stock options mandatory in the wake of recent corporate accounting scandals and discusses the pros and cons of voluntarily adopting the fair value method early.

From an overseas perspective, Jeffrey Wood, a partner in our Hong Kong office, reports that while the recently adopted 2003 Chinese foreign investment rules do not fundamentally change the overall attractiveness of investing in China-based venture capital funds, the rulemaking process illustrates the surprising willingness of Chinese rulemaking authorities to work constructively with industry professionals. From Europe, we also describe structuring techniques that can mimic some of the benefits of convertible redeemable preferred shares notwithstanding the absence of a class of preferred stock under French company law.

Steve Hertz provides an interesting analysis of the enforceability of "Big-Boy" letters given spare case law and legal prohibitions against waivers of securities law protections. His article suggests key provisions for private equity investors to include in such letters to maximize the prospect of their being enforced.

Finally, in the context of a chilled deal environment and with recent corporate scandals making all buyers of businesses, both public and private, skittish, Andrew Bab suggests that seeking a limited indemnity from stockholders of a public target may be just the way to move a stalled deal forward.

These are just some of the topics we present in this issue for your interest and consideration. As always, if there is a issue of concern or a region of interest to your business that you would like to see addressed in these pages, we welcome your comments and suggestions.

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Could This Be the Year to Start Expensing Stock Options?

It is usually taken as an article of faith that a portfolio company should use the "intrinsic value" method of APB Opinion No. 25 (*Accounting for Stock Issued to Employees*) to account for option grants to employees, because under this method a fixed stock option granted with a fair market value exercise price will have no intrinsic value – no difference between the share value and the exercise price – and therefore the portfolio company would not recognize any compensation cost. The alternative "fair value" method of FAS 123 would require the company to recognize the value of an option calculated under a Black-Scholes or other similar option-pricing model (usually recognized over the vesting period). Because fair value is measured on the grant date, all option grants have some value (even those that later wind up out of the money). When given the choice between using a method that requires a compensation cost to be recognized or one that does not, the decision to use the no-cost approach would seem to be an easy one.

But all that may be changing.

The intrinsic value method has become much maligned in these post-Enron times, and its days may be numbered.

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More than 200 public companies, including Coca-Cola and American Express, have switched to the fair value method. FASB has announced that it is reexamining the issue, which is usually viewed as an opening for FASB again to try to make the fair value method mandatory, as it tried in the mid-1990s (when it was forced to back down under overwhelming pressure from Congress and the corporate community). Finally, the International Accounting Standards Board's Proposed International Financial Reporting Standard, *Share-Based Payment*, uses a fair value method, so the fair value method might become the rule as a result of the international convergence of accounting standards. It is, of course, impossible to predict with certainty when or if the fair value method might be made a requirement. But the odds would seem to suggest 2004 or 2005.

Why would a company voluntarily adopt the fair value method before it becomes mandatory? Under limited circumstances, a company may want to switch now in order to qualify for favorable transition rules set to expire near the end of 2003.

When a company switches to the fair value method, the question of how to treat previously outstanding awards raises some knotty questions. Originally, the transition rules in FAS 123 required companies switching to the fair value method to apply the fair value method prospectively. All awards granted after the beginning of the year in which a company elects to switch to the fair value method must be reported using the fair value method, and companies are generally not permitted (much less required) to apply the fair value method to awards granted in prior years. This led to criticism. Some of it from "purists" who argued that companies were only telling half the story, in that only future grants would be expensed. In addition, and perhaps more importantly, many companies criticized the rule because compensation expenses would seem to artificially ramp up year-to-year. For example, let's take a company that each year grants options with a fair value of 100 vesting over four years. If the company first adopted the fair value method for 2003, it would show 25 of expense in 2003 – nothing for the prior awards, and 25 for the portion of the grants made in 2003 that vest in that period. In 2004, it would show 50 of expense, 25 from the vesting of the 2003 grants and 25 for the 2004 grant. An increase in expense, even though the company had been doing the same thing year after year. The "ramp up" problem is likely less of a concern for private equity portfolio companies, which typically do not make annual option awards (instead favoring one-time awards).

The difficulties raised by the transition rules originally found in FAS 123 led FASB to issue FAS 148, which generally supercedes FAS 123's transition rules. FAS 148 no longer permits the fair value method to be applied purely prospectively, *unless the company switches to the fair value method before December 15, 2003*. Companies switching to the fair value method in fiscal years beginning *after* December 15, 2003 (*i.e.*, the 2004 fiscal year) are required to recognize expense as if the fair value method had been applied to *all* awards granted after December 15, 1994. Thus, companies switching methods after December 15, 2003 would be required to recognize

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guest column

Due Diligence – A Duffer's Delight

Like many of you, two of my biggest interests are golf and the private equity business. Sometimes I think that the private equity business and a golf game are exact opposites except, perhaps, that both skill and luck are important in both. When it comes to due diligence in the private equity world, the "winner" of the game will not be the player with the lowest score, or the most direct approach to the hole. It will be the player who has covered the most terrain, landed in the most traps, explored neighboring fairways and roughs and ultimately arrives on the 18th green exhausted. Here, the miserable golfer is actually our due diligence Champion.

The role that insurance plays in private equity investing has never been more relevant. Since the late '70s, there have been two fundamental approaches to private equity investing – that of the financial buyer and the hybrid operational/financial buyer. While each style has its own pros and cons, historically the latter has had a more thorough approach to due diligence, in part because the operating partner has more first-hand knowledge of the impact of insurance costs and their effect on profit margin. For many years, however, this focus was not necessarily recognized. From 1985 through mid-2000 the insurance industry went through a downward-spiraling soft market, making insurance more of a commodity. It was plentiful, it was flexible and it was cheap. Insurance could easily and economically be used to fill inadvertent cracks that may have appeared in the walls or foundation of an acquired company even after closing. In short, making informed insurance decisions was less critical.

It certainly has been a new market over the last year-and-a-half. The once invincible soft market has been replaced with a new hard one that is wreaking havoc on its quest for underwriting stabilization and investment returns. The harshness of the current insurance environment has clearly made itself known in every boardroom of every portfolio company and at every private equity fund. The insurance marketplace has turned with a vengeance on unsuspecting private equity firms which were created in the soft cycle and which never experienced anything but year after year of 20% decreases in insurance costs. Gone, at least for now, are the days of tower programs with shared aggregate limits. Gone are the unsupported programs that did not require letters of credit. Surety issues are virtually impossible to weave around, and product liability and pension trust issues have everyone's ear. Today there is a forced awakening to insurance due diligence, and the very critical role insurance plays in private equity transactions.

Private equity firms contemplating divestitures need to pay careful attention to boxing future insurance impact on Newco prior to submitting a bid. Lenders are increasingly concerned about insurance programs and a comfort factor must be achieved to get funding commitments. In many cases it is not uncommon to have extremely intrusive questioning on behalf of lenders seeking a sense of security with insurance risk. Today's market demands accountability for the past, an understanding of the present and a business plan for the future.

In one recent example, three credible private equity bidders went head-to-head in an auction for a company with a bona fide product liability exposure. Only one firm had already received a firm commitment from the most viable insurer in this particular products arena to support a product liability program into the future. The other two firms are in for a rude awakening should their bids prevail. Even the most skilled investor cannot predict the tightness in the product liability marketplace without thorough due diligence of insurance options and potential litigation exposure. Multiple 100% increases tend to be hard to digest under the best of circumstances, let alone in a faltering economy.

We recommend that private equity players carefully diligence the insurance marketplace to determine the best way to provide the appropriate amount of coverage of potential acquisition targets with the best carriers at the lowest cost. The stakes in the insurance environment have gotten higher, and it deserves the kind of thoughtful due diligence that private equity investors undertake in many other aspects of their business. ▢

— Joseph F. Coughlin
Managing Partner, Corporate Risk Solutions LLC, an advisory services provider to the private equity and mergers and acquisitions communities

Do Big-Boy Letters Really Work?

In recent years, private equity players and other M&A professionals have increasingly employed so called "Big-Boy" letters as a means to allocate risk in transactions involving the sale of securities.

Big-Boy letters are typically utilized in connection with private sales of publicly traded securities, where one party has non-public information that is not available to the other party and both parties wish to preclude any subsequent claims by the non-insider based on the non-disclosure of that information, including any claims arising under Rule 10b-5. While Big-Boy letters come in different shapes and sizes, they all typically include very broad representations by the non-insider that (1) it is financially sophisticated, (2) it has had the opportunity (whether or not exercised) to conduct the due diligence it wishes to conduct in connection with the transaction, (3) it is not relying on any representations not expressly set forth in the Big-Boy letter, and (4) it waives all claims against the insider arising out of the purchase or sale of the securities, including all claims under Rule 10b-5 with respect to the non-disclosure of any non-public information.

There is no question that the colorful term "Big-Boy" letter deserves inclusion in the Legal Buzzwords Hall of Fame, right beside "poison pill," "cram-down" and "caveat emptor." But in light of Section 29(a) of the Securities Exchange Act, which provides that waivers of compliance with any portion of the Exchange Act are void, and the well-known common law principal that "fraud vitiates everything," the harder question is: are these letters enforceable?

The answer is "yes, probably." The reason for the hedge is due to the absence of any controlling case law in this area and the fact that most fraud and 10b-5 claims turn uniquely on the facts and circumstances of a particular transaction. But an emerging body of case law in similar – although not identical – contexts suggests that these letters are likely to be enforced in most circumstances, in large measure due to the very strong judicial bias in favor of enforcing express contractual provisions as written, particularly when they are the product of arm's-length negotiations between sophisticated, well-represented parties.

Background

Big-Boy letters have traditionally been utilized by financial sellers of distressed debt securities, where the seller has non-public information due to its membership on a creditor's committee of the issuer. In these situations, the seller is often barred by a confidentiality agreement from disclosing non-public information or concludes that it is simply impractical to disclose all of the non-public information in its possession to the purchaser. Even if the seller can disclose the information, the purchaser may be unwilling to accept it because it wants to be able to resell the securities freely, without having to worry about whether it is in possession of inside information.

Big-Boy letters are now also being employed by private equity funds when they seek to purchase or sell (typically in private transactions) securities of a portfolio company that they have successfully taken public, or in which they otherwise hold an investment. In this context, the fund may have non-public information as a result of its historical relationship with the issuer or, in some instances, as a result of its right to designate one or more directors or its provision of management services. Here, the fund is unlikely to be restricted by a confidentiality agreement from disclosing non-public information, but may not be in a position to disclose it for reasons similar to those that have historically applied to sellers of distressed debt securities.

In some cases, insiders recognize that the non-public information in their possession is material. In other cases, insiders genuinely believe that the non-public information in their possession is not material in light of the total mix of publicly available information. Still, given the volume

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Making Sense of the New Tax Rules Applicable to Confidential Transactions

You have probably heard about but do not really understand the new rules issued by the IRS regarding so-called "confidential transactions." This article explains the thinking behind the new rules and recommends an approach for dealing with them.

Background

In order to understand the new rules, it is helpful to put them in context. The last five to 10 years have witnessed a resurgence in the marketing of tax shelters. The tax shelters of today are far more sophisticated and complicated than the ones marketed 20 years ago and involve much larger dollars. An individual tax shelter often involves claimed tax savings in the hundreds of millions of dollars. Along with the level of sophistication and dollars involved, the types of promoters have grown to include the big accounting firms, large New York law firms and investment banks and the types of consumers of the tax shelters have expanded to include large public corporations.

Many of the tax shelters are considered proprietary by the promoter and are offered under conditions of confidentiality – meaning that a person offered an interest in the tax shelter is required to agree up front that it will not disclose the structure of the tax shelter to anyone, including its regular tax advisor.

Although the IRS invariably challenges each new tax shelter, there is a significant time lag between when a new shelter is first marketed and when the IRS learns about it. Also, less than 1% of taxpayers are audited each year, and, therefore, even if the IRS knows about a particular tax shelter, the chance of the IRS actually challenging the treatment by any particular taxpayer remains relatively small. As a result, the audit lottery has proven to be a profitable bet for many taxpayers participating in tax shelters.

The new regulations are intended to change the odds by listing a variety of features that are common to tax shelters (such as confidentiality) and requiring each taxpayer who engages in a transaction that has one of these features to file a form with the IRS Office of Tax Shelter Analysis that describes the transaction and its intended tax treatment. This allows the IRS to learn about tax shelters more quickly. In addition, if an advisor (such as a law firm or placement agent) to a transaction that has one of these features makes any kind of statement about the tax treatment of the transaction, the advisor is generally viewed as a promoter of the transaction and is required to keep a list of each person who participates in the transaction. This allows the IRS to learn about each taxpayer who participated in a particular tax shelter and challenge the treatment claimed by all of the participating taxpayers in a systematic and coordinated manner.

Confidentiality

Because tax shelters are often sold pursuant to confidential offerings, the regulations treat confidentiality as one of the features common to tax shelters. Accordingly, a transaction is considered a "reportable transaction" under the regulations (meaning that taxpayers who participate in the transaction are required to file the form with the IRS and material advisors are required to keep lists of taxpayers who participate in the transaction) if it is "offered under conditions of confidentiality." A transaction is considered offered under conditions of confidentiality if the taxpayer's disclosure of the "tax treatment" or the "tax structure" of the transaction is limited in any manner by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement to the taxpayer about the potential tax consequences of the transaction.

The fundamental problem with this new regulation is that many (if not most) regular, commercial transactions (such as M&A deals, debt and equity offerings, licenses, etc.) that have nothing to do with tax avoidance involve agreements that contain confidentiality agreements. As a result, these transactions are generally treated as reportable transactions under the regulations if any party makes any kind of statement about the tax treatment of the transaction to another party, unless the typical confidentiality provision is modified to permit disclosure (to anyone) of the tax structure and the tax treatment of the transaction. However, adding this carve-out is troubling because (1) the term "tax structure" is given an extremely broad meaning by the regulations, (2) nobody really knows how to apply the definition of "tax structure" to regular, commercial transactions, and (3) it probably includes waiving confidentiality as to underlying facts which the parties would otherwise prefer to keep confidential.

Also, even if carve-outs permitting disclosure of the tax structure and tax treatment are added to the express confidentiality provision, the IRS can still assert that there was an implied understanding that the tax structure would be kept confidential and therefore the transaction is reportable. In order to reduce this possibility, the regulations allow taxpayers to add the following language, in which case the transaction will be presumed *not* to have been offered under conditions of confidentiality: "The taxpayer (and each employee, representative or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer related to such tax treatment and tax structure." The downside to adding this language is that the reference to "all materials of any kind" will in many cases allow disclosure of even more information that the parties would prefer to keep confidential.

What's So Bad About Engaging in a Reportable Transaction?

For the taxpayer who participates in a reportable transaction, the most significant concern is that it will increase audit risk. (Of course, even taxpayers who believe their tax return is correct in every respect do not wish to be audited.) It is unclear whether the fear of increased audit risk will turn out to be justified in cases where the reportable transaction is clearly not designed for tax-avoidance purposes.

For the material advisors (*e.g.*, investment banks that serve as advisors or placement agents), the biggest concern is their ability to comply with their obligations to keep lists of information about each transaction that they are involved with and turn that information over to the IRS if the IRS asks for it. For investment banks and other advisors that work on thousands of transactions each year, this is an unbelievably difficult task, as the regulations generally require the advisor to keep a list of *each* participant in every transaction that is considered reportable under the regulations, as well as certain other information about the transaction. Although these obligations only arise in respect of a transaction if the advisor makes a statement (oral or written) that relates to a tax aspect of the transaction, such statements in fact are frequently made and it is virtually impossible for a large investment bank or other similar advisor to monitor whether any person (whether managing director or associate) on the team made such a statement at any point during the course of the transaction.

What Are Private Equity Firms Doing in the Face of These Regulations?

There has not been a universal response by private equity firms to these regulations. Some firms have decided not to add any kind of "tax structure" or "tax treatment" carve-out to the confidentiality provisions contained in their offering documents and fund agreements, based on the firm's decision that confidentiality is of utmost importance and that being considered a reportable transaction is not that bad. Other firms do not view confidentiality as important at all and have, therefore, added the presumption language to their offering documents and fund agreements.

Most funds have tried to have it both ways, meaning that they have added language that is intended to avoid treatment as a reportable transaction, but still limits disclosure of certain information that the fund feels is important to keep confidential. For example, some funds have said that the "tax structure" and "tax treatment" may be disclosed, but that the name (and identifying information) of the fund is not part of the tax structure and therefore may not be disclosed. Other funds have taken a similar position with respect to the track record and certain other information contained in the offering document. Still other funds are prohibiting disclosure of the name and other identifying information of the fund just during the marketing of the fund.

The new regulations are intended to change the odds by listing a variety of features that are common to tax shelters (such as confidentiality) and requiring that each taxpayer who engages in a transaction that has one of these features file a form with the IRS Office of Tax Shelter Analysis that describes the transaction and its intended tax treatment.

What Should You do in the Face of These Regulations?

The lawyerly answer is that you should consider the issue separately for each transaction, based on how important confidentiality is to that particular transaction. However, if you take this

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China's Revised Venture Capital Rules: The Rule-Making Process in China

In August 2001, China released then-new foreign investment rules intended to encourage foreign sponsors to form China-based venture capital funds. These rules (the 2001 Rules) imposed many non-market restrictions on fund formation and operation. There was also no way foreign investors could use them without becoming subject to on-shore rates of taxation on investment gains – at a 15% rate if you were an optimist and believed that the Chinese would allow foreign economic zone incentive tax rates to apply to financial investments as well as direct investments in productive assets, or otherwise at a 30% rate.

In December 2001, we were invited by Xiaoyang Yu, a principal of Victoria Capital (a Hong Kong-based boutique corporate finance advisory firm), to join them in explaining to the drafters of the 2001 Rules why those rules were destined to be unsuccessful. The all-day meeting with representatives of seven ministries led to a request that we and Victoria Capital suggest to the relevant staff members ways in which the 2001 Rules might be improved, within the context of existing laws and regulations.

From January to September 2002, we exchanged five or six drafts with MOFTEC (the Ministry of Foreign Trade and Economic Cooperation, now under the new name of the Ministry of Commerce), the lead agency responsible for the 2001 Rules, and provided them as well as the central taxation authority with a great deal of background information about the organization and technical operation of international venture capital funds. At the same time, our friends at Victoria Capital tried to make sure the staff members understood the economic and other practical motivations of fund managers and fund investors.

The most interesting thing about this process to us was the willingness of the various ministry representatives to listen to the suggestions we made and to take them into account in the successive drafts. The whole process bore little resemblance to some of the criticism one hears of Chinese rule-makers. They seemed genuinely interested in understanding industry practice and in accommodating to it whenever it would not conflict with fundamental principles that, as mid-level administrators, they could not easily change. Our lawyers and Xiaoyang Yu were able to talk quite openly with the staff members to ask them why particular comments from us were not accepted, or why they had implemented them in ways we found peculiar and counterproductive. Their answers were generally frank and straightforward.

The larger message we draw from this is twofold. first, if you have an interest in the Chinese rulemaking process you are far more likely to be successful if you try to insert yourself as an educator and not as a pleader for a specific interest or transaction. It was quite clear that we had no "client" whose particular views and needs we were seeking to accommodate. Similarly, Victoria Capital was not in the process of trying to get a specific fund approved. We were both honestly able to say that "this is business we want to do but under the rules you have drafted we simply can't do it – and here are the 15 reasons why."

Second, it was clear from the beginning that our goals were not at cross-purposes with the ministries' goals. The staff was charged with trying to bring both foreign capital and foreign fund management skills into China. We were not in the position of making zero-sum game arguments – where any gain for the foreigners would have been a loss for China. Instead, we were able to take what amounted to a moral high road and say, as to most of the unsatisfactory provisions of the 2001 Rules: "Look, these do nothing to protect legitimate Chinese interests, and at the same time they are totally inconsistent with the expectations of fund managers and investors as to the way in which venture capital and private equity funds operate."

And even in the taxation discussions, we could show that we were not pleading for special treatment in China because investing in China was, for example, more dangerous or more risky. It is easy to show that China's tax treatment of venture capital investments by off-shore investors diverges so much from the treatment of off-shore venture capital and private equity investment in most of the rest of the industrialized (and industrializing) world that a reasonable investor would not want to invest significant amounts

in a China-based fund even if the risk-reward profiles were otherwise equal.

This back-and-forth drafting process continued until the fourth quarter of 2002. Toward the end of the process, as word began to filter out that new rules were being considered, other venture capital and private equity firms begin asking about them. MOFTEC showed a good deal of bureaucratic sophistication at this point by converting the process to almost the equivalent of a public hearing on the new rules. The new China Venture Capital Association, a group of off-shore and domestic venture capital firms, including some of the biggest international players, was then just being formed. MOFTEC made the draft rules available to the association's board for comment, and then met with them (and with us again) to discuss the draft – effectively deflecting any future argument that the "industry hadn't been consulted."

So what did this nine- or 10-month process produce for the international venture capital industry? The best short answer is "not enough" – but this is not the fault of MOFTEC and the other ministries involved in formulating the new rules. The new rules, published in February 2003 (the 2003 Rules), eliminated many if not most of the structural problems associated with the 2001 Rules. Unfortunately, the central taxation authority did not, in spite of what appeared to be strenuous efforts by MOFTEC and others, change the tax rules applicable to off-shore investors in on-shore funds. So, for the time being, we are left with rules that would probably work procedurally and administratively, but in an uneconomic tax environment where China will tax investment gains by foreigners at rates of 30% or, in the best case, 15%. For this reason, we are of the view that the 2003 Rules "do not fundamentally change the overall attractiveness of investing in China."

Having said this, we think it is still useful to understand the structure of the 2003 Rules, including some of the ways in which they might be used, if only because we understand that the tax question is still under discussion in China.

- The 2003 Rules are officially targeted at "venture capital" sponsors and investors. However, because permitted investments are not limited to pure venture capital start-up situations, we believe that private equity fund sponsors could also organize a fund under the 2003 Rules. (Some thought, however, would have to be given to the fund's statement of purpose. As with many other things in China, so long as one's intent can be stated in language that complies with the terms of the relevant rules, and one operates within the letter of the relevant rules, the fact that the ultimate outcome somewhat differs from official expectations at the time the rules were promulgated is not normally a problem.)
- Even in the absence of favorable tax treatment, a fund sponsor could organize for a taxable manufacturing company (as distinct from a tax-exempt institutional investor) a very flexible vehicle for making, holding and disposing of industry-specific venture capital and other small strategic investments. In such a structure, the sponsor would have to cede much more investment control to the investor than is customary elsewhere in the world, and as a result would probably not be given the same upside as in a true managed fund. But such a vehicle would give the sponsor an opportunity, supported by a deep-pocket investor, to get inside the process and understand the 2003 Rules in anticipation of future tax changes that would make investing under the 2003 Rules viable for traditional private equity investors.
- The other interesting avenue for exploration is using the 2003 Rules as a basis for mobilizing primarily domestic money. A fund formed under the new rules need have only 25% foreign investment. The balance can be domestic. Moreover, the minimum size of a fund under the 2003 Rules is only U.S.$10 million. Therefore, a fund sponsor with Chinese domestic contacts could organize a small fund, of, say U.S.$20 million, with primarily domestic investors, and market the remaining interests to a few foreign investors on the basis that, although the tax rates are unattractive, this is an inexpensive

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...[I]f you have an interest in the Chinese rulemaking process you are far more likely to be successful if you try to insert yourself as an educator and not as a pleader for a specific interest or transaction.

Indemnification by Stockholders of Public Targets

Private equity firms considering acquisitions of public companies generally worry about all the added risks the public nature of the target entails – visibility, public disclosure, a hefty dispersed stockholder base (read: "potential plaintiffs"), limited due diligence. They also recognize that unlike in private deals, stockholders of public companies don't usually indemnify the buyer for breaches of representations and warranties. Since the Enron, WorldCom and other debacles, this absence of post-closing protection has become an even greater concern, as buyers of public companies become increasingly worried that no matter how good their due diligence may be, they could still miss something ugly that could come back to bite them after the acquisition closes.

In this brave new world marked by increased regulatory burdens on public companies and a skittishness for dealmaking, public companies may become more receptive to innovations that encourage dealmaking or help deals get across the finish line. A public indemnity is one such innovation. Why not ask the target's public stockholders to indemnify the private equity buyer for breaches of representations in the acquisition agreement? Although this technique was used fifteen years ago when U.S. Cable Television Group bought Essex Communications, very few if any deals have used a public indemnity since.

What would a public indemnity look like? In a cash acquisition, the private equity firm might place a portion of the cash consideration into a trust. Subject to a variety of negotiated limitations (*e.g.*, baskets, caps, survival periods), the private equity firm could recover cash held in trust if it demonstrates that the target breached its representations in the merger agreement. To protect the target stockholders, the agreement should contain a dispute resolution mechanism that ensures that appropriate challenges to the private equity firm's indemnity claims are made and resolved fairly. After all timely indemnity claims are resolved, each former target stockholder would receive its *pro rata* portion of the remaining corpus of the trust. The indemnity might be made more palatable to the target stockholders by limiting it to breaches of particularly important representations – accuracy of financial statements and absence of undisclosed liabilities, for instance.

Despite… concerns, a limited indemnity might be just the thing to jump-start a stalled deal in the current environment or to encourage a private equity firm to consider a public acquisition[;]… given the choice between no deal and a good deal with a limited indemnity, target stockholders may well choose the latter.

Would the target stockholders' contingent right to the money in trust be considered a security requiring registration under the federal securities laws? If the right is structured properly, the answer is probably no. In the 1988 *Essex Communications* no-action letter (which involved a public indemnity similar to the one described above), and in the later *Celina Financial* no-action letter, the SEC made clear that as long as the following conditions (among others) are met, contingent rights need not be registered:

- The rights must be granted *pro rata* to stockholders as an integral part of the acquisition consideration;
- The rights must be uncertificated and not transferable;
- The rights may have no voting or dividend privileges; and
- The amounts paid pursuant to the rights must not depend on the operating results of any relevant entity.

The proposed indemnity structure should satisfy all of these conditions.

Of course, if the logistical issues (*e.g.*, keeping track of the names and addresses of potentially tens of thousands of former stockholders) become overwhelming, or the target stockholders desire additional liquidity, there is no reason that the interests in the trust cannot be registered and traded publicly, although some of the benefits of a cash deal – speed and limited disclosure – would be lost. For private equity firms, the continuing disclosure obligations associated with a publicly traded security may be particularly distasteful. Fortunately, the logistics have been successfully addressed without registration in related contexts.

Whether or not the rights are traded, there is a question as to whether stockholders would discount the overall value of the transaction consideration due to the conditional nature of the contingent rights. And what would the investment banker's fairness opinion

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Going, Going, Gone?

In our last issue, we promised to update you once the Delaware Supreme Court issued a full opinion explaining its split 3-2 decision to enjoin a fully locked-up merger in Omnicare-NCS. *(See "Goodbye to Lockups?" in the Winter 2003 issue.) After a nearly four-month wait, the opinion has been released. It's an important decision for private equity firms because it sets a bright-line test that will limit a firm's ability to control the sale process for a public company. At the same time, it creates new line-drawing challenges for M&A dealmakers.*

Reminder of the Facts

Near-insolvent NCS looked for an acquiror. Of two nibblers, only Genesis initially offered a price that would repay NCS' debt and pay something to stockholders. Omnicare then made a higher bid, but with a due diligence condition. Genesis bumped, but only if NCS agreed to a total lock-up: NCS stockholders holding a majority of the voting power had to commit to vote for the merger, and NCS had to agree to put the merger to a stockholder vote, even if NCS' board no longer recommended the deal. These provisions guaranteed Genesis' deal would be approved, even if a better bid appeared (and one did: Omnicare offered more than double Genesis' price per NCS share).

The majority in *Omnicare* found the NCS lock-ups invalid and unenforceable because:

- they were "preclusive and coercive," and therefore not a reasonable response to a threat, under *Unocal*, since stockholders couldn't take a better deal; and
- the board had no authority to approve a merger agreement that prevented it from executing its ongoing fiduciary responsibilities.

The majority said boards may agree to merger protection devices that increase the cost to a competing bidder and are "economic and reasonable," but the devices "cannot limit or circumscribe the directors' fiduciary duties." The court held that the board was "required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities."

In a vigorous dissent, the minority justices called the majority rule "clearly erroneous" and noted there could be circumstances when business realities demand a lock-up to permit wealth-enhancing transactions to go forward. The dissenters, concerned that the majority's bright-line prohibition would deter bidders who are willing to bid only with solid deal protection, expressed the hope that the decision will be interpreted narrowly.

The majority's language, however, doesn't leave much room for a private equity firm holding a major stake in a public Delaware target to grant complete deal certainty to one bidder before the stockholders have voted. That's a bright-line test. Less clear is how far the large stockholder can still go to grant deal protection to a buyer.

Approaches to explore:

Lock Up Less Than a Majority

The NCS lock-up provided certainty that the deal would be approved. Target's board should be able to approve lock-up agreements with stockholders owning less than a majority, or perhaps covering only a portion of a majority stockholder's shares. How much less? Presumably, enough so that a competing bid still is a realistic possibility.

Dis-Incent the Private Equity Firm

Maybe the private equity firm, or another of Target's large stockholders, can agree to pay over to Bidder 1 much of its upside if Target is sold to a higher bidder. That's not a lock-up, but it lessens the big stockholder's incentive to entertain a competing bid. A private equity firm would need to consider carefully its fiduciary duties to its fund investors before deciding to give up possible upside.

Similarly, the large stockholder might agree with Bidder 1 not to tender to another bidder or to vote in favor of another bid even for some months after the deal with Bidder 1 is terminated. The legal question: for how long before that would be viewed as precluding a competing bid?

Is Target Board Approval Needed?

Can the deal be locked up by having the private equity firm commit to tender into Bidder 1's offer? That won't work if Target board action is otherwise required – *e.g.*, to amend a pill or bless a transaction under a business combination act. Would Bidder 1 be willing to proceed without the benefit of representations and warranties in a merger agreement

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One likely Omnicare *result: more private equity firms and founding stockholders will have companies opt out of business combination acts, and not adopt poison pills.*

Convertible Preferred Shares *à la Française*

U.S. private equity and venture capital funds are sometimes reluctant to make minority investments in or participate in LBOs of French companies or use a holding company outside of France once they learn that the equivalent of convertible, redeemable preferred shares does not exist under French company law. This initial reaction stems from a perception that the economic rights and legal protections offered by a U.S. preferred-share instrument cannot be obtained under French law. While it is unfortunately true that the U.S. investor may have to forego certain of the rights and protections a U.S.-style instrument would provide, there are structuring approaches that, although adding a layer of complexity, can provide a private equity or venture investor with rights and protections similar to those obtained in a U.S.-style preferred instrument.

The U.S. Investor's Perspective

A U.S. private equity or venture investor will generally approach a minority investment in a French company with the same expectations regarding the overall package of rights and protections as those involved in an investment in preferred shares in the U.S. These expectations typically include guaranteed economic returns via fixed dividends and a priority return upon a change of control, protection for the initial investment by way of a liquidation preference and mandatory redemption, the right to participate in the equity upside via a conversion feature, anti-dilution protection through adjustments to the conversion ratio and preemptive rights, governance rights via board representation and information rights and the additional liquidity provided by tag-along and drag-along rights.

The French Landscape

As a preliminary matter, this article assumes that the French company will be a *société anonyme* (SA), which is the French corporate form most analogous to an American corporation and one of only two allowable corporate forms for French publicly listed companies (the other form being of little interest where outside investors are involved). Where, however, the French company is a *société par actions simplifée* (SAS), greater flexibility exists to structure many of the U.S.-style rights and protections in the articles of incorporation, alleviating many of the concerns discussed in this article. Nonetheless, the SAS form would present separate issues, including the need for the company to be converted into an SA prior to any IPO. Additional structuring at the time of the investment would be required to provide for the eventual conversion and many authors suggest that, in some circumstances, a unanimous vote of shareholders would be required upon conversion.

Although French company law does allow for creation of a class of preferred shares (*actions de priorité*) that have special rights giving them a ranking superior to common shares, some of those desired rights cannot be built into the company's articles of incorporation as part of the preferred-share instrument. However, many of these rights can be obtained either through a shareholders' agreement or a simultaneous issuance of specially designed securities (*e.g.*, warrants or bonds). Additionally, shareholders' agreements can reinforce certain of the rights provided for in the preferred-share instrument.

The Share Instrument

The rights and protections that can be achieved through a preferred-share instrument include preferential dividends, a priority distribution upon liquidation, rights to nominate directors for election to the board and special veto and information rights. Certain particularities of the French legal system do, however, make French preferred-share instruments less effective in protecting the investors' rights and more difficult to implement than their U.S. counterparts.

Shareholder approval required for issuance of preferred shares. One of the principal hurdles U.S. investors will encounter when attempting to structure a preferred-share investment in a French company is the need to obtain shareholder approval for the issuance of the preferred shares. In Delaware, "blank check" preferred provisions are frequently contained in a company's certificate of incorporation and allow the board of directors acting alone to set the terms of and to issue a new series of preferred shares so long as the voting power of the preferred shares does not implicate the stock exchange shareholder approval requirements. In France, by contrast, the issuance of preferred shares will always require shareholder approval, because under French company law, all shareholders have statutory preemptive rights that would normally apply to the issuance of the preferred shares. A supermajority vote of the shareholders is required to waive these preemptive rights and allow the issuance of the preferred shares to the investors. Additionally, because the preferred shares can be viewed as creating special

rights for a particular group of shareholders (*i.e.*, the preferred investors), a report of a special auditor may be required to be presented at the shareholders' meeting approving the issuance of the preferred shares. The preparation of such a report can raise timing concerns, and the need for shareholder approval prior to the issuance of the preferred shares can present an execution risk, in part because the shareholder approval cannot be put in place in advance of the specific proposed issuance. An undertaking to vote in favor of the issuance of preferred shares could be provided for in a shareholders' agreement (but is not specifically enforceable).

Avoiding "clauses léonines." An impediment to crafting the financial preferences for the preferred shares, such as preferential dividends or a priority distribution upon liquidation, stems from the prohibition in French company law on provisions deemed "unconscionable" (*clauses léonines*), which includes provisions that completely deprive the common shareholders of interests in the profits of the company or that protect certain shareholders from participating in losses suffered by the company.

Liquidation preferences. In practice, this means that the liquidation preference of the preferred shares, *i.e.*, the amount of the priority distribution to preferred shareholders upon liquidation, should be structured as a percentage of the assets available for distribution to shareholders rather than the typical U.S.-style fixed dollar amount. (Note that the inclusion of a liquidation preference in the preferred applies only to the actual liquidation of the company and not to other events such as a merger, consolidation, asset sale, etc. that are sometimes characterized as "liquidation events" in U.S. preferred share instruments.) A consequence of structuring the liquidation preference as a percentage of distributable assets is that in the event of the company's liquidation the preferred shareholders are not guaranteed a return of their initial investment in priority to distributions to common shareholders. Super-multiple and participating preferences would most likely be viewed as unconscionable and, therefore, prohibited.

Preferential dividends. The prohibition on *clauses léonines* seems to have less of an effect when structuring preferential dividends than liquidation preferences. Specifically, French company law permits the dividend to be set at a percentage of the subscription price for the preferred shares. The major difficulty under French law would be to structure the preferred shares as a pay-in-kind (PIK) instrument, which frequently occurs in the U.S. when the company is not expected to generate significant distributable cash. A PIK instrument in France is impractical because it would require initial shareholder approval of the PIK feature as well as reauthorization for the issuance each year of additional shares in the amount of the dividend payment. In addition, if the company has already issued convertible bonds, the unanimous approval of the bondholders would be required before any preferred stock with preferential dividends could be issued.

Board representation. While French company law does allow assignment of rights to board representation to specific classes of shares, certain provisions make enforcing those rights difficult. As a general matter of French law, directors are elected by shareholders representing a majority of shares of all classes voting together without any class distinction. Several mechanisms exist to achieve the goal of electing directors designated by the investors. These mechanisms cannot, however, completely eliminate the freedom of shareholders to vote for the candidates of their choice. Accordingly, while French company law permits provisions requiring that a certain number of directors must fulfill specified criteria and/or be chosen from a list established, for instance, by the preferred shareholders, the company's shareholders must be able to decide between several candidates. Additionally, *any* director can be removed with or without cause by a majority of the shareholders. Consequently, even though the terms of the preferred shares may provide that the preferred shareholders are entitled to board representation, investors cannot be certain of having permanent board representation unless the company's

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While it is unfortunately true that the U.S. investor may have to forgo certain of the rights and protections a U.S.-style instrument would provide, there are structuring approaches that, although adding a layer of complexity, can provide a private equity or venture investor with rights and protections similar to those obtained in a U.S.-style preferred instrument.

transaction. The following is not intended to be a detailed examination of a securitization transaction, but rather a thumbnail sketch of the major issues of interest to a fund sponsor.

Structure

A securitization of interests in private equity funds generally involves the following basic (and for purposes of this article, simplified) steps: The limited partner (the Transferor) will transfer all or a portion of its portfolio of interests in private equity funds (the Funds) to an SPV. The SPV will be admitted to the Funds as a substitute limited partner in respect of the transferred interests. The SPV will assume all of the rights and obligations of the Transferor under the Funds' limited partnership agreements, including the obligation to make ongoing capital contributions for investments, expenses and management fees, as well as any "LP clawback" obligations, pursuant to an assignment agreement.

The SPV will grant a 100% (or nearly 100%) participation interest in the distributions and rights to distributions in respect of the SPV's interest in the Funds to a bankruptcy-remote entity that will serve as the securitization vehicle (the Issuer). Typically the SPV will also grant a security interest in the limited partnership interests held by it to the Issuer to secure payments due under the participation. As consideration for the participation, the Issuer will pay cash and other securities to the SPV.

The Issuer will be capitalized through the issuance of one or more tranches of rated and (for the more junior notes, unrated) notes (the Notes) to institutional investors that qualify as "qualified institutional buyers" within the meaning of Rule 144A promulgated under the Securities Act of 1933 (the Securities Act). The Notes will be secured by, among other things, a pledge by the Issuer of the participation interest in the limited partnership interests held by the SPV. The proceeds from the sale of the Notes will be used to capitalize the SPV and pay for the limited partnership interests transferred to it by the Transferor.

The SPV will be a limited partner in the Funds in which it acquires interests and, as such, will be entitled to exercise all of the rights, and will retain all of the obligations, of a limited partner of such Funds. The Issuer generally will be a passive entity (at least in the absence of a default) with no rights to cause the SPV to take any action as a limited partner of any of the Funds.

The Issuer will use distributions from the SPV (assuming that the SPV has received sufficient distributions from the Funds in which it holds interests) to service the Notes, generally backstopped by a liquidity facility and reserves. The SPV will honor its obligations to the Funds, such as the obligation to make capital contributions to fund investments and management fees, out of reserves, a liquidity facility and/or distributions from the underlying Funds.

Fund sponsors generally wish to keep information about the Fund, its performance and its portfolio companies confidential.... Fund sponsors should carefully consider what information can and should be released to the various third parties involved in a securitization transaction.

Disclosure Issues

Fund sponsors generally wish to keep information about the Fund, its performance and its portfolio companies confidential. Sensitivity to confidentiality issues has been increased by the recent flurry of state Freedom of Information Act (FOIA) requests made by newspapers and other organizations of public plan limited partners. Fund sponsors should carefully consider what information can and should be released to the various third parties involved in a securitization transaction.

In these transactions, disclosure of otherwise confidential information can take a variety of forms. For example, in order to value the Transferor's private equity portfolio, investment banks and appraisal firms (including their counsel) will ask to receive copies of all information distributed by a Fund's general partner to the limited partners, including financial statements, quarterly and annual reports and portfolio company information (basically, all the information relating to the Funds that is in the Transferor's files). In order for the Notes to be rated, rating agencies such as Moody's Investors Service, Inc. and Standard & Poor's Rating Services will need to receive the same information. Also, prospective purchasers of the Notes will receive an offering memorandum that is likely to disclose at least the following types of information: name of Fund, vintage year and jurisdiction, expected termination date, name of general partner, net asset value and amount of unfunded commitment. After the Notes are rated, the rating agencies will need further, ongoing access to information about the underlying Funds, including each Fund's net asset value, total contributions, total distributions and list of portfolio companies.

If a Fund's general partner is willing to consent to the disclosure described above, there are certain safeguards that can be put in place to limit the disclosure as much as possible. First, the general partner could require that the Transferor provide it with a list of recipients of the Fund information, preferably before such information is disclosed to such recipients. Alternatively, the Transferor could provide the general partner with periodic updates of the parties to whom information is sent. In addition, the general partner should seek to ensure that such parties receiving any Fund information agree to keep such information confidential pursuant to a confidentiality agreement. The general partner and the Fund ideally should be either parties to or third-party beneficiaries of the confidentiality agreement so that they may enforce their rights under the agreement. The agreement should provide that the general partner's consent would be required for any amendment or waiver of any provision of the confidentiality agreement in a manner that would adversely affect the general partner's or the Fund's rights thereunder. In the three securitization transactions mentioned at the beginning of this article, none of the confidentiality agreements initially provided to us contained these protections. And, while one of the rating agencies involved told us orally that it keeps all information provided to it confidential, it refuses "as a matter of policy" to sign a confidentiality agreement.

Even with confidentiality agreements in place, Fund sponsors should be aware that, obviously, the more parties that possess the Fund's information, the greater the likelihood that such information will find its way into the public domain. In order to adequately protect itself, the Fund's general partner should request an indemnity from the Transferor and the SPV against any claims, damages or losses suffered in connection with the disclosure of Fund information and, as further discussed below, the securitization transaction as a whole.

Even with the benefit of a confidentiality agreement, to the extent that a Fund discloses, or consents to the disclosure of, information to a broad circle of people and institutions (the SPV, the Issuer, evaluators and rating agencies, holders of the Notes, and their counsel and advisors), the Fund (1) subjects itself to an increased administrative burden, (2) may decrease its ability to argue, in connection with FOIA requests made of its public plan limited partners and other matters, that the information disclosed constitutes "trade secrets" that have been kept confidential and thus ought to be exempt from public disclosure, and (3) increases the likelihood that sensitive information, such as portfolio company information, will be disclosed, possibly to the detriment of the Fund or its portfolio companies.

Credit Risks

Any time that a limited partner requests a transfer to an SPV, the general partner should take steps to ensure that the new limited partner will be adequately funded so that it can fulfill its obligations under the Fund's limited partnership agreement with respect to (1) making capital contributions for future investments and expenses, including management fees, and (2) returning distributions if so required under an "LP clawback" provision.

The limited partners that are in the process of structuring a securitization have to varying degrees, and with varying degrees of specificity, anticipated this concern and have proposed different methods of giving a Fund's general partner comfort that the SPV will be able to satisfy its obligations under the partnership agreement. In each of the three proposed securitizations mentioned at the beginning of this article, the Transferor pointed out that it was transferring interests in dozens of Funds, of different types and different vintage years, into the SPV. Thus, each Transferor argued, this diversified portfolio of interests should generate sufficient cash flow to service all obligations. This might prove to be correct, of course, but many private equity funds only make distributions very infrequently in the best of times. It is possible that most if not all of the Funds in a portfolio might cease making distributions altogether at the same time if they are all unable to exit portfolio investments because the IPO window is closed, or if strategic buyers generally aren't buying during an economic downturn.

The Transferors acknowledged this possibility, and thus sought to provide additional comfort in the form of credit support. In one of the proposed transactions, the SPV will maintain a cash reserve account or liquid investments in an amount that the Transferor believes is sufficient for the SPV to meet its anticipated ongoing obligations. In another, a liquidity facility will be provided; the facility is intended to assure payment of the SPV's remaining capital commitments and clawback obligations. In a third case, the SPV will have the right to borrow funds as necessary from the Transferor (or an entity with equal or better credit standing). In certain of these cases, we were required to ask numerous questions before being given any detail about these arrangements. In one case it seems that the liquidity facility described as a potential source of comfort for our clients in fact was at the Issuer level, which protects the holders of the Notes but not the Funds; this was revised after we pressed. These problems did not necessarily arise because the Transferor was being

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unhelpful, but, instead, because (1) certain of the transactions were still being structured at the same time as consents were being obtained and (2) in other cases the lawyers structuring the transactions were familiar with securitizations but had little familiarity with private equity funds or the concerns of private equity fund sponsors. (This is a theme that became evident not just in the credit area, but also when we raised disclosure and regulatory concerns on behalf of our clients.) In all cases, it is a business call whether the credit backstops provide adequate credit protection, since the credit backstops are structured to cover anticipated needs, which can not be currently quantified with precision and may or may not prove to have been correctly estimated.

A Fund's general partner should not hesitate to ask questions of the Transferor and SPV, and should consider requiring as a condition to granting its consent that certain representations and covenants be included in the assignment agreement, in order to satisfy itself that the proposed manner of funding the SPV is indeed sufficient to meet its ongoing obligations under the Fund's limited partnership agreement.

Increased Risk of Litigation

A securitization transaction may have the effect of increasing somewhat the potential risk of litigation to the general partner and the Fund, simply because more players are involved. For example, a purchaser of the Notes could attempt to make a securities law claim against the Fund or the general partner with respect to the information (including valuations) provided by the Fund. In order to protect itself from any such potential litigation, a general partner should consider requiring that the Transferor and SPV indemnify it, the Fund and the Fund's manager against any claims, damages or losses that might arise from any aspect of the securitization transaction, including the disclosure of Fund information and the offering and sale of the Notes.

Publicly Traded Partnership

The transfer of a limited partnership interest in connection with a securitization transaction raises the concern that a Fund may become a "publicly traded partnership" (a PTP). This would be a disastrous result for most private equity funds, which are structured as flow through vehicles for tax purposes, because PTPs are taxable as corporations for U.S. federal income tax purposes.

A partnership becomes a PTP if direct or *indirect* interests in the partnership are traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof. (In the transactions in question the Notes are expected to trade in the 144A market.) This is because the U.S. tax rules provide in this context that interests in a partnership include any derivative instrument, other than a nonconvertible debt interest, the value of which is determined in whole or in part by reference to the partnership. Derivative instruments do not ordinarily present a PTP issue because a partnership generally cannot become a PTP unless it participates in the establishment of a market *or* recognizes any transfers made on any such market. Because the Transferor will ordinarily be required to obtain the general partner's consent to the securitization (which involves the creation of what are arguably derivative instruments), the latter exception will not be available to the Fund. We recommend that the Fund seek to obtain an opinion of counsel to the Transferor that the transactions contemplated by the securitization will not jeopardize the Fund's partnership status *either* because the Notes to be sold by the Issuer will constitute non-convertible debt for federal income tax purposes *or* because some other safe harbor applies.

Investment Company Act Concerns

A Fund that relies on the exception from registration provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the Investment Company Act) should carefully consider the following issues:

100-beneficial owner limit of Section 3(c)(1). If the Fund in question relies on the Section 3(c)(1) exception, the SPV in the securitization should be asked to represent that it will be treated as one beneficial owner of the Fund's outstanding securities for the purposes of Section 3(c)(1) of the Investment Company Act. It should be able to make this representation, if it owns less than 10% of each class of the Fund's securities. However, this should be confirmed with counsel for the SPV in light of the particular structure of the securitization. Also, general partners should remember that the Transferor will count as an additional beneficial owner if the Transferor retains some portion of its interest in the Fund.

Qualified purchaser requirement of Section 3(c)(7). If the Fund in question relies on the Section 3(c)(7) exception, the SPV in the securitization should represent that it is a "qualified purchaser" as defined in Section 2(a)(51) of the Investment Company Act. The SPV should be able to make this representation if at the time of the transfer it will hold more than $25 million of interests in Funds, which will almost certainly be the case. Again, however, this should be confirmed with counsel to the SPV.

Legal opinions. Virtually all partnership agreements of private equity funds provide that the general partner of the Fund may require, as a condition to granting its consent to a transfer by a limited partner, that the transferring limited partner or the transferee provide an opinion of outside counsel as to Investment Company Act compliance. (The opinion typically covers other matters as well, including that the offer and sale of the partnership interest being transferred did not require registration under the Securities Act.) Our clients occasionally waive this requirement, especially where they know the transferee, or where the transferee is an affiliate of the transferor. General partners should consider *not* waiving this requirement in connection with a transfer in a securitization transaction, however, because the structure may be more complex or novel than is typical, and the general partner and its counsel may not know all the facts they need to get comfortable with the Investment Company Act analysis.

Anti-Money Laundering Compliance

When a limited partner intends to transfer its interest, the general partner should consider whether the transfer will have implications for the Fund's compliance with anti-money laundering (AML) regulations. We note that at this time most buyout funds and venture funds are not required by U.S. law to institute AML compliance programs, although hedge funds generally are covered by U.S. AML regulations, and Funds organized in the Cayman Islands or in England, for example, will be subject to the AML regulations in those jurisdictions.

Whether or not a Fund is required to implement an AML compliance program under U.S. laws and regulations, we recommend that the general partner and the Fund obtain from the SPV representations on anti-money laundering procedures similar to those that would be obtained from any initial investor in the Fund who is serving as an intermediary (as in the fund of funds context). At a minimum, the general partner and the Fund should obtain assurances that the SPV has AML policies and procedures in place.

Expenses

Any transfer by a limited partner of its interest in a Fund will cause the Fund and the general partner to incur certain expenses, albeit generally of only a nominal amount. Given the complexity of securitizations and the fact that securitizations of interests in private equity funds in particular are relatively novel at this point in time, a transfer in connection with a securitization may cause the Fund and the general partner to incur substantial legal expenses. While most partnership agreements provide that expenses incurred by the Fund in connection with a transfer by a limited partner will be reimbursed by the transferring limited partner, the general partner may want to consider including an expense reimbursement provision in any written consent (as well as in the assignment agreement), so that if the transfer does not actually take place, the Fund may still seek reimbursement for its legal and other out of pocket expenses. In fact, a general partner may want to seek reimbursement of expenses incurred while determining whether to consent to the transfer, because it may ultimately decide that the credit support for future capital calls is inadequate and opt not to consent.

Most Favored Nations Provision

We have found that, as the structure for a particular CFO evolves, and as various Fund general partners negotiate with the Transferor to provide them with comfort on the issues discussed above and on other issues of concern, the rights granted to general partners may change. Accordingly, a general partner (particularly a general partner that grants its consent to the transaction relatively early in the process) should consider negotiating a "most-favored nations" provision in the original consent so that it may benefit from any side letters or other agreements entered into by the Transferor and the SPV with other general partners in connection with the securitization transaction.

In a [securitized pool of interests in private equity funds], even more so than in most securitizations, however, the assets being transferred... are highly illiquid and cash flows are unpredictable.... These limitations and other business and regulatory concerns... raise serious concerns about whether private equity funds are an appropriate asset class to be securitized....

This article has attempted to highlight and address the key legal and business considerations for a general partner raised by a securitization of private equity fund interests. Because of the very small number of completed CFOs to date, only time will tell whether general partners will obtain the comfort that they require on these issues and whether these kinds of securitization transactions will become commonplace in the private equity world. ▫

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Could This Be the Year to Start Expensing Stock Options? (continued)

expense amounts related to the unvested portion of previously issued awards. (Again, because this expense is notionally measured on the grant date, a company might find itself recognizing expense for options that are out of the money.)

So, to ask the question again, Why would a portfolio company switch to the fair value method now? To take advantage of the transition rule that lets the company avoid having to recognize compensation expense for prior option grants.

Is the decision to switch this year a no brainer? Clearly not. It is possible that the intrinsic value method may be allowed to live on, in which case making a preemptive switch now would be like securing a favorable berth on a ship that never sails. In addition, although adopting the fair value method only prospectively has the possible advantage of not having to recognize any of the expenses for pre-existing option grants, for companies that typically grant options on a regular basis it does raise the "ramp up" problem of increasing compensation expense as future awards are made. Nevertheless, and especially for private equity firms that are unlikely to experience a "ramp-up" problem, there is an opportunity to move now and avoid having to recognize the expenses of prior options, and it should be discussed with accounting advisors before slipping by.

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Making Sense of the New Tax Rules (continued)

approach, you will likely be driven mad since the issue is going to arise in virtually every transaction you do. Accordingly, we recommend that you talk through the issue once with your tax advisor and make a decision that will apply to each *type* of deal you do (*e.g.*, M&A deals, offering a new fund, etc.), unless the circumstances of a particular transaction are materially different from what you typically encounter in that type of transaction.

Besides confidentiality, a transaction may be considered reportable if (among other things) (1) it generates a significant loss for tax purposes or (2) there is a significant difference between how it is treated for GAAP purposes and how it is treated for tax purposes.

For most taxpayers, this will mean either adding to every confidentiality provision in every transaction they enter into either (1) the presumption language quoted above or (2) a modified form of the presumption language tailored to the taxpayer's particular confidentiality concerns for that type of transaction. In addition, many taxpayers will state explicitly that the name and identifying information may not be disclosed during the marketing period or is not part of the tax structure or tax treatment (meaning it cannot be disclosed even after the marketing period).

Two Other Points

Besides confidentiality, a transaction may be considered reportable if (among other things) (1) it generates a significant loss for tax purposes or (2) there is a significant difference between how it is treated for GAAP purposes and how it is treated for tax purposes. Also, there are a variety of special rules, such as (1) an exception that generally allows taxpayers to maintain confidentiality during the due diligence and negotiation of certain M&A transactions, including most acquisitions of at least 50% of the stock of a business and (2) an exception that allows limitations on disclosure that are reasonably necessary to comply with securities laws.

What's Next?

We expect that the IRS will significantly modify the regulations applicable to confidential transaction in the not-too-distant future. In the meantime, when you are faced with the issue, we recommend that you talk to your tax advisor, make a decision and stick to it.

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of information which may be in its possession and, in some cases, its unique access to the board or management of the issuer, a genuine risk exists that non-public information which is not viewed by the insider as material at the time of a securities transaction may later emerge as significant. This could occur with respect to information actually known to the insider but not then viewed as material (*e.g.*, a health problem for the company's CEO that initially appears to be benign but later proves problematic). It could also occur with respect to information not actually known by it but that perhaps could have been known through closer examination of the information then available to it or greater exercise of its access rights (*e.g.*, accounting irregularities).

In order to protect an insider against subsequent claims by a non-insider based on the insider's failure to disclose non-public information in connection with a securities transaction (whether or not such information is material), Big-Boy letters include very broad waivers by the non-insider of all such claims, including all claims under Rule 10b-5. In essence a non-insider tells the insider in a Big-Boy letter: "I am a sophisticated investor (*i.e.*, a Big-Boy); I understand the rules of engagement on this transaction; and I am not going to complain about any aspect of it later under any circumstances."

These letters make a whole lot of commercial sense. But do they work as a legal matter?

Section 29(a)

Section 29(a) provides that: "Any condition, stipulation or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder... shall be void." Rule 10b-5 prohibits the owner of a security in possession of material non-public information from purchasing or selling the security without disclosing that information. Thus, on its face, Section 29(a) would appear to invalidate the central feature of any Big-Boy letter: the waiver of all claims against the insider in connection with the purchase or sale of securities, including claims arising under Rule 10b-5.

Cases

Notwithstanding Section 29(a), many courts have enforced broad waivers and releases of federal securities law claims under a variety of circumstances.

For example, in *Korn v. Franchard*, 388 F. Supp 1326 (S.D.N.Y. 1975), the U.S. District Court for the Southern District of New York upheld a broad release of an existing, matured claim of which the releasing party had actual knowledge. The *Korn* court cited *Wilko v. Swan*, 346 U.S. 427 (1953), for the proposition that Section 29(a) bars anticipatory waivers of compliance with the provisions of the securities laws, not waivers or releases of known, ripened claims. Numerous cases in other jurisdictions have upheld similar waivers.

In *Goodman v. Epstein*, 582 F. 2d 388 (7th Cir. 1978), the Seventh Circuit went further, holding that waivers are valid under Section 29(a) with respect to claims which were known *or should have been known* by the waiving party. In *Goodman*, a group of LPs in a real estate venture released all securities law claims against the venture's GP. The LPs later discovered that the GP had called capital prior to the release without disclosing the existence of a variety of adverse developments which ultimately contributed to the demise of the project. The LPs sued, arguing that their release was void under Section 29(a) since they did not have actual knowledge of these adverse developments when they signed the release. But the Court enforced the release, holding that the GP's request for a release put the LPs on notice that further inquiry with respect to the actions of the GP should be undertaken, and that the LPs, therefore, had "constructive knowledge" of the underlying claims, which could have been discovered had due inquiry been taken.

In *Petro-Ventures, Inc. v. Takessian*, 967 F. 2d 1337 (9th Cir. 1992), the Ninth Circuit enforced a release of securities law claims on a basis that augers particularly well for the enforceability of Big-Boy letters.

In *Petro*, the parties had a dispute about the value of certain properties that the plaintiff had contributed to the defendant in exchange for partnership interests. The parties subsequently settled their dispute and released all claims against each other "regardless of whether or not such claims had been [raised in the dispute] to which the settlement agreement relates." Shortly thereafter, the plaintiff brought fraud and 10b-5 claims against the defendant after discovering that its partnership interests had not been properly registered with the SEC, thereby reducing their value. The plaintiff contended that its suit was not precluded by its release because "unknown claims pursuant to the federal securities laws cannot be released... even by the execution of a settlement agreement that purports to release all known and unknown claims."

The Ninth Circuit rejected the plaintiff's argument and upheld the validity of the release. Although the court

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could have applied the logic underlying *Goodman* to reach its conclusion, it instead focused principally on the express terms of the parties' contractual arrangement: "There is no doubt that the language of the release is unambiguous in conveying the intent of the parties to release all unknown claims... [W]hen, as here, a release is signed in a commercial context by parties in a roughly equal bargaining position and with ready access to counsel, the general rule is that, if the language of the release is clear,... the intent of the parties [is] indicated by the language employed."

A 1996 Second Circuit case, *Harsco v. Segui*, 91 F.3d 337, further illustrates the willingness of courts to enforce explicit Big-Boy-like waivers that are the result of arm's-length negotiations between sophisticated, well represented parties. In *Harsco*, the plaintiff/purchaser acquired all of the stock of an operating company following an extended period of due diligence. The definitive purchase agreement contained an extensive set of representations and related indemnities for the benefit of the plaintiff. It also contained an express disclaimer of any representations not contained in the definitive agreement. Following the closing, the purchaser sued the defendant/seller alleging various 10b-5 and fraud claims based on representations allegedly made by the defendant outside of the agreement. It argued that any provisions of the agreement which purported to bar such claims were void under Section 29(a).

The Second Circuit framed the central issue in the case as "whether parties who negotiate at arm's length for the sale and purchase of a business can define the transaction in a writing so as to preclude a claim of fraud based on representations not made, and explicitly disclaimed, in that writing." The court concluded that the answer to that question was yes, holding that enforcing the limitations in the contract did not run afoul of Section 29(a) in light of all the other substantive rights the plaintiff had bargained for under the contract. It noted:

"Harsco bought... 14 pages of representations. Unlike a contractual provision which prohibits a party from suing at all, the contract here reflects in detail the reasons why Harsco bought [the business] – in essence, Harsco bought the representations and... nothing else.... Thus it is not fair to characterize the [purchase agreement] as having prevented Harsco from protecting its substantive rights. Harsco rigorously defined those rights in [the balance of the purchase agreement.]"

So, What's the Answer?

Notwithstanding the outcome and the helpful language, *Korn, Goodman, Petro-Ventures* and *Harsco* do not allow one to conclude with certainty that the waiver provisions in a Big-Boy letter would be enforced. None of these cases is a U.S. Supreme Court case and some courts in other jurisdictions have been less willing to enforce similar waivers or releases of securities claims. Unlike a Big-Boy letter, most of these cases involved releases in connection with litigation settlements and thus may be driven more by an effort to further judicial economy than by a willingness to disregard Section 29(a) in other circumstances. The plaintiff in each of these cases was put on notice, with greater specificity than would be present in a typical Big-Boy letter, of the nature

The following are the key provisions to include in any Big-Boy letter to maximize its prospects for enforceability:

- The non-insider is a sophisticated investor, and has the appropriate knowledge and experience to evaluate and negotiate the transaction;
- The non-insider has had the opportunity to consult with such advisers as it deems appropriate;
- The non-insider has adequate information to evaluate the transaction and has had the opportunity to discuss such information with its advisers;
- Neither the insider nor any person affiliated with the insider has made any representation or warranty, express or implied, regarding any aspect of the transaction except as set forth in the Big-Boy letter, and the non-insider is not relying on any such representation or warranty not contained in such letter (the more particularized the disclaimer, the better);
- The non-insider acknowledges that the insider may possess or have access to material non-public information which has not been communicated to the non-insider;
- The non-insider waives any and all claims it may have or may hereafter acquire against the insider, relating to any failure to disclose non-public information in connection with the transaction; and
- The non-insider is aware that the insider is relying upon the truth of the foregoing representations in connection with the transaction.

of the claims it was waiving and was also in a better position than most non-insiders in a typical Big-Boy context to discover the underlying factors which gave rise to its later claim. And, in the case of *Harsco*, the plaintiff enjoyed the benefit of a number of other remedies, something that would not be true in the case of a Big-Boy letter.

Still, taken together, *Korn, Goodman, Petro-Ventures* and *Harsco*, along with a number of other cases decided under Section 29(a), make it more likely than not that the waiver provisions of a typical Big-Boy letter would be enforced in most cases. Like the releases in these cases, Big-Boy letters are the product of bilateral negotiations rather than unilateral relinquishments or waivers of rights. They do not waive future violations of the securities laws but only violations that might occur in connection with the closing of the transaction. The insider's request for a Big-Boy letter puts the non-insider on notice that further inquiry with respect to information known to the insider may be appropriate; to the extent the non-insider proceeds without such information, it reflects a knowing assumption of risk and may also directly benefit it by positioning it to resell the securities freely. In addition, in many situations, the insider genuinely believes that the non-public information in its possession is not material, unlike the defendants in *Goodman* and *Petro-Ventures*, who presumably were well aware of the materiality of the facts underlying the claims that were later brought against them. And most importantly, Big-Boy letters, by definition, reflect an express contractual allocation of risk between sophisticated, well represented parties under no compulsion to act, and courts consistently have been loathe to undue these type of arrangements.

Reasonable Reliance

Even if a waiver of 10b-5 claims in a Big-Boy letter were found to be void under Section 29(a), a separate provision of a typical Big-Boy letter – the non-insider's express disclaimer of reliance on any representations not set forth in the letter – may separately shield the insider from a successful 10b-5, fraud or negligent misrepresentation claim by the non-insider. This is because there is a substantial body of case law to the effect that a sophisticated, well represented party's express acknowledgment that it is not relying on any representation not set forth in a definitive agreement defeats its ability to demonstrate an essential element of any 10b-5, fraud or negligent misrepresentation claim – reasonable reliance on any fact or circumstance that is not the subject of the representations expressly set forth in the definitive agreement. The more explicit the disclaimer, the more difficult it will be to show reasonable reliance.

Some important distinctions exist between the disclaimers in the decided cases in this area and standard Big-Boy disclaimers. Big-Boy disclaimers are normally much more general than the kind of particularized disclaimers that have typically been held to bar a showing of reasonable reliance. They are typically furnished by a party who has performed little, if any, due diligence, thereby making it harder to conclude that the party made a knowing assumption of risk that would defeat reasonable reliance. A claim by a non-insider under a Big-Boy letter is more likely to relate to an omission than a misrepresentation, and some courts have held that reasonable reliance is not an essential element of a 10b-5 claim based on non-disclosure. And, finally, a court may conclude that to hold that the disclaimer clause in a Big-Boy letter precludes a showing of reasonable reliance is simply a back-door way to achieve an impermissible waiver of federal securities law claims under Section 29(a).

...Taken together Korn, Goodman, Petro-Ventures *and* Harsco, *along with a number of other cases decided under Section 29(a), make it more likely than not that the waiver provisions of a typical Big-Boy letter would be enforced in most cases.*

Still, courts have consistently enforced disclaimer clauses agreed to by sophisticated, well represented parties in a wide variety of circumstances, including in the face of egregious misstatements and deceptions by the non-disclaiming party. So the inclusion of a disclaimer clause in a Big-Boy letter, particularly a clause that disclaims reliance on any areas where there may be an identifiable risk of material non-disclosure or misrepresentation (*e.g.,* the *future* revenues, results of operations or financial condition of the issuer), may well give an insider a secondary line of defense against 10b-5, fraud and negligent misrepresentation claims if the waiver clause of the letter is set aside under Section 29(a). ■

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(in absolute dollar terms) and therefore low-risk way of getting to know the Chinese market better, and, by being an early investor in an on-shore fund, earning the favor of the Chinese authorities.

- The 2003 Rules contain a host of requirements relating to filing with the State Administration for Industry and Commerce (SAIC) that did not appear in the 2001 Rules or in all but the latest drafts of the 2003 Rules. We understand that this is largely the result of "turf" disputes between SAIC and MOFTEC – the last few months have seen a number of public references to efforts to limit the sweeping authority of MOFTEC over foreign investment in China. The outcome of this struggle will not be surprising to students of bureaucracies and public administration: the intrusion of a new regulatory authority rather than more individual investor freedom from regulation. SAIC's role is supposed to be more ministerial than substantive, but it is hard to believe that local SAIC officials will be able in all cases to refrain from second-guessing MOFTEC's judgment that a particular fund proposal complies with the 2003 Rules.
- We have no idea how willing MOFTEC or other relevant Chinese regulatory officials will be to accept fund documents that contain extensive references to U.S.-related income tax and ERISA provisions. Fund sponsors may want to consider adopting uniform subscription agreement provisions that contain appropriate VCOC undertakings, ERISA opt-out provisions, UBTI provisions and U.S.-specialized tax allocation provisions, recognizing, in the latter case, that it may not be possible to force a complete match between U.S. and Chinese PRC tax allocation provisions.
- The MOFTEC drafters of the 2003 Rules have bent over backwards to accommodate centralized general partner and fund manager operation of funds organized under the 2003 Rules. But the underlying regulatory framework leaves several oddities.
  - In the first place, China has no generally applicable limited partnership law and no laws permitting the tax equivalent of a U.S. limited liability company. The 2003 Rules are at bottom based on old rules relating to Sino-foreign "cooperative joint ventures," which assume partnership-like structures but contain nothing authorizing limited liability for one or more partners. The 2003 Rules (and their 2001 predecessors) contain only a single sentence declaring that if one investor has unlimited liability the others can each have liability limited to their capital commitments. Until there is clear authority for this in the law or in high-level judicial decisions, most investors will want to put a limited liability entity between themselves and a China venture capital fund.
  - Secondly, notwithstanding a clear provision in the 2003 Rules for the vesting of the fund management function in a third party manager or in a single fund investor (the 2003 Rule equivalent of a "general partner"), the 2003 Rules mandate the formation of a "joint management committee" responsible for the overall management supervision of the fund. This requirement is taken directly from the old "cooperative joint venture" rules, and we understand the MOFTEC drafters felt that they could not unilaterally eliminate this requirement. However, they carefully did not specify the composition of this committee, and until proven wrong, we are operating on the assumption that as long as there is something called a "joint management committee" consented to by all investors, there is no requirement that the "joint management committee" has as members people who are not affiliated with the general partner or the fund manager.
  - Thirdly, the absence of a limited partnership law in China means that fund sponsors will have to choose between including in their fund documents some of the basic "rules" governing general partner responsibilities and liability, or including nothing and risking criticism from skeptical investors who want their general partners to have at least the limited standards of care and loyalty imposed by Delaware's

Revised Uniform Limited Partnership Act (RULPA). Our initial draft of a fund agreement under the 2003 Rules assumes that fund sponsors will find their marketing task simplified if they include in the fund documentation some of the basic behavioral guidelines imposed by RULPA.

- Fourth, China's investment laws have historically assumed that invested capital (as opposed to profits) would be returned only at the termination of the investment vehicle. The MOFTEC drafters have recognized that in venture capital and private equity funds, invested capital is generally returned upon an investment-by-investment basis rather than upon the final liquidation of the fund. But it is not at all clear that the regulatory authorities will understand the concept of having the fund retaining otherwise distributable profits and cash flow and deeming the application of those funds to constitute additional "investments" by fund investors, to count against their investment commitments. Historically, "invested capital" is capital that flows from the hard currency world into the (relatively) closed world of the Chinese Renminbi. Initially, we suspect that funds will have to bypass the simplicity of recycling funds within a fund and crediting that usage against investor capital commitments. Instead, they will feel compelled to return excess cash and earnings to fund investors, and then make new draws on committed capital to cover fund operating expenses and new investments.
- Finally, the drafters of the 2003 Rules were ideologically limited by the notion, also imbedded in China's foreign investment laws, that committed capital has to be invested within a certain period of time after the formation of the investment vehicle. The 2003 Rules represent a huge step forward from the 2001 Rules in that they contemplate increases and decreases in committed capital during the investment period so that investors are not threatened with a legal investment requirement when the fund sponsor can't find appropriate investments, but they unfortunately still contain a requirement that all committed capital (as adjusted) has to be invested by the end of a five-year investment period.

This obviously makes follow-on investments difficult, and raises questions about the funding of fund operating expenses following the end of the investment period. At present, we think that the agreement to fund post-investment period operating expenses may have to be imbedded in the subscription agreement rather than in the fund documentation, and that follow-on investments after the expiration of the standard five-year investment period will require specific approval by the relevant regulatory authority.

The new [2003] Rules... eliminated many if not most of the structural problems associated with the 2001 Rules. Unfortunately, the central taxation authority did not... change the tax rules applicable to off-shore investors in on-shore funds.

If you would like more information about the 2003 Rules, our translation can be obtained from Dan Madden at djmadden@debevoise.com. We will also be happy to speak with any of our clients and friends about how our draft on-shore venture capital partnership agreement might be adopted to meet a specific need. ■

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Indemnification by Stockholders of Public Targets (continued)

look like? Would the banker be opining on the fairness of the total consideration, somehow attributing value to the target stockholder's contingent right to receive additional cash out of the trust? If not – if the fairness opinion covers only the consideration paid up front – then the greater the holdback, the more difficult it may be to obtain a fairness opinion.

Another related innovation that has cropped up in the past five years or so is representation and warranty insurance. Although readily available and still evolving, this type of insurance has rarely been used in the public context. Negotiating a tailored insurance policy for a public transaction will of course have costs of its own.

Private equity firms considering the use of indemnity structures in public deals will want to consider a number of other legal, tax and business issues. For instance, any trustee appointed to defend the target stockholders' rights might be expected to be overzealous in their defense, possibly degrading the benefit of the indemnity. (This problem might be mitigated if instead the target stockholders purchased for the buyer representation and warranty insurance, because the defense of claims would generally pass to the insurance company, which would not need to satisfy any fiduciary obligations to stockholders.) Another concern is that a fund's limited partners may not want to incur the opportunity costs (and possible reduction in overall IRR) of "paying" full price up-front, only to have some portion of the purchase price returned years later (with no return) as the result of an indemnity claim. While the same problem may arise with an indemnity in a private deal, limited partners may be less willing to add this risk to the other risks that arise in the public arena. Public disclosure is another issue – if the private equity firm needs to raise high-yield debt, will it be problematic to disclose that it has created a reserve (and the amount of the reserve) for potential problems with the business?

Despite these concerns, a limited indemnity might be just the thing to jump-start a stalled deal in the current environment or to encourage a private equity firm to consider a public acquisition. For reasons of custom, complexity and added uncertainty, private equity firms will need to overcome natural resistance in the market to the indemnity structure. Nevertheless, at the end of the day, given the choice between no deal and a good deal with a limited indemnity, target stockholders may well choose the latter. ▢

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Going, Going, Gone? (continued)

with Target? If not, Target board approval will be needed for the merger.

One likely *Omnicare* result: more private equity firms and founding stockholders will have companies opt out of business combination acts, and not adopt poison pills.

Early Stockholder Approval

If Target's stockholders can act by written consent, Bidder 1 could seek to have its deal approved up front by Target's big stockholders, since stockholder approval should extinguish the board's fiduciary duty to be able to entertain a superior bid. Under Exchange Act rule 14c-2(b), a private equity firm could sign a consent in favor of the merger when the merger agreement is signed – but the merger can't close for at least 20 days after Target stockholders have received a detailed information statement.

Termination Fees

One approach isn't glamorous or novel, but has been blessed by courts (even, *in dictum*, in *Omnicare*): if Target directors exercise their fiduciary out to take a competing bid, Target has to pay Bidder 1 a termination fee – equal say to 3% or so of what the first bidder was prepared to pay. That won't preclude a competing bid, but will make one more costly, and will cover Bidder 1's expenses.

Not Every Company is Incorporated in Delaware

Courts of other states have been influenced by Delaware decisions on corporate law matters, but may be more likely to defer to the business judgment of an informed and disinterested board to approve a lock-up. ▢

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principal shareholders agree to vote to elect the investors' designees in a shareholders' agreement.

Where U.S.-style is to provide veto rights directly to preferred shareholders, French practice is generally to place these rights at the board level by providing that the specified board decisions require the vote of the director(s) nominated by the preferred holders in addition to an affirmative vote of a majority of all the directors present. For maximum effectiveness, these veto rights are expressly set forth in the company's articles of incorporation. Although it is still debated among French legal commentators, it seems that a French company could follow the U.S. style and provide in its articles of incorporation that certain decisions of the board or of the shareholders would be subject to a veto right held by preferred shareholders (rather than the board members they have nominated). Certain complexities of French law, however, suggest that the French market practice of keeping the rights at the board level may be the better option. As a general rule, veto rights granted directly to the preferred shareholders would need to be structured to avoid a total usurpation of the decision-making powers reserved to the company's management bodies (*i.e.*, the board of directors or management committee) because the statutory allocation of powers to the managing bodies is not modifiable. Additionally, the veto rights must not cause the shareholders who enjoy them to be seen as *de facto* managers of the company; otherwise, such shareholders would be exposed to certain additional liabilities in the event of insolvency proceedings.

Information rights. French company law does allow specific information rights to be attached to a designated class of shares. As with veto rights, however, if these rights are too extensive, the shareholders benefiting from them might be considered as *de facto* managers of the company. Consequently, it is generally preferable for investors wishing to obtain more detailed information about the company than is made available to shareholders generally to insist on special representation on the board.

Shareholders' Agreements

In France, shareholders' agreements are the most common tool used to establish contractual rights for an investor. These agreements are generally valid under French contract law and help to avoid some of the rigidities encountered in French company law. (However, as noted below, in the event of breach, specific performance is not available.) Common features in shareholders' agreements provide for drag-along and tag-along rights, rights of first refusal, prohibitions on certain transfers, anti-dilution protection and voting agreements to ensure board representation.

Shareholders' agreements can also include provisions designed to imitate the feature of U.S.-style preferred that provides preferred shareholders with a priority distribution upon the occurrence of certain transactions. In this vein, to achieve the same economic result that is obtained in the U.S. by treating mergers, consolidations, assets sales, etc. as liquidation or redemption events, investors in France often rely on put or call options granted by other principal shareholders. These options would be exercisable at a pre-agreed price or a price based on a specified formula upon the occurrence of a triggering event such as a merger, consolidation or a sale of assets. The pricing of the put option may, however, be subject to the prohibition on unconscionable provisions (*clauses léonines*). In this context, the worry would be that a prespecified minimum price would allow the preferred shareholders to avoid participating in any losses the company suffered. While some French courts will allow contractual puts at a specified price to be enforced, others apply the unconscionability test to such provisions. Another complicating factor is the creditworthiness of the shareholders who are required to purchase the shares pursuant to the put. Although this solution does not appear widely tested in practice, put and call options could also be used to replicate mandatory redemption provisions, by requiring other shareholders (but not the company) to purchase the shares if the preferred shareholder has not been able to exit after a specified time.

Shareholders' agreements in France do have important limitations that can make relying on them more complex and problematic than in the U.S. In particular, any transfer restrictions must be limited in time and justified by a "serious and legitimate" interest, although in practice the restriction period often extends for decades. Of perhaps more importance to a U.S. investor is the fact that the remedy of specific performance – obtaining a court order forcing the violator to comply with its obligations under the shareholders' agreement – is not available in France. Under French law, shareholders agreements are enforceable only through money damages.

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Furthermore, there is uncertainty about the amount of damages an investor would be entitled to recover since damage payments are dependent on providing evidence of the economic damage actually suffered.

Additionally, the shareholders of a French publicly traded company must inform the *Conseil des Marchés Financiers* (CMF) of the provisions of any agreements containing preferential terms relating to transfers of shares. Such agreements could be deemed to constitute a "concerted action" (*action de concert*) among the shareholders who are parties to the agreement. If a concerted action is deemed to exist, such a conclusion could, in turn, trigger certain French securities laws requirements that can include joint and several responsibility for (1) fulfillment of notification requirements if the group of shareholders "acting in a concerted fashion" crosses certain aggregate percentage ownership thresholds and, once the group holds together more than 33 % of the share capital of the company; (2) observation of restrictions on how quickly the group can acquire additional shares; and (3) in certain instances, performance of the obligation to launch a tender offer for the remaining shares of the company.

The shareholders' agreement is nevertheless a widely practiced, and therefore a well-tested and accepted, mechanism for providing special rights to investors.

Specially Designed Securities

Among the rights and protections that are the most difficult for investors to replicate in France are rights to a priority distribution upon certain transactions, redemption rights and conversion rights with an adjustable conversion ratio. In practice, French investors generally take specially designed securities either in addition to or in place of preferred shares in order to obtain certain of these rights.

Priority distribution. As mentioned above, the priority distribution upon a merger, consolidation, asset sale, etc. could be provided for via put or call options in a shareholder agreement. Another solution involving a composite security would be the issuance of a preferred or common share coupled with a warrant that, upon the occurrence of certain events, can be either exercisable into new common shares of the company or mandatorily redeemable by the company at a price based on a pre-determined formula. These securities, referred to as *actions à bon de souscription avec faculté de rachat* (ABSARs), do not alone produce the result obtained by using a liquidation preference or redemption to provide for the priority distribution.

Specifically, ABSARs would normally permit the investors to retain the linked shares after exercise or repurchase of the warrants This continued equity ownership could result in the investors' receiving more than the return to which they are entitled unless (1) the linked preferred shares automatically convert into common shares and (2) other shareholders or the acquiror in the transaction giving rise to the exercise/redemption right has the right to purchase these common shares at a deep discount calculated to take into account that the preferred shareholders have already received the targeted return. Calculating and negotiating these formulas and discounted prices presents an additional complexity. Although these securities are not commonly used and remain somewhat untested in French practice, they can be structured. Finally, some commentators suggest that, under certain conditions, the company's obligation to repurchase the warrants could be considered unconscionable (a *clause léonine*) and therefore unenforceable.

Conversion and anti-dilution. French investors have embraced the protection afforded by the anti-dilution protection embodied in the U.S.-style conversion feature. Various market-tested solutions exist.

French investors do not generally rely simply on "convertible" shares because the conversion from preferred shares to common stock would normally have to occur at a one-to-one ratio. French legal commentators take the position that providing for an adjustment of the conversion ratio upon subsequent dilutive share issuances conflicts with the basic principle that in France shares may not be issued for less than their nominal value. The French legal community does seem to be warming to the idea that conversion could occur at less than a one-to-one ratio and so the practice in this area may gradually shift to a U.S.-style convertible preferred share with an adjustable conversion ratio.

Current practice, however, is for investors to purchase preferred shares with attached warrants (*bons de souscription d'actions*) or bonds. The warrants or bonds are exercisable or convertible upon the issuance of new shares and generally provide investors with adequate anti-dilution protection.

The warrants allow investors to obtain additional shares at a low, fixed price and accordingly reduce the average per

share price of their investment. They do not, however, confer voting rights prior to exercise and, therefore, would not allow the voting on an as-converted basis often provided in U.S.-style instruments. The exercise mechanism can be designed to replicate either full-ratchet or weighted average anti-dilution protection. However, unlike conversion price adjustments, the exercise of the warrants would require an additional cash payment by the investor.

Two types of bonds are commonly used to provide anti-dilution protection: convertible bonds (*obligations convertibles en actions* or OCA) and bonds that are redeemed exclusively in shares (*obligations remboursable en actions,* or ORA). In either case, like the warrants, the bonds can be designed to replicate either full-ratchet or weighted average protection but do not allow the bondholders any voting rights relating to the underlying shares prior to conversion or redemption. The principal disadvantage of the bonds compared to warrants is that the acquisition of the bonds requires the investor to make a cash payment in the amount of the debt. Unlike the warrants, however, the bonds allow investors to obtain the underlying shares without an additional cash payment. In practice, investments are structured so that the investment in the preferred shares coupled with the cash payment for the debt does not present an additional investment cost.

Redemption. French laws relating to stock repurchases by a company make it impossible to rely on mandatory redemption of preferred shares as a means of protecting an investor's original investment. Moreover, French investors have generally foregone the economic protection that could be provided by crafting instruments that mimic redemption provisions. Consequently, many of the solutions, although theoretically possible, remain untested in the market.

While a procedure (an *amortissement prioritaire*) does exist that allows designated classes of shareholders to require a company to reimburse (as distinct from repurchase) their shares on a priority basis, this procedure has significant limitations. Specifically, this procedure allows the company to reimburse all or a portion of only the *par value* of the preferred shares and would, therefore, not allow the preferred shareholders to receive a return on their investment. Additionally, this procedure requires approval of the shareholders at the time of the proposed reimbursement, although an undertaking to vote in favor of the reimbursement could be provided for in a shareholders' agreement. Finally, following the reimbursement, the preferred shareholders would retain their shares, with all privileges still intact, although the type of conversion and call right discussed above in relation to ABSARs could be utilized to extinguish these equity rights.

In light of these limitations of French company law, compound securities present the best hope (aside from put or call options contained in shareholders' agreement) for replicating U.S.-style redemption. Again, ABSARs could be employed to achieve the desired economic result.

Prospects for a French Evolution

The French private equity and venture capital investment community wants to encourage greater non-French participation in French private equity and venture capital activity and to improve the economic rights and legal protections afforded their investors. Therefore, it is attempting to rationalize the differences between the French legal system and market practice and those of markets where private equity and venture investing are more developed. The process of clarifying French rules and encouraging adoption of new ones where desirable will not occur rapidly, and the French, by choice and perhaps by circumstance, may never receive the identical package of rights and protections now familiar to U.S. investors. Nevertheless, through careful structuring, investors willing to adapt to the risks and challenges of investing in French companies can achieve rights and protections that are similar to many of those that they generally expect in other markets. ■

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In France, shareholders' agreements are the most common tool used to establish contractual rights for an investor... Shareholders' agreements can also include provisions designed to imitate the feature of U.S.-style preferred that provides preferred shareholders with a priority distribution upon the occurrence of certain transactions.

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German Funds Made Easier

The German legislature is currently working on two new laws that will make it easier for both German and non-German private equity and hedge funds to participate in the German markets. The new laws – the Investment Act and the Investment Taxation Act – will have a significant impact on the regulatory framework for the German investment management industry. The changes that will be most important to our private investment clients are:

- the discriminatory tax treatment of non-German funds, in particular hedge funds, sold in Germany is proposed to be abolished;
- the asset class limitations for funds licensed in Germany will be abolished for the most part, allowing for more flexibility and new types of funds, such as derivative funds;
- for the first time, a regulatory framework for German hedge funds will be created; currently existing instruments such as hedge fund certificates designed to give German investors access to hedge fund products will become superfluous; and
- the sale of hedge funds to institutional investors will generally be permitted; individuals will only have access through public funds of funds investing in hedge funds.

To date, drafts of the new laws have not been made available. We are closely monitoring the legislative process and would be happy to discuss any significant developments with you.

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Upcoming Speaking Engagements

May 22

Jonathan J. Rikoon
Estate Administration Conference
Family Limited Partnerships, Case History and Valuation Issues
New York, NY

June 24

Michael P. Harrell
Private Equity Analyst 2003 Limited Partners Summit
Negotiating Lower Management Fees, Carries and Other More Favorable Terms for Private Equity Funds
New York, NY

June 23-24

Adele M. Karig
Institute for International Research
Private Equity Tax Practices
Boston, MA

July 9-10

Marwan Al-Turki
The 2003 Private Equity COO's and CEO's Forum
Optimizing Operations – LP Reporting, Fund Administration, Technology and Compensation Issues Resolved
London, England