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Around the Fund and into the Deal — Co-investing in Europe

Co-investment opportunities in European buyout transactions do not often make it to the headlines of the business pages or the sector journals. By their nature, these investment opportunities are always something of a side-show to the main deal — a twilight zone in which fund and corporate practice intermingle. Notwithstanding the lack of buzz, this form of private equity investing has been very active this year in Europe. At least four deals (ISS, Ono, Cr Hansen and Rexel) are reported to involve more than €100m of co-investor equity. As would be expected, the sponsors' favorite LPs are invited to participate. So, LPs have been seeing more and more opportunities to directly invest larger amounts in European LBOs in 2005. With this additional visibility, we thought it worthwhile to explore some of the key aspects of co-investing.

There are many kinds of co-investors (see the Letter From the Editor). The arrangements with each will depend on the relative size and timing of their investment, whether they are in the habit of co-investing with the same lead sponsor, and the degree to which they are able to participate in the negotiation of the underlying deal.

The Advantages

Co-investing offers many advantages for the lead sponsor. Foremost, the sponsor may be reluctant or even unable to stretch its equity exposure 100% to the investment required. This may be as a result of diversification limits, or because of the relative risk profile of the target. And of course, the equity check in some deals is just too big. The ability to bring in one or more friendly minority partners to share directly in the equity risk burden might be just the comfort that a sponsor's investment committee needs in order to be able to commit to a deal that might otherwise be beyond its reach.

From the point of view of the co-investing partner, there are obvious advantages. First, in terms of potential upside, return on co-investments may not be subject to management fees or the carried interest that would apply were it to invest through a normal fund structure. Second, while doing a certain amount of financial due diligence on the opportunity itself, the co-investor will often be able to rely on most of the ground-work, particularly on legal, accounting and commercial due diligence, being coordinated by the lead sponsor. This can bring efficiencies in terms of costs. Finally, the co-investor will enjoy all of the fruits of a winning deal, without having its success offset by other, less successful investments made by a fund.

Some Disadvantages and Other Considerations

But keep in mind that a co-investment loses the benefits of diversification that exists in a fund structure, which gives each dollar invested an extra layer of protection through investment diversification. Co-investing requires the co-investor be especially selective in picking its deals. It is one thing to invest money with certain fund managers who have a positive track record *over a basket of deals*. It is quite another to take deal-by-deal risk, which is inherently higher than that of a fund taken as a whole.

Another limitation is that the co-investor's minority

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"I'm forming a consortium of side pockets to co-invest in club deals."

What's Inside

letter from the editor

This edition of the Private Equity Report emphasizes the global nature of the private equity marketplace. We explore European as well as Asian topics and trends.

On our cover, we offer the first installment in our series on co-investing and club deals with an article on co-investing in Europe. (Our next issue will focus on the increasingly important world of club deals.) The dynamics of co-investing are obviously different than those that dominate club deals, but there is also no bright line distinction between these two approaches to deal-by-deal investing. In fact, many recent transactions involve club deals with significant co-investment opportunities.

At one end of the spectrum, there is a classic club deal with multiple sponsors, all playing an active role in negotiating the acquisition and financing, and all writing an equal share of the equity check.

Co-investing, on the other hand, implies a much smaller portion of the equity in the deal, generally with less favorable governance rights than those enjoyed by the lead sponsors, and a less active role in the underlying acquisition transaction. When the equity checks are small and the participation comes after an equity commitment has been delivered, there is generally little negotiation involved.

It doesn't take too many examples to see that the border between these two forms of investing is more opaque than clear. In some deals, particularly large co-investors show up late in the game, but due to the size of their participation can demand rights with respect to governance matters. In other cases, regular co-investors take a small piece of the deal, but nonetheless arrive early and are relatively active in contributing to the transaction dynamics.

And of course, the tax lawyers don't care how much you negotiate the deal documentation. For them, the dividing line between clubbing and mere co-investing is hazy indeed.

Our Guest Column summarizes a recent panel discussion sponsored by Columbia Business School and Debevoise & Plimpton LLP in which Professor Laura Resnikoff , Robert L. Friedman, Senior Managing Director, Chief Administrative Officer and Chief Legal Officer for the Blackstone Group, Meryl D. Hartzband, the Chief Investment Officer of Stone Point Capital and our own Woody Campbell provide an overview of the evolution of private equity as an asset class, and the differences between private equity investment in the U.S. and in Europe.

Turning to the opportunities for private equity investment in emerging markets, Thomas Britt of our Hong Kong office answers the question of why sponsors should look at Asia and Holly Nielsen of our Moscow office gives us an update on how the markets are developing in the countries of Eastern Europe

Also in this issue, Sung Pak provides a review of the key mechanics and issues relating to bridge loan commitments, which have become a near fixture on the private equity scene. We also include several updates on court cases, IRS rulings and other developments of interest to private equity professionals.

Franci J. Blassberg
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Can Directors Relax? — The Disney Case, the Business Judgment Rule and the Importance of Process

In an atmosphere of intense scrutiny of board decision-making, many private equity professionals are understandably reluctant to serve as directors of their publicly traded portfolio companies. Should they reconsider that view? In this summer's most closely watched case, the Delaware Chancery Court found that Disney's board did not breach its fiduciary duties or act in bad faith when it hired and fired Michael Ovitz within a 14-month period, at substantial expense. The case confirmed that the business judgment rule — which protects good faith, informed decisions — remains an important feature in the landscape of Delaware corporate law, and that fiduciary duties do not automatically change as best practices in corporate governance evolve. However, it also described conduct that the court believed fell "significantly short of the best practices of ideal corporate governance" — and, in so doing, provided useful guidance for directors of Delaware companies and their advisers as to the importance of process in directors' decisions.

Fiduciary Duties and "Best Practices"

The decision noted that while directors are encouraged to employ best practices, "Delaware law does not — indeed, the common law cannot — hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices." Instead, liability is based on failure to fulfill fiduciary duties, which, according to the court, do not change over time. The wide latitude granted to directors who fulfill their duties is the "greatest strength" of Delaware corporate law, because it recognizes that business involves risk, that the ability and wisdom of directors will vary, and that the proper remedy for poor decisions made in good faith "must come from the markets, through the action of shareholders and the free flow of capital," and not from the court.

If it were otherwise, the court continued, and judges, with the benefit of hindsight, were to hold directors liable for good faith decisions that turn out badly, directors "would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike."

The Business Judgment Rule

Accordingly, the court reviewed the actions of Disney's directors through the lens of the business judgment rule, which presumes that directors act on an informed basis and in the honest belief that their actions were in the best interests of the company and its shareholders. To defeat this presumption, which applies absent evidence of fraud, bad faith or self-dealing, the plaintiffs must prove the directors violated their fiduciary duties of care and loyalty. Otherwise, the directors' decision will be upheld unless it cannot be "attributed to any rational business purpose."

The Duty of Good Faith

The court also explored the murky question of whether there is a separate fiduciary duty of good faith — a question especially relevant here because the court previously refused to dismiss the plaintiffs' claims on the basis that, if proved, they would show the absence of good faith necessary to sustain claims in the face of Disney's charter provision exculpating directors for breaches of the duty of care — as long as they act in good faith. In its prior decision, the court stated that directors have not acted in good faith if they "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."

In this summer's decision, the court confirmed that the concept of "intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." Although the court suggested that the duty of good faith is a subset of the duty of loyalty — "Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation" — it also said that good faith includes not simply duties of care and loyalty but also "all actions required by a true faithfulness and

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devotion to the interests of the corporation and its shareholders."

The Claims Against Disney's Directors

Against this backdrop, the court analyzed the claims against the individual defendant directors. The court found that Ovitz himself committed no breach because he was not a fiduciary at the time he was hired and did not participate on Disney's behalf in deliberations regarding his termination. The court rejected the plaintiffs' argument that the termination payment to Ovitz amounted to waste, since Ovitz received only what he was owed under his contract, and no basis existed for avoiding the payment by firing Ovitz for cause. While the court noted that there were "many lessons of what not to do" from the defendants' conduct in approving Ovitz's employment agreement, the court concluded that Disney's directors "did not act in bad faith, and were at most ordinarily negligent, in connection with the hiring of Ovitz."

In particular, the court found that although "legitimate criticisms" could be made against Disney CEO Michael Eisner — especially in light of his failure to receive board authorization before agreeing to hire Ovitz, agreeing to the substantive term of a letter agreement outlining his employment terms and issuing a press release announcing the hire — the court believed that Eisner's actions were taken with the subjective belief that they were in Disney's best interests. Similarly, while the court observed that it would have been better if the chairman of Disney's compensation committee (who negotiated the terms of Ovitz's employment with Disney) had not also been Eisner's personal lawyer, and if he had done more diligence on Ovitz's prior employment and background, the court found that the plaintiffs failed to prove that he was grossly negligent or that he acted in bad faith.

Considering claims against the other members of Disney's compensation committee, the court noted that although the committee did not review the text of Ovitz's employment agreement or receive a presentation from the committee's compensation expert, these steps were not required since the committee received a term sheet as well as a presentation from the committee's chairman, which was informed by his discussions with the compensation expert. The court stated that "it is not necessary for an expert to make a formal presentation" for directors to rely on the expert's analysis, "although that certainly would have been the better course of action." Even though the committee did not deliberate for an extended period about the proposed agreement, the committee discussed the agreement "for a not insignificant length of time" and its members were aware in advance of the purpose of the meeting.

The court contrasted the facts of *Smith v. Van Gorkom*, in which directors were held liable for approving, without documentation, a merger transaction at a meeting hastily called without notice of the meeting's purpose, noting that the nature of the *Van Gorkom* transaction was "fundamentally different, and orders of magnitude more important," than the hiring of Ovitz.

In *Disney*, the compensation committee approved the Ovitz agreement knowing that the committee's chairman had negotiated the agreement at arm's length, that Ovitz was a highly regarded industry figure who was widely believed to possess valuable skills and experience, that Ovitz was giving up a successful business to come to Disney, that the CEO and other senior managers supported his hiring and that Ovitz's potential compensation was not material to Disney. Accordingly, the court concluded they did not breach their duties or act in bad faith.

Considering whether the directors breached their duties in connection with Ovitz's termination, the court concluded that, because Eisner acted within his scope of authority in terminating Ovitz, the directors had no duty to act — and therefore did not breach their duties. When the court separately reviewed whether Eisner breached any duties in terminating Ovitz and paying a large termination fee, it found that Eisner "weighed the alternatives, received advice from counsel and then exercised his business judgment in the manner he thought best for the corporation." Because Eisner acted on an informed basis and was not personally interested in the transaction in a way that made him incapable of exercising business judgment, the court found that the plaintiffs had failed to prove that Eisner breached his duties or acted in bad faith.

What's Next?

Should directors of Delaware corporations now relax? Is it really true that fiduciary duties do not change over time, even as society demands greater accountability for board decisions? The Disney defendants were absolved, but only after a searching, 37-day trial that concluded a decade after the initial events giving rise to the litigation — and the decision is now being appealed to the Delaware Supreme Court. The *Disney* case is an important reaffirmation of the business judgment rule, but also a sobering reminder of the central importance of good process in board and committee decision making.

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Private Equity Investing on Both Sides of the Atlantic

We are pleased to summarize a panel discussion sponsored by Columbia Business School and Debevoise & Plimpton LLP and held on November 3, 2005 among Robert L. Friedman, Senior Managing Director, Chief Administrative Officer and Chief Legal Officer for the Blackstone Group, Meryl D. Hartzband, the Chief Investment Officer of Stone Point Capital, Professor Laura Resnikoff of the Columbia Business School, and Woodrow W. Campbell, Jr., a partner at Debevoise & Plimpton LLP.

The Evolution of the Private Equity Asset Class

Bob Friedman started off the discussion by summarizing the dramatic growth of private equity as an asset class.

Private equity has had an incredible evolution, transforming itself from an arcane specialty of financial engineering into an important and dominant force in the M&A market. As a result, managers have become one of the principal owners of businesses and the stewards of over $500 billion of enterprise value and millions of employees. One of the reasons for private equity's amazing growth is that private equity returns can and do provide an attractive premium to investors over public equity returns. In fact, the top quartile private equity managers have significantly outperformed underlying equity indices over various economic and equity market cycles.

The private equity market has grown dramatically in the last fifteen years. In 1980, there were 20 private equity funds, only one of which had committed capital of over $1 billion. Today, there are over 500 funds, 150 with committed capital over $1 billion and ten with committed capital over $5 billion. Geographically speaking, whereas in 1980 private equity was a U.S. -only market, today private equity deals are being done in the U.S., Europe, the Middle East and Asia. Over the same period, private equity funds have also dramatically increased their share of the total M&A market from 2 ½ -3 ½% in 1997 to 2001 to 11-14% in 2002-2004, both in the U.S. and Europe.

Many factors contributed to private equity's growth. But the most important is that top performing buyout funds have significantly and consistently outperformed the S&P 500 as well as other comparable investment vehicles. Between 2003 and 2004 the top-quartile private equity funds had a 15.1% internal rate of return, versus a negative 4% for the S&P during that period.

Large buyouts have also grown significantly. The volume of buyouts in excess of $1 billion was only $12.8 billion in 1998, but had grown to $48-53 million by 2003 to 2005. In fact, all but two of the13 largest buyouts ever done occurred in the last two years. Most industry participants believe the trend is going to continue. European buyouts have also grown rapidly in the last few years. In 2004 almost half of all buyouts were done in Europe compared to 26% of all buyouts in 1996. Looking solely at where funds have been raised understates the importance of Europe because funds like Blackstone and others are investing heavily in Europe. Of the $4.5 billion that Blackstone has invested in 20 transactions to date from its current fund, exactly half or 10 transactions, were in Europe.

Differences Between U.S. and Europe

There are differences between doing private equity deals in Europe versus the U.S.

First and foremost, Europe is not a monolithic market. It is a different buyout experience in each of the ten to fifteen countries in which private equity deals are currently being done. The deal process is different. Legal ramifications are different. The regulatory situation is different. Financing is different. Specifically, Europe has financial assistance rules which do not exist in the U.S. that have a meaningful impact on how you structure a transaction. Granting a security interest in European assets can have significant tax and other ramifications. And of course there are cultural differences from country to country which affect every single transaction.

Many U.S. buyout firms eagerly entered Europe over the last several years, believing the market was more opportune and transactions were not

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While there are greater opportunities in Europe than in the U.S. to improve operations and to reduce costs, those changes are all much more difficult to achieve in Europe. It is harder to fire people or close a plant in just about every European country, and in France, Germany and Spain, it is a real challenge to achieve any kind of cost cutting or plant rationalization.

being as competitively pursued. While that may have been true five years ago, the gap has now completely narrowed. Today the competition to find the gem of a deal that is not being chased by more and more firms is pretty much the same on both sides of the Atlantic.

There do remain differences, however. Some assets are priced higher in Europe. Real estate, for example, is valued at a much higher level than in the U.S. European industries have consolidated to a far lesser extent than the U.S. Industries like auto supply, nursing homes, theatre chains and distribution businesses are finally starting to be the subject of merger activity in Europe.

While there are greater opportunities in Europe than in the U.S. to improve operations and to reduce costs, those changes are all much more difficult to achieve in Europe. It is harder to fire people or close a plant in just about every European country, and in France, Germany and Spain, it is a real challenge to achieve any kind of cost cutting or plant rationalization.

In Europe, due diligence is more institutionalized than in the U.S. Accountants' reports are made available to every bidder. Lawyers' reports are more standardized. Stapled financing is more a part of the framework in Europe and has only just recently become common in the U.S.

On the plus side, there are more mid-sized family businesses in Europe that are ripe candidates for buyout transactions. In Italy, Germany and elsewhere, many more businesses are not public and many remain controlled by families in which the patriarch of the family is getting on in years and there is no son or daughter to take over. That's when the private equity firms get called.

Another advantage to doing deals in Europe is that European banks are much more willing to put their balance sheet at risk in transactions. In the U.S., that is just not the case any longer. There is no major U.S. bank that does not typically fully syndicate the senior loan in a leveraged buyout transaction. This gives European banks a distinctive advantage and most private equity firms have tended toward the European banks for that reason. While the financing markets used to be quite different, they are converging and are now quite similar. Mezzanine debt was much more expensive in Europe five years ago, because it was a far less developed market and banks would not allow as much leverage as in the U.S. But again that is converging. The high yield market is still a bit behind the U.S., but things like second lien debt and other phenomena that have affected financing structures in the U.S. have now become commonplace in Europe.

The Major Trends

Woody Campbell highlighted three major trends visible in the market on both sides of the Atlantic — increasing European allocations, domain knowledge and spinoffs of private equity teams.

First, from the investment perspective, there is a large and increasing demand for private equity fund investment opportunities among European institutional investors driven largely by pension funds. European pension funds need enhanced investment returns to compensate for declining birth rates. Private equity is the only asset class that has consistently done better than the public equity markets.

British pension funds have on average, about 2% of their assets in alternatives — primarily LBOs. On the other hand, CALPERS' alternatives, exclusive of real estate, are targeted at 6% or three times as much. (They actually are now at about 4.5%.) If the European pension funds pushed their allocations to the level of CALPERs and the other U.S. institutions, growth in demand for private equity investments will benefit both U.S. and European firms.

The second megatrend is the growing importance of "domain knowledge" or specialization. Some of this is informal, for example, Bruckman Rosser's focus on consumer goods, with recent deals like Easy Lube and California Pizza. For other firms, specialization may be built into the firm's charter. Examples of these include firms like J. C. Flowers' attention to financial services, Stonepoint Capital's focus on the insurance market and Providence, for example, in the media and telecom space. Firms that can demonstrate investment focus and have a track record that supports it can do better, sometimes dramatically better, than their peer firms in terms of raising capital, achieving size and, employing capital.

Doing European deals requires a specialized domain knowledge as well. For example, financial assistance rules, differing practices in insolvency, labor practices and a relatively intense governmental scrutiny on anti-trust issues are part of the puzzle that private equity firms need to solve. Due to the special nature of doing deals in Europe, funds who are specialized, who have been on the ground, who have been through an economic cycle or two will likely succeed.

A third megatrend is the tremendous turnover among the individual players in the LBO market. What is driving this trend? Private equity firms are being spun off by their institutional holders. Some individual private equity players simply feel that it is time for them to strike out on their own. A number of securities firms are exiting this business, in part because private equity has little synergy with their basic securities businesses, because of a Chinese wall and other regulatory issues. Some are leaving the business because the private equity business conflicts with their own private equity coverage groups within their own investment banks which market to competing firms. Others are leaving

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Just in Case — Bridge Loan Nuts and Bolts

A funded bridge loan has always been something of a rarity in the world of sponsored acquisitions. Particularly in recent years, when conditions in the high yield bond market have generally been good, even the 'old pros' who experienced the fallow high yield markets in 1999 and 2000 may have had little occasion to focus on the particulars of bridge commitment mechanics. Sponsors, of course, expect that the permanent bond financing will be in place at closing, and the financing sources would much prefer a fully marketed placement of bonds to a large, somewhat illiquid hold position in bridge loans. Bridge commitment papers are in many ways a "what-if" construct, full of fees and terms that the sponsor hopes will not apply, for a commitment that the financing provider hopes will not be needed. Of course, all those fees and terms become very real when a bridge loan actually funds, whether due to a bump in the markets or instead due to circumstances unique to a particular deal. In the spirit of hoping for the best, while at the same time preparing for the worst, here's a review course on some of the key mechanics and issues relating specifically to bridge lending commitments.

What's with all these fees?

As anyone who has seen a bridge fee letter knows, bridge financing providers seek to compensate for their illiquidity risk with an exquisitely constructed, complicated array of fees.

The Commitment Fee and the Funding Fee. The commitment fee and the funding fee are the fees payable at the time of funding of the bridge loan. Once funded, the commitment fee is non-refundable. A portion of the funding fee, on the other hand, is often subject to a sliding-scale rebate if the funded bridge is refinanced within a reasonable period following the funding with a take-out financing placed through the same financing provider (*e.g.* 50% if refinanced within 90 days, 25% if refinanced within 180 days).

The Conversion Fee. Sometimes instead called a rollover fee, the conversion fee is payable at the time of the initial 'maturity' of the bridge loan (*e.g.* 1 year), when the bridge loan flips into a more permanent type of financing.[1] The conversion fee is typically equal in amount to the underwriting fee that the financing provider would have been paid on the bond offering. While a rebate is less common in the context of the conversion fee than is the case with the funding fee, the sponsor can sometimes negotiate for a rebate of the conversion fee in the event that the converted bridge loans are refinanced following the conversion date with debt placed through the same financing provider.

The Refinancing Fee. The refinancing fee is payable when the bridge loan is refinanced between the funding date and the conversion date, and is typically equal in amount to the conversion fee. The refinancing fee should really function as a 'deal-away fee' — it should not be payable with respect to any refinancing where the financing provider that provided the bridge loan is being paid an underwriting fee or its functional equivalent.

Bond Underwriting Fee. The engagement for the bond offering (which is typically documented separately from the bridge loan commitment) will provide for an underwriting fee or discount. But the scope of the engagement is often broader than just a bond offering, and can include engagements for holding company notes, preferred stock, second lien bank loans and the like, for which the underwriting fee or discount may not be appropriate.[2]

No Doubling Up, Please. Given the number of fees involved in a bridge commitment, and given the financing provider's interest in making the applicability of each fee as broad as possible, the sponsor should be careful to ensure that the fees line up correctly and that it does not end up paying more than one functionally equivalent fee for the same financing. Some areas where overlap can most often be found:

- ***Refinancing Fee and Bond Underwriting Fee:*** It seems obvious enough that if a bridge loan funds and is then refinanced with a take out bond offering placed through the same financing provider, a bond underwriting fee should be all that's payable. Bridge fee structures are complicated enough, however, that it nonetheless makes sense to take care that the papers actually reflect that outcome.

- ***Deal Away Fee and Refinancing Fee:*** Given that the refinancing fee is functionally a 'deal-away' fee, the two should certainly not both be payable at the same time. The 'deal-away' fee is often in a different location within the commitment papers, and given the often broadly-worded scope of the 'deal-away' fee, the sponsor should take care to ensure that the two fees do not overlap.

- ***Overbroad Scope of Engagement:*** Because the engagement letter for the bond financing often covers a broader set of possible financings in addition to the bond offering, the underwriting fee contained in the engagement letter can sometimes be read to cover compensation for

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1 *See "So what exactly lies on the other side of this bridge?" below.*

2 *Often, the negotiated outcome with respect to the "underwriting fee" for such other financings is to provide for 'customary and market' fees for the type of financing that is consummated.*

financings as to which the financing provider is already being compensated elsewhere in the commitment papers. For this reason (as well as just for the sake of simplicity), it often make sense for the sponsor to ask that all fees payable to the financing provider be listed in a single place, where the relationship between the fees is made clear.

The banks are telling me they don't want the bridge to fund, so why are they tying me down so much?

In exchange for committing to provide the total amount of debt financing required for an acquisition, the financing provider wants to be sure that it will retain the right to provide the entirety of that debt financing (or at least to be compensated as though it were so acting). Given the unattractive nature of the bridge loan as a form of financing, however, the sponsor will want to maximize its ability to replace it with a more permanent form of financing. To put it another way, the sponsor's general desire for flexibility in the commitment papers with respect to the deal-away fee and other exclusivity provisions can be more acute in the context of the bridge commitment. While it is difficult to alter the basic bargain that the financing provider expects, the sponsor nonetheless can negotiate for flexibility within those bounds.

The financing provider's desire for exclusivity is reflected in the following set of provisions:

- ***The 'Deal-Away' Fee:*** The 'deal-away' fee is payable when the sponsor consummates the acquisition (or a similar transaction with the same target) utilizing a source of debt financing other than the one committed to by the financing provider. The amount of the fee is generally meant to give the financing provider fees equivalent to those it would have received if its commitment had been utilized.
- ***Exclusive Engagement:*** The engagement letter for the bond offering actually engages the financing provider for more than just the bond offering itself. While theoretically, the engagement for such other financings should be limited to financings that could plausibly take the place of the bond offering, in practice the scope of the engagement can cover the whole gamut of financing options (secured bank loans, including second lien loans; mezzanine or other subordinated debt; preferred or even common stock; and convertible debt).
- ***The 'Clear-Market' Provision:*** The flip side of the exclusive engagement is the 'clear-market' provision, which provides that the target, the sponsor and their affiliates will not solicit or participate in any financing that competes with the bridge/bond financing. Again, in practice the typical 'clear-market' provision tends to be quite broad in scope, with limited carveouts for ordinary course debt such as capital leases and foreign working capital debt.

Given this multi-layered web of restrictions, the sponsor may need to consider and negotiate for some additional flexibility in its financing options where necessary. Some of the ways in which such flexibility can be obtained:

Walk-Away Rights. The sponsor should be able to walk away from the bridge financing without penalty if the acquisition agreement with the Target terminates. There will normally be a 'tail' to the exclusive engagement and the "deal-away" fee that would protect the financing provider in the event the acquisition revives in another form, but in all events there should be a definitive sunset date to that engagement and fee. In addition, once the bridge loan is funded and subsequently reaches its conversion date (and turns into what is putatively a permanent form of financing), the financing provider is entitled to a conversion fee that is the rough equivalent of an underwriting fee, and the sponsor should be able to seek a refinancing at that point without any obligation to the financing provider. If the terms of a particular bond/bridge financing are particularly onerous (*i.e.* is the product of a temporarily bad market or a skewed bidding process), the sponsor may be able to argue for a greater ability to walk away. For example, the sponsor may be able to eliminate or limit the 'clear-market' with respect to that portion of the financing, and reduce or limit the applicability of the 'deal-away' fee (see *e.g.* "Right of First Offer" below).

Scope of Engagement. While the financing provider will argue that its economics are premised on providing the entirety of the debt financing for the acquisition, the sponsor can conversely argue that its economic expectations are largely based upon a successful marketing of a bond offering. While the sponsor's ability to cut back the scope of the engagement is fairly limited (and even more so in the case of the 'deal-away' fee), it may be possible in some instances to eliminate some of the more marginal types of financing, such as the raising of common equity.

Right of First Offer. A sponsor with good negotiating leverage in a given transaction may be able to lessen the impact of the exclusive engagement and 'deal-away' fee by providing that the sponsor has the right to shop the bridge financing to a competing financing provider, and will only be

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Taxpayers May Start Seeking Private IRS Rulings in Certain Private Equity Transactions

Private equity M&A runs the gamut from a simple purchase of stock to a complicated, multi-party transaction involving simultaneous acquisitions and dispositions of wanted and unwanted assets. Although the tax treatment of the more complicated transactions is not always certain, private equity firms have historically shied away from seeking a private ruling from the IRS about the intended tax treatment in light of the estimated four to six months usually estimated to get such a ruling. That may now change, at least when it comes to certain types of mergers designed to be tax free (so called "reorganizations") and certain transactions where the existing company splits into two or more separate companies in a tax free manner (a "spin-off").

New Expedited Procedure for Obtaining Spin-Off and Reorganization Ruling

Around two years ago, the IRS announced a pilot program, under which it would continue to issue spin-off rulings, but no longer rule on two critical requirements: "business purpose" and "device." For these two requirements taxpayers would need to rely upon the advice of an attorney, in practice usually rendered in a formal opinion of his or her law firm. This was no small matter, as both of these tests are heavily fact based and the "business purpose" requirement for spin-offs is a much more stringent test than the "business purpose" requirement for other types of transactions. As a result of the limitations imposed by the program, coupled with the length of time it would take to get the ruling, many taxpayers undertaking a spin-off decided to bypass the ruling process and rely entirely on a legal opinion.

The pilot program turned out to be a classic example of "be careful what you wish for, you might get it." The Service's stated purpose for limiting the available rulings was to free up IRS resources. However, the reduction in ruling requests turned out to be much greater than the IRS expected, so much so that IRS has now decided it is not receiving enough Ruling Requests. While private ruling requests do call upon resources, the IRS views them as an important way to keep abreast of transactions occurring in the marketplace.

Although the IRS is not ready to abandon the limitations imposed under the pilot program, it has decided to actively encourage the filing of more private ruling requests by creating an expedited process for obtaining private rulings concerning spin-offs and reorganizations. Under the new procedure, the IRS undertakes to issue rulings within ten weeks of submission, which is consistent with the period it frequently takes for a transaction to close in any event.

Although two and a half months may be consistent with the timing for closing a transaction, it is typically far longer than the time horizon for structuring and negotiating a transaction. However, it is frequently possible to get a preliminary reaction from the IRS about whether and how they would rule on a much faster time line. Specifically, taxpayers who seek a ruling, typically, first have a "pre-filing conference" with the IRS. This is an informal procedure that can often be set up in two or three days. Typically, the taxpayer sends the IRS a brief description of the proposed transactions and requested rulings and then meets with IRS personnel that will be reviewing the ruling request. The IRS is often quite forthcoming in offering a preliminary (non-binding, of course) assessment. The pre-filing conference also affords an opportunity to discuss the nature of the supporting documentation, *e.g.*, financials, representation letters, that the IRS will require.

It is clearly time to rethink the typical decision to avoid applying for a private ruling from the IRS in certain transactions

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Just in Case — Bridge Loan Nuts and Bolts (cont. from page 8)

obliged to pay the 'deal-away' fee if the original financing provider is able to match the competing proposal. While helpful in theory, in practice the original financing provider's right to match may greatly lessen the incentive for competing financing providers to participate.

Refusal to Fund. If the financing provider refuses to fund its bridge commitment in accordance with its terms, the 'deal-away' fee should not be payable.

What does all this have to do with my bond deal, exactly?

The Securities Demand. The functional flip-side of the financing provider's obligation to provide the bridge loan, the securities demand is an obligation of the sponsored company to commit to buy bonds placed by the financing provider. Subject to the pricing of the bonds being at or under a negotiated 'back-stop' rate, the securities demand allows the financing provider to force the sponsor to accept a bond offering at the closing of the acquisition, or to force the sponsor to effect a bond offering to fund a refinancing of a

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funded bridge loan. Given that high yield bonds, unlike a bridge loan prior to its conversion, carry a no-call period and high call premiums, the sponsor will want to avoid surprises by building in protections that limit the economic and other terms of the bonds. Some examples of such protections:

- *Pricing:* In addition to the 'back-stop' rate, the sponsor may seek to have the financing provider undertake some obligation to try to obtain the best pricing that market conditions can support.
- *Type of Securities:* The securities demand should not allow the financing provider to significantly alter the expected capital structure by turning the bond financing into a preferred stock offering, a holding company financing, etc., without the sponsor's consent.
- *Timing of Demand:* The sponsor may argue that a securities demand should only apply after the acquisition closes, so that the sponsor essentially has the option to fund the bridge rather than take a permanent bond deal at the back-stop price. The sponsor might also seek a 'holiday' of a fixed number of days following the closing of the acquisition before a securities demand can be made. Both of these provisions can help the sponsor if it wants to ride out a bump in the markets rather than take a permanent bond deal at the back-stop price. Finally, the sponsor can also argue that a securities demand should only be made after at least one *bona fide* road show has taken place, so that the financing provider must at least make a *bona fide* attempt to find and identify a market price for the bonds before forcing the sponsor to take bonds priced at the back-stop rate.
- *Terms of Bonds:* The coupon, obviously, is not the only term of a high yield bond issuance that matters. It is very much in the sponsor's interest to limit surprises in the covenant package, as well. For a sponsor with a number of high yield precedents, it may be possible to argue that the covenants for any bonds issued pursuant to a securities demand must be consistent with the sponsor's precedents (taking into account market conditions). If the demand is structured so that it can only be made following a road show, it may also be possible to tie the covenant package to the covenants that are described in the offering memorandum used for the road show, again taking into account market conditions.

So what exactly lies on the other side of this bridge?

Prior to Conversion — Economic Terms. Following the funding, a bridge loan typically bears interest at an agreed margin above LIBOR. The margin typically steps up in fixed increments from time to time following the funding date up to the conversion date (typically the one year anniversary of the funding date). Upon conversion, the margin may step up once again for the conversion of the bridge loan into a permanent financing. In all events, however, the interest rate should not exceed the agreed upon 'back-stop' rate. Prior to the conversion date, bridge loans are typically callable at par.

Prior to Conversion — Other Terms. The covenant package for a bridge loan varies from deal to deal. Some bridge loans have covenants that are based on the senior secured bank deal (with 'cushions' built in and modifications to loosen specified covenants). Other bridge loans have covenants that largely follow the high yield model, with modifications to tighten specified covenants, which is a more flexible approach from the sponsor's perspective. Typically, transfers of bridge loans are freely permitted, although the sponsor is sometimes able to negotiate for some consent rights.

Following Conversion — Economic Terms. Upon conversion into a permanent financing, the bridge loan will convert into long-term debt, with a maturity similar to that of a high yield bond issuance. The holder of the bridge loan typically has the option to hold the permanent financing either in the form of bonds (typically called 'exchange notes') or term loans (typically called 'term loans' or 'permanent loans'). In the case of exchange notes, the interest rate becomes fixed at the floating rate in effect immediately prior to conversion, plus a bump up that becomes effective as of the conversion date. In the case of term loans, interest continues to float, but with a bump up in the margin effective as of the conversion date. Exchange notes carry typical high-yield call provisions (no-call period of half the maturity, with high yield-style call premiums thereafter). Term loans do not always carry no-call provisions or call premium.

Following Conversion — Other Terms. In the case of the permanent term loans, the covenant package applicable to the bridge loans prior to conversion typically continues to apply following conversion. In the case of exchange notes, the bridge loan covenants flip into true high yield style covenants. Following conversion, exchange notes and term loans are typically freely transferable.

Although no borower wants to utilize a bridge loan commitment, knowing the ramifications of doing so may help make that eventuality less onerous.

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Some Garden Variety Deferred Compensation Arrangements Still Work

In September 2005, U.S. Treasury issued proposed regulations concerning the deferred compensation rules contained in Section 409A of the Internal Revenue Code. In many respects, the new regulations merely confirm the initial guidance issued last December. (See "Deferred Compensation Rules Revisited" in the Winter 2005 edition of the *Debevoise & Plimpton Private Equity Report*). However, the proposed regulations also clarify a number of issues and provide several new and for the most part helpful provisions, some of which are of particular interest to private equity funds.

Background

Last fall, Congress radically revised the income tax rules relating to deferred compensation by enacting Section 409A of the Internal Revenue Code. Section 409A applies to a broad range of deferred compensation arrangements (basically, any payment for services rendered in one year that is to be paid in a later year), many of which have historically been used by private equity funds in incentivizing portfolio company management teams. The statute imposes very mechanical rules requiring deferral elections (and changes in elections) to be made far in advance and stringent restrictions on what events can trigger payment of the deferred amounts. These new rules make it difficult to revise arrangements on a short time frame, as is typically required in private equity.

Section 409A adds significant penalties for non-compliance. Any deferred compensation arrangement subject to the deferred compensation rules that does not comply with the rules is subject to an additional 20% penalty tax, as well as the possibility of extra interest charges on any late tax payment.

An overview of the changes and new provisions found in the proposed regulations is set forth below.

SARs Are Back

The prior notice exempted grants of "at the money" stock options from the 409A deferred compensation rules, but did not contain a similar provision for stock appreciation rights ("SARs") granted by private corporations. The new proposed regulations include an exception for "at the money" SARs granted by private corporations, and also permit both cash- and stockpay SARs. The proposed regulations also permit adding a SAR feature to existing options without retesting fair market value. As a result, most grants of common stock options and SARs by private corporations will not be subject to the deferred compensation rules.

Valuation Guidance

Unlike "at the money" option and SAR grants, discounted option and SAR grants are subject to the 409A deferred compensation rules. Given the consequences of inadvertently issuing discount awards — especially the 20% penalty — it is obviously important that the value of the underlying stock be correctly determined. Under the proposed regulations, private companies may determine the fair market value of their stock by reasonably applying any reasonable valuation method. Factors to be considered under a reasonable valuation method include the value of tangible and intangible assets, the present value of future cash flows, analysis of comparable companies' equity and other relevant factors such as control premiums, discounts for lack of marketability and whether the valuation method is used for other purposes. There are also several specified valuation methods that are presumptively reasonable, including certain independent appraisals.

Rollovers in Corporate Transactions

The proposed regulations do little to facilitate tax efficient compensation "rollovers" of previously untaxed compensation in connection with acquisitions. As a result, it may no longer be possible to structure a tax deferred rollover in many cases. However, the proposed regulations do confirm that in connection with a corporate transaction such as a merger, stock purchase, recapitalization or extraordinary dividend, existing options may be substituted, assumed or modified as long as certain relatively flexible rules are satisfied. In order to avoid triggering the 409A deferred compensation rules, the "new" options generally must have the same terms as the "old" options, must not increase the built-in spread value and must not *increase* the ratio of the exercise price of the "old" options to the fair market value of the shares subject to the options. Because the third requirement — the ratio test — permits the ratio of the strike price to the fair market value of the underlying shares to decrease, private equity funds have the ability to reduce (or at least maintain) dilution levels when making option adjustments.

For example, if a target executive has 25 options with a strike price of $2 to purchase shares worth $5, in a merger these could be adjusted into 5 options with a strike price of $5 to purchase shares worth $20. Such an adjustment would reduce the dilution by 20%. In a properly structured leveraged recapitalization, it may be possible to avoid increasing the number of outstanding options while still preserving the built-in spread value by adjusting only the strike price. For example, if the value of each share of stock goes from $5 to $2 (as a result of a payment of $3 per share in the recap), an executive who has 25 options with a strike price of $4 could have the strike price of his 25 options reduced to $1.

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Some Garden Variety Deferred Compensation Arrangements Still Work (cont. from page 11)

The employer may not be able to distribute cash to option holders in lieu of (or as part of) an adjustment because of 409A. However, portfolio companies can convert a portion of the options into cash-pay SARs to achieve a similar result.

Private equity funds therefore still have some flexibility to adjust options in corporate transactions and permit management to defer income tax while avoiding unwanted dilution.

Short-Term Deferrals

The proposed regulations confirm that any compensation that is payable within 2-1/2 months after vesting (including in severance situations) is not subject to the 409A deferred compensation rules, even if the award covers several years of service. For example, grants of restricted stock that vest and become payable over time as long as the executive remains employed and performance shares that vest and become payable based upon EBITDA multiples achieved in an IPO would both not be subject to the deferred compensation rules.

Management Services are Not Exempt

While compensation payable to independent contractors is generally not subject to the 409A deferred compensation rules, the proposed regulations provide that deferred compensation for management services is not exempt. Management services include the direction or control over financial and operational aspects of a business and investment advisory services to an entity whose primary trade or business includes the management of financial assets for its own account. Some fee arrangements of private equity and hedge funds will thus have to comply with the deferred compensation rules (or be subject to the additional tax). Partnership profits interests are still OK (see below). In addition, if the service provider is an accrual basis taxpayer (as is often the case of fund management companies), the deferred compensation rules do not apply, even if the service recipient (the fund or a portfolio company) is not an accrual method taxpayer (the proposed regulations eliminated the previous requirement that the service recipient also be an accrual method taxpayer).

Payment upon a Change in Control

Even if a particular type of compensation is subject to the 409A deferred compensation rules, it is still possible to avoid the punitive aspects (such as the 20% penalty tax) by complying with the technical requirements of the rules concerning the timing of deferral elections and the timing of payments under the deferred compensation plan. The occurrence of a "change in control" as defined under the rules is one of the permissible events that may trigger a payout of deferred compensation. While the prior guidance limited the change in control definition to transactions involving only corporations, the proposed regulations indicate that the definition may be applied by analogy to partnerships until further guidance is issued. This change allows portfolio companies organized as partnerships to cash out deferred compensation arrangements in connection with a change in control.

Other Payment Triggers Associated with an Exit

Importantly (and unfortunately), many other common triggers that do not involve an actual change in control (like IPOs and recapitalizations) are not included as one of the permissible payment events for deferred compensation. However, the proposed regulations clarify that if a compensation arrangement becomes vested on a trigger event such as an IPO, then payment can be made right after the exit event (in which case it would not be deferred compensation under the short-term deferral exception described above), or upon a fixed schedule determined by reference to the trigger event (in which case it would be deferred compensation that complies with the rules). For example, a grant of restricted units that vests in connection with an IPO or after five years of service (whichever occurs first), may be paid out on the six-month anniversary of the vesting event, or in installments on each of the first three (or five) anniversaries of the vesting event.

Flexibility to Delay Payments

It's OK to be a bit late sometimes. The proposed regulations clarify that minimal delays in payment will not result in a violation of the rules. Payments may also be delayed in special circumstances, including where it is administratively unfeasible to calculate the amount or where payment would violate a law or loan covenant.

Limited Additional Flexibility to Accelerate Payments

The proposed regulations provide a limited ability to get out of deferred compensation plans after they have already been put in place. An employer can terminate and pay out amounts following a change in control in its discretion without violating the deferred compensation rules so long as payments of all amounts are made within twelve months of the change in control event. Employers also have the ability to terminate a plan and distribute deferred amounts in connection with a corporate dissolution or where the employer ceases providing non-qualified deferred compensation (by, for example, terminating all plans), subject to specified conditions designed to keep the employer out of the deferred compensation plan business for an extended period .

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European Commission Concludes its Investment Fund Framework "Could be Better"

In a mastery of understatement, the European Commission (EC) in July expressed concern over the lack of a coherent European-wide regulatory approach for investment funds, including private equity and hedge funds. The EC was forced to conclude in a "Green Paper" that the centerpiece of current European Union (EU) fund regulation, the so-called UCITs legislation which covers management companies and public investment funds, "could function better." Few would debate the fact that more needs to be done if the UCITS goal of a pan-European market for investment products and management services is to be achieved. According to the Green Paper, as well as most industry observers, the current cross-border fund legislation has "not yet delivered an optimally functioning European fund market." Nonetheless, the EC declined to throw out the existing legislative framework. And it will study further the alternative investment industry before taking any regulatory or remedial action. The EC does promise to issue some guidance with respect to investment fund regulation early in 2006.

Alternative Investments — Private Equity and Hedge Funds

The EC acknowledges that alternative investments, *i.e.*, hedge funds and private equity funds — which are among the fastest growing segments in the European investment industry — can no longer be ignored.

According to the EC statistics, assets under management in European hedge funds have grown from an estimated US$ 20.5 billion at the end of 2000 to an estimated US$ 255.85 billion at the end of 2004. Similarly, European private equity funds have grown from €59 billion in assets under management at the end of 1999 to €155 billion at the end of 2004.

The fact that private equity and hedge funds operate outside the current UCITs regulatory regime is generally viewed as a plus by industry participants. On the other hand, the situation poses very real market access and regulatory challenges since existing laws covering alternative investment products are highly fragmented across the European Member States.

No Coordination of Private Equity Funds

For example, there is no pan-European form of organization for private equity fund vehicles. In an effort to attract business, certain jurisdictions have created special types of entities designed for use as private equity fund vehicles (such as the SICAR in Luxembourg or the PRICAF in Belgium), each of which enjoys special tax treatment. In other Member States, private equity fund sponsors typically use the national version of a limited partnership (a limited partnership in the UK or a GmbH & Co. KG in Germany).

The differences between these national forms of fund vehicles, however, are significant and go far beyond the differences between a Delaware, New York and Cayman Islands limited partnership. Setting up private equity fund vehicles in various European jurisdictions requires customizing the structure to the national legislation. This increases costs, causes time delay, and reduces the commercial transparency and comparability of these funds for investors. Further, there currently exists no liquid pan-European market (such as NASDAQ) to provide exit opportunities through public listings.

Despite these barriers, almost all European private equity funds operate on a cross-border basis on the fund-raising side as well as on the investment side. Nearly half of EU private equity fund capital commitments between 1999 and 2003 were raised from investors outside the country where the fund was organized. On the investment side, while European private equity funds tend to invest the largest part of their investable assets in the country where they are organized, many invest in multiple EU Member States or even outside the EU.

While the EC Green Paper concludes that "the existence of 25 different legal structures and bilateral tax treaties prevents the private equity industry from achieving its full potential," it does not appear eager at the present time to attempt to regulate European private equity funds. By contrast, the European hedge fund industry is drawing regulatory scrutiny (as is the case in the U.S.).

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[1] *Directive 85/622/EEC (Dec. 20, 1985), amended, inter alia, by Directive 2001/107/EC ("Management Company Directive") (Jan. 21, 2002) and 2001/108/EC ("Product Directive") (Jan. 21, 2002). The Management Company Directive and the Product Directive are sometimes referred to as UCITS III.*

Investment Fund Framework "Could be Better" (cont. from page 13}

Hedge Funds Draw Greater Concern

Hedge fund regulation in Europe is even less homogeneous than the private equity industry. While most EU countries permit the formation and management of domestic hedge funds, there are significant differences among the Member States.

As a result of these differences, two jurisdictions have emerged as European hedge fund centers. The UK is the leading jurisdiction for hedge fund managers. About 74% of the assets under management of all European hedge funds were managed from the UK at the end of 2004. Ireland has emerged as the leader in fund administration, with Luxembourg following in second place.

The rules for marketing and distribution of hedge funds also vary significantly from country to country. For example, while the distribution of offshore hedge funds is completely prohibited in some jurisdictions, it is limited to certain types of investors in other jurisdictions. Further, in some jurisdictions, single hedge funds may be publicly sold to retail investors, while in Germany only funds of hedge funds — but not single hedge funds — may be sold to retail investors in public offerings. Investment thresholds (the minimum capital an investor must invest in the fund) vary from jurisdiction to jurisdiction. And the tax treatment of hedge fund investments is complex and diverse.

The EC fears that these multiple layers of regulatory differences could lead to even higher market fragmentation and an increased risk of regulatory arbitrage, accompanied by a risk that investors will be attracted to substitute investment products, which are often subject to less onerous regulatory requirements. In Germany, for example, as a result of strict tax reporting requirements for investments in hedge funds, many German investors prefer to invest in hedge fund certificates, which are subject to far less regulation than hedge funds themselves.

The EC has observed the ongoing trend toward "retailization" of hedge fund products. Its main concerns are the varying levels of retail investor protection at the Member State level (or lack thereof) and the stability of the European financial markets. These concerns echo those of the SEC, which has adopted rules requiring registration of hedge fund advisers under certain circumstances.

The EC proposes to convene a working group to assess whether a common regulatory approach could help or hinder development of the market for alternative investment products. One welcome suggestion is that a common definition of what constitutes a "private placement" could be helpful in overcoming barriers to marketing private equity and hedge funds to qualified investors.

We will continue to update you on the progress of the EC's investigation into regulation of alternative investments and will report on its definitive statement on UCITS investment fund regulation early in the New Year. In the meantime, private equity investors in Europe will have to continue to rely on counsel in each country to make sense of the diverse regulatory regimes affecting fund formation, marketing and cross border investments.

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Private Equity Investing on Both Sides of the Atlantic (cont. from page 6)

the business because many fund investors prefer independent firms to those inside a securities firm due to perceived conflicts of interest. These trends are also apparent in Europe.

The consequence of all of these changes is a great deal more complexity for investors. There may be multiple claimants to the same track record. There are more people and more firms to review. There is more difficulty in assessing how the personal chemistry at new firms will work. As a result, intermediaries and placement agents have become more important. Their role in doing due diligence becomes more critical. There is, in fact, evidence of some convergence as several of the European placement agents have taken on key U.S. veterans in order to give them more sophisticated, more quantitative, more investment banking-like capacity.

How to Achieve Better Returns

Professor Resnikoff then summarized a recent study by McKinsey & Co. which concluded that strengthening the management team and improving corporate performance were the key drivers distinguishing the best performing LBOs from the worst.

McKinsey & Co. recently completed a study of LBOs and noted that in 83% of the best deals and only 33% of the worst, the private equity firm had strengthened the management team before the closing. The report also found that in the more successful deals, sponsors were more likely to have used external support to complement management. The summary of the study clearly showed that outsize returns come from improving corporate performance. Yet, both of these factors are harder to achieve in Europe.

update

Private Equity in Emerging Europe

As the economies and legal systems in Central and Eastern Europe continue to mature and prosper as integrated market-based systems, the nascent private equity industries in these regions are growing and developing on a parallel track. The industry is still very small by global standards; private equity investment as a percentage of GDP in the emerging European countries is still less (and usually much less) than 1%, as contrasted with approximately 3% in continental Western Europe and almost 5% in the UK.

The Region

As a regional market, emerging Europe has a population that rivals North America or the European Union with approximately 325 million people. It comprises roughly three groups of countries: (1) the North Central European countries of Poland, the Czech Republic, Slovakia, Hungary, the Baltic States and Slovenia, with a combined population of 73 million, where market economies have emerged and succeeded most rapidly and which have attracted the lion's share of foreign investment in the region; (2) the South Central European countries of Romania, Bulgaria, and former Yugoslavia, with a combined population of approximately 50 million, where the economies and political systems have changed more slowly, but which are now in the process of joining the European Union and becoming more attractive to investors; and (3) the former Soviet countries, including principally Russia, Ukraine, and Kazakhstan, which have attracted less foreign investment to date but have impressive rates of growth since 2000 and abundant natural resources.

Although the GDPs of each of the countries of emerging Europe are still a fraction (generally less than 1%) of the GDPs of their more developed neighbor states in Western Europe, the rates of growth of GDPs in this region and the pace of annual increases in real foreign investment are much higher. The GDPs of these countries are growing by 4-7% each year and foreign investment is more than doubling each year in the faster growing countries.

The development of private equity in these regions began as mass privatization programs in the countries ended, resulting in hundreds of privately-owned companies and a huge demand for financing and investment. In North Central Europe this occurred in the early 1990s, and in South Central Europe and the former Soviet countries it occurred about five years later in the mid-1990s.

The Early Players

Although a few global private equity players, like AIG Capital Partners and ING Baring Private Equity Partners, entered these markets early, the vast majority of initial funds and their managers were established and financed by public and quasi-public foreign assistance. In Russia, for example, one of the first and the largest private equity funds to date was created with $440 million of U.S. government funds (The U.S.-Russia Investment Fund). OPIC provided guarantees and acted as an investor in two other initial funds — a $155 million Russia Partners Fund sponsored by PaineWebber, and the $289 million AIG-Brunswick Millenium Fund. EBRD also established and funded eight venture capital and ten regional investment funds in Russia during the second half of the 1990s. There was similar public and quasi-public seed money for private equity underlying the first funds in Central Europe.

These initial private equity funds across the entire region of emerging Europe were characterized as relatively small by global standards — average fund size of about $120 million; and making relatively small investments of about $10-50 million in companies across a spectrum of industry sectors. Making these early investments was a significant challenge because companies during this era had poor operational records, no financial reporting, unenlightened management and were often operating in a "gray" market to avoid or function in spite of undeveloped regulatory systems. Management companies either performed poorly or thrived, and the aggregate rates of return from these initial funds varied from 0 to 40% or more.[1]

The managers of these early funds were generally made up of a balance of foreign experts on the region and local nationals who often began their work with technical assistance or development bank programs. Those management companies with successful track records during the first wave of funds in the 1990s have "spun off" and are currently raising new funds specializing in a particular region of emerging Europe. Examples of these specialized, successful private equity managers in Central Europe include Innova Capital, Advent International, Argus Capital, Bedminster Capital, DBG Eastern Europe, Enterprise Investors, Riverside Europe, etc. In Eastern Europe, examples include Baring Vostok Capital, Delta Capital, Russia Partners, Alfa Capital, and Mint Capital. The average funds under management by these management companies range from about $400 million to $800 million.

The Next Phase

The characteristics of the post-2000 new funds are different from the first wave of

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[1] *Data taken from presentations made by Ms. Nielsen and David A. Fisher of Innova Capital at a panel entitled Private Equity in Central and Eastern Europe hosted by Debevoise & Plimpton at the September 2005 International Bar Association Annual Meeting in Prague.*

Update: Private Equity in Emerging Europe (cont. from page 15)

funds. New funds vary broadly in terms of the range and the investor base is much larger, more private and institutional. Investment size now ranges from $15 million to $75 million. Rates of return on these funds are expected to be more stable and homogenous at about 20-30%.

Over the past 15 years, total funds raised for private equity in Central Europe is calculated to be about 8 billion Euro, with a current annual estimated investment level of about 500 million Euro. Approximately half of these amounts is attributable to Poland. Statistics are more difficult for Eastern Europe (former Soviet countries), but total third-party funds raised for private equity since 1994 is roughly $4 billion, with current annual estimated investment of roughly $500 million. Most investments are in early stage or middle market companies, where significant value can be added through restructuring, modernizing sales and marketing techniques or strategic acquisitions and sector consolidation. The sectors that are popular for private equity investment have shifted from natural resources and telecommunications to the new branded consumer goods, retail, financial services and real estate sectors, where there are no dominant competitors. The majority of exits are still made to domestic and foreign strategic purchasers, but there have been a number of highly successful exits through IPOs in London and New York as well. Investment structures and financing are becoming more sophisticated in Central Europe, but still remain simple cash investments for majority or significant minority common equity stakes in Eastern Europe.

The second phase of development of private equity as a source of investment is well underway in Central Europe and beginning in Eastern Europe. After just 15 years in Central Europe and 10 years in Eastern Europe, a group of experienced and successful specialized management companies has emerged and are raising and investing funds and exiting investments in a manner that is more and more typical of private equity investing in other emerging markets and even more developed economies.

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Some Garden Variety Deferred Compensation Arrangements Still Work (cont. from page 12)

Earn Outs are OK

Earn-outs paid to former management stockholders in connection with change in control transactions are treated as paid in accordance with the deferred compensation rules so long as they are paid at the same time and on the same terms and conditions as other shareholders generally.

Partnership Interests

The proposed regulations do not address partnership issues (Treasury is expected to issue additional guidance at some undetermined future date.) Until further guidance is issued, partnerships may continue to treat the issuance of a profits interest for services as not being subject to the deferred compensation rules if the recipient is not required to recognize income at the time of issuance. The issuance of capital interests may (for now) be treated in the same manner as grants of stock and will generally not be subject to the deferred compensation rules.

Transition (or last chance to cash out now)

During 2005, post-2004 arrangements can be paid out without being subject to the new tax. Deferral elections can also be freely changed this year. Pre-2005 plans are generally grandfathered and exempt from the deferred compensation rules (but must be operated strictly in accordance with their 2004 provisions). Payments under grandfathered plans may also be accelerated into 2005, but doing so will cause the grandfathered plan to lose its grandfathered status and become subject to the new rules.

Treasury has extended the transition rules covering the amendment of plan rules to bring them into compliance with the new rules, payments based on qualified plan elections and new plan elections through the end of 2006. The provisions permitting cash out of deferred compensation, though, expire on December 31, 2005. The proposed regulations provide the information necessary to make most of the required changes. Any changes made during 2006, however, may not accelerate a payment into 2006 or defer an amount that would otherwise be payable in 2006 to another year. Of course, it may not always be feasible or desirable to change a deferred compensation arrangement to make it compliant with the new rules. In that case, the parties (meaning the service provider) will just have to live with the increased tax risk.

More to Come

Additional guidance is expected at some point in the future on several issues that are not covered by the proposed regulations.

Now is the time to take a new look at your plans and decide on your course of action.

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Asian Buyouts — Why Asia? Why Now?

The question being asked of large manufacturing businesses not many years ago is now being addressed to private equity firms. Do you have a viable Asian strategy? Today, as a result of the increase in Asian merger and acquisition activity and some well-publicized transactions, as well as the enormous real growth in the Asian economy, virtually every large private equity firm is wondering if they should be pursuing an Asian strategy and how they should approach an investment program in Asia.

Early Investment in Asia

Historically, international investment in Asia has been dominated by larger companies in the manufacturing sector migrating costly manufacturing processes in high wage rate countries such as the U.S. offshore to countries like China or India, where wages are fraction of the American pay scale. Increasingly, however, Asian strategies are driven by economic rationale much broader than lowering costs and involve industries outside the manufacturing sector. For example, with populations of over one billion each and rapidly expanding, increasingly affluent middle class ranks, China and India have become important domestic markets in and of themselves, not merely a inexpensive place to manufacture goods for sale elsewhere. Further, the service sector has also recognized that cost savings make outsourced services such as call centers, data input, software development, and others fair game for migration to Asia.

For many years, implementation of an Asian strategy involved the formation of joint ventures with local partners. Increasingly, however, M&A is the preferred way to implement an Asian strategy, with important advantages such as accelerated time to market and reduction of development risk. Recent years have witnessed a relatively significant pick up in Asian merger and acquisition activity. For example, Yahoo! acquired a 40% interest in Alibaba, a Chinese internet company and HSBC acquired a significant stake in China Bank of Communications. In Korea, Carlyle sold shares in Koram Bank to Citigroup and Newbridge Capital sold shares in Korea First Bank to Standard Chartered. Elsewhere in the Asia Pacific region, Philip Morris acquired Sampoerna, the third largest tobacco company in Indonesia, and Temasek Holdings, the Singapore government's investment vehicle, made a general offer for shares to Neptune Orient Lines in Singapore.

The Opportunity for Private Equity in Asia

Despite this seemingly high level of activity, Asia remains relatively under-penetrated from the private equity perspective. Measuring private equity deal value as a percentage of GDP in Asia vs. North America and private equity deal value as a percentage of overall M&A activity in North America and in Asia, Asia remains merely a fraction of the North American values. Also, although the average deal size for private equity transactions in Asia increased from US$4 million in 1997 to US$38 million in 2004, these deal sizes are still relatively small compared to North America and Europe.[1] However, if one looks at the funds that are dedicated to investment in Asia, funds that are greater than US$1 billion represent more than 40% of the total capital under management of private equity firms investing in Asia.[2] This strongly suggests that, as these funds are deployed, the need for more and bigger M&A transactions will become prevalent for private equity firms in Asia.

The Challenges

There are a number of critical considerations for private equity firms to bear in mind when contemplating the execution of an Asian strategy by means of acquisitions. What country? What industries? How to source deals and deal counterparties?

The first important point to make in any consideration of Asian buyouts or, more broadly, the execution of an Asian investment strategy, is that there is really no such thing as an "Asian" buyout or "Asian" strategy. There are Korean buyouts, Korean strategies, China buyouts, China strategies, and so forth. Asia is a patchwork quilt of different legal systems, banking systems, competitive strengths and weaknesses, languages, attitudes about foreign investment and numerous other factors that make the execution of an M&A strategy, or for that matter any strategy at all, in any one country in Asia entirely different from doing the same thing in another country. For, example, Japan, Korea and China still attract the biggest deals, in large part, due to rapid economic growth, pro-business governments and more developed infrastructures. Yet, more and more investors are taking a look at India, which boasts a more transparent legal system and a history a private sector economy, together with a population fluent in English. Perhaps even more important, India's developed capital markets provide the prospect of a profitable exit.

Another relevant consideration for private equity firms considering a strategy in Asia is that, despite the vast size of Asia and the interest, for many years, in the globalization of certain industries, buyouts in Asia are still relatively rare. Even in industrialized nations such as Japan and Korea, international buyouts of domestic industries are not a particularly common occurrence. Those that have taken place are often times the result of sectoral restructurings in countries where the financial services industry has

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1 *Asian Venture Capital Journals.*

2 *The Guide to Venture Capital in Asia 2004.*

position will provide it with very little influence over the management of the investment. The co-investor will thus need to trust that the lead investor has the experience and skills to manage the investment to maximum effect for all investors. As we have seen in our own practice acting for various clients in this area, relationships build up over time and often result in "clubs" made up largely of the same limited partners following a particular sponsor as co-investors in a number of its deals. In some circumstances, a limited partner might have a more or less formal arrangement with a sponsor to share opportunities, through a form of teaming arrangement.

Timing of the Investment

A direct co-investment might be made at the time of the equity funding of the main buy-out of the target, or perhaps afterwards by way of sell-down of the lead investor's equity investment. Which route is taken will often be dictated by the timetable dynamics of the underlying deal. Often a sponsor is pressed to close an acquisition before co-investors have had the opportunity to evaluate or fund their investment.

From the co-investor's point of view, participating at closing of the underlying acquisition is preferable, since it gives more of an opportunity to influence the documentation governing the relationship among the equity investors. By contrast, taking a post-deal piece of pre-existing equity creates more of a take-it-or-leave-it negotiating dynamic. There is also the question of price, particularly if there is a significant time lag between closing and co-investment. Often, the co-investor will want to come in at the same price as the lead sponsor, perhaps subject only to a carry charge. The sponsor may want to sell down at a higher price if there is reason to believe the target has appreciated in value or for other reasons.

Another situation in which a co-investor might enter into a pre-existing equity structure is upon a refinancing. In such a case, the negotiating leverage of the co-investor to customize terms of the investment in its favor will depend on how much of the post-refinancing equity is to be held by it.

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Protecting the Direct Co-investor — Legal Issues

The key issues for the parties are largely the same as in any minority/majority investment, primarily those affecting the value of the investment, governance and exit.

The legal documents often deal with other particular sensitivities of a co-investor. Where these may be sensitive vis-à-vis other investors, they can be addressed in side letters, although the parties will need to take care that these do not breach the terms of any "most favored nations" protection given to any other investors.

Due diligence reports and warranties. As discussed in previous issues of the Private Equity Report, the situation with due diligence reports in Europe is much different than in the US. For example, very often "vendor due diligence reports" prepared by the seller in anticipation of a sale will be made available to the buyer and its banks. Further, the lenders often seek to rely on reports prepared by the buyer's adviser.

The situation for co-investors is similar. In European deals, a co-investor will often request the benefit of due diligence reports and of any warranties given in the underlying purchase contact. If this is a possibility, the lead investor should make arrangements at the outset of the transaction to ensure that co-investors may share in reliance on any due diligence reports given and on any warranties received from vendors.

Due diligence reliance can be achieved by having the reports addressed to the holding company in which the equity investment is made, thereby giving the co-investors an indirect interest in any claim that the holding company might make against the provider of the report. This can work also for post-deal sell-down. Where reports are instead addressed solely to the lead investor, the co-investor will need to enter reliance letters directly with the provider of the report. Such letters typically recite the context in which and the terms on which the report was originally given and often state that provider's total liability for the due diligence report will not be increased as a result of the additional addressee.

Similarly, a co-investor will have the indirect benefit of any warranties given in a purchase agreement through the acquisition company. If any management warranties are also given in shareholder documentation, where management is also investing alongside the sponsor and other co-investors, it is important that the class to whom those warranties are given includes any third party that might co-invest by way of a post-deal sell-down and that signs a deed of adherence to the shareholder arrangements at that time.

Income and Capital Rights. One of the least controversial areas in a co-investment is the economics for the investment itself. The co-investor will want *pari passu* economics. Sometimes, the parties discuss the extent of pre-emption rights and anti-dilution protection regarding further issuances of equity by the acquisition vehicle or the target.

Governance. Depending on the percentage of the equity held by the co-investor, it might enjoy more or less direct influence over certain corporate decisions, including exit. Large co-investors negotiate for a board seat or a contractual right of veto over certain corporate actions. Also, to provide comfort regarding future liquidity of the investment, the co-investor may receive registration rights.

Conversely, where the co-investor's stake is relatively minor, it might enter into a voting agreement with the lead investor to vote its shares in the same way as the lead investor on all matters put to resolution in shareholders meeting. However, this would usually contain a carve-out in respect of any resolution the effect of which would be more detrimental to the co-investor's investment than for the lead investor.

Exits. The co-investor will be sure that it enjoys the same opportunities as the lead and other investors to realize its investment on the same terms. Typically, such provisions will include "tag-along" rights to sell on the same terms if the lead investor and/or others sell more than a certain percentage of the equity to a third party (the percentage trigger will be a matter for negotiation). In limited circumstances, the co-investor might even have a pro rata right of first refusal over transfers of equity by existing investors.

A corollary of the rights enjoyed by the co-investor is that it will typically not be able to stand in the way of an exit that the lead investor wishes to effect. So the co-investor is often subject to a "drag-along" right by which the lead investor and/or others selling more than a certain percentage (often mere control, but the percentage might be higher) can force the minority co-investor to sell on the same terms.

ERISA, VCOC, etc. If the co-investor is a U.S. pension fund or has U.S. pension investors, then, depending on the ERISA status of the co-investor, it may need to have the benefit of certain governance rights in order for it to qualify, or continue to qualify, as a Venture Capital Operating Company (VCOC). Typically, therefore, the co-investor will have contractual rights in the shareholder documentation entitling it at the very least to regularly receive certain minimum information regarding the investment and the underlying target group, often together with a right to appoint a non-director observer to the company board. Since the co-investor will need report back on the investment to its own limited partners and to make all necessary tax filings with regard to the investment, it will also need for the information that it passes on to its limited partners to be carved out from any of its confidentiality obligations.

European deals are often highly structured to address tax issues over the life of the investment and at exit, as well as the sponsor's own ERISA considerations. The structural aspects of the transaction may limit the flexibility for a co-investor to address all of the rights described above. Additional transfer restrictions may be imposed to ensure that the target company does not become a "controlled foreign corporation" for U.S. tax purposes.

Special Issues in Club Deals. In a multi-sponsor transaction, particular issues arise that may severely limit the rights and benefits available to the co-investors. For example, the sponsors will often agree that the co-investment process should be restricted in time and amount, and regulated as to price. Sponsors will also need to address what happens with LPs that are potential co-investors with more than one of the sponsors. In addition, the sponsors are unlikely to want another voice at the table and will thus insist that the co-investors have no or little governance rights (or governance rights that are controlled by the sponsor) and that they are subject to transfer provisions that ensure that each sponsor's co-investors move in and out of the deal with their sponsor as a group. Conversely, a sponsor may want to claim "credit" for the amount invested by "its" co-investors for purposes of meeting minimum thresholds under the equity agreements with the other sponsors. For example, if a sponsor needs to maintain a 20% investment to keep its board seat, the sponsor may want to receive credit for the holdings of its co-investors, particularly if the sponsor controls the votes of the shares held by the co-investors. Finally, ERISA-related complications may arise, depending on the tax and corporate structuring of the acquisition vehicles.

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Co-investing in Europe offers both sponsors and LPs particular benefits in the right circumstances. Market practice and relationships in this area continue to develop with the growth of larger European LBOs and club deals. While many of the legal issues are common to other investing situations, there are many areas where the parties are on new ground.

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Asian Buyouts — Why Asia? Why Now? (cont. from page 17)

been crippled by overly aggressive lending to fuel domestic growth. Notable buyout activity in this regard includes Ripplewood's acquisition of Shinsei Bank in Japan and Lonestar's acquisition of Korea Exchange Bank in that country.

Another relevant fact to consider is that, in some countries in Asia, leveraged buyouts, as that term is commonly understood among private equity professionals and their advisers, are simply not possible. For example, in India, it is illegal for a non-Indian resident to acquire shares of an Indian corporation using those shares or the underlying assets as collateral for a loan to a non-Indian purchaser. Similarly in China, currency control regulations limit the ability of local banks to provide offshore borrowers with RMB-denominated loans secured by the Chinese assets to be acquired by the offshore party. Furthermore, domestic financial institutions in China up until now have had no experience in leveraged acquisition finance and offshore lenders are not permitted to participate in this aspect of a RMB-denominated banking business.

Tax considerations are, increasingly, another important challenge for private equity firms investing in Asia. In recent months, high profile civil charges have been brought against prominent private equity firms alleging underpayment of domestic taxes in Japan and Korea that, the taxing authorities believe, were due to them when those firms reaped substantial profits from the sale of shares of companies in those countries. Local citizens bristle at the notion of "foreigners" becoming rich at the expense of the country and its citizens. With feelings like these simmering, its hardly surprising that further challenges, such as labor disputes, are another frequent operational challenge confronting private equity firms in some Asian countries.

The Future

Despite the challenges, record breaking amounts of capital are being raised for investment in Asia today. The risk-reward calculus is such that the high growth, increasingly affluent, large economies of Asia, and the increasing number of attractive investment opportunities within those economies, outweigh the perceived risks and challenges of running an Asian buyout business. As legal structures for Asian buyouts refine themselves, and as evolving rules for matters such as the application of domestic capital gains tax regimes to offshore private equity firms become clearer, we would expect that trend to continue and grow.

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Nov. 4 — Franci J. Blassberg
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Practising Law Institute 37th Annual Institute on Securities Regulation
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Nov. 10 — Friedrich E.F. Hey, Moderator
Geoffrey Kittredge
Terms & Conditions in Private Equity Funds: Developments, Differences US/Europe and Economic Relevance of Selected Terms
Wiesbaden Private Equity Colloquium
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Nov. 11 — Thomas M. Britt, III
The Small-to-Medium Sized MBO
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2005 Asian Private Equity & Buyouts Forum
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Proposed Tax Rules for Carried Interests
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