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The London Perspective on Cross-Border Private Equity: An Interview with Lord Peter Goldsmith

The *Private Equity Report* generally features a guest column written by, or based on, an interview with a leading member of the private equity community. In this issue, we break from tradition and introduce you to Lord Peter Goldsmith, who served in Tony Blair's cabinet for more than six years as Attorney General of the United Kingdom. Peter has recently joined us as a partner and European Chair of Litigation where he will be a hands-on lawyer, advising clients and being an advocate in court and in arbitration proceedings. Peter will be based in London, but actively working with the rest of the firm in solving legal problems that involve multi-national and multi-jurisdictional issues.

On one of Peter's recent trips to the New York office, Franci Blassberg sat down with him to get a sense of his perspective on cross-border issues affecting private equity and the commercial environment in Europe.

In business transactions in Europe or with European parties, Americans have traditionally been far more comfortable with English law as opposed to the laws of the continental jurisdictions, perhaps because of their familiarity with common law. Many commentators have suggested that English law is converging with European law. Do you think U.S. private equity investors should now feel less comfortable with English law?

I think English law remains the right choice of law for many transactions. It is correct that there are some areas where EU law has fashioned English law, but the core aspects of English commercial law really remain as they have always been. Most importantly, in interpreting contracts, English judges, like U.S. judges, continue to look very hard at the actual language of documents to deduce the business

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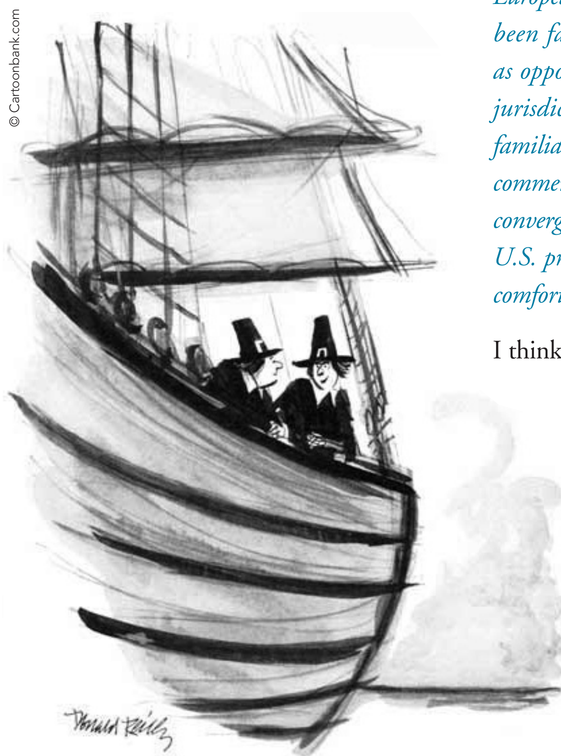

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"Religious freedom is my immediate goal, but my long-range plan is to go into real estate."

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Letter from the Editor

The popular media loves to bash private equity. How many articles have we all read about the deals that have not closed and those that were restructured? Or about the proposed changes to taxation of carry? Or about the labor opposition to private equity transactions? That slice of the private equity scene makes good headlines.

While the business press is busy reporting on a small subset of private equity transactions, the rest of the private equity community has been working away on actually closing transactions, raising new funds, monitoring the debt markets for a return to normalcy, contemplating new structures and generally devising ways to transform their limited partners' commitments into good returns.

One of the themes of our current issue is the increasingly global nature of the private equity asset class. In a break with tradition, our Guest Column is actually an interview with our new partner, the former Attorney General of the United Kingdom in the Blair administration, Lord Peter Goldsmith. Peter offers insight on cross-border issues affecting private equity and the commercial environment for private equity in Europe as only someone who has been personally involved in EU treaty negotiations can. For those of us who think there are a lot of constituencies in private equity merger agreement negotiations, Peter is a true source of perspective.

Elsewhere in this issue, we report on the French private equity scene, recent legislation in Japan that may make raising funds in Japan or from Japanese investors more cumbersome, and, more happily, proposed changes to the U.S.- Canada tax treaty which may have some favorable ramifications for U.S. funds with investments in Canada.

We do not have to tell you that the recent shakeup in the financial markets is already being felt in deal structures. Paul Bird and Jonathan Levitsky describe how the changing environment can impact acquisition agreement terms and their relationship to financing commitments. Peter Hockless, of our London office, reports on the UK perspective on MAC clauses. While the days of covenant-lite loans may be over for at least a while, the role of consortia in private equity deals seems to be a permanent fixture on the deal landscape. We continue our ongoing discussion of club deals by analyzing the benefits and challenges of adding a strategic partner to the investor mix, particularly in certain regulated industries like insurance and gaming.

We also have several news updates on recent legal developments of interest to the private equity community on issues as diverse as proxy disclosure rules and appraisal rights.

Franci J. Blassberg
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Acquisition Agreements After the Credit Crunch: What's Next?

"Seller friendly" is the way private equity acquisition contracts were generally described earlier this year in what was clearly a highly competitive buyout market. Conventional wisdom suggested that private equity firms had been forced to accept a number of seller-favorable terms, including the disappearance of financing conditions, non-survival of representations and warranties, tighter financing covenants requiring bridge financing drawdowns and what became nearly a page of exceptions to the "Material Adverse Effect" or "MAE" definition in acquisition agreements for large buyouts over the past several years.

However, the recent market turmoil has revealed that, in fact, private equity buyers had successfully negotiated contracts that included important and innovative protections—considerably more so than had generally been appreciated before the melt-down of the credit markets.

Leveling the Playing Field for Strategic and Private Equity Buyers

End of the Financing Out/Rise of the "Reverse Break-Up Fee"

The most important seller-friendly developments relate to the sponsor's commitment to a transaction in the event of adverse developments in the leveraged finance market or the performance of the target business.

Until early 2005, private equity deals generally permitted buyers to terminate the acquisition agreement without penalty if—despite the buyer's reasonable (or reasonable best) efforts—the debt financing necessary to consummate the transaction proved to be unavailable. A "financing condition" was viewed by sponsors and their counsel as indispensable. The proposed acquisition was, after all, a leveraged buyout: how could anyone expect it to proceed, and for the sponsor's equity to be funded, if the leverage was not available? The need for a financing condition, however, at times put private equity firms at a competitive disadvantage compared to strategic buyers. As favorable financing terms became readily available, sponsors' funds grew larger, club deals became more common and public companies reemerged as LBO targets, both sellers and private equity sponsors looked for ways to eliminate the financing condition and put LBO buyers on an equal footing with corporate buyers. For an early view on the evolving marketplace in this regard, see "Are Private Equity and Strategic Deal Terms Converging?" in Vol. 5, Number 4, of the *Private Equity Report* and for a follow up analysis, see "Trendwatch: 2005 Deal Terms" in Vol. 6, Number 2 of the *Private Equity Report.*

Reverse Termination Fees

The Sungard, Neiman Marcus and Hertz buyouts in 2005 ushered in a new market practice. There were variations and nuances, but the basic structure required the private equity buyer to proceed without a financing condition and to pay a fixed amount (generally ranging from one to three percent of transaction value and referred to as a "reverse break-up fee" or "reverse termination fee") if the deal was not consummated by the drop dead date specified in the acquisition agreement, whether due to the unavailability of the debt financing or another unexcused reason—assuming that at such time all other conditions to closing were satisfied. Sponsors also agreed to provide guarantees by their funds of the payment of the reverse break-up or termination fee.

The advent of the reverse break-up fee permitted corporate sellers and public company boards to announce that the agreement was not subject to financing. There was much more to the bargain, however, than the simple elimination of a debt financing condition. From the private equity firm's perspective, being on the hook for a damages payment of several tens to hundreds of millions of dollars if the debt financing was not available at closing was a material change in buyout terms (compared to limited or no exposure from a special purpose acquisition vehicle separated from the sponsor fund by the corporate veil, a structure relied upon by private equity firms and accepted by corporate sellers for years), and they wanted to make sure that the reverse termination fee amount would be the *limit* of their exposure *under any circumstances*.

To achieve this goal, as deal terms evolved, sponsors began to bargain for two other important deal terms relating to reverse termination fees: first, that their liability for any breach of the acquisition agreement would be capped at the amount of the reverse termination fee (or, in two-tier structures, some larger amount up to two times the reverse termination fee for a subset of certain types of breaches); and second, that the seller would expressly acknowledge its waiver of a right to specific performance and that the reverse termination fee (or the two-tier fee) would cap the liability of the acquisition

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vehicle and the sponsor fund for any breach of the agreement.

Specific Performance

The emergence of the seller's waiver of the right to specific performance was a hard-fought term that was several deals in the making. As noted above, the disappearance of the financing condition and the reverse termination fee went hand-in-hand; corporate sellers rarely resisted the premise that, at the end of the day, a private equity firm needed a right to get out of deal, albeit by paying a stiff fee, if the debt financing simply was not available. The elimination of the right to specific performance was not so obviously related to these developments, however, and some sellers bargained for the right to compel the buyer to close (and the sponsor firm to fund its equity commitment) in the event that the debt financing was available at closing, but the sponsor balked. Even this limited right to specific performance created a powerful incentive for the corporate seller to attempt to deal directly with the financing banks, or with alternate financing banks, to ensure that debt financing would be made available to the buyer. A seller's right to compel a closing if the debt is available, combined with various forms of buyer covenants to obtain alternate financing, even on terms less favorable than the originally committed financing, could put the private equity buyer in a position of having lost control of the economic terms on which it agreed to buy the target business.

By bargaining for a waiver of the seller's right to specific performance under any circumstances, even when the debt financing was available, together with a cap on liability for monetary damages, private equity buyers substantially enhanced their leverage in the event of an adverse change in the leveraged finance market or the target business. The developments of the past summer put such provisions to the test, with outcomes that appear to be largely attributable to the negotiating leverage those terms created.

... [T]he recent market turmoil has revealed that ... private equity buyers had successfully negotiated contracts that included important and innovative protections—considerably more so than had generally been appreciated before the melt-down of the credit markets.

Real World Examples

The issue at stake in the pending Sallie Mae transaction litigation is whether the reverse termination fee of $900 million will be payable by the sponsor firms, or whether they have a right to walk by virtue of an MAE. In either case, the sponsors will not be obligated to close the deal and put over $8 billion of equity at risk on debt financing terms less favorable than those originally committed. In August, three private equity firms behind the HD Supply buyout from The Home Depot negotiated a $1.8 billion purchase price reduction to bring the capital structure of the target business into line with the acceleration in the decline in the housing and building markets and the then current market for debt financing. And in October, two private equity firms walked away from a $3 billion deal to buy Acxiom Corp. by paying a $65 million reverse termination fee, and the sponsors behind the $8 billion Harman International buyout, after calling an MAE and terminating the merger agreement, agreed to purchase $400 million in the target's debt securities convertible at a strike price 13% below the per share price of the original merger. In all four transactions, MAE issues were raised, but the principal levers operating in favor of the private equity firms were the absence of a specific performance remedy for the seller and a clear cap on the buyer's liability for breach of the acquisition agreement.

Whittling Away Material Adverse Effect

Another contract term that has been substantially modified in private equity deals over the past few years to eliminate a perceived gap in the risk profile of strategic versus private equity buyers has been the definition of "Material Adverse Effect" or "MAE."

Although, in light of the case law, the MAE condition or termination right can be triggered only by very substantial adverse changes to the target business, the ability not to close a transaction in which the economic benefit to the buyer has been radically altered by intervening events remains a fundamental contract right. The dispute, of course, is what constitutes a "material adverse effect." While there are few reported decisions in this area, courts have generally required, in cases such as the 2001 Tyson Foods dispute, that the material adverse effect be serious and have long-term consequences for the target business, by which the court implied an adverse impact on earnings for two or more years into the future. Even though private equity firms typically rely on financial models that extend over five or more years, immediate and material one to two year shortfalls in operating cash flow can substantially impair the firm's equity in the new company and constrain operating flexibility.

Following Tyson, market developments made reliance on the MAE condition even

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Mixed Clubbing: Do PE Firms and Strategics Make Good Dance Partners?

Transactions in which a group of private equity firms join together to pursue an acquisition target are an established part of today's deal landscape. Indeed, in many instances, specific market terms have emerged for governance decision-making at different points in the deal life cycle, from bidding through exit. (In this regard, please see our prior articles on Club Deals in the Winter 2006, Fall 2006 and Winter 2003 issues of the *Private Equity Report*.) But increasingly, acquisition clubs are now including industry players as well as PE firms. Examples of such mixed club arrangements include Sony's partnership with PE firms in the acquisition of MGM, and in the financial services sector, Prudential participating in a Carlyle-led consortium to acquire a substantial minority stake in China Pacific Life, and the acquisition of Scottish Re by Cerberus and Mass Mutual. Going one step further, in the recent ABN-AMRO acquisition, a club made up entirely of strategic players (Banco Santander, Royal Bank of Scotland and Fortis) teamed up to do the deal.

In PE-only club deals, the investors' interests are generally straightforward and aligned: the proverbial buy low and sell high (as quickly as possible). This alignment of interests tends to result in deals in which the participants' roles are reasonably well-established. Although there are inevitably issues among club members such as how much control the individual investors will have over the negotiations, the ongoing operations of the business and the timing and nature of the exit, the issues are predictable and recurring and can generally be addressed with relative ease because of the overall alignment of interests and other commonalities among the club members.

The dynamics can change, however, once a strategic investor joins the club. Strategics often have different commercial objectives in pursuing a given deal as compared to private equity investors. Strategics may be more interested, for example, in distributing their products through the acquired company and continuing to own the investment beyond a private equity firm's typical exit time horizon (and possibly ultimately buying out the private equity investors' interest entirely).

This article discusses some of the unique issues in mixed private equity/strategic club deals, with a particular emphasis on these partnerships in the financial services industry.

Rationale of the Participants

Of course, having a clear sense of the participants' rationale for partnering is critical to anticipating the key process, governance and exit issues that will need to be discussed and agreed in any deal, including mixed club transactions.

A strategic investor might enter into a club deal with private equity firms for a variety of reasons, including to (1) gain a "toehold" in a particular market segment or country, (2) gain access to deals that private equity firms may hear about first, (3) acquire a key asset or line of business from the target company that is not core to the other members' investment thesis and (4) have an opportunity to participate in the outsize returns enjoyed by some PE firms in the most successful deals.

From the perspective of the PE club members, inviting in a strategic may be driven by a desire to (1) obtain and leverage off of industry or country expertise, (2) provide comfort to the regulators that the target company will be operated prudently, (3) assist in financing and evaluating the transaction, (4) tap into a potential source of management talent to help operate the target and (5) provide a potential exit opportunity for the private equity firms.

The Bid

In a private equity club deal, there is often one investor who leads the day-to-day discussions with the seller and consults with the balance of the group off-line and is hence largely invisible to the seller. Importantly, this can allow the bid to remain nimble and responsive and avoid an uncompetitive "too many chefs in the kitchen" dynamic. A strategic investor, on the other hand, may be more likely to seek a greater role in the deal than a typical club investor, and in fact may want to lead or meaningfully participate in dealings with regulators (particularly in an industry like insurance or other another financial service) and in due diligence. As noted above, this arrangement may make sense: strategics can add enormous value to the due diligence process (and cut down on fees payable to outside consultants and other service providers), shrewdly evaluate contingent risks, and effectively deal with regulators and other commercial

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constituents of the target. On the other hand, a strategic may seek more information from the seller than a straight PE club investor, particularly as to compliance, regulatory and litigation matters, due to heightened reputational concerns. It may also be more averse to assuming unknown and contingent risks. Also, if the strategic is not an active participant in today's M&A market, it may seek greater rights of indemnification from the seller than is the norm in a competitive bidding situation, and otherwise have less realistic expectations concerning other deal terms and process more generally.

Regulatory Issues

The involvement of a strategic will also require greater sensitivity to antitrust issues arising from disclosure of certain competitively sensitive information between the target, on the one hand, and the strategic investor, on the other hand, and may complicate the antitrust approval process. If the strategic is a non-U.S. company, its involvement may also raise questions if the target's business is viewed as sensitive to national security. In certain circumstances, the club's consortium agreement may need to allow for the removal of the strategic member if its participation prevents needed antitrust or other governmental approval.

In the case of a club deal in the financial services sector in particular, the private equity firms should anticipate that an industry player will want to lead all discussions with the regulators. Probably no issue is more near and dear to the heart of an insurance company than its relationship with its regulators. This can be a double-edged sword: having an insurance company with a stellar regulatory reputation gives the club significant credibility with the regulators. However, there can be a tendency for a strategic to be more conservative than the private equity investors may wish to be in dealing with the regulators so as to protect the strategic's reputation. Nevertheless, on balance, there is significant value added in most cases by having a blue chip strategic speaking for the club before the regulator and advising the group on related issues, such as restrictions on leverage and dividends and other inter-company or affiliate transactions.

As private equity firms start pursuing deals in highly regulated industries, such as the insurance and gaming sectors, they should be aware of heightened disclosure requirements to the regulators. In particular, the principals of the private equity firms in the club may need to make detailed disclosures about their personal wealth, which may come as an unwelcome surprise for private equity and hedge fund principals who are not accustomed to this type of public scrutiny. The presence of a strategic partner may result in the regulators showing some flexibility regarding the manner in which information relating to the private equity firms is disclosed, but will not eliminate the need for fairly comprehensive information from the principals. In regulated industries, the target's operations may also be subject to restrictions such as in the insurance sector where a target cannot be leveraged in the same manner as a typical LBO.

As private equity firms start pursuing deals in highly regulated industries, such as the insurance and gaming sectors, they should be aware of heightened disclosure requirements to the regulators.

Post-Closing Governance

Negotiations regarding post-closing governance arrangements with a strategic may be more difficult than negotiations among private equity firms (where the governance regime is largely influenced by the relative size of the equity contributions and other reasonably established commercial norms). A strategic may argue that it should have governance rights that are disproportionately large relative to its investment size. This may be appropriate if the private equity firms are looking to the strategic to bring operational expertise or personnel to the business. Additionally, in the financial services industry, there may be reputational concerns about being affiliated with the target entity that justify (or so the strategic will argue) greater governance control for the strategic, particularly in dealings with regulators.

The strategic may also be concerned about the need to maintain the credit rating of the target so that the strategic's reputation is not tarnished by having a controlled entity with a lower rating than the strategic. Similarly, the strategic may want an agreement upfront on how the need for future capital contributions will be addressed. Since the strategic will likely want to keep the target's rating and regulatory reputation unimpaired, to avoid collateral damage to its brand, tensions could result as to whether future capital contributions should be discretionary or mandatory. It is likely

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The Impact of the New Japanese Securities Law on Fund Sponsors

Marketing private equity funds in Japan or to Japanese investors has just gotten more complicated. New legislation significantly broadens the oversight authority of the Japanese regulator with respect to both boutique private equity firms and institutionally sponsored funds. However, potential fund sponsors should not be unduly concerned about marketing in Japan or admitting Japanese investors. The goal for most private equity sponsors will be to limit their obligations in Japan to mere notification filings, rather than registration obligations, which are far more cumbersome under the new regime.

Registration or Notification?

Under the new Japanese Financial Instruments and Exchange Law (the "FIEL"), a general partner (rather than the sponsor) of a private equity fund structured as a limited partnership may be required to register with the Japanese regulator, both in connection with offering fund interests in Japan and serving as an "investment manager" of a fund with Japanese investors. Registration is a document-intensive and time-consuming process, and once registered, the general partner will have considerable ongoing reporting obligations. In addition, if registration is required, the general partner will need to be organized as a corporation and meet certain other qualitative requirements.

The key to minimizing the impact of the new legislation is to satisfy certain statutory exemptions. If those statutory exemptions are met, the general partner will be exempt from registration and may be required to file only a simple notice, if anything, with the Japanese regulator. Failure to make a required registration or notification may lead to criminal and civil sanctions and/or fines for representatives of the general partner.

Japanese Qualified Institutional Investors

A key concept to the application of the registration exemptions is whether a fund's Japanese investors are "Qualified Institutional Investors" ("QIIs"). The different categories of QIIs, which include Japanese banks and insurance companies, are listed in the FIEL. Investors that do not fall within a pre-approved category but satisfy certain minimum economic criteria may become QIIs by registering with the Japanese regulator. For this reason, a general partner should obtain written assurances from each of its Japanese fund investors regarding its QII status prior to admitting such investor to its fund and, particularly with respect to an investor that is required to renew its registration biennially to maintain its QII status, that the investor will continue to qualify as a QII for the duration of its investment in the fund.

QII-Targeted Exemption for Marketing and Fund Management

A general partner will be exempt from registering with the Japanese regulator for purposes of offering and managing fund interests if it can comply with the "QII-Targeted Exemption." In order to qualify, (1) at least one investor in the fund must be a QII and (2) there can be no more than 49 Japanese fund investors that are not QIIs. Note that qualifying for the QII-Targeted Exemption becomes extremely complicated if a fund has Japanese investors that are organized as certain types of special purpose vehicles, silent partnerships (*tokumei kumiai*) or other collective investment schemes that have investors that are not QIIs.

De Minimis QII Exemption for Fund Management Only

A second exemption from registration with respect to managing a fund with Japanese investors, but not with respect to offering fund interests in Japan, is the "De Minimis QII Exemption." In order to qualify, (1) the fund, directly or indirectly, may have no more than nine Japanese investors, all of which must be QIIs, and (2) the aggregate capital contributions of such investors to the fund may not equal or exceed one-third of the total capital contributions to the fund. Since the De Minimis QII Exemption exempts a general partner from the registration and notice filing requirements only with respect to the investment management of the fund, the general partner will still need to make a filing in respect of its offering activities in Japan unless either it has

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... [P]otential fund sponsors should not be unduly concerned about marketing in Japan or admitting Japanese investors. The goal for most private equity sponsors will be to limit their obligations to mere notification filings, rather than registration obligations, which are far more cumbersome under the new regime.

completed its offering of fund interests in Japan prior to September 30, 2007 (the "Effective Date") or can rely on the Outsourcing Exemption (described immediately below).

Outsourcing Exemption for Marketing Only

Under the Outsourcing Exemption, if all marketing activities in Japan are carried out by a licensed placement agent in Japan (which could be an affiliate of a fund's general partner), the general partner generally will not need to register or file a notice in respect of such offering activities. However, if representatives of the general partner conduct any aspect of the offering in Japan, this exemption will not be available. Representatives of the general partner who are considering participating in meetings with prospective investors solely for informational purposes should proceed with caution in this regard, since there are no specific rules or guidelines concerning what constitutes prohibited offering activities in a joint visit. Japanese practitioners advise that the Japanese regulator is likely to interpret the Outsourcing Exemption strictly.

Even if an offering qualifies for the Outsourcing Exemption, if a fund admits a Japanese investor, its general partner will need to rely on another exemption in respect of the investment management of the fund since there are few scenarios in which a general partner would outsource all of its management responsibilities. The practical effect of the Outsourcing Exemption is that a general partner generally may wait to file its notification (if it needs to file one at all) until either a non-QII Japanese investor or a tenth QII is admitted to its fund.

Here are some basic guidelines that can help fund sponsors evaluate whether offerings in Japan and to Japanese investors will involve registration and/or notification requirements. The rules are complex and sponsors should consult Japanese counsel in specific cases.

The enactment of the FIEL will add another layer of complexity to offering fund interests in Japan and admitting Japanese investors into private equity funds structured as limited partnerships. In most cases, however, the impact will largely be administrative, and most general partners should be able to rely on the exemptions available from registration.

Actions Required of a General Partner

- ***No Marketing in Japan After the Effective Date:*** A general partner of a fund that completes all of its marketing activities in Japan prior to the Effective Date is still subject to the FIEL requirements with respect to funds that have Japanese investors.

  ✓ *De Minimis QII Exemption.* If a general partner can rely on this exemption, no further action is required.

  ✓ *QII-Targeted Exemption.* If a general partner cannot rely on the De Minimis QII Exemption, but the QII-Targeted Exemption is available, the general partner will have to file a notice with the Japanese regulator by December 31, 2007. This notice may be submitted in English.

  ✓ *Grandfathered Status.* A general partner that cannot rely on any of the aforementioned exemptions may be exempt from registering by virtue of a grandfathered status, but will have to file a special notice with the Japanese regulator by December 31, 2007 to qualify for such status. This notice must be submitted in Japanese.

  ✓ *Investment Period.* Even funds that have completed their active investment period are subject to these notification requirements.

- ***Marketing in Japan Both Before and After the Effective Date:***

  ✓ *FIEL Exemptions.* If a general partner commenced an offering in Japan prior to the Effective Date and it is eligible for one of the registration exemptions under the FIEL, but is relying on the QII Targeted Exemption, it will still be required to make the appropriate notification to the Japanese regulator by the earlier of (1) December 31, 2007 and (2) the admission of a Japanese investor after the Effective Date.

  ✓ *Grandfathered Status.* If a general partner commenced an offering in Japan prior to the Effective Date, but cannot rely upon one of the

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What Private Equity Needs to Know About Changes to the U.S.-Canada Tax Treaty

Canadian companies often figure prominently in private equity transactions, either as direct targets, or as subsidiaries of U.S. targets. After all, Canada is the U.S.'s biggest trading partner, and the bilateral trade relationship is the world's largest. Canada is, among other things, the largest energy exporter to the U.S. The economies of the two countries are highly integrated. Approximately 80% of Canada's population lives within 200 miles of the border with the U.S. Structuring financing for Canadian companies and maximizing tax advantages in connection with acquisitions involving Canadian companies are frequent challenges for private equity firms and their advisers.

The U.S.-Canada tax treaty is expected to be amended shortly when the protocol signed by Secretary Paulson and Minister Flaherty earlier this Fall is ratified by both countries. For private equity, the protocol contains a number of helpful provisions and presents some new opportunities.

Good News: Elimination of Withholding Tax on Interest

The current treaty between the U.S. and Canada reduces withholding on interest to 10%. (Canada's normal rate is 25%.) Under the protocol, the rate will be reduced to zero. The zero rate will apply shortly after ratification in the case of interest paid to unrelated parties (*e.g.*, payments made by Canadian companies to unrelated U.S. financial institutions) and will be phased in over an approximate two-year period in the case of interest paid to related parties.

U.S. institutions are frequently sole or lead lenders to Canadian companies in leveraged buyouts. Under today's rules, U.S. financial institutions either have to lend through Canadian subsidiaries or branches, or they have to structure their loans to comply with Canada's "5/25 exemption" (the loan must have a term of at least 5 years and the Canadian borrower cannot be obligated to repay more than 25% of the principal within the first 5 years). Otherwise, Canada will impose its interest withholding tax. Once the zero rate goes into effect, these cumbersome structures and arrangements will no longer be necessary.

In early October of this year, Canada announced legislative plans to eliminate its withholding tax on interest paid by Canadian companies to unrelated lenders in all jurisdictions. The elimination would be effective when the corresponding provision of the U.S. protocol becomes effective. This means that lending syndicates including non-U.S. lenders will enjoy the zero rate on interest as well. The result of the legislation will be greatly to expand the pool of syndicate members eligible for automatic zero withholding.

Good News: Treatment of LLCs and Other Transparent Entities More Favorable

Canada treats U.S. LLCs as corporations even though the U.S. generally treats them as flow-through or "transparent" entities. This has led to anomalous situations where U.S. members of an LLC have been denied treaty benefits by Canada (for example, on dividends paid by a Canadian company to a U.S. LLC with U.S. members). Canada has denied treaty benefits under the theory that it regards the LLC as a U.S. corporation but not as a "resident" of the U.S.; under the treaty, a "resident" of the U.S. has to be an entity generally subject to U.S. tax. Because the U.S. does not tax the LLC (but instead taxes the members), Canada has claimed that neither the LLC nor its members are entitled to treaty relief. This is why U.S. private equity funds and their general partners rarely take the form of LLCs.

The protocol changes this unhappy result. Under the protocol, Canada will look through a non-Canadian entity such as an LLC and grant treaty relief to the entity's U.S. owners provided that the U.S. treats the entity as transparent for U.S. tax purposes (which will generally be true in the case of the LLC). Does this mean that private equity funds and their general partners should henceforth organize themselves as LLCs? Not necessarily. The protocol affects only U.S. members of an LLC. If an LLC has non-U.S. members, Canada will still deny treaty benefits to them. However, the protocol, once effective, will allow LLCs to be used much

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... [L]egislative plans to eliminate withholding tax on interest paid by Canadian companies to unrelated lenders in all jurisdictions ... [will] mean[ ] that lending syndicates including non-U.S. lenders will enjoy the zero rate on interest as well ... [and will greatly] expand the pool of syndicate members eligible for automatic zero withholding.

Changes to the U.S.-Canada Tax Treaty (cont. from page 9)

more frequently when U.S. corporate portfolio companies make investments into Canada. The LLC will be the entity of choice where U.S. portfolio companies desire the flexibility of a partnership but also require limited liability.

Caution: Earnings-Stripping Opportunities Need to Be Re-evaluated

The zero withholding rate on related-party interest (once fully phased in), has the potential to open new opportunities to withdraw profits from Canada on a tax-deductible basis. This was apparently not lost on the Canadian government negotiators, who placed some new limitations in the treaty. To illustrate, suppose a U.S. portfolio company forms a Canadian unlimited liability company (a "ULC') to conduct a Canadian business. The U.S. company capitalizes the ULC in part with debt and elects to treat the ULC as transparent for U.S. tax purposes. In such a case, the interest disappears for U.S. tax purposes (the ULC is transparent and hence is just a branch of the U.S. portfolio company), but is recognized for Canadian tax purposes, which treats the ULC as a taxable corporation. If the interest is not subject to Canadian withholding tax, the result is that the Canadian tax rate is driven down with no tax cost in the U.S.

The protocol defeats this arrangement by denying treaty benefits in the case where the U.S., because of its entity classification rules, does not recognize the interest for U.S. tax purposes. If treaty benefits are denied, the Canadian domestic withholding rate of 25% will apply, which will make the arrangement much more expensive than is the case today, where the maximum withholding rate under the treaty is 10%.

Because many U.S. companies invested into Canada (and Canadian companies invested into the U.S.) in a manner designed to take advantage of earnings-stripping opportunities, the protocol will require those arrangements to be reevaluated and in some cases unwound. The anti-earnings stripping rules, however, will first be effective two years after ratification.

Even after the anti-earnings stripping rules of the protocol become effective, there may still be opportunities, by using a third country's treaty with Canada, to strip earnings out of Canada on a deductible basis without incurring Canada's full 25% withholding tax. For example, a U.S. portfolio company could establish a Luxembourg subsidiary and capitalize it in part with debt and in part with equity. The Luxembourg subsidiary, in turn, could capitalize a Canadian ULC with an equal amount of debt and equity. If the U.S. portfolio company elects to treat the Luxembourg subsidiary and the Canadian ULC as transparent, the interest will disappear for U.S. tax purposes but continue to exist for Canadian tax purposes. Under these circumstances, it is expected that Canada will subject the interest payments to withholding tax at a rate of 10% under the Canada-Luxembourg treaty (which contains none of the limitations introduced in the new protocol with the U.S.), but not to its regular 25% withholding tax, notwithstanding ultimate U.S. ownership. To date, Canada has generally not been successful in challenging similar structures, but it remains to be seen how the Canadian courts and legislature will react to such structures in the future.

Even after the anti-earnings stripping rules of the protocol become effective, there may still be opportunities, by using a third country's treaty with Canada, to strip earnings out of Canada on a deductible basis without incurring Canada's full 25% withholding tax.

* * *

In sum, the protocol will simplify the financing of Canadian targets and Canadian subsidiaries of targets, create new opportunities to use LLCs in connection with Canadian holdings and will require private equity firms and their advisers to be imaginative when considering earnings-stripping opportunities. ■

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ALERT

Where's the Beef?

SEC Critiques First Round of Proxy CD&A Disclosure

On October 9, 2007, the Securities and Exchange Commission's Division of Corporation Finance published observations from its review of the executive compensation and related disclosure of 350 public companies under the SEC's new executive compensation rules. The new rules apply to all Securities Exchange Act filers, including portfolio companies with outstanding public debt.

The Staff's observations focused primarily on the new Compensation Discussion and Analysis (CD&A) in proxies – and more particularly, what the Staff viewed as a significant lack of "A" in the CD&A. The release of the Division's observations coincided with public appearances by John White, Chief of the Division of Corporation Finance, and other Division of Corporation Finance staff members, echoing the observations in its published review. Following are highlights of what the Staff had to say, and what issuers should be prepared to provide in next year's filings:

- *More Analysis (or We Know What You Did; Now Tell Us Why).* Both the Staff in its published report and John White in his public comments took ample opportunity to tell issuers that, by and large, they failed to provide sufficient explanations for *how* and *why* their Compensation Committee made the decisions it did, as opposed to simply stating what the Committee's determinations were and providing plan descriptions. In the words of the Staff: "The focus should be on helping the reader understand the basis and the context for granting different types and amounts of executive compensation."
- *Focus on What's Material.* Longer, more technical discussions were not what the SEC was looking for. The 15 examples of items an issuer might discuss that were included in the new rules should be viewed as just that – examples – and not as a checklist. Issuers should discuss elements from the 15 examples only if they are material to their specific compensation decisions, and include a discussion of any other elements that had a material impact on their executive compensation decisions, even if they are not one of the 15 identified examples.
- *Connect Compensation Philosophies and Decision Mechanics to the Numbers.* The Staff noted that while many issuers discussed their compensation philosophies and decision mechanics in great detail, many issuers failed to explain how they analyzed information, and why their analysis resulted in the compensation they paid (including the specific numbers reflected in the tables).
- *Focus on Analysis.* The SEC also requested that issuers provide discussions of how the amounts paid or awarded under each compensation element affected decisions they made regarding amounts paid or awarded under other compensation elements. The Staff emphasized that the CD&A should focus on analysis, while descriptions of plan mechanics are appropriately situated in the narrative descriptions accompanying the required tables.
- *Explain Differences in Named Executive Officer ("NEO") Pay.* The Staff reminded issuers that, when it adopted the new rules, the SEC stated that the CD&A should identify material differences in compensation policies for individual named executives. Thus, for instance, if an issuer reports CEO compensation that is five times greater than the next NEO, it should explain the reasons for the difference.
- *Be Prepared to Disclose Your Performance Targets (or Fiercely Defend Non-Disclosure).* Disclosure (or rather, non-disclosure) of performance targets was the #1 area for comments in the Staff's review of these 350 companies. Where it appeared that performance targets were material to a company's decision-making process, the Staff asked the company to disclose its targets or demonstrate why that disclosure would cause it competitive harm. If you don't disclose the targets, you should be prepared to give a "pretty specific analysis" of how disclosure would create competitive harm.

  Where individual performance was a factor in compensation decisions, the Staff also asked issuers to provide more specific analysis of how the Compensation Committee considered and used individual performance to determine compensation levels.
- *Explain Your Use of Comparative Compensation Information.* In a substantial number of comment letters, the Staff asked issuers to provide a more detailed explanation of how they

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SEC Critiques First Round of Proxy CD&A Disclosure (cont. from page 11)

used comparative compensation information to make compensation decisions, and how and why benchmarking data was adjusted in determining compensation levels.

- *Situate Your Change in Control and Termination Arrangements in the Bigger Picture – (and By the Way, Tell Us How Much).* Consistent with its observations that companies need to explain how amounts paid or awarded under one element of compensation impacted the other elements, the Staff wants to see discussion of why an issuer structured its change in control and termination arrangements the way it did, as well as how potential payments under these arrangements may have influenced an issuer's decisions regarding other compensation elements. The Staff encouraged tabular presentations of potential change in control and termination payments and suggested including in the table a sum total of the amounts they would be required to pay.

- *Presentation Matters.* The Staff indicated that approximately two-thirds of the companies reviewed included charts, tables and graphs that are not required by the new rules. In almost all instances, the Staff found the additional presentations to be helpful – and in particular, tables providing information about potential change in control and termination payments. One notable exception outside the CD&A was the use of alternative summary compensation tables, which the Staff discourages. Any alternative tables should be presented if at all, in a manner that does not detract attention from the required tables, such as by using a smaller font and different column headings.

- *... And Don't Forget to Call.* The Staff encouraged issuers and their counsel in advance of filing to reach out to their SEC reviewers and discuss their questions over the phone. ■

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Do PE Firms and Strategics Make Good Dance Partners? (cont. from page 6)

that the strategic may want to require the private equity investors to match any contributions made by the strategic or be diluted.

Exit

Private equity firms invariably want a clear path to exit the investment, with the specifics of whether that exit will happen in months or years driven by the overall business plan and market dynamics. The strategic may or may not have a similar vision regarding an exit. If the strategic's rationale for doing the deal is to ultimately absorb the target's business or to acquire a particular asset, it will want to negotiate a right of first refusal or a hard-wired buy-sell arrangement when its partners want to exit. The dynamics of exit will impact the operations of the business from day one, as the strategic and the private equity investors may jockey for leverage in the final exit negotiation if the strategic player is or is perceived as a potential exit buyer. The threat of a sale of the target to a competitor could be a strong motivating factor to force the strategic investor to step up and buy out the private equity club. On the other hand, if the value of the target company depends upon its continued relationship with the strategic player, the strategic player could have the ultimate leverage in the exit negotiations. Viewed against this framework, virtually every major business decision could have ramifications with respect to the exit.

Conclusion

Mixed club deals present some unique and potentially complex issues not present in pure play PE club deals. However, they generally create commercial opportunities not present in PE only club deals. For this reason, these types of bids are likely to continue to develop as an important element of the overall deal landscape, particularly in industries where the commercial advantages of including a strategic on the bid team are most significant, such as insurance, gaming and other regulated industries. ■

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ALERT

Risk of Appraisal Proceeding May Not Be So Problematic

The risk to a PE buyer of an adverse result in a Delaware appraisal proceeding in many types of going private transactions and other public deals suddenly seems less weighty.

On August 27, 2007, Vice Chancellor Lamb, acting for the Delaware Chancery Court (the "Court"), determined in a Delaware appraisal proceeding that the fair value of each share in The MONY Group, Inc. ("MONY") at the time of its 2004 acquisition by AXA Financial, Inc. ("AXA") was $24.97 per share. This was $5.03 per share *less* than the deal price. The suit was brought by Highfields Capital, LTD and certain of its affiliates ("Highfields"), as the culmination of a vigorous effort by Highfields, as the holder of 4.4% of MONY's float at the time of the merger, and a number of other disgruntled MONY shareholders, to oppose the merger. Under the high stakes game of poker that is the Delaware appraisal rights statute, Highfields is now required to accept the Court's valuation, even though it is lower than the deal price.

In a Delaware appraisal proceeding, a court is required to determine the fair value of 100% of the corporation as a going concern based on all factors and elements which might be reasonably relevant to value, including market value, asset value, earnings prospects and the nature of the enterprise. Importantly, this value is to be determined as of the *closing* of the merger not the *signing*, and *without regard* to the impact of any operational or similar synergies on the deal price or any other speculative elements of value arising from the merger's accomplishment or expectation. Both parties have the burden of proving their respective valuation positions by a preponderance of the evidence, but if neither party adduces evidence sufficient to satisfy this burden, the Court must then use its own independent judgment to determine fair value.

Highfields took the position that the fair value of MONY's shares as of the closing of the merger was $43.04 per share. AXA set the value at $20.80 per share. Each party presented valuation experts to bolster their cases. These experts in turn presented a wide array of methodologies to support their respective determinations of value, including the methods traditionally used by investment bankers in similar contexts, such as DCF and comparable company and transaction analyses, as well as other techniques such as a shared synergies valuation (calculating fair value by deducting the value of synergies from the deal price) and a "sum of the parts" analysis. The latter metric was designed to take account of the fact that MONY operated three business units: insurance, brokerage and asset management. Each party's proffered valuation also reflected its own subjective weighted averaging of its various alternative measures of value.

But despite (or perhaps because of) the blizzard of data presented by the parties and a full trial, including spirited direct and cross examination testimony, the Court seemed to find the parties' battling valuation methodologies confusing, overly technical and, ultimately, not particularly probative. It concluded simply that in the AXA/MONY deal, with its fully negotiated agreement and non-preclusive deal protections, the price negotiated by the parties was a better indication of MONY's fair value than any of the values established under any of the techniques advanced by Highfields or AXA. The court noted:

> "…[A] court may derive fair value in a Delaware appraisal action if the sale of the company in question resulted from an arm's length bargaining process …. Of equal importance, no material impediments existed [in this transaction] to prevent another bidder from entering the sale process during the eight month period between the merger announcement and the MONY stockholder vote. With a market check of this length, the court must conclude that any serious bidder would have come forward, given that (1) AXA publicly stated it would not increase its bid beyond $31 per share, (2) industry analysts and executives understood that MONY was "in play" and (3) [the investment banker for MONY] was unaware of any other entity that had an interest in acquiring MONY at a higher price."

On this basis, the Court determined that the value of MONY under the statute was no more than $31 per share. Still, because the Delaware dissenters rights statute precludes an appraisal award from reflecting any shared synergies or speculative factors associated with the consummation of a merger, the court concluded that it also needed to determine the value of any synergies embedded in AXA's $31 deal price. For this purpose, it

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Risk of Appraisal Proceeding May Not Be So Problematic (cont. from page 13)

begrudgingly opted to utilize, on a modified basis, the "shared synergies" and "sum of the parts" valuation techniques advanced by AXA, noting that, like democracy was to Churchill, it was the least worse scheme presented by the parties. Utilizing these techniques to establish the value of the synergies embedded in AXA's price, and assigning a weighting of 75% to the former and 25% to the latter, the Court valued Highfields' stake in MONY at $24.97 a share, or $5.03 a share less than the deal price.

* * *

The Court's decision in the case is consistent with Delaware precedent in this area but is a useful reminder of the difficult nature of the appraisal right remedy in Delaware for plaintiffs. In unique cases, such as squeeze-out mergers involving closely-held companies and other instances where the transaction has not been market tested in a meaningful way, an appraisal rights remedy can be a valuable tool for disgruntled selling stockholders. But in most PE deals, it's circuitous, protracted and expensive nature, together with the downside risk inherent in its exercise, will render it a tool best left in the tool shed. The good news for PE buyers is that the Court's decision may often allow them (and their lenders) to live without a closing condition tied to the exercise of appraisal rights, thereby creating more deal certainty for the parties. ■

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The Impact of the New Japanese Securities Law on Fund Sponsors (cont. from page 8)

registration exemptions under the FIEL, the general partner will not have to register as long as the marketing of the fund in Japan is complete by March 31, 2008. A filing notice with the Japanese regulator must nonetheless be made by December 31, 2007. There is not clear guidance regarding the level of marketing required before the Effective Date in order for a general partner to be grandfathered under the FIEL as having "commenced" an offering prior to the Effective Date. Japanese practitioners seem to be comfortable that the threshold will be crossed if a private placement memorandum has been delivered to a prospective Japanese investor prior to the Effective Date. However, a general partner cannot rely on this grandfathered status with respect to Japanese investors contacted after the Effective Date.

- ***Marketing in Japan after the Effective Date:*** Unless the Outsourcing Exemption may be relied upon, a general partner commencing marketing activities in Japan after the Effective Date must file a notification (if an exemption from registration applies) or register under the FIEL prior to starting such activities. Unless a general partner relying on the Outsourcing Exemption may also rely on the De Minimis QII Exemption, it generally will have to file a notice (or register if the QII-Targeted Exemption is not available) with the Japanese regulator before admitting Japanese investors.

Transfer Restrictions Required

A general partner that is not required to register under the FIEL must enforce significant restrictions regarding transferring fund interests (and, in fact, such restrictions are specifically mandated by the FIEL for the QII-Targeted Exemption to apply). In addition, the FIEL requires that the relevant transfer restrictions be set forth in the applicable fund documentation.

Notification Filing Procedures

The notice to be filed with the Japanese regulator is fairly simple and contains little sensitive information, and may generally be made in English. However, it is not clear whether the information filed will be publicly available, so fund sponsors should assume it will be.

Conclusion

The enactment of the FIEL will add another layer of complexity to offering fund interests in Japan and admitting Japanese investors into private equity funds structured as limited partnerships. In most cases, however, the impact will largely be administrative, and most general partners should be able to rely on the exemptions available from registration. ■

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Is There Good News for Private Equity Investors in France?

For those sorting through the news and gossip surrounding Nicolas Sarkozy's first several months in office, it is difficult to discern any clear message for private equity investors. Sarkozy did rise to power this Spring buoyed by promises of change and a call to get France moving and working again. Since his election, there has been a flurry of activity and media coverage that has earned Sarkozy the titles of "hyperpresident" and "Czar-kozy," significant criticism that he is too pro-American and too pro-business and, more recently, widespread coverage of his marital woes and swift divorce.

Notwithstanding all of the distraction created by the popular media, we believe that the labor and tax reform initiatives of the new government and the French private equity market's increasing maturity continue to warrant cautious enthusiasm despite this fall's credit crunch.

Sarkozy's attitude towards private equity has been hard to read. In France, private equity has largely avoided the scrutiny and criticism that it has faced recently in other parts of Europe and the President has rarely spoken on the issue. But Sarkozy's policies, both as finance minister under the last government and as President, strongly support France's movement towards a more market-oriented economy, which should, at least indirectly, continue to spell promise for the private equity market in France.

In general terms, one of Sarkozy's key goals has been to debunk cultural myths about the value of work and to level the playing field for entrepreneurs and the private sector with a simple slogan, "Work more to earn more." One of the first initiatives of his government has been to announce that it intends to align so-called "special regimes," which can permit civil servants to retire several years earlier than private sector workers, closer to the less generous schemes in the private sector. Predictably, news of these plans caused the transport unions to call massive transit strikes in October and November. Less predictably, the strikes have not elicited particular public sympathy. In sharp contrast with previous strikes, the French economic daily, *Le Figaro*, noted that 55-65% of those surveyed indicated that the strikes were "not justified" and more than 80% expected that the government would not back down. The absence of widespread support for the strikes bodes well for the pension reform process, which is a key test of the government's policies. Of course, Sarkozy may well face additional strikes of a similar nature over time that will further test his resolve and the reformist credentials of his new government.

It is widely expected that pension reform will require alternative private pension structures to supplement the special regimes. It is hoped that some of the additional funding for private pension funds will flow into the French private equity sector. This seems more likely given that, when he was Finance Minister, Sarkozy obtained a significant commitment from the French insurance industry to allocate a fixed percentage of their assets to private equity investments.

In more specific and concrete terms, shortly after his election, Sarkozy instituted a number of tax reforms that, while not tailored to private equity *per se,* are likely to be helpful to the general economic and entrepreneurial environment:

- in its tax reform voted during the summer of 2007, the government reduced the cap on the aggregate amount of direct taxes payable by French residents (the *bouclier fiscal*, or income cap, introduced in 2005) from 60% to 50% of annual income, and included social contributions (which give rise to a 11% tax on investment income and an 8% tax on salaries) in the basket of taxes included in the cap (income tax, wealth tax and real estate taxes);
- the summer tax reform also included significant tax incentives to the highest French taxpayers and allowed a credit against the French wealth tax ("*Impôt de Solidarité sur la Fortune*" or "ISF") of up to 75% of amounts invested in small or medium-sized companies (within a limit of €50,000). This comes on top of other recent reforms which permit corporate executives to exclude shares held for more than six years from calculation of amounts taxable under the ISF. More investor-friendly measures are promised for the 2008 budget, which should further ease the conditions under which up to 75% of the value of certain shares and business assets will be exempt from the ISF and donation/inheritance taxes;
- taxes and social security charges payable on overtime for salaried workers have been eliminated to encourage salaried employees to work more than the 35-hour limit; and
- the 2008 budget provides that French residents will be able to opt for a flat tax on dividends (18% according to latest parliamentary discussions), rather than having such dividends taxed as income at progressive rates of up to 40%.

In addition to recent tax reform, private equity investors are keeping their eye on the French State's impressive investment portfolio in hopes that the State is getting ready to engage in a new round of privatizations. Since 1986, the French treasury has raised €82 billion from privatizing state-owned companies. However, the government still holds interests in a number of attractive French companies estimated to be worth more than €200 billion. In the short term, the French State is likely to reduce its 87% interest in the French electrical utility EDF

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Is There Good News for Private Equity Investors in France? (cont. from page 15)

and to list the shares of AREVA on Eurolist of Euronext Paris. In the longer term, the State's 15% interest in Renault and EADS may also end up on the block.

Despite these promising signs, the Sarkozy government has also already partially demonstrated the truth of Alphonse Karr's adage "*plus ça change, plus c'est la même chose*" (the more it changes, the more it's the same thing). Most recently, with the government's promotion of the Gaz de France-SUEZ merger as a means of creating a French energy powerhouse, the government has shown its continuing preference for the creation of French national champions—a persistent French policy under both leftist and rightist regimes. In addition, the new government has recently curried political favor by enacting legislation on the amounts payable under "golden parachutes" pursuant to an August 21, 2007 law that outlaws extra compensation that is not keyed to performance-based criteria.

In light of the new government's recent restrictions on executives' "golden parachutes," certain private equity commentators have observed that Sarkozy's government may turn its attention to clamping down on the increasingly lucrative management packages in recent French buy-outs. In contrast to other European markets, management deals in France have been relatively lucrative as investors appear to have been competing as much on the attractiveness of the management package as on the price of the deal. In France, where the attitude towards wealth creation remains generally critical, increased attention to the disparity between the salaries of management and French employees could bring private equity investors unwanted attention.

Ultimately, however, the most encouraging signs for private equity and the evolution of the French economy lie not in what the French government is promising or doing, but in the stability and diversity of deal flow that has in recent years made France the most mature European private equity market outside the UK. It is that growing maturity which led the *Economist* magazine to identify two very different kinds of capitalism in France and to contrast Sarkozy's intervention on the GDF-Suez deal with the dynamic development of a dinosaur of French heavy industry, the Marine Wendel Group, into one of the most successful investment funds in Europe. According to the *Economist*, Wendel is now Europe's second-biggest investment group—behind Sweden's Investor, but ahead of Britain's 3i and the European arm of KKR. In September, Wendel announced that its net asset value has grown by 31% on average in each of the past five years and the group recently floated its largest investment, BureauVeritas (BV), which Wendel acquired in 2004 for approximately €1.4 billion, in an IPO on Euronext Paris that values the BV group in excess of €4 billion.

At the end of the day, that kind of performance is likely to do much more for the private equity deal market in France than any policy initiative of the new President. ■

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Recent and Upcoming Speaking Engagements

November 1
James C. Scoville
Hot Topics Cross-Border Securities
Securities Litigation and Enforcement Trends & Developments / Listing and Offering Trends Outside The U.S., Including Emerging Markets and Fund IPOs
London, England

November 9
Rebecca F. Silberstein
Dow Jones Virtual Seminar
Fundraising In-Depth: The Key Terms and Questions LPs & GPs Must Know
Washington, D.C.

November 13-14
Paul R. Berger
Foreign Corrupt Practices Act
Implementing and Monitoring a Global Anti-Corruption Compliance Program
Arlington, VA

November 14-16
David H. Schnabel
Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings
Tax Strategies for Private Equity
Los Angeles, CA

January 18
David A. Brittenham, Co-Chair
Gregory H. Woods, III
Private Equity Acquisition Financing Summit 2008
New York, NY

January 29
Noëlle Lenoir
Cross-Border Mergers and European Company Statute (SE)
Insights from the Diversity of Firms That Have Chosen the European Company
Paris, France

Material Adverse Change (MAC) Clauses from a UK Perspective

Teams of lawyers for private equity sponsors and their bankers on both sides of the Atlantic are poring over the fine print in acquisition and loan documentation for a number of pending transactions in the wake of recent turmoil in credit markets, analyzing the implications of terminating these agreements. In particular, material adverse change clauses (MACs) and the risks associated with invoking them have received renewed scrutiny.

The MAC clause is an unlikely refuge for an acquirer or its financing sources in a UK public transaction, but may be of greater relevance in a private deal.

Public to Private Transactions

A large proportion of recent private equity deals in the UK have been in the public listed company sector. Although this would have been unheard of several years ago, as larger and larger PE funds were raised and financing became increasingly available by virtue of unprecedented liquidity and historically low interest rates, bigger companies, including companies one would not have thought of previously, became potential LBO targets for PE buyers. This trend culminated in the £11.1 billion buy-out of Alliance Boots, the UK-listed healthcare company, in summer 2007.

Public to private transactions in the UK are effected by means of an agreed public takeover of the UK-listed company by the private equity sponsor consortium. This requires a takeover offer to be made by Bidco under the provisions of the City Code on Takeovers and Mergers (the "Code") which is administered by the Takeover Panel.

Certain Funds. Under the Code, Bidco cannot announce an intention to bid for a UK-listed company without having every reason to believe that it can and will continue to be able to implement the offer. Bidco is also required to appoint a financial adviser to the offer which in turn must provide a cash confirmation in the offer document to the effect that sufficient funds are available to Bidco to consummate the offer if the offer is accepted by all shareholders. In order to give the cash confirmation, the financial adviser (generally an investment bank) will require that Bidco has committed financing ("certain funds") available to it before it launches the bid. Therefore, Bidco must enter into a fully negotiated credit facility and other financing documents which are subject to the minimum conditionality possible. This means there is no MAC out in the financing documentation and the lenders are obliged to lend for the purposes of the bid in all circumstances (other than, generally, in the case of insolvency and deliberate breach of contract on the part of Bidco).

By virtue of the requirement for "certain funds," there is minimal conditionality on the financing side of the public offer and absolutely no financing "out." (It has been suggested that U.S. private equity firms became comfortable with removing financing conditions in U.S. deals due to their forced acceptance of that approach in the UK. See "Are Private Equity and Strategic Deal Terms Converging," in the Summer 2005 issue of *The Private Equity Report*.) There are, though, certain customary conditions included in the offer document which is sent to all share-holders of the target (for their "acceptance") following the launch of the bid. These conditions typically do include a MAC clause as well as an "acceptance" condition, and antitrust/competition clearances in relevant jurisdictions.

The effectiveness of the MAC clause in a public offer document was tested in 2001 as a result of the economic turmoil triggered by the events of 9/11. WPP, the advertising company, attempted to pull its planned takeover of Tempus, another listed advertising company, by arguing that the events of 9/11 had caused a material adverse change in the prospects of Tempus, which was of material significance to WPP in the context of its offer to Tempus. The MAC clause was broadly drafted and referred to "no material adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects of any member of the wider Tempus Group."

The Takeover Panel dismissed WPP's claim, saying that the "material significance to the offer" test (which a MAC would have to meet under the Takeover Code) was not met. To be met, it required "an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous … to something that would justify frustration of a legal contract." The Takeover Panel also stated that the effect of the adverse change had to be long-lasting and a mere temporary effect on profitability was not enough. The Takeover Panel did eventually clarify the requirement of being "analogous to … something which would justify frustration of a legal contract" by saying that the effect did not actually have to be a legal frustration of the contract. However, in essence, something very serious will have to have happened to

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The MAC clause is an unlikely refuge for an acquirer or its financing sources in a UK public transaction, but may be of greater relevance in a private deal.

the target to justify triggering a MAC out in a UK public to private transaction and a change in general economic conditions is generally not enough.

In view of this tough stance taken by the Takeover Panel under the Code, to the extent a public to private bid is aborted, it is typically pulled on the basis that the acceptance condition has not been met on a closing date for the takeover offer, not the existence of a MAC. The acceptance condition is normally set at 90% (of shareholders accepting the offer) (but can be waived down to 51% by the offeror at its discretion). Therefore, if a MAC occurs before 90% is reached at a closing date, the offer can be allowed to lapse without any reason needing to be given. A MAC is likely to be tested, therefore, only in circumstances where the 90% threshold has been attained and the MAC then occurs (as was the case in WPP/Tempus).

Private Acquisitions

Most private company acquisitions by PE sponsors in recent years have tended to be made by way of an auction organised by the seller. In competitive auctions, acquirors have not had the luxury of being able to insert a MAC clause in the Share Purchase Agreement (SPA) and, as a result such clauses are rare in recent UK transactions. However, MAC clauses are more customary in US style transactions which have an important European element and in mid-market deals. If there is no MAC clause in the SPA, the financing documentation (which is entered immediately prior to signing the SPA) has tended not to have any MAC out for the lenders. Therefore, as a result of the robust market, banks have generally been pushed to accepting a position analogous to "certain funds" in private transactions, which was unheard of until recent times). There has, therefore, been very limited conditionality in private acquisitions by way of auction and MAC clauses have not played a part. By way of example, in some recent auction transactions, the only condition to closing was the anti-trust/competition clearances.

MAC clauses as closing conditions in private acquisitions and related financing arrangements could become more common again in different deal environments. If a MAC is included in a private acquisition SPA, it is likely to be construed in accordance with normal contractual principles and will be given the meaning which it conveys to a reasonable person, having all the background knowledge which would reasonably have been available to the parties at the time of entry into the contract. In other words, even if MAC clauses return on large private deals, well-negotiated clauses should not be expansively interpreted.

Recent Example

One recent example of an interpretative dispute under English law regarding a MAC clause arose in a different context. In 2005, a syndicate of international banks invoked a MAC as a basis to call a default under their UK law-governed credit facility with Yukos Oil Company. The banks were reacting to an entry of a judgment against Yukos for several billion dollars of tax liabilities, which in turn had led to the freezing of Yuko's assets and its issuance of a press release stating that it was at risk of an insolvency. Under the credit facility, a MAC event of default was defined essentially as the occurrence of any event or circumstance which (in the reasonable opinion of the lenders) had or might reasonably be expected to have a material adverse effect). Yukos challenged the lenders right to invoke this MAC clause but the court held that the MAC event of default had occurred in line with the wording of the contract and the loan could be accelerated.

Note though that because this case arose "after the fact" in the context of a credit facility, it is not necessarily predictive of how a similar case might play out in an acquisition context. In addition, the value of the case for an M&A deal in terms of legal precedent could be limited by the extreme facts in the case and the formulation of the MAC clause itself, which included a subjective element—*i.e.*, the reasonable opinion of the lender.

Failure to Lend/Measure of Damages

Of course an equally, if not more interesting, question as to what constitutes a MAC under English law is what would be the measure of a PE firms' damages if a MAC clause were wrongly invoked by its lenders? Put differently, what would be a private equity firm's measure of damages if its lenders blocked an acquisition by refusing to fund on the basis of an alleged MAC, but a court later concluded that the MAC clause had not been triggered and that the banks were therefore in default? As stated above, we believe this would occur in the UK only in a private deal. But if a lender pulled its financing in breach of contract, the measure of damages would likely be (1) reasonably foreseeable losses *e.g.*, extra interest and other costs and fees incurred in arranging alternative financing and (2) specially contemplated losses *e.g.*, losses arising out of the failure of the borrower to complete the acquisition to be financed by the loan. This would include any termination fee payable for not completing the deal plus any other wasted expenditure or costs incurred. The alternative to claiming wasted expenditure is to claim loss of profit suffered as a result of the termination (under English law you have to choose between claiming wasted expenditure of loss of profit—you cannot

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Material Adverse Change (MAC) Clauses from a UK Perspective (cont. from page 18)

claim both). Loss of profit may be hard to quantify but could be significant enough to incentivize the lender to reach an accommodation rather than litigate. It should be noted that a borrower will generally not able to obtain specific performance of a loan obligation from a lender, in which case its only remedy under English law will be in damages, with an obligation to mitigate its loss *e.g.*, by seeking alternative financing.

Conclusion

Unlike the U.S., where MAC clauses have entered the lexicon of the general press in the wake of the credit crunch, MAC clauses have not come into play very often in the UK context owing to the UK public takeover regime and the recent negotiating strength of sellers on the private acquisition side. But although MAC clauses may always be of little import on the public offer side in the UK, under current market conditions there may well be some movement back to including MAC clauses in private acquisition agreements and related financings in the UK. ■

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An Interview with Lord Peter Goldsmith (cont. from page 1)

intent rather than rewriting a contract into something that they think is reasonable. UK judges also focus on issues of causation and loss — all of which are basic common law concepts. Although EU law has some impact on English law contracts, English law is still very familiar to those accustomed to U.S. law contracts — much more so than contracts which are governed by French or German law or the laws of other continental European jurisdictions.

As I understand it, the national law of EU member countries like the UK is required to comply with EU directives. To what extent has the EU forced the UK to change its historical approach in certain areas such as employment and product liability?

I think there are two points here. The first is that in every country, including the United States, traditional common law concepts have been fashioned by legislative enactments or local laws. In the United Kingdom, both parliamentary laws and EU law have imposed new regulations relating to employment, product liability and the like. That does not erase the core concepts of commercial contracts. What it does mean is that those doing business in any European country need to be well aware of the local law and be advised about its impact.

The second point is that EU law is always subject to negotiation and in many areas has to be a subject of unanimous agreement among the member states, including the United Kingdom. Having been very closely involved in negotiating some aspects of EU law on behalf of the United Kingdom, I can say that the United Kingdom has always advocated that some of the solutions which work for our continental colleagues don't work for us and cannot be reconciled with our common law. Actually, there is now more of a voice for the common law countries because there are now three other common law countries—Ireland, Cyprus and Malta—in the EU. I can assure U.S. investors that the United Kingdom government has always believed that the legacy of common law has been important for British business and has been at pains to keep alive the core concepts underlying our common law.

At a time when London is clearly the center of European business, are there areas that concern you about the impact that the EU will have on English business and on others doing business in the UK?

One aspect that has been of great concern to British industry is the industrial relations settlement, which governs the relationship that employers have with unions, and is different in the United Kingdom from the rest of Europe. The UK government has been very keen to preserve those rights. At the moment, we are going through the final stages of a new EU treaty, following failed attempts at a full European Union Constitution. It will contain a specific protocol which is designed to protect the United Kingdom settlement in relation to social and economic rights. One of the very last things I did in government before I stepped down was to draft that protocol to be satisfactory to both Tony Blair and Gordon Brown, the outgoing and the in-coming Prime Ministers. Another area of concern that should be followed carefully is the increase in responsibilities and duties of

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directors, although it is not specific to the United Kingdom.

Can you help those of our readers based in America to understand the difference between what it means to be a director of, say, a Delaware company and the director of a UK company?

In the past, very similar concepts have applied—the concept of loyalty and the concept of reasonable business care. In the United Kingdom, the basic Companies' legislation has just been rewritten. I was very closely involved in formulating the new approach to directors' duties and the new approach to derivatives claims. The new legislation seeks to strike a balance between the importance of duties to shareholders, on the one hand, and the interests of suppliers, employees, and the local community in which businesses may be located, on the other hand.

Let me make sure I understand. Under Delaware law, a director is supposed to put the interests of shareholders above all else unless the company is insolvent. In some states, the directors are permitted to consider the interests of the relevant communities and the interests of other stakeholders, but they are not required to do so. Are you saying that, in the UK, the directors are, in fact, required to take into account those considerations?

The new legislation does *require* directors to have regard to these considerations. But, the precise language is very important. These matters are to be given regard by the directors, in good faith, as part of an overriding obligation to promote the success of the company for the benefit of its members as a whole. There is nothing that requires these other concerns to be determinative, but directors of companies must give a fair consideration to these issues. In the discussions I've had with directors of public companies in the UK, even though they weren't happy about these considerations being raised to legal obligations, they didn't think this would actually change the way they did business, because those were the things for which they traditionally had regard—on the theory that building long-term shareholder value is dependent on having these considerations in mind.

The UK's tax rate of 10% on private equity carry and other business assets held for two years was particularly generous .... [T]he proposed tax is exactly where they thought it ... a comfortable place to end up.

Many private equity firms still control their portfolio companies even after an IPO. In many of these cases, there are also significant minority shareholders. How have the obligations of directors and majority stockholders in public UK companies changed as a result of the new UK Companies Act, and is this something that our private equity investors should be particularly concerned about?

Concern is not necessary, but knowledge is. What has really changed is a codification of laws which always existed in the United Kingdom. Minority shareholders could in certain circumstances bring claims on behalf of the company which were not being pursued by the majority shareholders, or directors. As in the U.S., these were shareholders' derivative actions. The new legislation was actually designed to avoid a situation in which shareholders of the company find themselves faced with vexatious, frivolous claims of the sort that we know from time to time are brought by litigious shareholders. The new legislation provides protection by mandating that these types of claims cannot be brought without judicial consent. In this regard, the judge is required to consider a number of circumstances including whether the conduct is likely to be ratified by shareholders.

The private equity community breathed a collective sigh of relief earlier this Fall when the proposed tax changes announced by Gordon Brown's government maintained the basic premise that carried interest would be taxed as capital gains and revised the capital gains rate applicable to that carried interest from 10% to 18%. Do you think that's a shortsighted sigh of relief?

No. This must have been under consideration for some time. This question has been quite a hot political potato. I think it's a good overall solution. It has helped a lot of investors by reducing the rate of capital gains tax. It also produced a resulting tax for private equity carry that is not out of line with the rate of tax that applies in a number of other important jurisdictions. The UK's tax rate of 10% on private equity carry and other business assets held for two years was particularly generous. From private conversations I've had with people in the market, I think the proposed tax is exactly where they thought it would be a comfortable place to end up. Interestingly, the initial complaints about this change were not from our private equity community, but from small business

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owners who thought this new proposal created an unexpected tax hardship for them. In response to these complaints, Gordon Brown's government looks likely to concede extra capital gains tax relief intended especially to benefit retiring small business owners. One other effect of the proposed change is to remove some uncertainties and complications about the present regime. But having said that, it is right to point out that the government has said it will continue to monitor the operation of some of the rules relating to the taxation of private equity.

UK investors in the stock market, as I understand it, also benefit from this tax proposal because their tax rate for capital gains on sales of securities would be reduced from potentially up to 40% to 18%.

Absolutely. This is welcomed as a result by small investors who would have been paying the high rate of tax on capital gains and will now simply pay this flat 18%.

Is this almost a match to what the U.S. has been doing for a number of years with its 15% capital gains rate?

I cannot believe that my former colleague would not have looked hard at what other markets were doing when they decided on the tax rate. That private equity community is very important to the City of London and the government would not have wanted to drive people away by making it uncompetitive.

Some of my private equity friends in the U.S. have remarked from time to time that there are more non-domiciliaries in the private equity business in London than there are domiciliaries. Can you explain why that has been of concern to U.S. business and what the new tax proposal suggests will happen?

This is another issue that has been around for quite a long time. Non-domiciliaries in the United Kingdom, who usually "live" in London, have been entitled to very favorable tax treatment especially as compared to those residents who are UK domiciliaries. The dilemma for government has been: Do you then bring these people into the tax regime even though they are not domiciled in the UK and perhaps risk driving them away from the London market, together with all the benefits that they provide with respect to the creation of wealth in the United Kingdom. Or do you leave what appears to be a huge inequality with bosses who are paying no tax, employing ordinary and dutiful people who are paying a lot of tax. This issue has been bubbling away in the political world for some time. What brought it to a head appears to have been a proposal launched by the Conservative party to raise a flat rate on non-domiciliaries. Labour's Chancellor has now announced changes which are different, but which also propose a flat rate levy. That may well satisfy the political demand to make a big change in relation to non-domicilaries and yet not jeopardize the business climate. The government has said it will continue to review this area, including whether people who have been resident in the UK for over ten years should make a great contribution.

You have assured us that English law remains very suitable for many business transactions and that the UK remains a prime player in the private equity community, but I have heard concern that Britain is moving towards a U.S.-style transaction culture which would suggest that litigation risk and the potential for disastrous recoveries may soon be coming to London.

My judgment is that the litigation risk in the UK remains and will remain significantly less than in the U.S. It is true that there have been a number of high profile actions which could, because of the number of plaintiffs involved, be thought of as akin to class actions. It is also true that these claims are a bit easier to bring than they were historically because of changes to the procedural law. But there remain very, very significant and quite deliberate differences between the UK law in this area and U.S. law. First of all, lawyers can't get enough lift of their fees if they succeed in the action; they cannot go for a straight contingency agreement irrespective of the amount of work that they do. The rewards for lawyers therefore are significantly less. Secondly, you cannot get general punitive

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damages as a plaintiff in a UK class action. Each claimant has got to prove his or her actual loss. Thirdly, claimants come into the UK litigation group as a result of a deliberate decision to "opt-in"—a claimant says he wants to be part of an action and has the opportunity of doing so. It is not a situation where one person can bring a class action on behalf of a broad class of unidentified people who then have to opt-out if they don't want to be bound by the result. These vast differences have, unfortunately, not convinced some U.S. plaintiff-oriented law firms that it is not lucrative for them to set up shop in London. But the general consensus of the UK legal profession remains that the culture and legal structure of U.S.-style class actions does not exist, thereby creating a more benign business environment.

Are there other types of regulatory changes that may have a major business impact in Europe that the PE community should be aware of?

There are two aspects that I would mention. The first is merger control and the second is the responsibility of directors and corporate supervision. My perspective on merger control is as a result of the Sony-BMG merger being declared void by a lower European court after the EC had cleared the merger. The bottom line is that a decision of the European Commission clearing a merger is not final. Even after the merger takes place, and indeed when the businesses are merged, a court can come along and void it. That decision has caused a lot of consternation about the future of merger control in Europe.

There is also a series of events, including European Union Directives, which make corporate financial supervision all the more important. These will increase the risk of personal responsibility of directors, including audit committee members. For example, if there is a whistle-blower or some allegations of illegal conduct, such as bribery within a subsidiary company, the risk of personal liability means that directors must be cautious not to sanction only limited investigations.

U.S. directors have always been concerned that serving on the boards of European companies or even European subsidiaries of U.S. companies creates more of a risk of personal liability than serving on U.S. corporate boards. Do you think that perception is now even more justified?

There is some truth in it. If I look at English corporate law going back less than 100 years ago, a director was a gentleman who was expected simply to act in good faith and wasn't expected to have any particular degree of business judgment, let alone skill. That has changed. The legislation alone has not changed it, but rather the evolution of the common law in light of a number of corporate disasters.

Do you anticipate, for example, Audit Committees having their own counsel on a regular basis, as opposed to just when there is some provider concern about the financial statements or about management's activities?

It is not going to be necessary for an Audit Committee to have counsel on all occasions. It may be prudent for Audit Committees to take good independent advice when they see a problem, in order to make sure that the solution is the right solution and to give themselves protection.

So now that you're a month or so into your new position, tell me about your dream private equity assignment?

Before I went into public service, I spent my time solving problems after they'd arisen—trying to pick up the pieces after deals had gone wrong. That is, of course, what litigators do. In public service, I spent a lot of time trying to make sure things happened right from the start. I am very excited about the prospect of being more involved in the transaction side, but I very much want to do a lot on the litigation dispute resolution side as well. The problems are global, there are jurisdiction issues arising in a number of different places, and you want to plan from the start how you are going to resolve your disputes. I can envision a situation in which it would be very good to be involved in the early stages, hoping to anticipate problems so that actual disputes don't arise, but if they do, then having in place a good dispute resolution mechanism so as to sort them out in the most advantageous way.

In a multi-jurisdictional transaction, would you recommend using litigation or arbitration as the best dispute resolution method?

If you're going across a number of countries, I think it is likely to be most effective to use arbitration. Where a contract is entered into by parties from multiple States, they often choose arbitration over litigation in one of those States in order to avoid giving an actual or apparent advantage to one side. Certainly you don't want to have a situation where, frankly, your choice of forum is going to be in a country which doesn't have a long experience in dealing with commercial disputes. You can decide things in Delaware; you can decide things in London, but it is not desirable to go to courts in places without a long history of successful commercial dispute resolution. That state of facts creates an international arbitration lawyer's dream assignment. ■

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less appealing for private equity firms. Prior to the flurry of deal-making that began in 2004, it was not uncommon for an MAE to be defined in a private equity firm's acquisition agreement without exceptions that were standard in strategic transactions; that is, without carving out particular occurrences that the parties agreed would not be taken into account for purposes of determining whether an MAE had occurred. This meant that adverse changes in the target business's industry, the financial markets or the economy generally, applicable law, accounting rules and other background events not specific to the target alone could be invoked by a private equity buyer as a reason not to close the purchase. Unlike strategic buyers, who could be deemed to be already exposed to such risks in their own business and for that reason better able to weather such adverse changes and consummate a purchase, private equity firms, with a three to five year investment horizon and no current exposure to the target business, considered themselves, and were able to persuade sellers that they were, in need of such protection.

Two developments combined to take this protection away from private equity firms. First, sellers simply became more focused on removing all forms of conditionality from acquisition agreements. Second, many sizeable transactions were sold through an auction process, in which private equity buyers, competing with strategics in the auction, faced substantial pressure to agree to the lowest common denominator in contract terms. The result was that, in most recent transactions with values of greater than $1 billion, a private equity buyer was typically required to accept the laundry list of exceptions to the MAE definition described above. In addition, over time, both private equity and strategic buyers were pressured to accept still broader carve-outs, such as changes resulting from war and terrorism, the target's failure to meet earnings forecasts and, in some cases, contingencies set forth (often without great specificity) in seller disclosure schedules. A parallel and key development was the acceptance by lenders that the MAE definition in the acquisition agreement would be the MAE standard applicable to the debt financing commitment letters. This meant, at least theoretically, that the lender would not be able to rely on an MAE condition not also available to the private equity buyer, and therefore made the private equity buyer less wary of proceeding without a financing condition.

Although strategic buyers were, of course, required to accept the same risks, the loosening of MAE terms has posed less risk for private equity buyers in light of the liability limitations discussed above. Whereas a strategic buyer might face both an unlimited damages claim and an action for specific performance if it were to lose an MAE dispute arising from a failure to close an acquisition, the private equity buyer that has bargained for the package of liability limitation described above—liability limited to a negotiated, reverse termination fee and a seller waiver of specific performance—is in a substantially stronger position, both as to its limited downside and its ability to negotiate terms for a revised transaction.

Representations, Warranties and Indemnities

Until recently, a sponsor would have expected to receive detailed representations and warranties about the target business from the seller in private deals. Those representations and warranties serve two purposes. Unless the representations and warranties remain true and correct—or, at least, true and correct with certain materiality or MAE qualifications—the buyer would be excused from closing the transaction. In addition, the representations and warranties supported the buyer's due diligence review, and—if, post-closing, it emerged that the statements were materially untrue—were typically backed up in a non-public deal by an indemnity from the seller.

That general approach shifted under the pressure of recent market conditions. Particularly in the largest transactions, sponsors have increasingly been asked to do deals with a "public M&A style" contract—containing representations and warranties heavily qualified by materiality, knowledge or MAE, and either no indemnity or a very limited one, with all claims confined to an escrow. The use of MAE qualifications in particular has had a powerful effect in undermining the significance of representations and warranties since, as noted above, the kinds of changes that would constitute an MAE as defined in current deals are very limited. For the private equity buyer that has bargained for a cap on liability and specific performance waiver, however, a looser and more frequently used MAE standard in the representations and warranties has less bite, or balance, than for a strategic buyer who does not benefit from the companion limitations such terms provide.

Tighter Financing Covenants

As the focus of both PE buyers and corporate targets and sellers on the need to ensure that the debt financing for a buyout would be available at closing sharpened, both sides perceived the need for stronger financing covenants. The private equity buyer required the seller to commit in great detail to facilitate the financing, including providing financial statements and other information and making target company executives available to participate in the preparation of debt offering memoranda and in road shows to sell the debt. For its part, the seller required the private equity buyer to use reasonable best efforts to obtain the debt financing, to seek alternative financing if necessary and to

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draw down on committed bridge financing if the permanent financing could not be sold within a specified marketing period.

The imposition of strict timelines within which the financing covenants played out had the unintended, but predictable, consequence of making, at certain key times during the life of a deal, the relationships among the various parties required to consummate a successful high yield debt financing or a bank loan syndication (that is, the buyer, seller and financing sources) adversarial. After all, each party was jockeying to preserve its rights under either the acquisition agreement or the debt financing commitments. Many sellers thought they would benefit from having ratcheted up the financing covenants. In practice, what sellers discovered was that the limited flexibility afforded buyers in a tight credit market only made those buyers more likely to tap the contractual outs they had bargained for in the acquisition agreement.

What's Next?

It is hard to predict at this stage how sellers, buyers and their traditional financing sources will recreate the deal marketplace. Each side has a wish list, and whose favored approach prevails will depend – as always – on changes in market leverage of buyers and sellers that will be affected by a host of variables. However this situation evolves, the battle lines are clearly drawn.

On the sponsor side, we expect to see pressure for tighter MAE provisions with fewer carve-outs. With regard to financing outs and reverse termination fees, we expect sponsors to hold the line on the *status quo*, by insisting on the kind of liability limitations and waivers of specific performance that were the natural result of losing the financing condition that had been part of their deals for so many years. Whether private equity buyers will continue to do deals without financing conditions will depend on the willingness of the banks and other financing sources to limit the conditionality of their financing commitments. Recent evidence shows an understandable reluctance on the part of providers of staple and other financing to accept limited conditionality. There are many negotiations now in process and yet to come between sponsors and lenders relating to market MACs, limited due diligence outs, and many other harbingers of conditionality and old-style deal making that were once part of the leveraged finance playbook. Of course, since the leverage in new deals is significantly lower than in deals done earlier this year, it is too soon to tell how the market will develop.

At least once recently announced deal, the $2.65 billion acquisition of Goodman International, has an express EBITDA-based closing condition requiring the target to achieve a specified minimum EBITDA over the last six months of 2007. The benefit of such an express condition seems favorable from a buyer's point of view; however, because debt financing commitments typically do not permit a buyer to waive such a condition without the lenders' consent, such a condition can come back to bite a buyer who still desires to fund the acquisition even in the event of a minor EBITDA shortfall. The "take-away" here is that negotiated protection can be two-edged and sometimes create unintended consequences. The acquisition agreement in Goodman also contains an express seller waiver of specific performance and a clear limitation on liability, using the two-tier structure, to a bit less than twice the reverse termination fee amount.

Sellers have different priorities. We expect them to press for higher reverse break-up fees in order to induce buyers to close. Whether that will be successful is hard to predict, especially when auctions become competitive again. In "going private" deals, in which a public seller requires for fiduciary reasons the right to terminate before a stockholder vote approving the transaction, it may be hard for sellers to demand a reverse break-up fee much greater than the amount the Delaware courts will permit sellers to pay to buyers in case of such a fiduciary termination—generally in the range of two to four percent of transaction value—although the need for symmetry in the size of such fees can be debated.

Sellers may increasingly press for the "specific performance" right to force buyers to close where debt financing is available. We may also see sellers pressing for third party beneficiary rights under debt commitment letters in order to overcome the sponsors' natural disinclination to sue their lenders, a demand that is certain to be hotly contested by the banks and their counsel. As an alternative, sellers may request that sponsors agree in the acquisition agreement that their "reasonable best efforts" to get a deal done will include bringing a claim against the lending banks in case of a failure to provide financing pursuant to a commitment letter.

These are challenging times for the deal community. As the buyout market recovers from the events of the summer of 2007, we expect that buyers, sellers and financing sources will each be finding their way until a new "market" in contract terms develops. ■

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