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Slip Out the Back or Make a New Plan? A Look at Recently Renegotiated Private Equity Deals

In his 1975 hit song about ways to end a stale relationship, Paul Simon told his audience that there were 50 ways to leave a lover. These days, many sponsors wish that Simon's lyrics could be readily applied to private equity transactions signed prior to the credit crunch.

But, as many have learned, breaking up is not always easy. True, many pre-crunch deals effectively are structured to give sponsors the option to abandon the transaction upon payment of the reverse breakup fee (though, technically, most contracts provide that the reverse breakup fee is triggered by the target's termination of the contract following the sponsor's refusal to close). Others, however, prevent an easy exit by granting the target a specific performance remedy. Yet others, such as the Cerberus-United Rentals transaction (discussed elsewhere in this issue) include contradictory provisions that require a court to decide whether there is a walk-away right or not.

What's more, even where the contract permits a sponsor to "slip out the back" (after depositing the fee check on the counter), several considerations weigh against a decision to terminate. Firstly, exercising a walk-away right, or attempting to reduce its price tag by involving a target in litigation over whether or not there has been a material adverse effect, or MAC,

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Fundraising is challenging even though our track record is great. Sometimes I wish we were a sovereign wealth fund.

WHAT'S INSIDE

Letter from the Editor

You don't need us to tell you that private equity has seen happier days. However, we can provide some guidance on how to handle the variety of challenges facing the private equity scene and offer you some perspective on some of the opportunities that may lie ahead. We can also remind you that private equity has never been for those who lack patience or side-stepped challenges.

On our cover, we review a variety of renegotiated transactions and offer several perspectives on how transactions have been renegotiated or exited. As we all know, there may be restructurings ahead and in one of our articles, My Chi To explains how changes in the lending market and the bankruptcy code will impact those restructurings.

Alan Davies and Jim Kiernan report on some good news for private equity in the UK. Upcoming changes to the English financial assistance rules will make the old "whitewash" procedures unnecessary and will permit leveraged acquisitions of private English companies to be accomplished more easily. And Kevin Rinker and Michael Diz warn that a recent Delaware case illustrates that what you don't say (as well as what you do say) can be crucial in determining whether you are deemed a "forthright negotiator" and possibly determinative of contract interpretation by the courts.

In our guest column, we are pleased to hear from Professor Dr. Ann-Kristen Achleitner of the Technical University of Munich about the changing attitudes of German labor unions towards private equity deals. After a period of some hostility, the unions now appear to be more interested in working with private equity sponsors to protect workers and build businesses.

Elsewhere in this issue, we address several regulatory changes that may affect you or your deals, including new disclosure guidelines for some UK portfolio companies and private equity funds in the United Kingdom, liberalizing amendments to Rule 144 and a recent U.S. Supreme Court decision that significantly reduces secondary liability under Section 10(b).

Finally, sensing that unanswered question among business school graduates and other young people entering the job market about whether given the current financial downturn private equity is no longer the opportunity it once was, we asked some of our friends in the industry whether they would recommend that their children go to work in private equity? We hope you enjoy their answers.

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Editor-in-Chief

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Will the Next Downturn Be That Different?

Default rates and bankruptcy filings hit historic lows in 2007. Until last summer's credit crunch, the availability of financing on very favorable terms allowed companies facing a liquidity problem or a potential default to borrow their way out of trouble. With the lending window now all but shuttered, more and more businesses will find themselves forced to reach out to their creditors to restructure.

Professionals active in the field generally agree that the next wave of restructurings will be very different than the last. A recurrent theme is that workouts and bankruptcies will be more contentious and more complex—and therefore more costly—than in the past. Some go even further and argue that a fundamental shift in restructuring dynamics has quietly taken place over the last few years, leading certain investors to complain that Chapter 11 is no longer about fixing companies.

Restructurings are shaped, to a large extent, by the credit cycle that gave rise to them as well as constraints imposed by bankruptcy laws. As both the lending market and the Bankruptcy Code have undergone significant changes since the last downturn, it is safe to predict that these changes will affect how the restructuring game is played. Given the low number of recent large corporate bankruptcies, however, the impact of these changes has yet to be fully observed.

New Players

In the old days, when a company needed covenant relief, it would speak to its bank agent, who would herd the lenders in the syndicate and, after some negotiation, deliver the requested amendment or waiver. The company knew who its lenders were and, in most cases, they were prepared to work with the company to address its problems. Things could get trickier if the company also had bond debt. But even in that case, the company could, with the banks' support, file for bankruptcy, obtain post-petition financing permitting the company to continue to operate, and threaten to cram down a plan of reorganization on the bondholders. While this picture oversimplifies the complexities of the process, borrowers could usually rely on a degree of cooperation from their senior lenders in times of need, at a price to be negotiated.

One of the defining features of the last credit cycle was the rise of hedge funds and other non-institutional lenders, which have effectively stepped into the shoes of banks and other financial institutions as primary investors in corporate loans. In addition, while a company may know who its lenders are at the outset, it may be difficult to determine who holds the debt once the company becomes distressed. If the company needs to negotiate with its creditors, it may not readily know who to speak to or who represents a majority of the debt. In many cases, the company may discover that substantially all of its debt is now held by distressed funds, which have raised billions of dollars in anticipation of the tide of investment opportunities that the next downturn is expected to bring. Even after a lender group coalesces and negotiations commence, dramatic shifts in holdings and, as a consequence, negotiating positions may occur.

People tend to talk about distressed funds as a monolithic group. However, their interests in any given workout may be far from uniform or predictable. For example, different funds have different investment strategies. Certain funds have a trading mentality, with a shorter-term investment horizon that may be at odds with the operational turnaround of a business. Other funds adopt loan-to-own strategies, which tend to be consistent with a longer, more traditional reorganization process, but may be incompatible with the wishes of management or other creditor groups. Further complicating the analysis, investors often accumulate positions in multiple layers of debt and may have bought the same debt at substantially different prices. Compared to the last downturn, workouts and bankruptcies will likely involve a greater number of players with potentially more varied and less predictable interests. As a result, it may become more difficult for companies to find common ground within and among their creditor constituencies.

More troubling is the potential impact of credit default swaps and other derivatives on creditor motivations. For example, a creditor who holds a credit default swap may actually be better off by pushing a troubled company into bankruptcy. Because derivative transactions are not publicly disclosed, creditors' real economic interests may be impossible to determine. Certain commentators believe that the growth of the derivatives market has increased the systemic risk of default and

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bankruptcy. Others dispute this contention, remarking that for every investor who benefits from a company's default, another loses, thereby creating countervailing incentives to rescue troubled companies. To date, there is no evidence, other than perhaps anecdotal, that derivatives are affecting restructuring dynamics in a meaningful way. By separating economic risk from ownership, however, derivative transactions raise interesting policy issues as to whether and the extent to which investors should be required to disclose those transactions.

More Leverage

The proliferation of new financing sources gave rise to more leveraged—and in many cases more complex—capital structures as lenders aggressively competed for business from private equity sponsors and companies. In particular, many borrowers have taken advantage of the leveraged loan market, including second-lien loans, to recapitalize.

Although second-lien debt appears to have become a standard component of leveraged capital structures, there remains much uncertainty about the leverage and recovery prospects of second-lien lenders in a distressed scenario.[1] Complex intercreditor agreements between first- and second-lien lenders create new opportunities for disputes on a wide range of issues yet to be settled by courts, including second-lien lenders' right to block a priming debtor-in-possession (DIP) financing or a sale of collateral in bankruptcy (so-called section 363 sales). In addition, even if second-lien lenders are significantly undersecured, as is likely in many cases, their nominally secured status nonetheless will afford them a greater ability to influence the Chapter 11 process than unsecured creditors. This is not good news for unsecured creditors, whose traditional role and relevance effectively may be usurped by second-lien lenders.

More problematic is the impact of second-lien financings on the ability of companies to obtain DIP financing. In order to fix their business and reorganize in bankruptcy, a large company will typically need time and significant financing; by contrast, selling the company in bankruptcy will usually be faster and require less financing. If substantially all of a company's assets are already pledged, secured lenders may refuse to provide a large DIP facility, even if they are oversecured, out of fear that it will impair their recovery. This, in turn, will increase secured creditors' leverage over debtors and limit debtors' options in bankruptcy.

As a general matter, more layers of debt means more people fighting for the same pie and accordingly more voices demanding to be heard in the restructuring process. If there is substantial overlap among the various creditor groups, consensus may be easier to achieve; otherwise, there will likely be more intercreditor disputes, which may translate into fewer consensual out-of-court workouts, more uncertainty and delay, and higher costs. However, as these disputes are resolved by parties or courts over time, the uncertainty about the outcome of these disputes—and the corresponding appetite of investors to fight over them—will likely decrease.

Amendments to Bankruptcy Code

The overall effect of the 2005 amendments to the Bankruptcy Code is to shift leverage from debtors to creditors. Major changes effected by the amendments include greater restrictions on debtors' freedom of action such as the new 18-month limit on debtors' exclusive right to file a plan of reorganization and increased demands on debtors' liquidity resulting from greater protection for trade creditors, utilities and landlords.

Many restructuring experts predict that these changes will result in more section 363 sales than in the last downturn. With less time and liquidity with which to restructure, more debtors may be forced to sell or liquidate their businesses, some

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Major changes effected by the [2005] amendments [to the Bankruptcy Code] include greater restrictions on debtors' freedom of action such as the new 18-month limit on debtors' exclusive right to file a plan of reorganization and increased demands on debtors' liquidity resulting from greater protection for trade creditors, utilities and landlords.

1 *For more information on second-lien financings in bankruptcy, see "What Borrowers (and Sponsors) Should Know About Second-Lien Financings in Bankruptcy," published in The Debevoise & Plimpton Private Equity Report, Volume 7, Number 1, Fall 2006.*

2 *For more information on acquisitions of companies in bankruptcy, see "Section 363 Sales: How To Play The Game," published in The Debevoise & Plimpton Private Equity Report, Volume 7, Number 4, Summer 2007.*

GUEST COLUMN

Labor Unions and Private Equity in Germany—The Current State of Play

There is hardly a more contested issue in the debate on private equity than the question as to whether it creates or destroys jobs. And there is hardly a place where the pros and cons of private equity have been debated more passionately than in Germany. However, the relationship between German labor unions and private equity has evolved in recent months. A look at the current state of play reveals that unions are about to give up demonizing the private equity industry in favor of a more practical approach: cooperation.

Back in 2005, Franz Müntefering, a leading Social Democrat who later became Germany's vice chancellor (he is now retired) famously remarked: "Some of these investors do not waste a thought on people whose jobs they destroy. They remain anonymous, faceless, descend like swarms of locusts on companies, devour them and move on. It is this kind of capitalism we are fighting."

It is not entirely clear whether Mr. Müntefering's "locusts remarks" were indeed directed at the private equity industry (some think that he was referring to hedge funds whose attacks on Deutsche Börse were then widely debated in Germany). What is clear, however, is that Mr. Müntefering's comments prompted unions in Germany and elsewhere in Europe to launch a campaign against the private equity industry, reverberating around one central accusation: private equity firms pursue brutal cost reduction strategies to achieve exceptional rates of return at the expense of the employees. In making their case, unions successfully played on fears (deeply routed among many Germans) that the increased influx of foreign private equity capital was tantamount to the advent of an era of Anglo-Saxon style capitalism.

German and European industry associations tried to quell these fears by commissioning studies on the employment effects of private equity. The studies were based on questionnaires distributed to private equity firms and portfolio companies. With the exception of turnaround investments, their findings were uniformly positive. However, the German media and unions challenged the results. They alleged the questionnaire approach was flawed because it did not permit independent verification of the results. They also predicted that only those private equity firms that had positive employment data to show for themselves would return the questionnaires. Indeed, the surveys drew only a very small number of responses, leaving press and unions to speculate that private equity professionals either were not able to corroborate their public assertions on the employment issue or, worse, were indifferent towards the demands for more transparency in their industry. The surveys, initially aimed at alleviating jitters, thus inadvertently poured oil into the fire and allowed the unions to keep the locusts campaign alive.

In recent months, however, German labor unions seem to have reverted to a more pragmatic approach towards the private equity industry. In November of 2006, IG Metall—a metalworkers' union and the largest organized employee representation worldwide—created the "Netzwerk Private Equity" (Private Equity Network) and hired a former investment banker and private equity expert, Babette Fröhlich, to run it. The network is an online platform designed to facilitate the exchange of private equity-related information among IG Metall members. Among other things, the network permits union members to retrieve information on a private equity firm's previous transactions and on its track record on specific employment-related issues. The network data may prove a powerful tool for many union members, particularly those that are represented on the supervisory boards of German companies and, thereby, get to assess acquisition overtures by private equity firms.

A similar effort has been launched by the Hans-Böckler Foundation, the co-determination, research, and scholarship institution of the German Labor Union Association (DGB), the umbrella organization for German unions. The Foundation recently commissioned several analyses and reports on the private equity and hedge funds industries, including studies on particular private equity investments and on the impacts of debt

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German labor seems to have come to terms with the fact that private equity is here to stay and is now trying to optimally position itself for the period of cooperation that lies ahead.

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financing in leveraged acquisitions. In parallel with these data collection projects, unions have begun to formulate their political demands with more precision. In July of 2007, DGB and IG Metall articulated their views on the draft private equity law proposed by the German Ministry of Finance. They requested, among other things, to limit the amount of debt permitted to be used in acquisitions by stipulating a minimum equity requirement of 30%, to prohibit special dividends, to provide post-closing consultation and information rights of the employee councils and to pass a code of conduct for hedge funds and private equity funds.

Overall, the shift from cheap rhetoric to gathering information and firming up policy positions appears to mark a sea change in the attitude of unions towards private equity. German labor seems to have come to terms with the fact that private equity is here to stay and is now trying to optimally position itself for the period of cooperation that lies ahead. ■

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of which may be attractive targets for private equity buyers.[2] These and other constraints imposed on debtors by the Bankruptcy Code may encourage more companies to try to restructure out of court.

It is too early to tell which of these predictions, if any, will materialize. In practice, what will make sense in any given case will depend on the value of the business, the nature of the problems faced by the debtor and a variety of other case-specific factors.

Covenant-Lite

With the increasing leverage in the last credit cycle, came declining covenant protection. To remain competitive in an extraordinarily liquid market, lenders made "covenant-lite" loans (which contain few restrictions on the borrower) and borrowers issued "PIK toggle" notes (which give the borrower the option to pay interest in cash or new notes).

These features severely impair the ability of lenders to force a change of course if the borrower's financial performance begins to deteriorate. In addition, the absence of financial covenants deprives lenders of an early warning system to detect problems. By the time a default occurs, there may be little enterprise value left to repay the loan.

For borrowers, relaxed lending terms allow them to focus on their business without being distracted by creditor demands. But it is important for borrowers to use this breathing room wisely and to address any liquidity or other financial problems early. If a company waits until it runs out of money, it will have limited options and may be forced to file for bankruptcy. On the other hand, by addressing problems early, the company may be able to explore alternatives to a formal restructuring.

The first step that many troubled companies often take too late is consulting with restructuring professionals. When legal and financial advisers are involved sufficiently early, they can assist companies and private equity sponsors on a wide range of critical issues and decisions, including getting a handle on the cash needs of a business, developing a viable operational and/or financial restructuring plan, exploring strategic transactions or assessing the advisability of infusing capital in the business.

Conclusion

Recent developments in the lending market combined with the 2005 amendments to the Bankruptcy Code will no doubt have an impact on restructuring dynamics, and although the nature and extent of these changes remain unclear, it seems likely that achieving a successful restructuring will be an increasingly contentious challenge. One thing is certain: In the future as in the past, restructurings will continue to be about enterprise value—how to reconcile different views on value and how best to preserve that value. ■

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Are You a Forthright Negotiator?

The opinion recently handed down by the Delaware Chancery Court in the much talked about *United Rentals* case—one of the first to be decided in an ever growing list of debt crisis fueled broken deals—contains a number of lessons for dealmakers, the most significant of which is that what you don't say in merger negotiations may prove to be every bit as important as what you do say. This article briefly summarizes the case, and then discusses a few key takeaways for private equity professionals, bankers and lawyers who regularly analyze, negotiate and document these transactions.

Background

On July 22, 2007, affiliates of Cerberus Capital Partners, L.P. signed a merger agreement to acquire United Rentals, Inc. for $34.50 per share. On August 29, 2007 citing the deteriorating credit markets, Cerberus sought to renegotiate the terms of the transaction with United Rentals, but United Rentals refused. On November 14, 2007 Cerberus informed United Rentals that it did not intend to consummate the transaction and invited United Rentals to either negotiate revised deal terms or accept payment of the $100 million reverse termination fee. United Rentals declined this invitation and filed suit five days later in the Delaware Chancery Court seeking an order to force Cerberus to "specifically perform" its obligation to close. Cerberus responded not by disputing whether it was in breach of its obligation to close, but by asserting that its liability was limited to payment of the reverse termination fee and that the merger agreement did not provide for a specific performance remedy.

In an opinion that begins by likening the dispute to the mythical battle between Heracles and the beastly three-headed dog from which Cerberus takes its name, the Delaware court sided with Cerberus and rejected United Rentals' plea for specific performance. In doing so, it invoked the "forthright negotiator" principle to determine that the parties did not intend for United Rentals to have the ability to force Cerberus to close, but rather that Cerberus was entitled to pay the $100 million reverse termination fee and walk away from the deal.

The Importance of Being Forthright

The *United Rentals* case would not have come to pass if the merger agreement between United Rentals and affiliates of Cerberus had unambiguously stated the parties' agreement on the topic of specific performance. Traditional specific performance provisions permit a party to an agreement to seek an order from a court requiring the other party to perform its obligations under that agreement, as an alternative to simply seeking monetary compensation for a breach. Specific performance provisions did not get much attention in the LBO context until the recent demise of financing conditions and the related emergence of reverse termination fee provisions.

The interplay between these two provisions in the United Rentals merger agreement—one providing for the payment of a reverse termination fee as an exclusive remedy and the other providing for specific performance—was the focus of the case. The court found the two provisions as drafted to be irreconcilable on their face and so looked to external evidence to discern the parties' intent. Concluding that the negotiating history on the issue was "muddled" and "ultimately not conclusive," the Delaware court turned to the "forthright negotiator principle" to determine whether the parties intended that United Rentals' sole remedy for Cerberus' failure to close would be payment of the termination fee (which, in effect, would provide Cerberus with a $100 million option). Under the forthright negotiator principle, when a contractual provision is ambiguous and the external evidence does not reveal an express meeting of the minds, the subjective understanding of one party may bind the other party if the other party knows or has reason to know of that understanding and does not convey its contrary interpretation.

Testimony at trial revealed that the specific performance provisions in the United Rentals merger agreement were hotly contested from the outset of the negotiations, with United Rentals initially taking the position, reflected in the auction draft, that the reverse termination fee should not be United Rental's sole remedy in the event of a breach, notwithstanding the use of that approach in a number of precedent transactions. Ultimately, however, United Rentals agreed to Cerberus' proposed changes. When Cerberus' counsel explained his view that the modified language prohibited United Rentals from seeking specific performance, United Rentals' lawyer responded "I get it." However, when a Cerberus managing director mentioned to United Rentals' financial adviser that the deal was structured as an option, the adviser insisted that his client would never agree to such an arrangement. But, the next day, having received a report on that conversation, United Rentals nonetheless signed the contract without any changes to Cerberus' language.

On the basis of these and similar communications, the Delaware court concluded that United Rentals knew or should have known that Cerberus thought it had an option and that if United Rentals had a different view, it had an affirmative duty to convey such view to Cerberus. Under the forthright negotiator principle,

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this was sufficient to bind United Rentals to Cerberus' interpretation of the agreement.

Given that this point appears to have been one of the central and most heavily negotiated issues in the deal, why did United Rentals fail to rebut Cerberus' interpretation if it did not intend to give Cerberus an option? One explanation, borne out by the decision's portrayal of Cerberus as a reluctant suitor from the earliest days of the auction: United Rentals was convinced that Cerberus would not proceed with the transaction if it was subject to a specific performance remedy and, feeling the initial tremors of the disruption in the credit markets, decided a calculated retreat was required to get the deal signed up. The ambiguous specific performance language in Cerberus' redraft of the merger agreement provided a welcome opportunity to "fight another day".

In any event, the *United Rentals* case serves as a useful reminder that the on-going dialogue between the parties during a deal can matter greatly, and that silence can prove as meaningful as a fully articulated position. Careful drafting is, of course, of equal or greater importance, but it would be dangerous to underestimate the ability of an army of litigators to find (or manufacture) ambiguity to open up a dispute to a review of the negotiating history. For this reason, what is communicated in negotiating sessions, sidebars and email exchanges, whether involving lawyers, bankers or clients, can carry great weight in shaping a court's understanding of a disputed contract. The timing and content of such communications—as well as any response to them—should therefore be carefully thought through (and in some cases discussed in advance with counsel).

... [I]t would be dangerous to underestimate the ability of an army of litigators to find (or manufacture) ambiguity to open up a dispute to a review of the negotiating history

The forthright negotiator principle has rarely been applied in interpreting contracts, and will likely be confined to cases in which (i) the court is otherwise unable to discern the parties' intent and (ii) the totality of evidence indicates that the silent party intended to assent to the vocal party's position. But dealmakers should be aware that in certain circumstances they may be held to a vocal counterparty's interpretation of an ambiguous provision if they do not convey their contrary view.

Choice of Courts Matters

This case also illustrates why M&A practitioners in the United States are increasingly pushing to have the agreements they negotiate subject to the exclusive jurisdiction of courts in Delaware. First, it is an example of the striking speed with which the Delaware Chancery Court is able to process complex disputes. United Rentals filed its initial complaint on November 19, and by December 21 the court had heard and denied a motion for summary judgment, conducted a trial and issued its opinion.

Second, the opinion—even without its literary bravado—exhibits a level of sophistication and understanding of the reasons deals are done, and the process for getting them done, that significantly increases the likelihood that the outcome of a dispute will be consistent with the parties' expectations. While it is difficult to say with certainty that Cerberus and United Rentals got the outcome they would have predicted when they signed the merger agreement, the evidence suggests that they probably did.

* * *

The *United Rentals* saga is of interest to M&A professionals for a number of reasons. The central lesson, though, is one we all probably should have learned in college or graduate school, if not pre-school—in deals, as in life, good communication is imperative. In this case, clear, consistent oral communication allowed Cerebrus to exercise the option it had bargained for, which was to be able to leave United Rentals at the altar upon payment of a predetermined fee, although poor written communication (in the form of suboptimal drafting) forced it into painful litigation to secure its freedom. ■

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Reform of the English Financial Assistance Regime

The whitewash procedures that have been a fixture of private equity financing in the UK are about to be consigned to the history books. Forthcoming changes to English "financial assistance" rules will facilitate leveraged acquisitions of private English companies and are a welcome development for private equity sponsors and their lenders. The changes are part of the comprehensive amendment of English company law and will become effective in October 2008.

The Current Regime

By way of background, "financial assistance" rules restrict and can, in some instances, prohibit use of the target's assets as security. The legislation as currently in effect prohibits the giving of "financial assistance" by an English company (or any of its English subsidiaries) for the acquisition of shares in such company. It also prohibits an English company (or any of its English subsidiaries) from giving "financial assistance" for the purpose of discharging a liability originally incurred to acquire shares in such company.

Financial assistance includes assistance by way of guarantee, security, indemnity or loan, and is broadly defined to include "any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets." Accordingly, the current financial assistance regime restricts English companies from, for example, giving guarantees and security to support debt incurred to purchase shares in themselves or in their parent companies. It also restricts upstream loans made to service or repay acquisition debt.

Failure to comply with the English "financial assistance" rules can have draconian consequences, including criminal liabilities for the directors involved and unenforceability of any guarantees, security or loans given in breach of their requirements and in some circumstances the illegal "financial assistance" may also taint connected transactions. The restrictions must therefore be carefully considered in the context of any share acquisition where the target or one of its subsidiaries is an English company, and financial assistance issues will generally arise if the target or one of its subsidiaries is giving guarantees or security or making loans to support acquisition debt.

If only private (as opposed to public) limited companies are involved, "whitewash" procedures are generally utilized to sanction otherwise illegal financial assistance so long as the assisting company has positive net assets. However, those procedures are time-consuming and complex, and their availability depends, not only on the financial position of the English companies involved, but also on the willingness of the directors and auditors of the relevant English target companies to go through the procedures and give the confirmations and declarations they require.

The Need for Reform

When the Company Law Review Steering Group considered reforming legislation back in November 2000, it noted that the absence of financial assistance regulations in other markets, including the United States, had not been problematic. In any event, other English legislation protects against some of the abuses at which the financial assistance restrictions are aimed, including the law on directors' fiduciary duties (which law has been codified and revised by the Companies Act 2006), English insolvency legislation and legislation on market abuse.

English law financial assistance restrictions have rarely made transactions "unbankable," because the whitewash procedure is usually available or, if it is not, it is often possible to structure transactions around the restrictions. Nevertheless, they have had the following principal disadvantages:

- considerable costs are often incurred obtaining legal and accountancy advice and assistance with the implementation of the financial assistance whitewash;
- large amounts of management time can be taken up as directors of target companies carry out the financial due diligence necessary to enable them to give the formal declarations the whitewash procedure requires;
- complicated structures are often necessary to avoid financial assistance restrictions;
- if financial assistance restrictions restrict the security and guarantees that lenders can obtain or delay them from obtaining such security or guarantees, such lenders may impose increased

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... [F]rom October 1, 2008, financial assistance restrictions will no longer apply where English private companies assist the acquisition of shares in their private company parents.

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financing fees or interest rates to compensate them for the increased risks they are taking; and

- some transactions have had to be delayed to enable legal and accounting diligence to take place.

Given the above disadvantages, the serious consequences of breach of the prohibition and the existence of other legislation that provides some protection against the concerns designed to be addressed by the financial assistance prohibition, the financial assistance rules have long been ripe for reform.

Reform

The Companies Act 2006 is the largest statute ever to be enacted in the UK, a traditionally common law jurisdiction. While many of its 1,300 sections are consolidations of modifications made to the Companies Act 1985 over the last 20 years, the statute also makes a number of significant changes to English company law. Among the most notable for the private equity community is the removal of the prohibition on financial assistance for private companies (other than subsidiaries of public companies). The provisions amending the current financial assistance legislation are scheduled to come into force on October 1, 2008. Accordingly, from October 1, 2008, financial assistance restrictions will no longer apply where English private companies assist the acquisition of shares in their private company parents. This change has been almost universally welcomed by lenders and borrowers alike and should greatly simplify the legal and financial analysis in the context of most debt financed acquisitions of English private limited companies.

The new legislation makes it clear that the repeal of some of the existing financial assistance restrictions does not effectively revive common law restrictions on financial assistance and so prohibit transactions that could now be lawfully entered into under the whitewash procedure. Some have therefore speculated that lenders will require additional contractual protections to ensure that financial assistance is not given absent lender consent or without additional financial due diligence being carried out since companies giving assistance will no longer be required to go through the whitewash procedure with its attendant diligence. However, we think this unlikely given that the lack of a whitewash procedure in other jurisdictions has not led to the imposition of additional protections of this nature.

Public Company Prohibition Remains

Under the Companies Act 2006 there will, as required by European law, remain a financial assistance prohibition with respect to public limited companies (which include all public limited companies or "plcs" and not just listed companies). That prohibition is essentially the same as the one that currently applies to public companies and prohibits financial assistance given, by private or public companies, for the acquisition of shares in public limited companies and financial assistance given by public limited companies for the acquisition of shares in their private parent companies. As under the current regime, there is an exception to the prohibition on financial assistance if the company's principal purpose is not to give the assistance for the purpose of the acquisition or if it is given only as an incidental part of some larger purpose of the company, so long as the assistance is given in good faith in the interests of the company. However, as under the current regime, no "whitewash" procedure is available with respect to public companies.

Therefore, with respect to public to private transactions, English companies in the target group still will not be able to give financial assistance with respect to debt used to acquire shares in a public target company until such time as that public target company has been re-registered as a private company. Those versed in UK public to private transactions will recall that converting a public target to a private company requires, amongst other things, a resolution of those holding 75% of the voting stock. Accordingly, there will continue to be a delay after completion of public to privates before target group guarantees and security to support acquisition debt can be provided, although once re-registration as a private company has taken place, financial assistance can be given beginning October 1st without a whitewash procedure.

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... [T]here will, as required by European law, remain a financial assistance prohibition with respect to public limited companies (which include all public limited companies or "plcs" and not just listed companies).

GUEST FEATURE

Should Your Child Take a Job in Private Equity?

Classified ad in *The Wall Street Journal*:

Help Wanted (1a): Senior private equity executive. Exciting global opportunity to join highly talented, multidisciplinary team to invest in large-scale buyouts in leading industries. Live in New York or London. First class air travel and top-flight restaurants. Savile Row tailoring a must. Meet and develop relationships with top investment bankers and chief executives. Remuneration commensurate with experience and successful performance record.

Help Wanted (1b). Senior private equity executive. High-pressure opportunity in brutally competitive environment with too much money chasing too few deals. Live anywhere since you will rarely be at home. Anticipate travel to underserved locations on regional airlines using 30-year old turboprops. Think Dunkin Donuts, Burger King, Bud Lite and Motel 6. Opportunity to meet frustrated corporate development vice presidents, to draft documents with dozens of grumpy lawyers who have not slept in a week, and to negotiate covenant packages with irritable bankers who will not be paid bonuses this year. Expect to be the whipping boy of the media for all the ills of the economy, real and imagined. Remuneration based on a roll of the dice.

Important note: Successful applicant must expect to fill both of the above-mentioned jobs simultaneously; the first job is not available without the second

The private equity community has had its share of challenges over the last nine months. While many were thrilled that the focus of the recent Davos World Economic Forum meetings were on sovereign wealth funds rather than private equity, others were busy attending a session entitled "What Job Should My Child Take in a Globalizing Economy." That got us to wondering: given how much the climate for private equity investing has changed over the last two decades, is private equity still a desirable career for young people? We decided to poll a few of our friends in the industry to find out if they would recommend it to their own children.

Here is what they had to say:

Nate C. Thorne

President
Merrill Lynch Global Private Equity

Buying, guiding, nurturing and selling businesses is, and will continue to be, a thoroughly rewarding career. As the world's economies continue to become more and more connected and as the developing part of the world evolves into a large part of the developed world, many of the macro trends are directionally predictable. Historical, political and cultural sensitivity will become even more important for our children. Therefore, study the history of China and India, for example. Learn to speak Mandarin. But, continue to get early business training in investment banking and strategic consulting firms.

Colin C. Blaydon

Director
Center for Private Equity and Entrepeneurship
Tuck School of Business

I believe this is a good time for young professionals to enter the private equity sector. PE has grown enormously. For the first time there are entry-level jobs with clear career paths, and while the "deal" professional is still the key position it is not the only opportunity. Today there are professional PE positions in operations, due diligence, fund raising, public relations, investor relations, risk management and human resources. These jobs require diverse backgrounds and training. There are also attractive new opportunities in organizations that invest in and provide services to private equity. For a young person interested in PE, and our MBAs in particular, the opportunities have never been so broad, but landing these very competitive jobs still requires passion, perseverance, patience and (extensive) preparation.

Jean Eric Salata

CEO
Baring Private Equity Asia Ltd.

I would wholeheartedly recommend that my children pursue a career in private equity, or to be more precise, Asian private equity. My kids are still young, and I have enrolled them in Chinese local school in Hong Kong rather than send them to international school; this way they will be fluent in reading, writing and speaking Chinese, which will be an essential success factor for Asian private equity investors in twenty years. I think private equity is one of the best jobs a young professional can have. Aside from having the potential to be financially rewarding over the long run, in terms of job satisfaction it puts you in direct contact with incredibly talented, entrepreneurial and successful people, and enables you to have a real, measurable impact in building a businesses. Private equity is an apprenticeship business where investment judgment and deal making nuances are learned through experience. The best way to prepare for a career in the field is to find a way to get your foot in the door of an established firm as early as possible in your career and to learn the business from the ground up.

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Should Your Child Take a Job in Private Equity? (cont. from page 11)

Donald J. Gogel

President and CEO
Clayton, Dubilier & Rice, Inc.

In 1990, when I spoke to about 700 students at the Harvard Business School, I noted that the entire private industry employed only a few thousand professionals and I predicted less than 30 students in the audience would find employment with a buyout or venture capital firm. Buyout firms in that era were small, loosely organized and highly entrepreneurial. When CD&R raised its first billion dollar fund (and still had under ten professionals), it was in a group of only five firms that had such a stupendous amount of capital under management. Only a handful of investment banks (led by Drexel Burnham) were able to finance billion dollar transactions and with Drexel's fall, the LBO business went into hibernation for a few years. Our Lexmark acquisition from IBM in 1991—at $1.5 billion— was probably the largest LBO of the year and required a consortium of non-U.S. banks and mezzanine lenders. I suggested to the students that to be great investors they might productively gain experience with "real businesses" that make, sell and finance products on a global basis.

In 2007, about 17% of the graduating class at HBS joined a private equity firm. Some PE firms now employ over 500 professionals and many have offices around the world. Many firms are highly institutionalized, with internal specializations organized by industry, and they have become increasingly hierarchical. Many students joining these firms expect—with reason—that they will receive broad deal exposure for a few years, but do not expect to progress through the ranks to the senior levels of ownership and management. Joining a private equity firm is now a legitimate career path. It often can be exciting and for the best performers it can be highly rewarding. It's a great industry to start a career, but the excitement and energy of the entrepreneurial era is gone, at least in the major developed economies. And, I still believe that real world experience away from the rarified world of private equity (and ideally with a few stints in Europe and Asia) can form an exceptional foundation for would-be private equity investors.

Frank T. Nickell

President, CEO and Chairman
Kelso & Company

Would I recommend that my children work in private equity? Working in this field has been extremely gratifying and stimulating for me, and I would not hesitate to recommend it to my children. Obviously, this would be dependent on it being a field in which they have an interest and the requisite skills.

The question of how should they prepare in an increasingly complex and global PE scene is somewhat more complex. I think that they should learn basic accounting skills (so that they can read and understand basic financial statements). They should study finance, some basic business law, and economics. Also, they need to learn to write and speak accurately and clearly. (Accurately means good grammar and use of proper vocabulary; clearly means doing so in a manner that is easily understood by the reader or listener… short, choppy sentences help to accomplish this.) In today's world, it is important to be good at not only math, probability and statistics, but also to be very facile with the computer.

By the way, the disciplines listed above will prepare someone for many careers other than private equity.

Russell W. Steenberg

Managing Director
BlackRock, Inc.

What is a good model or path for a young talented person aspiring to a career in private equity? There is no one way. However, this is my prescription. Get a great liberal arts education that teaches you to think so that you can challenge arguments and conclusions in an analytical manner. Show through work experiences a sense of entrepreneurship and the ability to take risk. Find that first job that allows you to learn about business, organizations and further trains your analytical thinking. Leverage these skills and experiences into a private equity entry-level position with a fund or a fund of funds. After four or five years go to the best business school you can get into. With this kind of background sell yourself very hard to the private equity world using every contact you have developed. The road is hard, frustrating and few succeed. But for the ones who get there, the career prospects are wonderful.

Tom U.W. Puetter

CEO
Allianz Capital Partners

In any career decision three fundamental factors are key in the decision process of what suits somebody best as a career:

1. Natural interest in the topic
2. Natural aptitude
3. Relevant skill set

The biggest mistake is to engage on a career for the wrong motive. Wrong motives may be because you seek above average compensation or because you think a particular activity is especially fashionable or carries kudos. It is important, therefore, that a career choice

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ALERT

Euronext Launches New Private Equity Index

Yet another convergence of the public markets and private equity is in its infancy. The launch by the NYSE Euronext of an index of listed private equity vehicles on Valentine's Day 2008 is another step in the "retailization" of private equity. The NYSE Euronext's stated intention for creating the index is to raise the profile of private equity among retail investors and of its exchanges in Paris, Amsterdam and Brussels with private equity funds considering a listing.

While arguably not the ideal moment for the launch of a private equity index, any retail marketing initiative for private equity listings is welcome news to those focused on attracting retail investors to the asset class. The credit crunch and stock market volatility of recent months have combined to negatively impact the market for new listings of private equity funds. Meanwhile, the falling share prices of most listed funds have severely dampened the kind of investor enthusiasm that permitted KKR Private Equity Investors, for example, to raise $5 billion when it listed its feeder fund on Euronext Amsterdam in early 2006.

Euronext is trying to do more than catch the eye of retail investors; it is also jockeying to attract private equity firms that are likely to go public when the markets stabilize. In 2007, Euronext's Amsterdam board managed to prevail over the London Stock Exchange in attracting a number of high-profile funds of funds equity fund launches, including the offerings by Lehman Brothers and Conversus Capital last summer. Since the UK's Financial Services Authority has recently been busy reforming its listing standards in order to better compete with Amsterdam, Euronext is obviously watching carefully. In particular, Euronext must be worried that the reforms will make it easier to list alternative investment entities on the London Stock Exchange, where liquidity tends to be higher than on the Euronext exchanges.

Apart from serving as an opportune marketing tool for Euronext and its listed private equity vehicles, the index is designed to increase visibility of the relative performance of a number of European private equity funds. A significant number of the initial index members are in fact off-shore closed-ended feeder funds set up to invest in the affiliated private equity funds managed by their parent entities. In theory, these listed funds should also constitute a relatively accurate proxy for the performance of their parents' funds (which can be difficult to benchmark because of their limited public disclosure and investment periods).

The index, which will start out solely as a benchmark index but may eventually become tradable, will initially be made up of fourteen private equity companies listed on the Euronext boards. In order to qualify for inclusion, funds will need to have a minimum market capitalization of 300 million and invest more than two-thirds of their contributions in private companies. No single fund will be permitted to account for more than 15% of the index.

Critics will undoubtedly claim that the criteria for including a private equity vehicle in the index is not appropriate. Indeed, the pool of companies included in the index are so diverse in terms of investment strategies and structure that their benchmarking value may be limited. Nonetheless, the broad definition of private equity accurately reflects the growing use of the term in Europe to include not only classic private equity funds but also a large number of vehicles with limited external fundraising and much longer investment horizons that only recently were considered family-controlled holding companies, such as France's Eurazeo SA and Wendel Investissement SA.

In any event, the launch of the Euronext index is a positive sign that Euronext, like the London Stock Exchange, is preparing to attract listed funds when the market stabilizes and investors return to the market. There are, of course, many open questions, including how quickly market conditions will move to facilitate the access for private equity firms to the deep and permanent pool of capital that listed funds offer, how long it will take to restoke retail investors' enthusiasm in this route to investing in private equity and, most importantly, how accurately the benchmark will reflect private equity performance. ■

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Gabriel Weiss
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Funds Included in Euronext Index

- Conversus Capital (of Conversus Asset Management LLC)
- AP Alternative Assets (of Apollo Management LP)
- Wendel Investissement SA
- HarbourVest Global Private Equity Ltd. (of HarbourVest Partners LLC)
- Eurazeo, KKR Private Equity Investors LP (of Kolberg Kravis Roberts & Co.)
- Lehman Brothers Private Equity Partners Ltd. (of Lehman Brothers Inc.)
- Hal Trust
- Ackermans van Haaren
- GIMV NV
- Compagnie du Bois Sauvage SA/NV RHJ International (of Ripplewood Holdings LLC)
- Altamir Amboise SCR (of Apax Partners SA)
- Financière Moncey SA (of the Rivaud group, which is controlled by Vincent Bolloré)

Recent and Upcoming Speaking Engagements

January 9
Gregory V. Gooding
Drafting Corporate Agreements 2008
Stockholder Agreements
PLI New York Center
New York

January 18
David A. Brittenham, Co-Chair
Private Equity Acquisition Financing Summit 2008
Private Equity Financing Today; Dealing with Existing Public Debt
PLI New York Center
New York

January 18
Gregory H. Woods, III
Private Equity Acquisition Financing Summit 2008
Recent Developments and Trends
PLI New York Center
New York

January 25
Steven J. Slutzky
Spinoffs: Learn the Advantages, Strategies, and Why Companies Should Do Them, Especially in a Difficult Financing Market
The Basics of Spin-offs
New York

February 8
Michael P. Harrell
Private Equity Conference
Limited Partner/Investor Panel
Stern (NYU Business School)
New York

February 9
Gregory V. Gooding
Drafting Corporate Agreements 2008
Stockholder Agreements
New York

February 12
Heidi A. Lawson
Zurich International Directors and Officers Conference
Does Your Global Directors and Officers Policy Stand Up Locally?
Bloomberg News Center
New York

February 24-27
Stuart Hammer
2008 SME Annual Meeting and Exhibit
Analyzing and Allocating Environmental Risks in Acquisitions
Salt Lake City

February 28
Michael J. Gillespie
Latin American and North American Regional Conference
Capital Markets/Private Equity: What Is Happening in the Private Equity Market?
Mexico City

February 28
Gregory V. Gooding
NYU Journal of Law and Business Symposium
Private Equity's Current Challenges and Their Impact on Future Transactions
New York University School of Law
New York

February 28
Michael P. Harrell, Heidi A. Lawson, Robert F. Quaintance, Jr.
Protections Against the Enhanced Risks Faced By Alternative Asset Managers Today
Debevoise & Plimpton LLP
New York

February 28-29
Franci J. Blassberg
23rd Annual Advanced ALI-ABA Course of Study on Corporate Mergers and Acquisitions
Special Problems When Acquiring Divisions and Subsidiaries and Negotiating the Acquisition of the Private Company
Scottsdale Plaza Resort
Scottsdale

March 6-7
Jonathan J. Rikoon
ACTEC 2008 Annual Meeting
FLP/LLC Checklist and the Model LLP Operating Agreement
Boca Raton

March 6-7
My Chi To
The Distressed Debt Conference 2008
Section 363 Sales in the Next Downturn
The Hilton Hotel
New York

March 12
Rebecca F. Silberstein
Doing Deals 2008: Understanding the Nuts and Bolts of Transactional Practice
The Role of Private Equity Deals and Investment Bankers
PLI Conference Center
New York

March 27
Keith J. Slattery
Nuts and Bolts of Managing a Private Equity or Venture Capital Firm
Discussion Panelist
University Club
New York

Looking for a past article?

A complete article index, along with all past issues of the *Debevoise & Plimpton Private Equity Report*, are available in the "publications" section of the firm's website, www.debevoise.com.

Loosening the Ties: Amendments to Rule 144 and Rule 145

In an admittedly challenging time for the private equity community, there is at least a little good news for private equity firms holding restricted securities (*i.e.*, securities acquired in transactions not involving a public offering). Rule 144, the principal source of liquidity for sales of those securities into the markets by affiliates of public issuers, including private equity investors and management, has been liberalized and should make it easier to dispose of non-registered securities of public companies. Rule 145 has also been amended in a manner which may provide enhanced liquidity to sponsors in connection with registered securities acquired in certain public company mergers.

Overview of Rule 144 Amendments

The amendments to Rule 144, which became effective on February 15, 2008, shorten the holding period requirements applicable to resales of restricted securities, drawing a distinction between issuers who have been subject to the SEC's Exchange Act reporting requirements for at least 90 days before the Rule 144 sale ("reporting issuers") and non-reporting issuers. In the case of reporting issuers, the holding period is six months and, in the case of non-reporting issuers, the holding period is one year. Note that issuers who comply with the SEC's reporting requirements on a voluntary basis are considered non-reporting issuers under the amended rules. This includes many private equity portfolio companies that file with the SEC on a voluntary basis pursuant to an indenture covenant entered into in connection with a 144A offering of debt.

Prior Rule

Under the prior rule, no resales of restricted securities were permitted under Rule 144 during a one-year holding period. Thereafter, affiliates and non-affiliates were permitted to sell limited amounts of restricted securities subject to the other conditions imposed by Rule 144. After two years, non-affiliates could sell such restricted securities freely without being subject to any of the conditions of Rule 144 whereas affiliates of the issuer continued to be subject to the conditions of Rule 144, including volume limitations, adequacy of current public information, manner of sale requirements and the filing of a Form 144.

New Rule—Non-Affiliates

The amended rules continue to distinguish between non-affiliates and affiliates of the issuer. But, as noted above, the new rules also make a key distinction between SEC reporting issuers and non-reporting issuers. Now, non-affiliates who hold restricted securities of reporting issuers for a period of at least six months can make unlimited resales under the rule, subject only to the requirement that the issuer is current in its public reporting requirements. In the case of non-reporting issuers, non-affiliates are subject to a one-year holding period during which no resales of restricted securities are permitted under Rule 144. For both reporting and non-reporting issuers, after one year, no restrictions of any kind apply under Rule 144 to sales by non-affiliates.

New Rule—Affiliates.

The new rules are less liberating to affiliates. While affiliates benefit as much as non-affiliates from the shortened six-month holding period for resales of securities of reporting issuers and the one-year holding period for securities of non-reporting issuers, affiliates are not able to resell their restricted securities freely after satisfying the holding periods. Instead, after the expiration of the applicable holding period for restricted securities, affiliates must comply with the conditions of Rule 144, including volume limitations, adequacy of current public information, manner of sale requirements (for equity securities) and the filing of a Form 144.

The following chart summarizes the application of these amendments:

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	Affiliate	Non-Affiliate
Reporting Issuers	**During six-month holding period** no resales under Rule 144 permitted. **After six-month holding period** may resell subject to all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements (for equity securities), and • Filing of Form 144	**During six-month holding period** no resales under Rule 144 permitted. **After six-month holding period but before one year** unlimited public resales under Rule 144 except that the current public information requirement still applies. **After one-year holding period** unlimited public resales under Rule 144. No additional Rule 144 requirements.
Non-Reporting Issuers, including Voluntary Filers	**During one-year holding period** no resales under Rule 144 permitted. **After one-year period holding period** may resell subject to all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144	**During one-year holding period** no resales under Rule 144 permitted. **After one-year period holding period** unlimited public resales under Rule 144. No additional Rule 144 requirements.

Loosening the Ties: Amendments to Rule 144 and Rule 145 (cont. from page 15)

Other Amendments

The SEC also amended the manner of sale requirements for resales of equity securities of affiliates, eliminated the manner of sale requirements for resales of debt securities, increased the volume limitations for debt securities, amended the threshold requirements for filing a Form 144 and codified a number of previously issued Staff positions (*e.g.*, regarding the tacking of holding periods in certain contexts).

Overview of Rule 145 Amendments

Under the prior version of Rule 145, parties (other than the issuer) and affiliates of parties to certain business combinations such as mergers, that are subject to a shareholder vote, were deemed to be underwriters with respect to the securities acquired in the transaction. As a result, the acquired securities were subject to Rule 144-type restrictions on transfer. The amendments to Rule 145 eliminate this presumptive underwriter provision in Rule 145 (except in connection with transactions by shell companies other than business combination shell companies). As a result, shares acquired by non-affiliates of the issuer in a registered merger transaction can be resold without restriction under Rule 144 after the closing of the merger.

Impact of the Amendments

Rule 144A Debt Offerings

Historically, purchasers of 144A high yield debt securities required registration rights from bond issuers. For the issuers, these registration rights have involved effecting a registered exchange offering with respect to the 144A securities within a negotiated period of time post closing (an "A/B exchange offer") and providing a resale shelf registration for specified parties who could not participate in the A/B exchange offer. Under the Rule 144 amendments, bond holders will now be able to transfer these securities freely no later than one year after issuance (or six months after issuance if the issuer is a reporting issuer and in compliance with its Exchange Act reporting requirements). This has lead to debate about whether the current regime for registration rights in connection with high yield debt offerings will remain intact. In analyzing this issue, it is important to distinguish between the two categories of issuers: reporting and non-reporting. For reporting issuers, the new holding period of six months may well provide investors sufficient liquidity such that they will no longer need registration rights, although investors will likely require the issuer to covenant to remain current with its Exchange Act reporting for at least one year after the issuance of the applicable notes. In the private equity context, however, most bond issuers are likely to be non-reporting issuers since these types of bonds typically are issued by a private company as part of the acquisition financing. In these cases, the holding period will be one-year, not six-months. Some have suggested that the one year holding period is also short enough to obviate the need for registration rights, and that the 144A debt market will evolve to a private, or 144A, for life regime. However, some investors are likely to see significant benefits from registration beyond enhanced liquidity, such as requiring the bond issuer to become subject to SEC Exchange Act reporting and applicable Sarbanes-Oxley requirements, and SEC oversight. For these reasons, A/B exchanges and resale shelf registration requirements will likely continue to be important to bond purchasers in many deals.

Equity Registration Rights Agreements

In most leveraged buyouts, the sponsor and management stockholders of the portfolio company enter into a registration rights agreement providing the sponsor and management with registration rights following, and in some cases in connection with, an IPO of the portfolio company. The amendments to Rule 144 raise the question of whether, given the accelerated liquidity (90 days post-IPO if the management stockholder has held the shares for six months and the Company is in Exchange Act reporting compliance), it makes sense to continue to provide non-affiliate management stockholders with contractual registration rights, particularly given the administrative cost to the sponsor/issuer of providing such rights.

In some cases, the new rules may enable sponsors not to provide contractual registration rights to non-affiliate management stockholders. Still, there are several reasons why nonaffiliate management stockholders may continue to request and receive registration rights in many deals. First, bifurcating members of management based on their affiliate status could create unnecessary issues among members of a management team which the sponsor might prefer to avoid, particularly during the delicate negotiation associated with cutting a management equity deal. Second, the non-affiliated management stockholders may desire the marketing and pricing benefits offered by an underwritten registered offering, as compared with a sale under Rule 144, notwithstanding the associated underwriter discount. What's more, some sponsors may prefer to have non-affiliate management stockholders sign a registration rights agreement for their own reasons. For instance, by providing registration rights to all members of the management team, the sponsor readily obtains holdback protection from the entire management team, something that they

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Walker Report Stalls Treasury Regulation of UK Private Equity—But for How Long?

Large segments of the UK private equity industry have embraced voluntary disclosure guidelines recently adopted by the British Venture Capital Association (BVCA) that it is hoped will forestall possibly more stringent government regulation of the industry.

In March 2007, in response to increased public scrutiny of private equity ownership and "take private" transactions, the UK Treasury Committee announced that it was initiating an inquiry into private equity with transparency in financial markets as a primary theme. To preempt the Treasury action, the BVCA and a group of private equity firms engaged Sir David Walker, a Senior Advisor at Morgan Stanley International, former Executive Director of the Bank of England and a widely respected member of the English financial community, to undertake an independent review of transparency and disclosure in private equity with a view to developing voluntary guidelines for private equity firms and their large portfolio companies. The Walker Report (strictly, the "Final Guidelines for Disclosure and Transparency in Private Equity") was published in December and after its adoption by the BVCA quickly captured many prominent UK private equity adherents.

Which firms and companies are affected?

The Walker Report does not cover all private equity transactions in the UK. The guidelines apply to certain private equity firms ("Private Equity Firms") and to certain companies with significant operations in the UK ("Portfolio Companies"):

- **Private Equity Firms:** These are private equity firms authorized by the UK Financial Services Authority ("FSA") which manage or advise one or more funds that either own or control (or have a designated capability to engage in investment activity in the future that might result in their owning or controlling) Portfolio Companies.
- **Portfolio Companies:** These are companies that have more than 1,000 full-time equivalent UK employees; generate more than 50% of their revenue in the UK; were acquired by one or more private equity firms through a public to private transaction or a secondary or other non-market transaction; and have an enterprise value in excess of £500 million at the time of acquisition (or in the case of a company acquired through a take private transaction, £300 million in market capitalization and acquisition premium).

What is not completely clear from the report is whether the guidelines are to apply to all companies satisfying the above criteria held by private equity funds or only those held by private equity funds that are managed or advised by Private Equity Firms. This distinction may have little significance in practice as we suspect most private equity funds that have the capacity to acquire large UK companies to which the guidelines apply are likely to be advised by or managed by a private equity firm which is authorized by the FSA.

Compliance Mentality

The Walker Report contemplates a "comply or explain" approach to the detailed guidelines. It also makes specific recommendations to the BVCA on how it should improve its operations and better represent buyout firms.

Reporting Guidelines: Private Equity Firms

Private Equity Firms are supposed to publish, either in the form of an annual review (within four months of their year-end) or through regular updating of their websites, a description of their own structure and investment approach and of the large UK companies in their portfolios, an indication of the leadership of the firm in the UK and confirmation that arrangements are in place to deal with conflicts of interest; a commitment to conform to the guidelines on a comply or explain basis; and a categorization of their limited partners by geography and by type. They should also commit to following the International Private Equity and Venture Capital Valuation Guidelines and other relevant guidelines. At a time of strategic change in respect of a Portfolio Company, for example, when the Portfolio Company is rolling out a new strategic initiative which could involve downsizing or expansion, the Private Equity Firm is to ensure timely and effective communication with employees, either directly or through the portfolio company, as soon as confidentiality constraints are no longer applicable.

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The question is whether the Walker Report goes far enough in providing a transparency regime for private equity firms and their portfolio companies to assuage the regulatory impulses of Gordon Brown's government.

Walker Report Stalls Treasury Regulation of UK Private Equity (cont. from page 17)

Reporting Guidelines: Portfolio Companies

The voluntary reporting guidelines also provide for Portfolio Companies to publish their annual report and accounts on their website within six months of their year-end. Such reports are to include:

- the identity of the private equity fund or funds that own the Portfolio Company;
- the senior managers or advisers who have oversight of the fund or funds;
- detail on the composition of the Portfolio Company's board;
- a business review that substantially conforms to the director's business review report contemplated under section 417 of the UK Companies Act 2006 for quoted companies, which calls for, among other things, a fair review of the company's business and risks, and the uncertainties facing the company and an indication of the main trends and factors likely to affect the future development, performance, and position of the company's business, including information on the company's employees, environmental matters, and social and community issues; and
- a financial review to cover risk management objectives and policies in the light of the principal financial risks and uncertainties facing the company, including those relating to leverage.

In addition, the reporting guidelines require that Portfolio Companies publish a summary mid-year update no later than three months after mid-year giving a brief account of major developments in the company and provide data to the BVCA in support of its enlarged role in the gathering and aggregation of data and associated economic impact analysis.

The guidelines thus mandate substantially greater public disclosure for included private portfolio companies than historically has been the norm for private companies in the UK.

Private Equity Participation

The Walker Report, which contains opt out provisions for private equity firms that would be put at a competitive disadvantage by complying, has been compared to the UK combined code of corporate governance for public companies (the "best practice" governance principles which larger UK-listed companies are required to give effect to on a "comply or explain" basis). To date, 26 firms, including some of the biggest names in the industry, have signed onto the Walker Report guidelines. These are 3i Group plc, AAC Capital Partners, Advent International plc, Apax Partners, Bain Capital Ltd., BC Partners, Blackstone Group International Ltd., Bridgepoint, Candover, The Carlyle Group, CCMP, Charterhouse Capital Partners LLP, Cinven, Clayton Dubilier & Rice Ltd, Close Brothers Private Equity LLP, CVC Capital Partners, Doughty Hanson & Co. Ltd., Duke Street Capital, KKR & Co. Ltd., Montagu Private Equity LLP, Permira Advisers LLP, Providence Equity LLP, Terra Firma Capital Partners Limited, TPG Capital LLP, Vision Capital Ltd. and Warburg Pincus.

High-Powered BVCA Committee Formed

On February 12, 2008, the BVCA formed the "Guideline Monitoring and Review Group" to oversee compliance with the disclosure regime and keep the guidelines under review. The body comprises three members independent of the private equity industry (Sir Michael Rake, chairman of BT Group plc, as chairman; Alan Thompson, former group finance director of Smith Group; and Jeannie Drake, retiring deputy general secretary of the Communications Workers Union) and two members from the private equity industry (The Carlyle Group's Robert Easton and The Blackstone Group's David Blitzer). Thus, it is majority independent.

Treasury Reaction Wild Card

The Treasury Committee resumed work after halting pending the outcome of the Walker review. It is not clear whether it will be satisfied with the self-regulatory approach promoted by the BVCA or whether the Treasury Committee will recommend changes to UK corporate regulations. However, the Committee Chairman, John McFall's comment that the Walker Report is a "whitewash" and a "wimpish" finale suggests the committee's view may be less than positive and that government regulation of UK private equity could still be possible. A recent proposal to tax foreigners in the UK shows that the UK government is not afraid to introduce measures which critics argue would turn back the clock on the pro-market approach of recent governments that has been critical to London's emergence as the financial center of Europe. The question is whether the Walker Report goes far enough in providing a transparency regime for private equity firms and their portfolio companies to assuage the regulatory impulses of Gordon Brown's government. ■

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ALERT

U.S. Supreme Court Significantly Restricts Secondary Actor Liability Under Section 10(b)

On January 15, 2008, the Supreme Court issued its much anticipated decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, No. 06 43, __, 2008 U.S. LEXIS 1091 (U.S. January 15, 2009). The decision continues the court's recent pro-business securities law jurisprudence, drawing a clear, defense-friendly boundary on the private liability of "secondary actors"—*e.g.*, business partners, banks, consultants – under Section 10(b) of the Securities Exchange Act of 1934.

The decision all but closes the door on the plaintiffs bar's recent attempts to stretch the limits of "scheme liability" to reach the conduct of entities who do business with an issuer accused of fraud but make no statement to investors and are under no duty to speak. It thus provides an important defense for a private equity firm against a Section 10(b) claim predicated on allegations that it was involved behind the scenes in a scheme to defraud investors. In *Stoneridge*, the Court considered whether secondary actors Scientific-Atlanta and Motorola, who were suppliers and later customers of cable company Charter Communications, Inc., could be held liable to Charter's investors based on their alleged role in a scheme to artificially inflate Charter's financial statements. In an opinion written by Justice Kennedy for a 5-3 majority, the Court refused to extend Section 10(b) liability to cover Scientific-Atlanta's and Motorola's conduct because investors had not *relied on* that conduct in purchasing Charter securities.

The Court's opinion effectively immunizes from private Section 10(b) liability mere "silent business partners" of companies alleged to have prepared false financial statements. It remains to be seen, however, how lower courts will interpret Stoneridge in cases where the conduct of secondary actors is not silent, for instance where it is explicitly referenced in a company's public filings. Moreover, note that private equity firms that hold controlling stakes in public companies are still subject to control person claims under Section 20(a) of the Securities Exchange Act of 1934.

The Stoneridge Claim

In *Stoneridge*, plaintiffs sued Scientific-Atlanta and Motorola for engaging in a series of transactions with Charter that allegedly were designed to artificially inflate Charter's earnings. Plaintiffs alleged a series of carefully crafted agreements in which Charter overpaid Scientific-Atlanta and Motorola for digital cable boxes, only to have Scientific-Atlanta and Motorola return the overpayment by purchasing advertising from Charter. These transactions purportedly allowed Charter to dupe its auditor into approving financial statements that falsely portrayed Charter as meeting its revenue and cash flow projections. Motorola's and Scientific-Atlanta's roles in these transactions, however, were not described or identified in Charter's public filings.

The district court granted Scientific-Atlanta's and Motorola's motion to dismiss, and the Court of Appeals for the Eighth Circuit affirmed, reasoning that neither Scientific-Atlanta nor Motorola was alleged to have made a misstatement relied on by investors or to have violated a duty to disclose. The Supreme Court granted *certiorari* to resolve a conflict among the Courts of Appeals as to when, if at all, investors may recover from secondary actors who neither make public statements nor violate a duty to disclose, but participate in an alleged *scheme* to violate § 10(b)—the so-called "scheme liability" theory.

Before the Supreme Court, plaintiffs argued that Scientific-Atlanta and Motorola should be held liable under Section 10(b) because they knew or recklessly disregarded that Charter intended to use their transactions to inflate its revenues in financial statements upon which investors would rely. In response, defendants argued that plaintiffs' scheme liability theory amounted to nothing more than a species of the "aiding and abetting" liability foreclosed in private actions by the Supreme Court's decision in *Central Bank of Denver, N.S. v. First Interstate Bank of Denver, N.A. Central Bank*, however, left open the possibility that secondary actors could be liable under Section 10(b) if plaintiffs could establish each of the claim's requisite elements.

The Supreme Court's Decision

The Supreme Court affirmed the Eighth Circuit's decision in favor of Scientific-Atlanta and Motorola, but cautioned that it would be wrong to read its decision as requiring a specific statement by the secondary actor for the imposition of Section 10(b) liability. Rather, the *Stoneridge* Court grounded its decision in plaintiffs' failure to allege facts showing that investors had *relied on* Scientific-Atlanta's and Motorola's allegedly deceptive transactions with Charter.

Reliance, of course, is one of the elements plaintiffs must satisfy under any Section 10(b) claim. In the secondary-actor context, *Stoneridge* makes clear that plaintiffs cannot benefit from the presumption of reliance based on the "fraud

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Supreme Court Significantly Restricts Secondary Actor Liability (cont. from page 19)

on the market theory" unless the secondary actor's acts or statements are somehow made public, and thereafter immediately incorporated into the primary violator's security prices through the operation of the efficient market. Because Scientific-Atlanta's and Motorola's allegedly deceptive conduct was never made public, that conduct could not have been relied on by investors purchasing Charter's securities.

(The majority's opinion, however, suggests it is grounded not just in the non-public nature of Scientific-Atlanta's and Motorola's conduct, but also in the lack of proximity of that conduct to plaintiffs' alleged harm. The Court noted that "reliance is tied to causation, leading to the inquiry whether [the secondary actors'] acts were immediate or remote to the injury." The causal chain alleged by plaintiffs—that but for Scientific-Atlanta and Motorola's deceptive acts, Charter would not have been able to dupe its auditor or present financial statements misrepresenting the true state of Charter's affairs—was too remote for the majority to accept. The majority concluded that it was "Charter, not respondents [*i.e.*, Scientific-Atlanta or Motorola], that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.")

In an important postscript to the *Stoneridge* decision, on January 22 the Supreme Court refused to review the Fifth Circuit's decision in *Regents of the University of California v. Merrill Lynch*, which blocked securities fraud claims brought by Enron, Inc. shareholders against three major investment banks. The Supreme Court's decision to let the Fifth Circuit's Enron decision stand supports the proposition that the *Stoneridge* decision applies to an issuer's financial service providers who, like private equity firms, typically do not speak to the market on behalf of the issuer.

Implications of Stoneridge

There is no doubt that the Supreme Court's decision in *Stoneridge* severely undercuts the theory on which a growing number of "scheme liability" cases have been premised and deals yet another blow to plaintiffs in private securities fraud actions. In denying plaintiffs the presumption of reliance with respect to the undisclosed conduct of secondary actors, such as business partners, bankers, lawyers, and consultants, the Court significantly narrowed plaintiffs' potential avenues for recovery from those entities.

For private equity firms and their portfolio companies, *Stoneridge* is certainly useful in defending against Section 10(b) claims based on allegations that the fund or portfolio company (in its ordinary business dealings with a public company) was involved behind the scenes in a scheme to defraud investors. It is important to note, however, that the Court did not entirely foreclose the possibility of private Section 10(b) actions against private equity funds and other secondary actors. Plaintiffs may still bring Section 10(b) claims against secondary actors who violate Section 10(b) directly, as opposed to as part of a scheme, provided plaintiffs can establish all the elements of a Section 10(b) claim, including reliance—which, after *Stoneridge*, requires plaintiffs to show that the allegedly deceptive conduct is made public and thereby incorporated into the company's stock price.

Moreover, it is not completely clear whether *Stoneridge* will preclude actions against secondary actors whose conduct is explicitly referenced in the issuer's financial statements. Lower courts will be left to sort out the implications of *Stoneridge* for claims against secondary actors whose transactions or conduct is highlighted in company filings, but who (like Scientific-Atlanta and Motorola) do not make the ultimate decision to report those transactions in allegedly misleading company financial statements. This could be significant for private equity funds if their conduct or actions are highlighted in the issuer's public filings and therefore, arguably, are proximate enough to the investors' damages to fall outside the confines of *Stoneridge*. We note though that the actions of a private equity firm in its capacity as a control investor of an issuer are not typically described in any depth in the public filings of the portfolio company.

Perhaps most significant for private equity funds, which typically hold board seats and a greater than 10 percent stake in their public portfolio companies —key indicia of control under the securities laws—the *Stoneridge* decision does *not* affect the threat of possible private actions against private equity funds and their principals based on what is commonly referred to as "control person" or Section 20(a) claims. Unlike scheme liability claims under Section 10(b), these claims are based on the theory that the primary violator (*i.e.*, the portfolio company issuer or its officers/directors) is in effect controlled by the fund and, therefore, that the control person is vicariously liable for the primary actor's conduct.

Private equity funds should also take note that *Stoneridge* does not affect other possible enforcement mechanisms, including criminal penalties, civil enforcement by the SEC, state laws permitting restitution from aiders and abettors, and private rights of action against lawyers, accountants and underwriters in direct or derivative litigation under professional liability and fiduciary theories. ■

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Life Insurance "Embedded Value" Transactions Present PE Firms with an Efficient Opportunity to Invest in Life Insurance Cash Flows

Although private equity firms in the United States have shown increased interest in recent years in investments in financial institutions, specific interest in life insurance companies has remained muted, in part because of the capital intensive nature of the life insurance business. The profits that emerge from blocks of life insurance business have provided a steady rate of return to investors in publicly traded life insurance companies, but have generally not provided the levels of return on capital that attract private equity investment.

Life insurance companies have for many years been working on strategies aimed at managing their capital with increased efficiency. Of particular interest to private equity firms and hedge funds that may be looking for diversification in their invested assets are "embedded value" securitization structures. These transactions provide life insurance companies with the ability to realize the discounted value of future cash flows arising out of a defined block of life insurance business, or its "embedded value," and release the capital required to be held against that business. The securities issued are designed to provide a reasonably steady and predictable stream of cash flows for investors.

There were over $4 billion of embedded value securities issued last year, in the form of private financings with investment banks and Rule 144A offerings to other institutional investors. Clearly, the market for structured financings of almost any sort has been severely dampened in the current credit crisis, and in particular assets that do not have a readily realizable market value are very much out of favor. However, the compelling economics of these transactions for both sponsoring life insurance companies and investors give reason to believe that more of these deals will get done, and that opportunities will continue to arise for investment in this emerging asset class. Another interesting prospect as the market develops is the use of embedded value securitization as a technique for financing private equity acquisitions of life insurance companies.

Traditional Securitization and Embedded Value Securitization

A traditional securitization is a financing supported by cash flows that have been legally segregated from the originator of the assets. There are typically two fundamental legal elements for a securitization: the creation of a bankruptcy remote "special purpose" financing vehicle, and a "true sale" of assets from the originator to the special purpose vehicle. The special-purpose vehicle will issue securities in one or more tranches, and will deliver the net proceeds of the offering to the originator as consideration for the transfer of securitized assets. The special-purpose vehicle, in turn, will use cash flows from the securitized assets to support periodic payments due under the securities. The isolation of specific cash flows from the risks of the originator can permit the originator to raise capital at a significantly lower cost than would otherwise be available based on its overall credit profile.

An embedded value securitization is similar in many respects to a traditional securitization (in particular a so-called "whole business" securitization), but is different in at least one key respect. Specifically, the life insurance company is not able to enter into a true sale of assets to the special purpose vehicle. Life insurance, unlike bank loans or mortgages, involves a promise by the originator that is not performed at the time the cash flows are created. In other words, while banks make a loan on Day 1 and then receive interest and principal payments over the life of the loan, life insurance works the other way around—insurers receive premiums over the life of the policy, but do not make a payment until the insured has died. Thus, the transfer of cash flows emerging out of a block of life insurance business (often referred to as the "defined block business") is implemented under the terms of an indemnity reinsurance contract entered into between the originating life insurance company and a newly formed special purpose captive reinsurance company. The originating company remains primarily liable to the policyholders, but transfers the assets and liabilities associated with the defined block business to the special purpose captive reinsurer which uses the profits earned on that business to fund periodic payments on securities issued by it or its parent.

There is a key risk inherent in this structure, and in particular in the absence of

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Life Insurance "Embedded Value" Transactions (cont. from page 21)

a "true sale" of securitized assets. Specifically, an embedded value deal is premised on the securitization of assets that are subject to a prior lien in favor of the payment of liabilities under in-force life insurance policies. As a result, embedded value securitizations are subject to the risk that policy reserves will ultimately prove inadequate to fund policyholder claims. This risk is mitigated by the level of capital required to be maintained at the special purpose captive reinsurer, and by the volumes of historical and projected actuarial data that accompany each transaction, but it remains the case that in extreme mortality scenarios the investor is exposed to assets being used to pay policy claims rather than interest and principal on their securities.

The Basic Building Blocks of an Embedded Value Securitization

Identifying and Segregating the Block of Business

As a first step in an embedded value securitization, a life insurance company or financial sponsor will need to identify a block of life insurance business suitable for securitization. Cash flows emerging from the business will need to support periodic payments to investors participating in the securitization. As a consequence, well-established, diversified blocks of business that exhibit steady, predictable cash flows are ideal.

Although the assets supporting the defined block business will remain available to pay policyholder claims, it will be important to investors that (1) these assets are managed in accordance with well understood and clearly documented investment guidelines and (2) the assets and related investment earnings are segregated from other assets of the life insurance company. The specific concern is to ensure that assets supporting the defined block business are not available for the payment of liabilities that bear no relation to the defined block business. Segregation requirements are therefore incorporated into the contracts underlying the securitization.

The Reinsurance Transaction

Once a block of business has been identified, the life insurance company or one of its affiliates will form a special purpose financial captive reinsurance company. A number of U.S. jurisdictions, including Delaware, South Carolina, Missouri and Vermont, have enacted legislation that specifically contemplates the establishment and operation of special-purpose reinsurers for purposes of insurance-linked securitizations. Off-shore jurisdictions may be selected as well. The life insurer will enter into an indemnity reinsurance contract with the special-purpose reinsurer under which the life insurer will "cede" to the reinsurer the assets and liabilities, and profit and loss, relating to the defined block business.

Financial Statement Credit for Reinsurance

In order to realize the full benefit of the securitization, the originating life insurer will need to be able to reduce the liabilities reflected on its statutory financial statements by the full amount of liabilities assumed by the special-purpose reinsurer under the reinsurance contract. The special-purpose reinsurer is not usually licensed in the ceding life insurer's state of domicile, and is therefore required under applicable U.S. insurance regulations to post collateral equal to 100% of the balance sheet credit sought to be taken. In some cases, the reinsurance will be collateralized through a single beneficiary reinsurance trust or a qualifying letter of credit obtained for the benefit of the ceding life insurance company. In other cases, the ceding life insurance company will retain assets supporting the ceded reserves (using either coinsurance on a "funds withheld" basis or a "modified" coinsurance structure) or may obtain security for the reinsurance through a combination of several methods. This regulatory requirement to collateralize the reinsurance balance further amplifies the point that the securitized assets are subject to the prior claim of the ceding company and are not fully "owned" by the special purpose vehicle.

The Structure of the Capital Markets Offering

An offering of securities in an embedded value securitization may be accomplished using a wide array of structures. The two most typical structures involve either the issuance of deeply subordinated "surplus notes" by the special purpose captive, or the issuance of term securities by a parent holding company of the special purpose captive, payments on which are dependent on receipt of common stock dividends. In either case, payments from the captive to the issuer of the notes, whether in the form of periodic payments on surplus notes or dividends to a holding company, will be subject to prior regulatory approval by the domestic regulator of a special-purpose reinsurer domiciled in a U.S. jurisdiction. In many cases, the regulator will pre-approve or adopt a payment formula governing these payments, a feature that is important to investors looking to minimize regulatory risks associated with their investment.

An embedded value securitization has elements of both a securities offering and an acquisition transaction. The due diligence undertaken by underwriters and (where involved) bond insurers, has the feel of that undertaken by the buyer of a block of business—there is a detailed review of actuarial data underlying the block of business and a series of actuarial stress tests are run. At the same time, the credit of the ceding company is a critical element of the

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Life Insurance "Embedded Value" Transactions (cont. from page 22)

deal, as are the various structural features of the securitization itself. Most of these deals have been sold in the 144A market, and thus it has been the practice to prepare a detailed offering memorandum describing the transaction and appending an actuarial report prepared by an independent actuarial firm such as Milliman or Tillinghast.

Credit Enhancement

Given the complex actuarial analysis underlying embedded value securitizations, it is not realistic to expect that investors will necessarily have the expertise required to assess the risks of each transaction and price the deal on the basis solely of the credit characteristics of the defined block business. Accordingly, it has been the practice to incorporate some form of credit enhancement into the transaction structure. Securities may be guaranteed by a holding company parent or another affiliate of the ceding life insurance company. Other forms of credit enhancement are also possible, including keepwell or capital maintenance arrangements with affiliates, bond insurance or the issuance of subordinated tranches of securities at higher rates to investors willing to bear additional risk.

Administration of the Defined Block Business

Arrangements for the ongoing administration of the defined block business are critical in these transactions. In most cases, the ceding life insurance company or an affiliate will remain responsible for the ongoing administration of the defined block business. Investors and other parties will be interested in protecting against degradation in the administration of life insurance policies, and will want to ensure that the parties are diligent in their upkeep of the underlying infrastructure supporting the securitization. Administrative responsibilities can be significant, often lasting for thirty to forty years or more, until the securities have been repaid and policy liabilities associated with the business have been satisfied in full. An array of administrative service and other similar servicing agreements typically comprise a significant portion of the transaction documents negotiated in connection with an embedded value securitization.

Transaction Execution

Embedded value securitizations are highly complex deals, involving challenging actuarial analysis, long-tail risks and a large number of parties. In addition to the ceding life insurance company, independent actuaries, accountants, tax experts, underwriters, financial guarantors and rating agencies are heavily involved. In addition, approvals of multiple regulators are often required, and depending on the circumstances, the process of regulatory review can extend for many months. This complexity can increase execution risk significantly, and may drive companies to pursue more traditional M&A transactions even if they promise less compelling returns than an embedded value securitization. Nonetheless, as the market develops, greater standardization and reduced execution risk should become the rule.

Prospects for the Future

The current credit crisis, coupled with execution risk and the other issues typically associated with the creation of a new asset class have caused the embedded value market to get off to a slow, though reasonably steady, start. There have been large deals done, and there is a great deal of interest on the part of life insurers in seeing these transactions take off.

Assuming that regulatory hurdles and heavy capital requirements will continue to serve as impediments to financial investors buying directly into the equity of life insurance companies, we expect that both life insurers and private equity firms will continue to look favorably upon embedded value structures as a means to meet their mutual objective of efficiently deploying capital.

Another interesting prospect is the use of the embedded value transactions as a feature of M&A financing. We have seen asset-backed financings become an important part of the leveraged financing landscape in other industries (rental cars, for example), and there is reason to believe that embedded value technology could ultimately develop into an efficient means to finance private equity acquisitions of large life insurance businesses.

Overall, embedded value securitizations represent an emerging asset class that holds promise for private equity investors looking to diversify their investment portfolio and benefit from a reasonably steady stream of life insurance-based cash flows. ■

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A Look at Recently Renegotiated Private Equity Deals (cont. from page 1)

may leave a sponsor's name tarnished. Concerns about reputation have begun to fade as an increasing number of private equity firms go down the termination route. But, ultimately, the jury is still out on this issue and will not be in until deal activity levels surge again. Secondly, even where the contract with the target is clearly structured as an option, different members of a buy-out consortium may have different appetites for exercising the termination right. And thirdly, paying a reverse breakup fee is, euphemistically put, not an ideal deployment of capital and the reaction of limited partners to the payment of these fees has yet to be fully tested.

Given these considerations, it is perhaps not surprising that, so far, sponsors have exercised the walk-away right in only a handful of pre-crunch transactions. And it is likewise not surprising that, in many of these abandoned transactions, sponsors did not get stuck with payment of the full fee. Instead, sponsors often were successful in negotiating a reduction of the fee with the target (typically in situations where the sponsor was able to make a strong case that a MAC had occurred despite the many exceptions to MAC provisions that private equity firms have come to accept over recent years) or in getting the lenders to share in the fee.

Where "staying together" is not feasible economically and "breaking up" is hard to do, the focus turns to a third category of transaction: those that were renegotiated. Here is a look at some examples:

Getting Everyone to Give A Little (Or A Lot)

With targets falling behind projections and industry comparables declining, perhaps the most logical angle for renegotiation is to seek better pricing terms from the target.

Such was the outcome in the acquisition of Home Depot Supply by Bain Capital, Carlyle and CD&R. The sponsor group believed it had a plausible argument that a MAC had occurred, but rather than taking the MAC battle to court, terms for the acquisition were modified. The aggregate transaction price was reduced from $10.3 billion to $8.5 billion and Home Depot agreed to acquire a 12.5% equity stake in the surviving entity and to guarantee a portion of the acquisition debt. Some of Home Depot's concessions were passed through to the lenders: the debt package was reduced by approximately 30% to $5.9 billion and restructured to take the form of an asset-backed loan with higher interest rates on portions of the debt. The buyout consortium, in turn, increased its equity stake.

A similar compromise, also with a price reduction as its core, was reached in the acquisition of subprime mortgage lender Accredited Home Lenders by Lone Star Fund. In this transaction, the dispute over whether or not there had been a MAC did make it to the courts, but the parties settled the litigation and struck a new deal, including a reduction in purchase price (from $400 million to $296 million), an interim loan provided by Loan Star and intended to keep Accredited Home Lenders afloat, and a deletion of the no-MAC condition. The new agreement also permitted Lone Star to actively solicit better offers and to terminate the agreement upon the emergence of a superior offer at half of the originally contemplated break-up fee.

A variation on the price-reduction theme can be seen in the August amendment of the (now terminated) acquisition of Reddy Ice Holdings by GSO Capital Partners. Reddy Ice agreed, along with other amendments, to cap the dividends Reddy Ice could pay until closing, thus reducing total cash to shareholders. As with the Home Depot Supply transaction, the reduction in price came in tandem with an equity roll-over, in this case by a minority shareholder of Reddy Ice. Reddy Ice also granted GSO Capital Partners an extended period to market the debt.

Two factors, both interesting from a sponsor perspective, contributed to the Reddy Ice transaction ultimately failing despite the August amendment. For one, the debt financing sources threatened to withdraw from the deal, claiming that the August amendment required their consent. Reasonable minds may have

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...[A] crucial point that sponsors should bear in mind when planning to renegotiate pending transactions [is that] financing sources may, at least as long as current market conditions prevail, seek to leverage any amendment to the terms of a pending transaction to extricate themselves from the original commitment or, at least, improve its terms.

A Look at Recently Renegotiated Private Equity Deals (cont. from page 24)

different views on whether the Reddy Ice amendment was in fact adverse from the lenders' point of view, but the position taken by the banks demonstrates a crucial point that sponsors should bear in mind when planning to renegotiate pending transactions: financing sources may, at least as long as current market conditions prevail, seek to leverage any amendment to the terms of a pending transaction to extricate themselves from the original commitment or, at least, improve its terms. A recent case in point, further illustrating the current interplay between renegotiation and lender commitments, is the law suit brought by one of the debt financing sources following Providence's and Clear Channel's agreement to reduce the price tag for the acquisition by Providence of Clear Channel's television group.

For another, GSO's termination right survived the August amendment of the merger agreement permitting GSO to walk from the transaction for a fee payment of $21 million. This illustrates another important point, *i.e.*, the enormous bargaining power that comes with a clean walk-away right. While GSO managed to preserve the option character of its agreement, sponsors should be aware that those provisions may not always survive renegotiation. In any renegotiation, target boards may seek to prevent sponsors from having a second bite at the "walk-away apple" or to significantly reduce the appeal of the walk-away right by increasing the economic pain associated with its exercise (the reverse break-up fee) or by limiting the circumstances in which it is available.

Taking a Close Look at the Existing Debt

Renegotiation does not necessarily have to involve pricing concessions on the part of the target. The lenders for BC Partners' contemplated acquisition of Intelsat recently initiated an amendment of Intelsat's existing debt that permits leaving the debt in place after BC Partners takes control. To make the proposition appealing, Intelsat's existing lenders were promised higher spreads, tighter covenants, call premiums and an amendment premium of 500 bps. Rolling-over a target's existing debt, as in the Intelsat transaction, is no doubt an appealing alternative when new financing is not readily available although doing so will often require an amendment, and, along with it, possible negotiation of an amendment fee and increased interest rates, among other concessions.

Sponsors may thus want to explore with counsel whether a particular transaction can be structured—at least on an interim basis until the financing markets improve —to fit within the confines of the change of control, restricted payments, and other covenants of a target's existing debt. Such a structure may be possible, for example, where the transaction includes a significant target shareholder who constitutes an exempt person for purposes of the change of control definition. However, sculpting a transaction around a target's pre-acquisition debt may necessitate major changes to the envisioned equity and governance arrangements and those changes may or may not be palatable from the sponsor's perspective. In addition, even the most careful structuring around a target's existing debt documents may not eliminate all risk that the target's banks will seek to accelerate the loans, whether at closing or at a later point in time, if they have a different view.

Buying Time

In lieu of seeking a reduction in deal price—directly from the target or via enhanced financing terms—two recent transactions have opted for another strategy: buying time.

The first of these two is Goldman Sachs Capital Partners' proposed acquisition of Myers Industries. Financing for the transaction was reportedly not a concern, but GSCP had purportedly become worried about the impact of high commodity prices and the housing market on Myers' business.

Shortly before the contract's "drop-dead" date, GSCP obtained an amendment that permitted it to delay closing until 15 days after delivery by Myers of its first quarter 2008 financials. To get this extension, GSCP agreed to make a non-refundable $35 million payment to Myers (an amount not coincidentally equal to the reverse breakup-fee) and conceded that there had not been a MAC as of the amendment date. The amendment also included a renouncement by Myers of its right to seek specific performance, a waiver of any further rights to the reverse break-up fee,

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In lieu of seeking a reduction in deal price—directly from the target or via enhanced financing terms—two recent transactions have opted for another strategy: buying time.

A Look at Recently Renegotiated Private Equity Deals (cont. from page 25)

and a consent to GSCP terminating the limited guarantee (curiously, effective as of the date of the amendment, *i.e.*, before the actual payment of the $35 million). Myers, in turn, was permitted to shop the company and to terminate the contract upon emergence of a superior proposal without payment of a break-up fee though GSCP retained an express six-day matching right. Myers was also freed from many of the restrictions of the interim covenant. Finally, Myers was granted the right to pay a special $10 million dividend to its shareholders and given the green light to repurchase its shares at prices lower than the merger consideration.

Dubbed "The Goldman Sachs No-Fault Divorce" by the *Wall Street Journal*, the Myers approach could just as aptly be characterized as a "friends with benefits" arrangement. Assuming that GSCP would not have been able to successfully assert a MAC, GSCP would have been required to pay the reverse breakup fee upon passage of the debt marketing period in any event. Rather than merely a payment for release from its obligations, the fee payment thus effectively bought GSCP time to make up its mind, including on whether or not to ask for a price reduction in the future. Permitting Myers to effectuate repurchases while the transaction remains in limbo adds an interesting twist to this compromise. If the deal ultimately goes through, repurchases below the deal price will make the overall economics sweeter from GSCP's perspective. If the deal collapses, repurchases may well be a plausible strategic alternative from Myers' perspective.

That said, sponsors should be mindful that share repurchases by a public target during a pending transaction present their own legal challenges. Firstly, they confront the target board with a conundrum, *i.e.*, whether permitting the shareholders to effectively make a bet on the fate of a pending buy-out constitutes an appropriate discharge of the board's fiduciary duties. Secondly, where Rule 13e-3 applies, any repurchases will likely be viewed as an initial, integrated part of a control transaction, requiring the filing of an information statement with the SEC or an amendment to an existing Schedule 13E-3. Thirdly, repurchases may expose a target (and the sponsor) to claims of trading on the basis of material non-public information (*e.g.*, assertions that the target and its officers had information about the state of the acquisition financing that was not public at the time of the repurchases) or market manipulation claims. While the securities laws exposure can be managed to some extent with careful legal planning, including by adopting a 10b5-1 plan and bringing repurchases inside the safe harbor provisions of Rule 10b-18, such structuring may have its own drawbacks (such as the volume limitations of Rule 10b-18) and may not fully insulate the parties from litigation risk.

Another recently renegotiated acquisition that could be viewed as reflecting a play for time, on the sponsors' part, is the acquisition of Harman International. In lieu of commencing litigation over whether or not there had been a MAC, the parties agreed to convert the KKR and GSCP-led going-private transaction into a $400 million PIPEs (private investment in public equity) investment in the form of convertible debt. As in Myers, the proceeds of the $400 million investment were earmarked, among other things, to permit Harman to conduct share repurchases. The debt securities will pay out 1.25% interest annually. They can be converted into Harman shares should Harman trade up to $104 per share in the next 5 years, a number well below the $120 deal price but significantly higher than the current share price. KKR also was given a board nomination right.

PIPEs transactions raise a host of legal and strategic issues. But a threshold concern is feasibility. Whether or not a particular PIPEs investment is permissible under a target's organizational and debt documents should always be carefully reviewed with counsel. Where practicable, though, acquiring a minority stake in a public target may prove an interesting play for time and can give a sponsor a leg up with respect to a control transaction at a later juncture.

The Outlook

When this article went to press, more than 50 private equity transactions with an aggregate transaction value of in excess of $60 billion involving North American targets that were signed prior to the credit crunch were pending. While it is safe to predict that the next weeks will bring more "slipping out the back" and more "making new plans," it remains to be seen whether the credit crunch will show us 50 different ways for sponsors to get themselves free. A separate question is how the changed economic environment will impact deal terms going forward. We expect that meaningful answers to this question will likely remain elusive until more sizeable, precedent-setting transactions make a comeback. ■

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Reform of the English Financial Assistance Regime (cont. from page 10)

European legislation on capital maintenance and share capital required to be implemented in member states by April 15, 2008 provides an option for member states to relax the prohibition on public companies giving financial assistance, allowing public companies to give financial assistance up to the limit of their distributable reserves if the transaction meets certain specific requirements. It is not yet clear if, and to what extent, these changes will be implemented in the UK.

Residual Grey Areas

The English financial assistance regime does not currently apply to the giving of assistance by non-English companies and so is not in that sense "extra-territorial." The position will be the same when the relevant provisions of the Companies Act 2006 come into effect. However, there has historically been some legal debate as to whether an English company can give financial assistance for the acquisition of shares in its non-English parent companies. The new legislation does not clarify this and accordingly there remain residual doubts as to whether it could apply where a public company is involved in an acquisition financing of a non-English company. Other areas of uncertainty include the exact meaning of "financial assistance" in the public company context.

Conclusion

The repeal of the current English financial assistance regime insofar as it applies to English private companies is a very positive change to English company law. It should facilitate shares acquisitions involving English private limited companies, by helping to simplify transaction structures and avoiding much of the complex and costly legal and financial analysis currently required. The demise of the cumbersome whitewash procedures will be particularly welcome to those involved in acquisition financing in the UK. ■

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Should Your Child Take a Job in Private Equity? (cont. from page 12)

in favor of private equity is made because of a natural curiosity, and inquisitiveness, a natural interest in business, and for example its value drivers and the methods by which to effect change in companies for the benefit of stakeholders.

Many people who choose to ignore the opportunity of turning a hobby into one's career end up unhappy. It is then most important to be honest about one's own aptitude—that is to say, to analyze whether one has the requisite characteristics to be effective. Some of these characteristics include a natural aptitude for hard work and long hours, enjoying the intellectual challenges of the business, taking delight in constant mental sparring, never accepting the obvious view at first sight, reveling under the intensity of time pressure and deadlines and welcoming the challenge to juggle many balls in the air at the same time. If you don't like stress, private equity is probably not for you. If you can't take the heat, don't get into the private equity-kitchen.

When natural interest and appropriate aptitudes combine with the pertinent skill set private equity may be an option. One should distinguish between skills that are natural skills such as intelligence or people skills, and skills that can be learned. If all that is missing are the learnable skills then the decision "where to go" (*i.e.*, which PE firm to join) should be based on the best platform to acquire those skills (be it by formal or informal learning programs). The technical skills required in today's private equity industry are very diverse and the decision whether to become the financing expert, the modeler, the front office marketing person or the investor relations officer can be made drawing on the same analysis of natural interest and aptitude. Intensity may differ among firms however. Intensity is important because it shapes the learning curve. "Time multiplied by intensity" produces experience. Ultimately, private equity is an experienced-based and skill-supported judgment business.

If you love that challenge, go for it. The industry needs good people. ■

Loosening the Ties: Amendments to Rule 144 and Rule 145 (cont. from page 16)

may regard as even more valuable given the liberalized selling landscape afforded non-affiliate stockholders under the new rule.

Sale of Portfolio Company to a Public Company for Stock.

Previously, when a sponsor agreed to sell its portfolio company to a public company for stock consideration, the sponsor and the target had to agree on the terms of registration rights in order to provide liquidity for the public company shares received by the sponsor. Otherwise, in the absence of such registration rights, the sponsor was subject to restrictions on selling the securities.

Now, due to the elimination of the "presumptive underwriter" doctrine under Rule 145, in public merger or other transactions where a sponsor receives *registered* stock of the public company, the sponsor can sell the stock it receives freely if the sponsor is not an affiliate of the public company post-merger. In those transactions where the public company issues its shares to the sponsor in a private placement, or the sponsor is an affiliate of the public company post-closing, the sponsor will be subject to resale restrictions and will therefore continue to need registration rights post-closing. In this regard, note that under the securities laws, buyers are not able to issue registered stock to a sponsor in a stock for stock sale of most controlled, private portfolio companies, as these sales are privately negotiated. But buyers may be able to issue registered stock to sponsors in other stock for stock deals involving a public target, especially in deals, including club deals, where the sponsor(s) have already sold down the target's shares to the public.

Given that public, strategic buyers may be more likely acquirers of sponsors' portfolio companies in the current financing markets, this amendment could provide useful liquidity to sponsors and reduce the need to negotiate registration rights in connection with certain public mergers.

* * *

The amendments to Rules 144 and 145 are significant and have the potential to impact the market for registration rights in a number of ways as discussed above. We will keep you informed as the market adjusts to these rule changes. ■

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