

## Something Old, New, Borrowed, and Blue: Have Strategics Borrowed Conditionality from the Private Equity World?

During the seemingly distant wave of M&A activity from 2005 through the first half of 2007, deal terms evolved with the birth in private equity transactions of the reverse termination fee, or RTF. Reverse termination fees limit a buyer's exposure in the event it fails to close a deal under certain circumstances. Notably, this structure is now creeping into strategic acquisitions, with interesting implications for private equity buyers.

### The Rise of Reverse Termination Fees

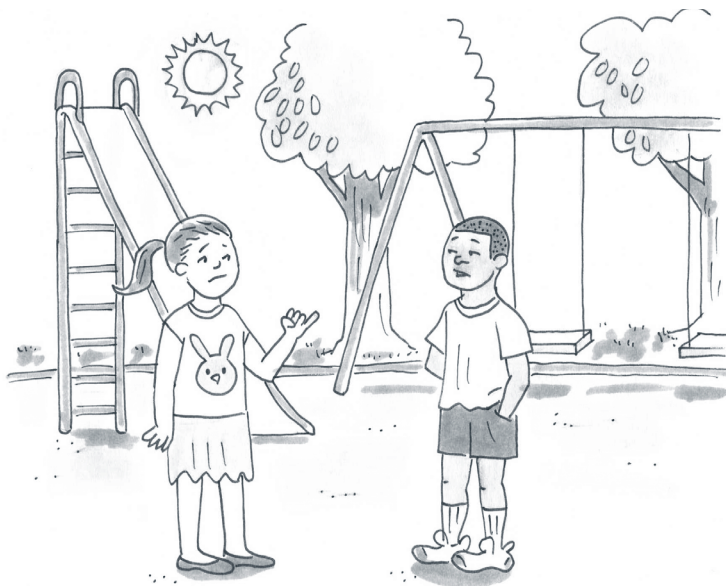
Reverse termination fees in the private equity context were initially conceived as an alternative to a financing condition. With frothy credit markets and heightened competition for assets, private equity buyers

(especially in large cap deals) began in 2005 to give up their long-cherished financing outs in order to compete on more equal footing with strategic buyers. Private equity buyers, however, were not willing to expose themselves to unlimited monetary damages or a specific performance claim that could theoretically force them to close on transactions even if their lenders had balked. Sponsors thus negotiated for a limitation on their liability, usually in the form of a pre-determined fee (ranging from 3% to 4% of deal value and often the size of breakup fees in going private transactions), which would serve as the target's sole recourse in the event that the buyer failed to close due to an inability to obtain its financing. In many deals, this limitation on liability extended to

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# Letter from the Editor

If there is one word that characterizes the current private equity scene (and, for that matter, the general economy), it is uncertainty. Although pundits may disagree over whether this is the Great Recession and whether the traditional private equity model is viable, few debate that the fundraising and credit environment and the regulatory landscape for private equity investors is increasingly hard to handicap. In this issue, we offer several articles to help you anticipate the legal context for the next era of private equity.

Increased regulation of private equity is a highly anticipated consequence of the prevailing economic situation. The Obama Administration proposal just released at press time focuses primarily on traditional financial institutions, but also encompasses, to a lesser degree, private equity funds and hedge funds. We offer separate articles on the revised regulatory regimes currently proposed in the U.S. and the European Union, which, while subject to change, are likely to be indicative of the future landscape.

We also have some good news for those focused on current deal activity. On our cover, we discuss the migration of the use of reverse termination fees from private equity to strategic buyers, which may help to level the playing field for private equity bidders in this difficult market. Elsewhere in the issue, we tackle the issues you should consider if you are contemplating a loan-to-own strategy in distressed real estate.

Also in the good news department, we report that corporate directors and corporate acquirors should be relieved by the Delaware Supreme Court's recent opinion restoring long-accepted fiduciary duty expectations that had become muddled by a lower court's decision in the *Lyondell* case.

In our Guest Column, we present an interview by our partner, Rob Quaintance, with a PricewaterhouseCoopers's private equity transaction team, focusing on the impact on private equity acquisitions of the FASB's new M&A accounting standards. They discuss not only the potential increased earnings volatility and the trickle-down effect on financial covenants in debt agreements, but also provide guidance on how to structure deal terms and closings to minimize any negative impact of the new standards.

While we do not have an elixir to ease the economic dilemmas of the day, we do know we are uniquely well positioned to advise you on how private equity will be impacted by the impending regulatory and market changes. If there are questions or areas of particular concern that you would like addressed in an upcoming issue of *The Debevoise & Plimpton Private Equity Report*, we encourage you to contact a member of the Private Equity Group.

**Franci J. Blassberg**  
*Editor-in-Chief*

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# What U.S. Regulatory Reform Could Mean for Private Equity

Increased regulation of the U.S. financial system in the United States, including regulation of private equity funds and advisers, is an inevitable consequence of the recent financial crisis. The ball has started rolling on proposals for regulatory reform, particularly as it pertains to bank solvency, so-called “toxic assets” and certain tax matters. As we go to press, the Obama Administration’s proposals for a larger revamping of the regulatory system, including the regulation of private equity funds, has just been released. More details, particularly how these proposals will impact private equity funds, will likely be revealed this summer as the Administration proposals make their way through Congress. Still, the Administration proposal, as well as other legislative initiatives, suggests how private equity funds and their sponsors may be affected by future initiatives.

First, although private equity funds played little, if any, role in the current crisis, proposals from the Administration and Congress show little inclination to distinguish between private equity funds and hedge funds. This itself represents a departure from

the SEC’s prior attempt to regulate hedge fund advisers but not private equity and venture capital fund advisers.

Second, it seems clear that either private funds or their advisers or both will be subject to some form of registration (and related regulation). It is possible that certain types of private funds will fall under the oversight of a systemic risk regulator.

Finally, additional regulatory requirements are likely to be imposed on private fund sponsors that are registered investment advisers.

## Adviser Registration and Regulation

It is highly likely that fund sponsors will be required to register with the SEC. The most straightforward way to implement such a requirement would be to revise or repeal the provision of the Advisers Act that provides an exemption for those investment advisers that, among other things, have fewer than 15 clients (with each fund counting as a single client). This is the approach taken by the Administration proposal that has just been released. On the legislative front, this is also the approach that is taken in the “Hedge

Fund Adviser Registration Act of 2009” introduced this year by Congressmen Capuano (D-Mass.) and Castle (R-Del.) and more recently by the Private Fund Transparency Act of 2009 introduced by Senator Jack Reed (D-RI) on June 16.

The Obama Administration proposal contemplates that advisers to hedge funds and other private pools of capital whose assets under management exceed a “modest” threshold would register as investment advisers. (Senator Reed’s legislation provides a \$30 million threshold.)

The Administration proposal also

contemplates that private funds advised by SEC-registered investment advisers would be subject to recordkeeping requirements, requirements with respect to disclosure to investors, creditors and counterparties, and regulatory reporting requirements. The regulatory reporting requirements would require reporting on a confidential basis of the amount of assets under management, borrowings and other data necessary to assess “whether the fund...is so large, highly leveraged, or interconnected that it poses a threat to financial stability.” This information would be reported to the SEC but shared with the Federal Reserve for purposes of identifying which, if any, funds should be subject to the oversight of the systemic risk regulator (discussed below). It does not appear that private funds would be subject to the oversight of a new “Consumer Financial Protection Agency” that would be created under the administration’s recent proposal.

Senator Reed, in introducing the Private Fund Transparency Act, stated that it would “clarify” other aspects of the SEC’s authority with respect to its ability to oversee registered investment advisers. It is unclear at this point whether this legislation would open the door for greater substantive regulation of private funds.

Another alternative that has been discussed would be to require certain private funds to register under the Investment Company Act. This is the approach that would be taken under the “The Hedge Fund Transparency Act” (HFTA) introduced by Senators Grassley (R-IA) and Levin (D-MI). While not entirely clear, this proposed legislation may have been designed to require the fund sponsor to register as well. We discuss other aspects of the HFTA below.

Regardless of the mechanism, registration

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## What U.S. Regulatory Reform Could Mean for Private Equity (cont. from page 3)

as an investment adviser could impose substantial costs on a fund sponsor. In addition to preparing and filing a Form ADV (the Advisers Act registration form), a registered investment adviser must, among other things, (1) adopt and implement policies and programs related to compliance and personal securities trading by employees; (2) appoint a chief compliance officer; (3) maintain books and records, which are subject to SEC examination; (4) comply with certain limitations on advertisements and marketing presentations; and (5) arrange for fund assets to be maintained with a third-party custodian. Many private equity sponsors with multiple investment strategies and funds have already registered as investment advisers and have found compliance to be manageable, although clearly involving increased costs and burdens.

Regardless of the outcome of these legislative initiatives, registered investment advisers are likely to face increased regulatory requirements. In response to recent investigations that uncovered the misuse of client funds by advisory firms, the SEC recently proposed amendments to its investment adviser custody rule that are designed to impose significant new safeguards for client assets. Among other things, the amendments would require all private fund sponsors who are registered with the SEC to be subject to an annual “surprise exam” by an independent public accountant to verify that client assets exist. This requirement would be in addition to the fund’s annual audit.

### Fund Registration and Regulation

Fund registration is another option that is being considered. The HFTA would require private funds (including private equity funds) with \$50 million or more of assets under management to register with the SEC; however, a fund that is required to

register would not face the full panoply of regulation under the Investment Company Act. Instead, these registered private funds would be subject to separate information disclosure requirements and, perhaps, additional SEC regulation.

There have been some statements (most notably from SEC Chairman Mary Schapiro and the Administration) that private funds will face a regulatory regime that, while less onerous than it would be under the Investment Company Act, could include substantive regulation (particularly with regard to short-selling and leverage). Although public disclosure of private fund trading strategies and holdings seems to be inconsistent with the notion of a private fund, it may indeed be implemented as a means to promote market transparency. Ideas for substantive regulation appear to be mostly focused on trading activities and leverage. Policy concerns have also been raised concerning private equity funds and leveraged buyout activity. For example, a September 2008 report of the U.S. Government Accountability Office recommended that the heads of the Federal Reserve, Office of the Comptroller of the Currency, and the SEC give increased attention to ensuring that their oversight of leveraged lending at their regulated institutions takes into consideration systemic risk implications raised by changes in the broader financial markets, as a whole. There could also be increased regulation of valuation, risk management, trading and operations, and compliance and conflicts of interest practices (although this could be covered by the adviser regulation discussed above or in certain instances by the proposed systemic risk regulator discussed immediately below).

### Systemic Risk Regulation

There appears to be a consensus among policy makers that it would be desirable to have a government entity whose

responsibilities include the monitoring of the financial system for system-wide risk with the tools to forestall emergencies. At this point, there appears to be less consensus about the precise form such a regulator should take—whether a single entity, such as the Federal Reserve, a “College of Regulators,” or a hybrid consisting of a single regulator for systemically significant firms coupled with a systemic risk council to provide macro-prudential oversight of risk. The Obama Administration proposal just released as we go to press contemplates the creation of a “Financial Services Oversight Council” chaired by the Secretary of the Treasury and whose members would include the Chairs of various regulatory agencies (including the Chairs of the SEC and CFTC) as well as new regulatory agencies that would be created under the proposal.

Assuming that some form of systemic risk regulation is implemented, private funds of substantial size would likely come under its jurisdiction. As discussed above, the Administration proposal contemplates that the Federal Reserve would determine if certain private funds present sufficient systemic risks to come under the jurisdiction of the systemic risk regulator. Presumably, any such fund would face increased disclosure (although likely to be confidential) and also increased substantive restrictions (particularly related to leverage and risk management).

### State Regulation

Beyond federal regulation, private funds could face a changed landscape of state regulation. Most significantly, the Connecticut legislature recently considered several bills that would have subjected private funds sponsors based in Connecticut to some form of additional regulation. Although the Connecticut legislation was ultimately not enacted, the specter of future state regulation remains. Depending on

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## GUEST COLUMN

# Fair Value Accounting—Or Foul?

## The New M&A Accounting Standards

*Post-acquisition earnings dilution! Greater earnings volatility! More visibility on transaction costs! Financial covenant traps! These are some of the potential side effects of the FASB's new M&A accounting standards, which apply to all acquisitions that close in years beginning after December 15, 2008.\**

*Debevoise partner Rob Quaintance recently sat down with Donna Coallier, Jillian Griffiths and Jason Waldie of PricewaterhouseCoopers ("PwC") to discuss the new standards and their impact on private equity transactions. Here are the highlights of that conversation.*

### General

**RQ:** Before we get into the details on how these standards will affect private equity transactions, what context do we need? Are there any general points we should focus on?

**PwC:** The accounting profession has been gradually moving toward fair value accounting for some time now, in an effort to provide information that is more relevant and understandable than historical cost and that aims to represent the true value of a business. The new standards require that more items be recorded on the target's opening balance sheet. Some of these items will be amortized or depreciated or, in case of impairment, written down. The additional expenses and the amortization, depreciation and write-downs of the "new" balance sheet items will dilute post-acquisition earnings. Others of the new balance sheet items are now required to be marked to fair value each reporting

period. This, along with the potential for write-downs, will increase earnings volatility.

**RQ:** Do the changes bring U.S. GAAP closer to international standards?

**PwC:** Yes. The FASB was looking to harmonize U.S. GAAP with International Financial Reporting Standards—or "IFRS." While FAS 141 was being revised, the IASB (the international accounting standard-setting body) concurrently revised the international M&A accounting standard, IFRS 3. Although there are still a few differences, the standards are now very similar.

**RQ:** Why are the new standards important to private equity sponsors and not just public companies?

**PwC:** Private equity sponsors will be most interested in how the new standards treat deal fees and other transaction expenses, as well as how the new standards affect financial covenants in debt agreements. Also, sponsors who hold a significant stake in a public company or who are contemplating taking a portfolio company public should be interested in the same things as management of any reporting company. When private equity sponsors are competing with public companies for targets, they will also want to understand the impact of the accounting standards on the competing bidders and their proposed transactions.

**RQ:** One other general question before we delve into the details: If an acquired company and its subsidiaries operate in several jurisdictions and not just in the U.S., which standards apply—U.S. or international?

**PwC:** U.S. standards apply for domestic SEC filers. International standards apply where required by statute. In some cases, the foreign subsidiaries of a U.S. parent will have to comply with both U.S. and international standards.

### Transaction Costs

**RQ:** Historically, a lot of the buyer's transaction costs, including the sponsor's deal fee, could be capitalized. How do the new standards change that?

**PwC:** Now only costs related to the issuance of debt and/or equity to finance the acquisition can be capitalized. All other costs, such as investment banking fees, due diligence expenses, accounting fees, legal fees and the sponsor's deal fee, must be expensed as incurred. Unless the fees are contingent on the deal closing,

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**...[U]nder the new standards there will be more items on the opening balance sheet that are subject to post-acquisition adjustment through earnings. Examples include earn-outs and tax reserves, both of which can be adjusted up or down.**

\* The full releases containing the new standards (FAS 141(R)) are available at [www.fasb.org](http://www.fasb.org).

## The New M&A Accounting Standards (cont. from page 5)

this means they are expensed when the services are provided.

**RQ:** *Do you think there is going to be any change in the way these fees are structured, billed or paid, in order to get the expense into one accounting period rather than another, for example?*

**PwC:** This may not matter much to private equity buyers, but some reporting companies have not been pleased about the impact of deal expenses on their earnings. If significant enough, those expenses can require discussion in their MD&A and draw attention to their contemplated (but not yet complete) acquisition activity. Early on, there was speculation that the expense could be avoided by getting the target to pay the buyer's transaction costs, with the buyer effectively reimbursing the target by increasing the purchase price. The FASB has since made clear that even costs paid by the target must—if the services being paid for benefited the buyer—be reflected in the buyer's earnings.

**RQ:** *Are the expensed items also required to be expensed for tax purposes now, too?*

**PwC:** The tax rules that apply to acquisition-related transaction costs have not changed and so, at least for U.S. tax purposes, these expenses will still be capitalized as part of the purchase price, so long as the deal actually closes. The resulting difference between tax and book reporting may need to be reflected in the company's deferred tax balances, and it will be important for companies to determine whether and how any tax benefit should be recorded as these costs are incurred. There's a host of issues to consider when making this decision, but the key point is that companies should consider the impact on their tax rate.

## The Opening Balance Sheet and Timing the Closing to Decrease Volatility

**RQ:** *You mentioned that one impact of the new standards is a potential increase in earnings volatility post-acquisition. Can you explain in more detail what causes the volatility?*

**PwC:** To do that requires a brief review of acquisition accounting. When a buyer acquires a target, the target's opening balance sheet is prepared as of the closing date and is added to the buyer's balance sheet to reflect the consolidated company. In preparing the opening balance sheet, the buyer estimates the fair value of the individual assets and liabilities of the target. The net aggregate amount is compared to the purchase price paid by the buyer, and the difference represents goodwill—positive or negative. Positive goodwill is reported in the balance sheet and must be tested periodically for impairment. Negative goodwill is reported as income by the buyer on the closing date. The individual assets and liabilities acquired are also reported at their fair values in the target's opening balance sheet.

**RQ:** *So what causes the volatility?*

**PwC:** The short answer is that under the new standards there will be more items on the opening balance sheet that are subject to post-acquisition adjustment through earnings. Examples include earn-outs and tax reserves, both of which can be adjusted up or down. In process research and development is another source of potential unexpected expense.

**RQ:** *I understand that under the new standards adjustments to estimates are required to be treated differently. Acquirers used to adjust where appropriate and record the effect of the adjustment in the period in*

*which the adjustment was made. What happens now?*

**PwC:** Acquirers still have a “measurement period” in which they can adjust the preliminary estimates of fair value recorded in their opening balance sheet. That measurement period, which cannot be longer than one year, ends when the acquirer is no longer waiting for information that it needs to complete its estimates. The new twist is that changes to the estimates will be reflected in prior period balance sheets and income statements.

As you indicated, under past practice, if preliminary estimates of fair value were reported in a March 31, 2010 balance sheet, for example, and final adjustments were made in the next quarter, the adjustments would be recorded in the June 30 balance sheet and income statement, with no effect on the March 31 financial statements. The new standards require that the previous period, in which the estimates were made, be “recast.” So in our example, the March 31 balance sheet and income statements would need to be adjusted for the change in estimates.

**RQ:** *Why does the income statement have to be recast if the changes are to the estimates used in the opening balance sheet?*

**PwC:** Because, for example, if the value at which an asset is booked on the opening balance sheet changes, any amortization or depreciation of that asset reflected in post-acquisition income statements will also change. Note also that as a result, these subsequent adjustments to fair values are another source of potential earnings' volatility.

**RQ:** *When companies make these adjustments, are they going to have to restate their financials? Amend and reissue their 10-Qs or 10-Ks?*

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# Order Restored for Directors' Decisions in Delaware

Corporate directors everywhere are relieved by the Delaware Supreme Court's recent opinion overturning the Delaware Chancery Court's decision in *Ryan v. Lyondell*, which has restored the established structure of fiduciary duty law in Delaware. In a world in which directors of public targets already have enough reasons to be cautious, the Delaware Supreme Court pulled back on a budding doctrine that would have created increased skittishness for board members in connection with their consideration of potential sale transactions. This, in turn, could have increased deal execution risk and created other complications for private equity and other buyers in going private and similar change of control transactions.

In our article in the Fall 2008 *Debevoise & Plimpton Private Equity Report* ("How Bad is 'Bad Faith'?—New Delaware Perspectives"), we wrote about a trio of cases—*McPadden v. i2 Technologies, Inc.*, *In re Lear Corp. Shareholder Litig.*, and *Ryan v. Lyondell*—that considered whether the directors of a company could violate their Revlon duties to such an extent that they can be said to have acted in bad faith, thereby *intentionally* disregarding their fiduciary duties. If so, they would have breached their duty of loyalty, for which they may not be exculpated under Delaware law.

Fortunately for directors, the first two cases, *McPadden* and *Lear*, set a relatively high bar for what constitutes bad faith. Practitioners and directors alike, however, were taken aback by the Chancery Court's decision in *Lyondell*, which held that independent, disinterested directors may be deemed to have breached their duty of good faith to a company's stockholders, by failing to engage in a proactive, competitive process even though doing so could have

risked losing a high-premium cash merger offer on customary terms. This outcome suggested to many observers that basic principles of director duties in Delaware, including the business judgment rule, could be changing in fundamental ways.

As many of you may recall, the facts of *Lyondell* are key to understanding the case. In May 2007, Basell AF disclosed in a Schedule 13D filing that it had acquired an 8.3% stake in, and was interested in pursuing a transaction with, Lyondell. Shortly thereafter, Lyondell's board met to review the filing and decided to take a "wait and see" approach. Although the Schedule 13D arguably had put Lyondell "in play," the only other party to come forward was a private equity firm that proposed a management buyout, which Lyondell decided not to pursue. On June 26, Basell agreed to acquire Huntsman Corporation, but soon turned back to Lyondell after its bid for Huntsman was topped. On July 9, Basell raised its initial offer of \$40 per share to \$48 per share, conditioned on the parties signing a merger agreement with a \$400 million break-up fee by July 16. Lyondell's board met to consider the offer and decided to ask Basell for a written offer and more information about its financing. Basell complied, but said it needed a firm indication of interest in the transaction from Lyondell by July 11, Basell's deadline for making a new bid for Huntsman. Lyondell's board met again on July 11 and instructed the CEO to negotiate for a higher price and looser deal protection terms. Basell refused to increase its price, but agreed to reduce the break-up fee to \$385 million. On July 16, Lyondell's board approved the merger, which was later overwhelmingly approved by Lyondell stockholders.

In a decision that surprised many, the

Chancery Court found that the board may have breached its duty to act in good faith, because the directors failed "to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities." In overturning the Chancery Court's decision, the Delaware Supreme Court made clear that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard of those duties, constituting bad faith under Delaware law." While the Lyondell directors may not have done all they should have, they could not be found to have acted in bad faith unless they had "knowingly and completely failed to undertake their responsibilities." Because the directors met several times to consider Basell's offer, were generally aware of the value of their company and the chemical company market, acted on the advice of their legal and financial advisers

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**In overturning the Chancery Court's decision, the Delaware Supreme Court made clear that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard of those duties, constituting bad faith under Delaware law."**

## Order Restored for Directors' Decisions in Delaware (cont. from page 7)

and attempted to negotiate a higher offer even though they considered \$48 to be a “blowout” price, the record clearly established that any shortcomings in the Lyondell board’s decision-making process did not amount to bad faith.

As a result of this decision, directors of Delaware companies can take comfort that a fundamental element of fiduciary duty law in Delaware, as understood by most practitioners and market participants, remains in place. The Court’s decision is also relevant to private equity buyers because it should remove the incremental deal risks they would have faced under the Chancery Court’s decision as a result of increased uncertainty on the part of target company boards of directors as to the scope of their fiduciary duties in Delaware.

### Increasing Scrutiny of Executive Compensation Decisions

While the Delaware Supreme Court’s decision in *Lyondell* seems to reaffirm the

Delaware courts’ willingness to defer where appropriate to a board’s business judgment in order to encourage reasonable corporate risk-taking, some recent developments in Delaware suggest that the Delaware courts may be more willing these days to tighten the duties of directors in connection with certain executive compensation matters. In *In re Citigroup Inc. Shareholder Derivative Litigation* (C.A. No. 3338-C, Feb. 24, 2009), for instance, Chancellor Chandler refused to dismiss a claim of waste where Citigroup’s departing CEO received \$68 million and an office, an administrative assistant and a car and driver for up to five years in exchange for non-competition, non-disparagement and non-solicitation agreements and a release of claims. Moreover, in January of this year, Justice Carolyn Berger of the Delaware Supreme Court stated that courts may review board decisions on executive pay and bonuses if they “subvert basic values and standards.”

Given the current political and cultural backlash against executive compensation in general, it will be important to watch upcoming Delaware cases in this area to assess if the possible tightening suggested by *Citibank* of the business judgment rule as it applies to executive compensation arrangements continues. The good news for the private equity and broader deal community is that at least for now, it appears that the business judgment rule as it applies to M&A transactions is alive and well in Delaware, and that in general the Delaware courts are not seeking to expand existing concepts in order to impose greater liability on directors. ■

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# Just the FAQs:

## New Government Review of Foreign Investments in Germany

Non-EU private equity investors should be aware of a new Exon-Florio-like hurdle to making certain control investments in Germany. An amendment to the German Foreign Trade Act (*Außenwirtschaftsgesetz*) which authorizes the Federal Government to prohibit certain foreign investors from buying stakes of 25% or more in German companies if such acquisition would endanger “public order” or “public security” has recently become effective.

### Who is considered a foreign investor?

Entities with registered office or central headquarters outside the European Union (EU) or the European Free Trade Association (EFTA) are considered foreign investors, including many private equity funds doing business in Europe. Also, an acquisition by an entity based in the EU or the EFTA may be subject to review if a foreign investor directly or indirectly holds at least 25% of the entity’s voting rights and if there is an indication that this structure is designed to circumvent the foreign investment rules (*e.g.*, by means of establishing a letterbox company).

Note that the Isle of Man and the Channel Islands are part of the EU customs territory. Therefore, investors based there will not be considered foreign investors. By contrast, overseas territories like the Cayman Islands, the British Virgin Islands, Bermuda, Aruba and the Netherlands Antilles are not part of the EU customs territory.

### What types of transactions may be subject to review?

All types of transactions leading to an acquisition of 25% or more of the voting rights in a German company may be subject to review. This includes the acquisition of shares, debt-equity swaps or capital increases. This legislation is *not*

limited to transactions in specific business sectors.

To determine whether a foreign participation in the German target meets the 25% threshold, any voting shares held by an entity that is owned 25% or more by the investor must be taken into account. Moreover, if the investor has entered into a joint voting agreement with a third party, the third party’s shares are attributed to the investor.

### When can a foreign investment be prohibited?

An investment may only be prohibited if it threatens Germany’s “public order” or “public security.” This requires a genuine and sufficiently serious threat affecting one of the fundamental interests of society. The German government has made clear that such a threat will exist only in rare and exceptional cases. Note that the interpretation of “public order” and “public security” must comply with EU law. The European Court of Justice, for example, has acknowledged that public security may require to safeguard supply in the sectors of telecommunications and electricity in the event of a crisis. General economic, financial or labor market policy concerns are not sufficient justifications for restrictions.

### Is there a notification requirement and what is the procedure for government review?

A notification is not required but, as noted below, may be made voluntarily. If no notification is made the Federal Ministry of Economics and Technology relies on information made available by the Federal German Cartel Office, the Federal Financial Supervisory Authority or other public sources in order to review an acquisition *ex officio*. The Ministry must initiate such a

review within three months after (1) the signing of the transaction, (2) the publication of the decision to submit a public takeover bid or (3) the publication of the acquisition of control. If the Ministry initiates a review, the investor must submit specified documentation. Upon receipt, the Ministry has another two-month period to restrict or prohibit the acquisition. Should the Ministry conclude that the acquisition endangers public order or public security, it may impose certain obligations on the investor or even prohibit the acquisition entirely. Such a decision of the Ministry requires the consent of the Federal Government, *i.e.*, the Cabinet, and is subject to review by the courts.

### How can an investor obtain deal certainty?

In order to obtain deal certainty, an investor may apply to the Ministry for a certificate of non-objection while the transaction is still in the planning stage. Such application merely needs to outline the basic elements of the contemplated transaction, the investor and its field of business. This information is treated as confidential. If the Ministry issues the desired certificate or does not launch a formal review within one month of receipt of such application, the transaction is cleared.

Non-EU private equity investors should not overreact to this legislation since the review is meant to occur only in unusual circumstances, but should be mindful of the opportunity to pre-clear possibly sensitive transactions. ■

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# Recent and Upcoming Speaking Engagements

**April 29, 2009**

**Marwan Al-Turki**

**Sherri G. Caplan**

**William Godwin**

**Geoffrey Kittredge**

**Anthony McWhirter**

*Private Equity Funds: Should You Be*

*Thinking About Limited Partner Defaults*

Debevoise & Plimpton LLP

London

**May 12, 2009**

**Jordan C. Murray**

*Intro to PE Funds*

The Fundamentals of Private Equity and

Venture Capital

PEI

New York

**May 12, 2009**

**Paul R. Berger**

*Tips and Traps for the Unwary:*

*Due Diligence in Mergers, Acquisitions and  
Joint Ventures*

Second Annual Anti-Corruption for

Pharma and Life Sciences

London

**May 12, 2009**

**Rebecca F. Silberstein**

*Alternative Approaches for Private Equity*

*Fund Raising in the Current Market*

Twentieth Annual Conference on the

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International Bar Association

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Drafting Partnership Agreements for

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Foreign Investment in India

National Law School of India University

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*The Troubled Partnership—Workouts and  
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*Debt Restructurings in Light of Recent*

*Changes*

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*Implications of Section 704(c) for Negotiating  
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**May 28, 2009**

**Geoff Kittredge**

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*Age of Anxiety and Fund recapitalizations*

*EVCA Institute Pan-European Tax & Legal*

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Association

Brussels

**June 12, 2009**

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or Subsidiaries of Larger Companies*

Acquiring or Selling the Privately Held

Company 2009

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**Adele M. Karig**

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Funds*

Private Equity Tax Practices Forum 2009

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**June 16, 2009**

**Linda Lerner**

*Proposed Regulations for Hedge Funds and*

*AML Requirements for Broker Dealers*

Regulatory Compliance Update

BDO Consulting

New York

**June 18, 2009**

**Elizabeth Pagel Serebransky**

*Employment Issues, Including Developments*

*Relating to Salary Limits, Deferred*

*Compensation Issues and Bonus Accruals*

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New York

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**Jennifer J. Burleigh**

*Raising a Private Equity Fund*

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# Loan-to-Own Transactions:

## Considerations in Evaluating Distressed Real Estate Debt Instruments

With commercial real estate debt trading at deep discounts, defaults looming and the credit markets still largely frozen, traditional equity real estate investors are increasingly utilizing so called “loan-to-own” techniques to acquire real estate assets. A loan-to-own deal involves buying one or more debt instruments tied to underlying real property with the intent to own equity in the real property in the near term. While private equity firms are using similar structures to acquire equity in assets in other sectors as well, loan-to-own transactions appear to present particularly attractive opportunities in the real estate debt markets for savvy investors.

### Introduction

While many investors are holding assets that are deeply underwater, investors with “dry powder” at their disposal may have some unique opportunities. Without rehashing the factors that led to the dramatic decline in asset values since the summer of 2007, it is clear that the economic landscape today differs significantly from previous down cycles in two key respects: first, stand-alone assets and companies are heavily laden with secured debt incurred during better times; and second, refinancing remains elusive even if the sponsor is willing to contribute additional equity.

This, in turn, is creating a variety of opportunities for private equity buyers to potentially generate robust returns without utilizing much leverage, by buying deeply discounted debt instruments tied to attractive real estate assets, with the intent to convert those debt interests into ownership of equity in the assets upon the impending re-organization of the property, whether in or out of bankruptcy. If asset values appreciate over the next 5-7 year period, as they might in this real estate environment, private equity firms could generate attractive returns in a normalized investment period even without

the use of significant leverage. On the other hand, because most loan-to-own investments are made in the context of a potential foreclosure on the assets in question or the bankruptcy of the owner of the assets, investors need to evaluate the range of potential legal scenarios that could ensue under applicable foreclosure, bankruptcy and similar laws following any such loan-to-own investment.

### Background—Real Property Debt Structures

The structure of commercial real estate loans prior to the early 1990s was relatively simple, highlighted by low leverage (*i.e.*, 60% loan to value) and a single class of creditors. However, after the Resolution Trust Corporation successfully employed the “mortgaged-backed securities” structure to dispose of real estate assets held by insolvent savings and loan institutions in 1991, investment banks got into the game and the Commercial Mortgaged-Backed Securities (CMBS) business began in earnest. CMBS structures vary from deal to deal, but all feature a common thread; namely, multiple layers of vertically-tranched debt that permit investors to acquire particular senior or subordinate tranches, based upon their risk tolerances and desired yields.

### Mortgage Loan Structures

The most senior tier of debt is almost always a mortgage loan—an obligation of the real property owner secured by a first lien mortgage or deed of trust encumbering the real property and the rents generated by the tenants at the property. In mortgage loans bearing a fixed rate of interest priced off of the applicable swap rate, typically with a 10-year term, the loans are evidenced by at least two notes issued by the property owner—an “A Note” and a “B Note” (and if more than two tranches are involved, a C Note, D Note, etc.). Pursuant to a co-lender agreement, the

B Note holders (and the holders of any other tranches) are subordinated to the A Note holders, with the subordinated B note holders receiving a higher rate of interest, but bearing greater risk in a default situation. A Notes generally represent the majority of the mortgage financing and, until the credit markets seized up, were pooled into CMBS vehicles and further vertically tranced and sold in the bond market. In the case of mortgage loans bearing a variable rate of interest priced off of 30-day LIBOR, typically with a three to five year term, the loans are evidenced by a single note issued by the property owner. The originating lender then pools the most senior interest in the loan into CMBS vehicles. The remaining interests are sold outside of the CMBS vehicle and are subordinated via a participation agreement. In recent years, property owners could obtain

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**If asset values appreciate over the next 5-7 year period, as they might in this real estate environment, private equity firms could [utilize loan-to-own structures to] generate attractive returns in a normalized investment period even without the use of significant leverage.**

## Loan-to-Own Transactions (cont. from page 11)

mortgage financing for up to 75% of the value of the property utilizing the foregoing structure(s).

### *Mezzanine Loan Structures*

The boom in mortgage securitizations led to the development of a new financing technique in the real estate market—mezzanine loans to a single purpose entity which holds the equity in the property owner. Unlike mortgage loans where the borrower owns the underlying real property asset, a mezzanine borrower instead owns all of the equity in the property owner, with the equity pledged to secure the mezzanine loan. As a result of this structuring technique, mezzanine loans are contractually and structurally subordinated to all tranches of mortgage loans, but are senior to the sponsor's equity in the property. This means that once a mortgage loan default has occurred, the holder of the mezzanine loan will not be paid until after

the mortgage loan has been paid in full. In addition, in a bankruptcy of the property owner, the mezzanine lender will not receive any funds until all creditors of the property owner have been paid in full.

### *Intercreditor Arrangements*

The multiple layers of debt involved in CMBS real estate financings results in complex intercreditor arrangements, which are critical to the success or failure of each tier within the capital stack. The terms of co-lender agreements vary from deal to deal but, in general, junior lenders have: (1) consent rights over modifications of the mortgage loan terms (*e.g.*, extending the term of the loan, increasing the interest rate spread and permitting additional senior financing, including debtor-in-possession financing); (2) rights during a senior loan default (notice and cure and the ability to purchase the senior loan); (3) as to B Note holders, the right to appoint a “special servicer” to service the mortgage loan when it becomes distressed; and (4) as to mezzanine lenders, the right to foreclose on the equity in the property owner following a default, which equity foreclosure would still leave the property subject to the lien of the mortgage loan.

### *Loan-to-Own*

Given this backdrop, there are several ways to convert an investment in one or more of these debt positions into equity in today's real estate market. As was the case during previous down cycles, and as described below, lenders have the option to foreclose on real property and investors may purchase the property and related assets at a foreclosure sale, through a plan of reorganization or pursuant to a “363 sale.” These options afford investors an opportunity, prior to actually acquiring the asset, to conduct due diligence (both legal and financial) in order to determine why

the loan is or may become distressed (*e.g.*, whether the asset is ripe for default as a result of overleverage and the frozen credit markets or whether the distress is caused by events at the property itself, including extensive lease rollover, high vacancy or the need for significant near-term capital expenditures). The combination of (1) the historic lows at which distressed secured debt is currently trading and (2) the still-frozen capital markets, also offers new opportunities for loan-to-own investors, as discussed below.

### *Foreclosure*

Ownership by way of foreclosure is available to both mortgage lenders and mezzanine lenders. In each case, an investor purchases the distressed loan at a discount. Following an event of default, the investor may commence foreclosure proceedings—on the real property in the case of a mortgage loan and on the equity of the property owner in the case of a mezzanine loan. The foreclosure process may be consensual via a “deed in lieu” or an “assignment in lieu” of foreclosure, as the case may be. The primary shortcoming is that, at any time during the foreclosure process, the borrower may file for bankruptcy or contest the foreclosure in state court, thereby staying the foreclosure proceedings and causing potentially lengthy and expensive litigation. In addition, in the mezzanine loan foreclosure context, some additional considerations are: (1) that the underlying mortgage loan will likely remain outstanding and various requirements may need to be satisfied (*e.g.*, curing existing monetary defaults, providing a replacement guarantor/indemnitor and replenishing reserve accounts); and (2) if the property owner is insolvent, its directors (which will be appointed by a foreclosing acquirer) will owe fiduciary duties to creditors of the

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**The primary benefits of foreclosure are that it can be completed relatively quickly and inexpensively, if uncontested. The primary shortcoming is that, at any time during the foreclosure process, the borrower may file for bankruptcy or contest the foreclosure in state court, thereby ... causing potentially lengthy and expensive litigation.**

# What You Need to Know About the Proposed EU Directive on Alternative Investment Fund Managers

The landscape for the private equity community doing business in the European Union (the “EU”) is headed for change as the EU takes an increasing role in regulating managers of alternative assets. Managers of private equity funds, hedge funds and other alternative funds would face important new regulation under the European Commission’s proposed Directive (the “Proposed Directive”) on Alternative Investment Fund Managers (“AIF Managers”), issued on April 30, 2009. This is the first time that the EU has proposed legislation with such far-reaching impact on the private equity arena. Although the Proposed Directive will undoubtedly go through substantial revision before it is effective and will then need to be implemented by each of the EU Member States, it gives AIF Managers an indication of the shape of the future regulatory landscape for private equity in the EU.

This article focuses on a number of the frequently asked questions that have arisen about the Proposed Directive and illustrates that many of the most obvious questions cannot as yet be fully answered.

## Question 1

### *Who would be impacted by the Directive?*

Under the Proposed Directive, every AIF Manager “established and operating in the EU” and which provides “managing and administrative services” to any alternative investment funds (“AIFs”) will need to obtain authorization within one year after its home Member State implements the final Directive. Upon authorization by its home Member State, an AIF Manager established in the EU (“EU AIF Manager”) will be able to perform managing and administrative services to AIFs and market AIFs that are domiciled in the EU (“EU AIFs”) cross-border within the EU via a passporting regime.

Once the Directive has been implemented, AIF Managers established outside the EU (“non-EU AIF Managers”)

cannot provide “managing and administrative services” to EU AIFs but will be able to market AIFs if they are authorized to do so. There is an extended three-year deadline for non-EU AIF Managers to obtain authorization to market AIFs in the EU. Requirements for qualifying non-EU AIFs for sale in the EU are also covered by the Proposed Directive. For details, see Questions 8, 9 and 10.

The earliest the Directive would come into force would likely be 2010. Thereafter, the necessary implementation by the EU Member States needs to take place and this will take more time. The deadline for Member State implementation has not been set, but it probably will not be before mid-2012. Until the Member State in which an AIF Manager is established has implemented the Directive, that AIF Manager does not need to be authorized in the EU to provide “managing and administrative services” to AIFs except as required by existing national laws.

## Question 2

### *What types of alternative investment funds are covered?*

Under the Proposed Directive, AIFs include vehicles for pooled investment that are not regulated under the Directive for Collective Investment in Transferable Securities or UCITs. AIFs include hedge funds, private equity funds, funds of hedge funds, real estate funds, infrastructure funds and commodity funds. It does not matter how the AIF is organized, whether it is open-ended or closed-ended, or where it is domiciled. Certain exceptions for AIFs based on their size, participation in the EU market and other factors are described in Question 7.

## Question 3

### *What are “managing and administrative services”?*

This is a crucial interpretive issue for AIF Managers. Unfortunately, because the terms

“managing” and “administrative services” are not defined in the Proposed Directive or discussed in any of the associated legislative commentary, there is no certain answer to this question. It is also unclear if an AIF Manager must provide both management *and* administrative services in order to be subject to the Proposed Directive. If only one is required, then even firms that provide only minimal administrative services would be covered.

There is a consensus among relevant industry groups and regulatory authorities that the European Commission itself will need to answer these questions with precision in the final Directive.

## Question 4

### *How can an AIF Manager become authorized? How burdensome are the requirements?*

Importantly, in order to be authorized, an AIF Manager must be established in the EU and apply for authorization with the

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**It is also unclear if an AIF Manager must provide both management and administrative services in order to be subject to the Proposed Directive. If only one is required, then even firms that provide only minimal administrative services would be covered.**

## Proposed Directive on Alternative Investment Fund Managers (cont. from page 13)

competent authority in its home Member State (the country where its registered office is located). The AIF Manager will have to provide detailed information about its owners, planned activities, the identity and characteristics of the managed AIFs, the governance of the AIF Manager, information about any plans for the delegation of management services, the arrangements for valuation and safe-keeping of assets, and its auditors and regulatory reporting systems.

Under the Proposed Directive, the minimum capital requirement for obtaining an authorization as an EU AIF Manager is €125,000, with additional capital required if the value of the assets under management exceeds €250 million. Capital requirements could be substantially higher depending on whether the AIF Manager is subject to the capital adequacy directive.

A non-EU AIF Manager cannot be authorized to perform managing and administrative services for an EU AIF but can be authorized to market them. The requirements for a non-EU AIF Manager to be authorized by an EU Member State to market AIFs in the EU are discussed in Question 8(iv).

### Question 5

#### *Will there be other obligations and costs associated with being authorized as an EU AIF Manager?*

Yes. Under the Proposed Directive, EU AIF Managers can be authorized to provide services in the EU only if they comply with numerous business conduct regulations, including conflict of interest policies as well as risk management and liquidity management policies, procedures and systems. Specific guidance fleshing out these concepts will be issued by the European Commission at some point. We expect that many AIF Managers either already have implemented these or more rigorous policies or will do so prior to the

time the Directive becomes effective.

The Proposed Directive would also require that AIFs must have independent valuers and depositories to hold AIF assets in segregated accounts.

AIF Managers will also be subject to the new annual AIF reporting requirements to investors and regulators, additional offering memorandum disclosure requirements, reporting obligations to regulatory authorities in Member States about the assets in which AIFs are invested, side pocket investments, AIF liquidity and risk profiles, and the use of short-selling. These requirements are expected to substantially increase compliance costs of many AIF Managers.

### Question 6

#### *Are special disclosures required if an AIF Manager acquires a controlling influence over portfolio companies?*

The Proposed Directive contains controversial disclosure requirements that apply to an AIF Manager managing AIFs “in a position to exercise” 30% or more of the voting rights of any unlisted issuer domiciled in the EU. Once the AIF Manager “acquires” 30% or more of the voting rights in a listed or unlisted company, the AIF Manager has an obligation to provide detailed information to the company, its shareholders and employee representatives. For a non-listed company, the AIF Manager has to disclose its “development plan” for the company and policies for dealing with conflicts of interest. It is currently unclear under the Proposed Directive what would constitute a “position to exercise” voting rights or how voting rights would be defined. It is also not certain how the Proposed Directive would intersect with Member State corporate and disclosure laws applicable to listed companies.

There is a limited exception to these requirements for a non-listed small or

medium enterprise that employs fewer than 250 persons, has an annual turnover not exceeding €50 million and/or an annual balance sheet not exceeding €43 million.

### Question 7

#### *What exemptions from regulation under the Directive would be available for AIF Managers?*

Under the Proposed Directive, there are four possible exemptions available for AIF Managers:

- (1) **€100 million threshold.** An AIF Manager would be exempt if it manages, directly or indirectly, with its controlled or controlling affiliates, AIFs with assets under management (including assets acquired through leverage) not exceeding €100 million. An AIF Manager that manages AIFs with assets under management of more than €100 million and which utilizes leverage will not be eligible for any exemption. The Proposed Directive does not provide any guidance on how assets under management should be determined. Leverage is any method used to “increase exposure to an investment” and includes borrowed cash, securities or derivative positions. It is estimated that 90% of the hedge fund assets under management in the EU will be covered by the Proposed Directive.
- (2) **€500 million threshold.** An AIF Manager is exempt if it manages, directly or indirectly, AIFs with assets under management not exceeding €500 million as long as the AIFs both do not use leverage and have a five-year lock-up period. This threshold is too low to be applicable to many private equity firms and the lock-up period will make the exemption inapplicable for most hedge fund and listed private

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# Tax, Tax, Tax: The Not-so-Bad, the Bad and The Ugly

The Obama Administration has proposed a variety of tax changes that would affect private equity funds, their portfolio companies, and business in general. Some of the proposals have been made before (such as the proposal to change the tax treatment of carried interest) and other proposals are relatively new (such as the proposal to modify the so-called check-the-box rules). If the proposals were enacted, they would significantly affect how many businesses are structured and how much tax they pay (and to what jurisdiction they pay it). Moreover, many business groups have voiced concern that the proposals would reduce the competitiveness of U.S. firms in the global marketplace. However, since the proposals are generally long on concepts but short on specifics, it is hard to know exactly what the proposals would mean to many businesses or what actions (if any) they should take now in response to the proposals. Below is a brief description of some of the more important proposals.

## Eliminate Elective Classification for Certain Foreign Corporations

Under current law, U.S. corporations with international operations can reduce taxes paid to non-U.S. governments without increasing their U.S. taxes. For example, a U.S. portfolio company may (directly or indirectly) charge its foreign subsidiaries interest for the use of capital or royalties for the use of an intangible property. Under such arrangements, the interest or royalty payments may be deductible by the foreign subsidiary for non-US tax purposes but not includible in income by the recipient for U.S. (or other) tax purposes. The ability of portfolio companies to use these arrangements is facilitated by the so-called “check-the-box” rules, which permit an election to be made that causes the foreign

subsidiaries to be disregarded (or ignored) entirely for U.S. federal income tax purposes. The check-the-box rules also facilitate numerous other transactions, such as the movement of cash among non-U.S. operations without triggering a deemed dividend for U.S. purposes each time cash crosses a border.

In many cases the proposal would create a new U.S. tax cost to portfolio companies that continue to use intercompany charges to reduce their non-U.S. taxes. In many other cases, that new U.S. tax cost would be so high that it would force the portfolio company not to use intercompany charges to reduce its non-U.S. taxes. Strangely, in the later case the proposal could actually reduce the total U.S. taxes that get paid if the U.S. parent company is able to credit the increased foreign taxes against its U.S. taxes. Of course, the U.S. foreign tax regime is far from perfect and, as discussed below, another proposal made by the Obama Administration would make it more difficult for U.S. corporations to claim foreign tax credits.

## Defer Interest and Other Deductions of Companies With Non-U.S. Operations

Under current law, a U.S. corporation with multinational operations is generally entitled to deduct in the U.S. 100% of the expenses (including interest expense) incurred by the U.S. parent even if (as is typical) the corporation’s income from the non-U.S. operations is not currently taxable in the U.S. and will not be taxable in the U.S. until it is dividended (or otherwise repatriated) to the U.S.

The Administration has proposed requiring that the deduction for such expenses be deferred to the extent “properly allocable and apportioned to foreign-source income” to the extent such income is not

currently subject to U.S. tax. If enacted, the proposal would likely defer a portion of the U.S. deduction for interest (and potentially other expenses) of U.S. portfolio companies with non-U.S. subsidiaries and thereby increase the current tax payable in the United States. Private equity firms could respond by structuring some of the borrowing at the foreign subsidiary level. In many cases, however, leverage overseas is easier said than done.

## Limit Utilization of Foreign Tax Credits

Under current law, U.S. corporations are generally entitled to a U.S. foreign tax credit for foreign income taxes imposed on their 10% or greater owned foreign subsidiaries. The credit can be claimed when the subsidiaries make, or are deemed to make, distributions to the U.S. U.S. corporations generally manage actual and deemed distributions from high- and low-taxed pools of foreign earnings to optimize

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**If the proposals ... [are] enacted, they would significantly affect how many businesses are structured and how much tax they pay (and to what jurisdiction they pay it).**

## Something Old, New, Borrowed, and Blue (cont. from page 1)

any failure by buyer to close, regardless of whether related to a financing issue or not, and with different approaches depending on whether the buyer was in intentional breach.

Target boards often accepted this structure, although it was not actually equivalent in terms of deal certainty as the formulation being offered by strategic buyers (*i.e.*, no financing out and no limitations on monetary damages or injunctive relief). The fee was viewed as painful enough that a private equity firm would be unlikely to pay it simply to abandon a deal. And while there have been some well-documented, unintended consequences of this structure, ranging from buyers renegotiating transactions between signing and closing to buyers completely

abandoning deals as in the Cerberus/United Rentals transaction, such terms have largely survived the market disruption (albeit with modifications in some cases).

### The Trend Emerges Among Strategic Buyers

In contrast to the private equity formulation, strategic deals have not historically included any financing contingencies or limitations on liability, either because third-party financing is often not required (buyer stock or cash on hand is used instead) or because strategic buyers, who usually have a stronger credit profile, are simply willing to bear the more limited financing risk. However, the use of stock as acquisition currency has declined significantly in the past year or so, primarily as a result of the significant downturn in the equity markets, and cash deals have become much more prevalent, even in very large transactions. This trend has forced strategic buyers in many cases to turn to third-party financing to fund their deals, and in the process they have discovered that even investment grade companies are unfortunately not immune to the credit crisis. In light of the difficulty in securing financing in the current markets, strategic buyers are beginning to turn to the RTF structure as a means of sharing this risk with the target company. Ironically, in our first article on the emergence of RTFs in this publication in 2005, we asked whether strategic and private equity terms were converging with the elimination of the financing condition in large private equity transactions.

Mars' acquisition of Wrigley, announced in April 2008, is perhaps the purest example of the emergence of RTFs in strategic transactions. In that transaction, Mars successfully negotiated for an RTF of \$1 billion – about 4.35% of the total transaction value – and payment of the reverse termination fee was Wrigley's sole

remedy if Mars failed to close for any reason (*i.e.*, Wrigley was not entitled to seek specific performance or monetary damages beyond the amount of the RTF). Mars therefore obtained what has been referred to as a “pure option,” much like the prevailing private equity structure. While \$1 billion is not an insubstantial sum, the size of the fee is, as a percentage of deal value, well within the range of RTFs seen in LBOs, and would, of course, provide scant comfort to Wrigley if it were to be left at the altar in a situation where the company's value had declined by an amount substantially in excess of 4.35%.

Other strategic buyers have also successfully capped their exposure for failure to close as a result of a financing failure, though not all deals have been as buyer-friendly as Mars-Wrigley. Pfizer, for instance, in its \$68 billion acquisition of Wyeth signed in January 2009, is subject to an RTF of \$4.5 billion (approximately 6.6% of total deal value), but it is not Wyeth's sole remedy in the event the failure to close is unrelated to the financing. So, unlike Mars-Wrigley, in such event Pfizer's monetary liability is not limited in any way, and Wyeth is also entitled to seek specific performance.

A similar deal structure was utilized in Merck's acquisition of Schering-Plough, which was announced in March 2009. That transaction featured a \$2.5 billion RTF (approximately 6.1% of transaction value) payable by Merck should its financing fall through, and is Schering-Plough's sole remedy in such circumstance. Like Pfizer though, Merck was not able to limit its liability for a breach unrelated to the financing, nor was it able to avoid granting Schering-Plough a right to specific performance in such event.

One recent mega deal that departs from the trend is Roche's \$46.8 billion purchase

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**And while there have been some well-documented, unintended consequences of ... [RTF structures], ranging from buyers renegotiating transactions between signing and closing to buyers completely abandoning deals ... , such terms have largely survived the market disruption (albeit with modifications in some cases).**



## Something Old, New, Borrowed, and Blue (cont. from page 16)

of the shares of Genentech that it did not already own, which was announced just a few days after the Schering-Plough transaction. The acquisition, ultimately structured as a negotiated tender offer, did

not include any financing contingencies or limitations on liability. But there was a good reason for Roche's confidence—the company had already raised \$39 billion by the time the deal was announced, which

greatly reduced its financing risk. Roche was basically in the position of a large, credit worthy strategic buyer back in the days of more available capital, and thus was

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### Survey of Certain Remedies Provisions in Select Strategic Transactions

TRANSACTION	TARGET'S REMEDIES
<ul style="list-style-type: none"> <li>● <b>Target:</b> Weyerhaeuser Co.</li> <li>● <b>Buyer:</b> International Paper Co.</li> <li>● Transaction value: \$6B</li> <li>● Form of Consideration: All cash</li> <li>● Announced: 3-17-2008</li> </ul>	<ul style="list-style-type: none"> <li>● Reverse Termination Fee (RTF) of \$100M (1.67% of total transaction value) payable in the event of a financing failure</li> <li>● RTF and specific performance of financing covenant are sole remedies for unavailability of financing</li> <li>● No cap on damages</li> <li>● Specific performance (unless financing not available)</li> </ul>
<ul style="list-style-type: none"> <li>● <b>Target:</b> Wm. Wrigley Jr. Co.</li> <li>● <b>Buyer:</b> Mars, Inc.</li> <li>● Transaction Value: \$23B</li> <li>● Form of Consideration: All cash</li> <li>● Announced: 4-28-2008</li> </ul>	<ul style="list-style-type: none"> <li>● RTF of \$1B (4.35%) payable in the event of a breach by Buyer as a result of which the Closing doesn't occur (or if Closing doesn't occur because of regulatory issues), which is Target's sole remedy with respect thereto</li> <li>● \$1B (4.35%) cap on damages</li> <li>● No financing condition</li> <li>● No specific performance</li> </ul>
<ul style="list-style-type: none"> <li>● <b>Target:</b> Alltel Corporation</li> <li>● <b>Buyer:</b> Verizon Wireless</li> <li>● Transaction Value: \$28B</li> <li>● Non-Cash Consideration: All cash</li> <li>● Announced: 6-5-2008</li> </ul>	<ul style="list-style-type: none"> <li>● No RTF or cap on damages</li> <li>● No financing condition</li> <li>● Specific Performance</li> </ul>
<ul style="list-style-type: none"> <li>● <b>Target:</b> Wyeth</li> <li>● <b>Buyer:</b> Pfizer, Inc.</li> <li>● Transaction Value: \$68B</li> <li>● Form of Consideration: \$44.7B cash, \$23.3B stock</li> <li>● Announced: 1-26-2009</li> </ul>	<ul style="list-style-type: none"> <li>● RTF of \$4.5B (6.6%) payable if all conditions other than financing are satisfied and Buyer fails to close</li> <li>● In circumstances in which RTF is payable, it is the sole remedy</li> <li>● No cap on damages</li> <li>● Specific performance (except if no financing)</li> </ul>
<ul style="list-style-type: none"> <li>● <b>Target:</b> Schering-Plough Corp.</li> <li>● <b>Buyer:</b> Merck &amp; Co., Inc.</li> <li>● Transaction Value: \$41.1B</li> <li>● Form of consideration: \$18.3B cash, \$22.8B stock</li> <li>● Announced: 3-09-2009</li> </ul>	<ul style="list-style-type: none"> <li>● RTF of \$2.5B (6.1%) payable if either party terminates as a result of failure to receive financing by the drop-dead date, which is Target's sole remedy with respect to Buyer's failure to seek or obtain financing</li> <li>● No cap on damages</li> <li>● No financing condition</li> <li>● Specific performance, except if financing is not available</li> </ul>
<ul style="list-style-type: none"> <li>● <b>Target:</b> Genentech, Inc.</li> <li>● <b>Buyer:</b> Roche Holdings, Inc.</li> <li>● Transaction value: \$46.8B</li> <li>● Form of consideration: All cash</li> <li>● Announced: 3-12-09</li> </ul>	<ul style="list-style-type: none"> <li>● No RTF or cap on damages</li> <li>● No financing condition</li> <li>● Standard specific performance language</li> </ul>

## Something Old, New, Borrowed, and Blue (cont. from page 16)

apparently willing to forego a cap on its exposure for failure to close.

The Mars, Pfizer and Merck experiences are just a few recent examples of the convergence of private equity and strategic deal terms. International Paper obtained similar financing-related protections in its acquisition of Weyerhaeuser back in March of 2008. And variations on the structure were also utilized in the following transactions: JDA Software/i2 Technologies, Kinetic Concepts/Lifecell, Excel Maritime Carriers/Quintana Maritime, Macrovision Solutions/Gemstar-TV Guide, Ashland/Hercules and Brocade Communications/Foundry Networks.

The chart on page 17 highlights certain provisions of a number of these strategic deals.

### Impact on Private Equity

The conventional wisdom is that except in times of exuberant credit markets, strategic buyers have a number of advantages over financial buyers in competing for assets. Key among them is the willingness to enter into acquisition agreements with far less conditionality than private equity firms are prepared to bear. But with strategics' stock prices at or near historic lows and with very little liquidity in the credit markets, they have been forced to move toward a private

equity model with respect to terms relating to deal certainty, an important consideration for target boards. This convergence could level the playing field for financial sponsors, at least for so long as it lasts. Of course, when the debt and equity markets return to some semblance of normalcy, it is quite possible that strategics will be willing once again to forego these limitations on their exposure. But that creates an opportunity for private equity buyers—albeit a somewhat limited one—that unfortunately comes at a time when LBO financing is nearly impossible to obtain. If firms are willing to put more equity into transactions, they would not only take advantage of depressed asset values, but could also benefit from newfound parity with respect to deal conditionality.

It is worth noting that private equity buyers have certain other inherent advantages over their strategic counterparts in the auction context. For example, a potential sale necessarily involves the provision by the target of a large amount of sensitive information, which is particularly unsettling where the merger discussions are with a major competitor. Because there are necessary linkages between the parties that have led the buyer to believe that the acquisition would be attractive in the first

place, including synergistic product lines, or similar customer pools, there is a greater risk that a failed transaction with a strategic buyer would have more problematic commercial consequences. Although potential buyers are typically bound by confidentiality agreements, they are often not enough to assuage the target's fear of entering into talks with a competitor, and rightly so. In addition, strategic acquirors may face more stringent antitrust review in the Obama Administration than was the case during the Bush Administration.

The convergence in deal terms with respect to conditionality may offer some welcome relief to private equity buyers plagued by less than active leveraged financing markets. They can offer terms on conditionality similar to those being used by strategics, but with the added benefit that a busted deal with a private equity firm is far less damaging to a business than one with a competitor. While this may not be enough to increase deal activity without a far more vibrant financing market, it is a modest silver lining – and illustrates how the deal world constantly evolves. ■

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## What U.S. Regulatory Reform Could Mean for Private Equity (cont. from page 4)

progress of initiatives at the federal level, such increased state regulation could be preempted (in whole or in part) or, at the other end of the spectrum, lead to a patchwork of regulatory requirements for private funds.

### Conclusion

Private fund regulation in some form is coming, although the precise scope of this regulation is still taking shape. At a

minimum, it is likely that private funds sponsors will be facing a more rigorous compliance regime. Sponsors should consider how they will adapt to that regime even before it is finalized. They should begin to review their compliance policies, particularly their policies that relate to personal securities trading by employees, as well as their policies and procedures to protect material non-public information.

They should also keep their eyes out for future issues of *The Debevoise & Plimpton Private Equity Report*, as we will continue to update our readership on developments in this area. ■

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## The New M&A Accounting Standards (cont. from page 6)

**PwC:** No. These are not restatements. The adjustments will just need to be reflected in any financial statements issued following the adjustment. Using our example, when the first quarter 2011 financials are published, the prior year comparable numbers—for the quarter ended March 31, 2010—would include the adjusted numbers. 10-Ks and 10-Qs will not be re-filed as adjusted—unless there is a need to reissue the financial statements in connection with a registration of securities.

**RQ:** *If buyers can choose to close their deals on either September 29 or October 2 will you now be recommending an October 2 closing because that will give more time to get the opening balance sheet correct and minimize adjustments?*

**PwC:** If an acquirer is otherwise relatively indifferent to the timing of the closing date, then yes, I think we'd recommend that they close their acquisition as early as possible in the beginning of a new quarter. That way they would have more time to value the acquired assets and liabilities and less risk that material movements in fair value will be required to be disclosed in the subsequent financial statements as the valuation is finalized. These movements can sometimes be difficult to explain to the investment community.

**RQ:** *It must vary company by company, depending on size, complexity, etc., but traditionally how long has it taken before items of this type "settle?"*

**PwC:** It really depends on the complexity of the deal. We've seen large multi-national acquisitions utilize the better part of the measurement period before finalizing the purchase price allocation. On the other hand, we have some clients who, especially in smaller deals, have undertaken the purchase accounting process during deal negotiations and had

everything more or less finalized within one month after the closing date.

### Debt Covenants; Purchase Price Adjustments

**RQ:** *Let's double back to something you said earlier. You mentioned that private equity sponsors should be concerned about the effect of the new standards on financial covenants in debt agreements. Can you elaborate on that?*

**PwC:** Many of the changes we are discussing, such as the new treatment for transaction costs had no income statement impact under the old standards, but now they do. In addition, they are outside of the traditional add-backs for financial covenant measures, such as "Adjusted EBITDA." Accordingly, many of these charges, to the extent they are not already captured as non-cash adjustments, will have to be addressed in the structuring and negotiation of financial covenants.

**RQ:** *Will the new standards have any impact on the standard working capital or net worth purchase price adjustments?*

**PwC:** As we understand them, working capital and net worth-based adjustments to purchase price tend to drive off of the closing balance sheet of the target—the balance sheet immediately before the deal closes. The new standards really affect the opening balance sheet and post-closing earnings and, as such, shouldn't impact purchase price adjustments.

### Earn-outs

**RQ:** *Notwithstanding that lawyers may try to strike fear in their clients' hearts about the difficulties of negotiating and then administering earn-outs, they have been a consistent M&A feature, and they are probably even more popular in a climate like today's, in which buyers and sellers have widely differing views on value. What has*

*the FASB done with respect to the treatment of earn-outs?*

**PwC:** Under the historical guidance, earn-outs were typically not recorded until settled, at which point the original purchase price was generally increased, through an adjustment to goodwill, without affecting earnings. Under the new standards, earn-outs are recorded at fair value in the opening balance sheet, either as a liability or in shareholders equity. Earn-outs that are payable in cash will generally be recorded as a liability.

**RQ:** *It always seemed odd that buyers did not have to book any liability for an earn-out. What happens under the new standards, post-opening balance sheet?*

**PwC:** Earn-outs that must be classified as a liability are marked to fair value at each reporting period through earnings. This remeasurement to fair value each reporting period will result in post-acquisition earnings volatility.

**RQ:** *So if the acquired business does well, increasing earnings, that increase will be offset to some extent by the hit to earnings that results from the increased likelihood of paying a bigger earn-out?*

**PwC:** Yes. That is correct.

**RQ:** *But if the new subsidiary performs below expectations, that may actually boost earnings, as it reduces the liability booked for the earn-out?*

**PwC:** Yes, that is also true, and as your questions imply, some consider these results counterintuitive. Of course, an under-performing subsidiary may also be required to report impairments of goodwill or other assets, which could offset the earnings boost to some degree.

**RQ:** *One other question—any changes in what acquirers can do to make the earn-out*

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## The New M&A Accounting Standards (cont. from page 19)

*serve as a retention device, as well as a bridge between differing opinions on value?*

**PwC:** Not really. The new standards have not changed the historical requirement to look through the form of a transaction and determine if the earn-out is really designed to compensate former owners for ongoing service to the company. If that is the case, the earn-out is considered to be compensation and, instead of being recorded in the opening balance sheet, will accrue as expense over its term.

### Valuing the Equity in a Stock for Stock Deal

**RQ:** *Let's talk about stock mergers for a minute. These transactions are sometimes the competing alternative to a private equity cash deal, so it will be useful for private equity buyers to understand any changes in how they are treated. Is it true that in a stock merger the acquirer will now have to value the merger consideration at the closing date, instead of at the signing date?*

**PwC:** Yes. In any deal in which all or part of the purchase price consists of equity, the price used for purposes of the acquisition accounting will be based on the fair value of the equity transferred at the date the acquisition is consummated. Under previous guidance acquirers valued equity consideration at the average fair value during the period commencing five days before and ending five days after the announcement of the acquisition.

**RQ:** *That seems kind of nutty. If Company X has a share price of \$20 and agrees to acquire Company Y for 100 million shares, and the market loves the deal and sends the price of Company X stock to \$30 before the closing, then Company X is suddenly paying \$3 billion instead of \$2 billion?*

**PwC:** Yes. The theory is that the fair value of the consideration exchanged was \$3 billion, and that is what should be

reflected as purchase price.

**RQ:** *Management will love that. What are the accounting consequences? Where does the \$3 billion hit the financial statements?*

**PwC:** The \$3 billion in purchase price will be compared to the net assets and liabilities of Company Y that will appear on the opening balance sheet, and any excess will be allocated to goodwill. Note, though, that if in your scenario Company Y's projected cash flows support only a \$2 billion purchase price, buyer may not be able to avoid an immediate goodwill impairment charge. Under the old standards, immediate goodwill impairment was discouraged by the SEC staff. It will be interesting to see whether that staff changes its position in the face of a scenario like the one you describe.

**RQ:** *Don't the new standards make it look like Company X overpaid?*

**PwC:** I'm not sure I'd blame the standards here. Under your facts, the stock price did rise, and Company X was required to transfer more value, as required under its agreement with the target. Did the standards make it look like Company X overpaid, or did Company X actually hand over more value to Company Y's owners? Under the old guidance, there wasn't much transparency around the ultimate consideration in a stock deal. Given the increased transparency, we believe the use of caps and floors to collar the value transferred may become even more common which could impact how targets view the alternatives to the private equity deal.

**RQ:** *What if the market doesn't like the deal, or other circumstances intervene, and the acquirer's share price drops to \$10? Now the acquirer is paying \$1 billion for a company that it believes is worth much more—say \$2 billion. Then what?*

**PwC:** That could definitely happen and in accounting terminology might result in a bargain purchase, giving rise to negative goodwill. To the extent that the aggregate fair value of the net assets acquired exceeds \$1 billion in your example, the difference would be negative goodwill and would be recognized as a gain in the income statement for the period in which the closing occurs.

### Restructuring Costs

**RQ:** *Sometimes buyers acquire a company with the intention of effecting a reorganization post-acquisition. Historically, the liability for the anticipated restructuring costs was recorded in the opening balance sheet, with no impact on post-acquisition earnings. Does it still work that way?*

**PwC:** No. Under the new standards, restructuring costs may be accrued as liabilities *only* if they were initiated by the target prior to the acquisition and do not benefit the acquirer, a situation that we expect to be rare. Otherwise, restructuring costs must be expensed as incurred and will reduce post-acquisition earnings.

### Tax

**RQ:** *Notwithstanding a flurry of proposed tax changes in many areas, the tax code is not being modified along with the new accounting standards. How are the differences between the new accounting treatment and the tax treatment of some of these items going to manifest themselves in a portfolio company's financial statements?*

**PwC:** You are correct that the tax code is not being altered in tandem with the accounting rules. This means there will be new sources of book-tax differences, which manifest themselves as deferred tax assets and liabilities. Companies will need to update their tax accounting systems

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## The New M&A Accounting Standards (cont. from page 20)

and processes to take into account the changes. They'll also need to ready themselves for increased volatility in their effective tax rates.

**RQ:** *But none of this has any effect on true cash tax expense—right?*

**PwC:** Right. The new M&A accounting standards do not affect how much tax will be paid.

### Projections; Valuation Models; Financial Due Diligence

**RQ:** *Public companies, and companies that might go public, are unhappy about the increased likelihood of post-acquisition earnings dilution and volatility. Practically speaking, is there anything they can do?*

**PwC:** There are two main points to be made here. First, deal modeling techniques must be modified to account for the new standards. A five year earnings forecast will need to factor in the items we have been discussing to be a useful predictor of future performance. Second, to properly manage the expectations of the investment community, we recommend that acquirers engage in more thorough financial due diligence, including valuation analysis, earlier in the deal process and take steps to communicate with investors in advance about anticipated dilution and volatility. To use a simple and obvious example, no company wants to announce that an acquisition is expected to be immediately

accretive, only to find out later that restructuring activity had such a negative impact on earnings that the transaction was dilutive for its first three quarters.

**RQ:** *That sounds like good advice. It looks like staying in close touch with accountants (as well as lawyers) early in the deal process has never been more important. ■*

## Tax, Tax, Tax: The Not-so-Bad, the Bad and the Ugly (cont. from page 15)

foreign tax credit utilization. The Administration proposes to restrict the ability to optimize foreign tax credit utilization by determining creditable foreign taxes based on the amount of total foreign tax the taxpayer actually pays on its total foreign earnings, regardless of which pool of earnings is actually repatriated to the U.S.

The Administration also proposes to limit the ability of taxpayers to claim a foreign tax credit on income that is not subject to U.S. tax. It is not clear how this limitation will fit into existing foreign tax credit limitations that are also designed to prevent this outcome.

The primary affect of these proposals would be to increase the current tax cost to U.S. corporations that receive dividends from their subsidiaries.

### Taxation of Carried Interest

Various proposals have been made over

the last couple of years to change the taxation of carried interest so that the profits received by the general partner of a private equity fund are taxable as ordinary income (rather than by reference to the types of income or gain generated by the fund, including long-term capital gain). Although the profits received in respect of the general partner's own capital would generally still be taxed by reference to the income and gain of the fund, at least some of the proposals appear to treat 20% of the profits on the GP's own capital as ordinary income where the capital is invested through the fund. Moreover, some of the proposals would treat all of the profits on the GP's own capital as ordinary income when it is borrowed from a limited partner (with no carve out for loans made in the ordinary course of a limited partner's lending business).

### Deferral of COD Income

As part of the Stimulus Bill enacted earlier this year, the tax law relating to cancellation of debt income was changed in a manner designed to provide relief to taxpayers. Under the new law, taxpayers who realize COD income can generally elect to defer that income and include it ratably over a five-year period beginning in 2014. ■

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## Loan-to-Own Transactions (cont. from page 12)

property owner and, accordingly, may be obligated to vote to put the property owner into bankruptcy.

### **Ownership Pursuant to Plan of Reorganization**

In order to acquire real property under a plan of reorganization, an investor purchases a substantial position in the “fulcrum security” (*i.e.*, the class of claims that the investor anticipates will receive new equity under a plan of reorganization based on the value of the debtor’s assets) at a significant discount from face value. The investor then seeks to participate in the bankruptcy process to influence the direction and speed of the proceeding. If all goes as planned, the investor will eventually receive a substantial piece of new equity in the reorganized entity pursuant to a plan of reorganization.

Much, however, can go wrong. To begin with, the bankruptcy process is inherently slow—often taking one or two years—and expensive. Moreover, the debtor’s exclusive period—the period of up to 18 months during which the debtor has the sole right to propose a plan of reorganization—may allow the debtor to delay the process significantly. During this time, values may deteriorate and the class of claims originally identified by the investor as the fulcrum security may now be under water. Finally, under certain circumstances, a plan of reorganization may be imposed over an investor’s objections.

### **363 Sales**

A sale pursuant to Section 363 of the Bankruptcy Code (a “363 sale”) permits an investor, including a secured creditor with an allowed claim with respect to the asset in question, to acquire assets from a debtor during the pendency of the bankruptcy case. 363 sales are not subject to the procedural and substantive requirements of

a plan of reorganization and, accordingly, are not accompanied by many of the risks outlined above. Generally, 363 sales may be consummated fairly quickly and efficiently. Another feature attractive to investors is that assets are sold free and clear of liens and are approved by the bankruptcy court. Notwithstanding the relatively speedy process, 363 sales pose certain basic challenges. Traditionally, investors have had limited control over the sale process. First, only the debtor may initiate a 363 sale, so the sale must be consensual. Second, a 363 sale will be approved by the bankruptcy court only if it represents the “highest and best” price available for the assets in question. In order to achieve this goal, the bankruptcy court may require more than one auction and, accordingly, the initial “stalking horse bidder” may ultimately be outbid.

Under Section 363(k) of the Bankruptcy Code, a secured creditor with an allowed claim may “credit bid” in a 363 sale (*i.e.*, offset the claim against the purchase price in the sale). A secured creditor may bid the full amount of its claim without regard to the value of the underlying collateral. This is not a new right, but in previous downturns senior debt traded at such a modest discount that the right to credit bid was not a particularly valuable tool. Secured debt is now an attractive bidding currency because it is trading at a substantial discount in the secondary market. As a result of current market conditions, in many bankruptcies, a credit bidder will likely win the auction or perhaps even be the sole bidder.

### **Debtor-in-Possession Financing**

The debtor-in-possession (“DIP”) financing market is suffering from the same deep freeze that is affecting the broader credit markets. This fact presents distressed

borrowers who are experiencing liquidity issues with yet another hurdle to clear on the road to financial recovery. In the absence of competing sources of DIP financing, a loan-to-own investor may take advantage of the distressed borrower’s circumstances in order to obtain favorable loan terms and to exert significant control over the bankruptcy process. An investor willing to provide DIP financing may use the financing to its benefit by imposing strict terms that include: (1) a requirement that the debtor sell assets in accordance with a tight timetable; (2) prepayment fees in the event of a sale to another bidder; (3) a short maturity; and (4) granting the investor the option to require partial repayment in equity of the reorganized entity.

### **Conclusion**

Complicated, multi-tiered capital structures of real estate ownership vehicles provide many opportunities for investors willing to look outside-the-box in order to obtain equity-like returns. Choosing the right debt tranche and carefully evaluating the rights and obligations associated with each tier of the capital structure are critical to the successful execution of the loan-to-own strategy. ■

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## Proposed Directive on Alternative Investment Fund Managers (cont. from page 14)

equity funds or funds of funds. The exemption would most likely apply to many smaller venture capital and private equity AIF Managers.

- (3) *AIF Managers neither managing nor marketing AIFs in the EU.* Any AIF Manager is exempt, even if it is established in the EU, as long as it neither provides management services to EU AIFs nor markets any AIFs within the EU. For example, an AIF Manager established in London that only manages a private equity fund organized as a Cayman Islands limited liability company marketed solely to US investors would be exempt.
- (4) *Other exemptions.* Managers of pension funds and non-pooled investments (such as endowments, sovereign wealth funds or assets held for their own account by credit institutions, insurance or reinsurance undertakings) are also exempted under the Proposed Directive. In addition, actively managed investments in the form of securities, such as certificates whose performance is linked to a pool of assets, managed futures, or index-linked bonds are apparently not treated as AIFs under the Proposed Directive.

### Question 8

#### *Can AIF Managers continue to market AIFs in the EU? What constitutes “marketing”?*

Under the Proposed Directive:

- (1) Marketing means any “general offering or placement of units or shares” in an AIF with investors domiciled in the EU, *regardless of at whose initiative the offer or placement takes place.* It appears that this is meant to include private placements as well as public offerings. It also seems to include offers made to

persons that are not solicited by the AIF Manager.

- (2) The general rule is that an AIF Manager established in the EU can market EU AIFs only to “professional investors/professional clients” (as defined by the Markets in Financial Instruments Directive (MiFID)) in the Member State in which the AIF Manager is authorized and other Member States subject to compliance with a passporting regime. Until the final Directive is adopted by the European Commission and implemented by Member States into their national laws, AIFs can be marketed in accordance with historic practice to EU investors, consistent with local law. Once effective, the Directive is expected to make it difficult to market AIFs throughout the EU to high net worth individuals and other non-professional investors as is currently permitted in some EU jurisdictions.
- (3) An individual Member State can decide to adopt regulations to allow an AIF Manager authorized by the Member State to market AIFs *to retail investors within the Member State’s territory* (but not elsewhere in the EU). Additional regulatory safeguards and stricter standards would be imposed on types of AIFs and on how they are marketed to individuals. Today, some Member States permit units in certain open-ended real estate and other types of funds to be sold to retail investors. Others presently allow AIFs to be sold to individuals with a specified net worth.
- (4) An important exception to the requirement to obtain authorization for marketing AIFs to EU investors is

available for non-EU AIF Managers for a period of three years after the date the Directive is adopted by Member States (the “Grace Period”), which will likely not start before 2012. Until the expiration of the three-year Grace Period, a non-EU AIF Manager can continue to market AIFs within the EU consistent with the domestic laws of the Member State in which the marketing is conducted. After the end of the Grace Period, a non-EU AIF Manager will be required to be authorized under the Directive in a Member State in order to market AIFs in the EU. Marketing will be limited to professional investors. It does not appear that non-EU AIF Managers will be eligible for any passporting regime. There are additional issues relating to the ability of non-EU AIF Managers to obtain authorization under the Directive. In addition, there are limitations on the ability to market non-EU AIFs. For more details, see the answers to Questions 9 and 10.

### Question 9

#### *Are there restrictions on the ability to market a non-EU AIF to investors in the EU?*

Under the Proposed Directive, an EU AIF Manager, once authorized in its home Member State under the Directive, can market non-EU AIFs to professional investors but only if the country where the non-EU AIF is domiciled agrees to comply with Article 26 of the OECD Model Tax Convention and “ensures the exchange of information on tax matters.” It can be expected that this tax requirement will particularly affect non-EU AIFs domiciled in certain countries, such as the Cayman Islands, the British Virgin Islands and the

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## Proposed Directive on Alternative Investment Fund Managers (cont. from page 23)

Channel Islands, as well as Indian, Asian and Middle Eastern jurisdictions, unless those countries agree to comply with Article 26. Clearly, these requirements will not be popular within the private equity community.

During the Grace Period, a non-EU AIF Manager can continue to market to EU investors AIFs, wherever they are organized or domiciled, as long as local laws are observed. After the end of the Grace Period, a non-EU AIF Manager will be required to be authorized under the Directive in a Member State to market AIFs to investors in that Member State. In order to be authorized, the non-EU AIF Manager must meet the requirements described below in Question 10. Like EU AIF Managers, even an authorized non-EU AIF Manager will be able to market only those non-EU AIFs that meet the tax transparency requirements described in the paragraph above.

### Question 10

#### *Are there restrictions on the ability of non-EU AIF Managers to become authorized to market to EU investors?*

After the end of the Grace Period, a non-EU AIF Manager may be authorized by a Member State to market non-EU AIFs to investors in that Member State but only if the European Commission has determined that the country where the non-EU AIF Manager is established has equivalent regulation, supervision and enforcement, provides effective comparable market access, agrees to cooperate in the exchange of information about AIF Managers, and has signed an agreement with the Member State to comply with Article 26 of the OECD Model Tax Convention.

Qualification in one Member State cannot be passported into another Member State.

We expect that the intersection of the

requirements described in Question 9 and in this Question 10 would have a substantial negative impact on the activities of AIF Managers domiciled in many countries outside the EU.

### Question 11

#### *Can an AIF Manager retain a placement agent to market AIFs in Europe?*

The Directive contains language that could in fact be read to state that entities not authorized by the Directive cannot market AIFs in the EU. This will need to be clarified in the final Directive.

### Question 12

#### *Can services be delegated to third parties?*

Under the Proposed Directive, an authorized AIF Manager can delegate one or more of its functions to third parties with the prior authorization of the competent authority of its home Member State. Delegation of portfolio management or risk management can be made only to and AIF Manager authorized to perform such functions, and no sub-delegation is permitted. The delegate has to meet certain qualification requirements and remains subject to supervision by the AIF Manager. Delegation of administrative or depository functions to an entity in a non-EU country is possible, subject to demonstration of necessary safeguards.

### Question 13

#### *Will AIFs be regulated?*

Most AIFs are not regulated under the Proposed Directive. As is the case now, AIFs are subject to the laws of the country of their respective organization and fund documentation. However, the Proposed Directive states that there would be new substantive requirements imposed on AIF Managers whose AIFs invest in securitized instruments.

### Question 14

#### *Should AIFs be restructuring their businesses in anticipation of the regulatory change?*

There is no need for immediate action. We expect that the Proposed Directive will go through substantial revision. It will take two years or longer before the Directive is effective and somewhat longer for implementation by the Member States. In addition, non-EU AIF Managers will enjoy the three-year Grace Period during which they will be able to market AIFs in the EU, subject to local national laws.

### Conclusion

The Proposed Directive is part of the world-wide initiative to regulate the financial markets more vigorously and is a good indication of what can be expected in Europe. For a discussion of pending regulation of private equity in the United States, see the article on page 3 of this issue of the *Debevoise & Plimpton Private Equity Report*. It is important to remember that all these initiatives remain subject to change before having the force of law. Nonetheless, anticipating the enhanced regulatory environment is important, as is making sure that the regulations are shaped to be effective and focused on significant commercial rather than political issues. ■

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