Allocating Financing Risk: Recent Trends in Sponsor-Led Public Company LBOs

Private equity-led buyouts of public companies have reemerged over the past several months, with at least 11 announced deals since November of 2009. Although this may not signal a return to the pace of the market in 2006-2007, it has provided an opportunity to test the durability of some of the key paradigms under which PE deals were done during that period. This article focuses on the state of play in recent deals with respect to one of the most heavily scrutinized constructs of that era—the suite of provisions that address the target’s remedies in the event the buyer fails to close. These provisions are increasingly important in today’s market, as private equity buyers get pressured by sellers to tighten the terms of acquisition agreements and by lenders to loosen financing commitments.

At the peak of the PE deal market in 2006-2007, “reverse termination fees” (or “RTFs”) and waivers of the target’s right to seek “specific performance” (a court order requiring the buyer to perform its obligations) often combined to effectively provide the buyer an “option” to walk from the deal with its liability capped at the amount of the RTF. RTFs during this period were typically in the range of 2-4% of the deal’s equity value, though in some instances, the buyer was potentially liable for a higher amount—in the range of 6%—if the target could prove actual damages. Less frequently, and perhaps reflecting...

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Letter from the Editor

Although many in the private equity community would argue that their activities did not contribute to the recent financial crisis, few would disagree that its aftermath will change the private equity environment. In our spring issue, we discuss a number of these developments and how they may impact fundraising and dealmaking.

Ironically, one of the areas in which major change has not emerged is in the way deal terms are evolving. As Kevin Rinker and Michael Diz explain on our cover, as financing has reappeared in recent months for a small (relatively speaking) flurry of sponsored going-private transactions in the U.S., the now familiar reverse termination fee (albeit in a slightly larger amount) has re-emerged as the way in which targets are compensated financially if the transaction does not close. The more subtle change is that all the constituencies to these transactions — targets, sponsors and financing sources — now understand that the deal document’s specific performance language, once considered boilerplate by the uninstructed, may also determine what happens if a deal runs into trouble and how small differences in approach to these provisions can impact the playing field.

Regulation of the private equity industry is a foregone conclusion, and the only remaining issue is how broad that legislation will be and how it will work for a global industry across jurisdictions. Geoff Kittredge and Anthony McWhirter of our London funds team discuss the current state of the European AIFM legislation and explain the possible compromises ahead. The so-called Volcker Rule’s prohibitions on private equity investing and sponsorship by banking institutions is a nightmare for members of the private equity community and it may soon become a fact of life. Greg Lyons and Jen Burleigh discuss the broad scope of the proposed legislation and how financial institutions may best cope with it without violating their fiduciary and contractual obligations to investors and others. They also point out that the phase-in rules, as drafted, do not apply to all aspects of the rule and that if the legislation is adopted this summer in its currently proposed form, it will have an immediate impact on lending and other transactions between banking institutions and their affiliated funds. We note that the final shape of the Volcker Rule is still very much a work in progress as we go to press on June 20 and we will update our readers in our next issue.

In our Guest Column, Tom Franco of Clayton, Dubilier & Rice, and one of the founders of the Private Equity Capital Research Institute, reports on a recent workshop in Brussels among European regulators, politicians, labor leaders, academics and industry leaders focusing on the impact of private equity on employment, management and systemic risk. Tom highlights some evolving academic research in these areas and makes the case that regulation should be based on a fact-based analysis rather than on the political climate.

Brazil is considered one of the best jurisdictions for private equity. We explain how to structure investments in Brazil to utilize the tax advantaged approach devised by the Brazilian government to attract investment.

We also focus on a new trend in private equity fundraising — bespoke arrangements between very large investors and private equity managers, who create separate accounts for these investors offering customized structuring, investment strategy and/or reporting features.

To round out our issue, we discuss the proposed ban on the use of placement agents in connection with California public investors and potential developments in the UK Takeover law that may impact the ease of UK transactions. Finally, while most in the private equity industry anxiously await major tax changes relating to the taxation of carried interest, we focus instead on legislation already enacted by Congress in March designed to force certain types of non-U.S. entities, including non-U.S. private funds, to disclose to the IRS information about their U.S. account holders and U.S. owners.

As the private equity industry confronts more cumbersome regulation and renewed attention, we hope that you will continue to look to the Debevoise & Plimpton Private Equity Report to assist you in finding ways to manage this evolving environment. We welcome your guidance on the topics that would be of most interest to you.

Franci J. Blassberg
Editor-in-Chief

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The Debevoise & Plimpton Private Equity Report to assist you in finding ways to manage this evolving environment. We welcome your guidance on the topics that would be of most interest to you.

Franci J. Blassberg
Editor-in-Chief
From Long Shot to Likely in Six Months: Coming to Grips with the Volcker Rule and Its Private Equity/Hedge Fund Implications

At its inception, the so-called “Volcker Rule,” which would ban proprietary trading and the operation of, or investment in, hedge and private equity funds by U.S. banking organizations, seemed unlikely to gain much traction. But a confluence of political and economic currents has brought the proposed legislation to the brink of enactment with torrential speed.

Reflecting the original prospects of the Volcker Rule, the House financial services reform bill, passed on December 11, 2009, had no reference to it. And, as late as March 2010, Chairman Dodd of the Senate Banking Committee noted that regulators were better suited than legislators to devise limits on proprietary trading and private equity and hedge fund investment by banking firms. As a result, many in the financial services industry had breathed a sigh of relief.

But amid the stormy political waters for the financial services industry since March, legislators changed course and included the Volcker Rule in the reform bill passed by the Senate on May 20. Deputy U.S. Treasury Secretary Neil Wolin indicated that the Administration “will work hard to include” the Volcker Rule in the final bill that currently is expected to be signed by the President in early July. As a result, banking institutions (including not only traditional bank-centric organizations, but also investment banks, insurance companies and other financial services firms with insured banks or thrifts as part of their organizations), and the private equity and hedge fund industries that interact with them, are preparing to deal with the reality of the Volcker Rule’s likely impact.

We should emphasize that the provisions of the Volcker Rule are not yet final — the financial services industry is lobbying to limit its scope, and at the same time, legislative proposals are being discussed that could make it even more restrictive. However, the potential ramifications of the Volcker Rule are sufficiently dramatic, and the implementation of parts of the Volcker Rule potentially so rapid, as to warrant banking institutions and private equity and hedge fund professionals understanding its current provisions and evaluating possible responses. This article, which of course can speak only as of the date we go to press, is intended to assist with that effort by summarizing the Volcker Rule and then describing some alternatives that financial institutions might consider in dealing with their private equity activities.

Private Equity/Hedge Fund Limitations

Under the Senate bill, the federal banking agencies will be required to issue regulations prohibiting any insured bank or thrift, or any subsidiary of such a holding company, from (1) sponsoring (i.e., serving as the general partner or managing member or selecting the majority of the management of, or sharing a name with) a private equity or hedge fund, or (2) investing in such a fund. The scope of the prohibitions are subject to modification, including potentially via de minimis exemptions or similar changes recommended by a newly-established council of regulators (the “Council”). Those potential modifications are hoped by many to include the ability to invest in or sponsor private equity funds up to a certain percentage of a banking organization’s and/or a fund’s total capital.

The Senate bill defines a private equity or hedge fund as one that is exempt from registration as an investment company pursuant to Section 3(c)(1) of the Investment Company Act of 1940 (the “’40 Act”) (one with 100 or fewer beneficial owners) or 3(c)(7) of the ’40 Act (one with only qualified purchasers), as well as any “similar fund” as jointly determined by the relevant federal banking agencies. As a result, unless and until the agencies define “similar funds,” those funds relying on an exemption from the ’40 Act other than 3(c)(1) or 3(c)(7) thereof may not be affected by the Volcker Rule’s provisions. Investments in small business investment companies, and investments designed to promote the public welfare (as defined in the National Bank Act) are also expressly exempted from coverage. Direct investments in operating companies by banking organizations, via the merchant banking rules, also do not appear to be covered (although companies holding such investments must not themselves be 3(c)(1) or 3(c)(7) funds).

Foreign banking organizations are not

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subject to the Volcker Rule as currently proposed to the extent that their investment or activity occurs “solely outside of the United States,” a term that is undefined in the legislation. A banking organization whose parent is organized in the United States cannot rely on that exemption for either its U.S. or foreign activities. As a result, if the Volcker Rule becomes law, U.S.- headquartered bank holding companies will be at a competitive disadvantage to their non-U.S. competitors in connection with non-U.S. activities.

The approach taken in Europe, where many countries historically have permitted “universal” banks that engage in a wide range of financial service activities, is quite different. The European governments thus far have chosen not to impose a similar outright prohibition on private equity and hedge fund activities of holding companies headquartered in their jurisdictions, but instead to address perceived risky activities via increased capital and liquidity charges currently being proposed by the Basel Committee on Banking Supervision.

A study and rulemaking process is mandated before most of the Volcker Rule prohibitions become effective. The Senate bill requires the Council to complete a study of the impact of these prohibitions within six months and make any recommendations for modification. After the completion of the study, the federal banking agencies have nine months to issue implementing regulations. Industry comment and involvement is expected and will be critical during this period as a way of trying to minimize the burden of the law and to prevent any further unintended adverse consequences. The Senate bill provides for a two-year divestiture period after the regulations become final, with the possibility of up to three one-year extensions, which could be sought on a case-by-case basis.

**Affiliate Transactions**

Although the study period and phase-in rules may well ameliorate the impact of the Volcker Rule, at least in the short run, that relief could be undercut because of the possible immediate applicability of the affiliate transaction limitations in the rule. The banking industry has been subject to affiliate transaction rules for some time, but the proposed rules targeted at private equity and hedge funds are far more stringent than those currently in effect. The existing regulations generally prevent a bank or thrift from supporting its parent and sister companies to the insured depository institution’s detriment by imposing a set of quantitative and qualitative limits on a bank engaging in so-called “covered transactions” with those affiliates; covered transactions include any dealings that place the bank’s funds “at risk” for the benefit of an affiliate, including through a capital contribution, purchase of assets, loan, guarantee or otherwise.

The Volcker Rule materially expands the application of these affiliate transaction rules. Rather than focusing on transactions potentially creating risk for a bank or thrift, the Volcker Rule applies the affiliate transaction limitations more broadly to cover any entity in a banking enterprise that provides investment advice to a private equity/hedge fund, and also likely covers entities in the chain up to and including the holding company of that adviser. Sister nonbank companies of the adviser are not expressly covered in the Senate bill, although the ultimate breadth of these rules within a banking organization is still not clear. Moreover, rather than permitting but imposing quantitative and qualitative limits on covered transactions with an affiliated private equity or hedge fund, the Volcker Rule completely bars covered transactions with these funds. In other words, under the Volcker Rule, if a banking enterprise provides investment advice to a private equity fund, at a minimum, the banking enterprise’s investment adviser, and also its holding company, are barred from making an investment in the fund, making a loan to the fund or otherwise supporting the fund financially. The Volcker Rule also makes any contractual provisions between a covered fund, on the one hand, and the insured bank or thrift, its direct or indirect holding company and any subsidiary of the holding company that serves as an investment adviser to a hedge or private equity fund, on the other hand, subject to the requirement that the arrangement be on terms at least as favorable to the banking enterprise as an arms’-length relationship with an unaffiliated fund.

Unlike the prohibitions on sponsoring or investing in private equity or hedge funds discussed above, there is no express transition period for the application of these enhanced affiliate transaction rules. As a result, while not at all clear from the text of the Volcker Rule itself, there is concern that
GUEST COLUMN
The Word from Brussels: Confusion or Good Policy?

The etymology of “Brussels” – which is from the Old Flemish word for marshland – provides an apt moniker for Brussels’ current role as the epicenter of the European Union. As observers of the European political scene can attest, it often appears that the laws and policies of the EU are mired in a kind of muddy institutional complexity.

Case in point: the ongoing tug-of-war over the proposed Alternative Investment Fund Managers (AIFM) Directive aimed at tightening the regulation of hedge funds and private equity fund managers now taking place between the Council (representing national governments), the European Parliament (representing the people) and the European Commission (a body independent of EU governments that upholds the collective European interest.)

(For the latest on this tug-of-war, see the article entitled “Update: EU Directive on Alternative Investment Fund Managers: Are the Trialogues Almost Over?,” on page 7 of this issue.)

Let’s Give Them Something to Talk About

The AIFM Directive was the proverbial elephant in the room at an April workshop in Brussels focusing on the economic impact of private equity. Sponsored by the Bruegel Institute, the European think tank, together with the newly-formed Private Capital Research Institute (PCRI), the workshop brought together high-level EU policymakers from central banks and the European Commission, as well as leading economists, executives from the financial and corporate sector, and labor. While viewpoints were mixed, the clear presumption among the policymakers, economists and labor representatives was that private equity firms overleveraged transactions during the credit bubble, and are now making cuts at their portfolio companies that will have grave social and economic consequences.


Each panel included prominent commentators representing diverse interests. For example, John Monks, General Secretary of the European Trade Unions Confederation, participated on the employment panel. In a back-handed compliment to the industry, Mr. Monks admitted that he had modified his views concerning private equity. “Public companies can be just as bad or worse,” he proclaimed, going on to suggest that quarterly reporting is “the curse of the plc sector.”

Among the more than 50 registered participants were senior executives from the Bank of Belgium and Portugal and the International Limited Partners Association, whose members control the vast majority of commitments to private equity across the world, as well as the chief of staff of the EU Internal Market Commissioner, Michael Barnier. There were also representatives from the European Venture Capital Association, along with a handful of private equity firm executives.

Research Controverts Policymaker Concerns
The employment panel was the most controversial. A stream of well-publicized studies over the past five years, many of which have been industry-backed, has suggested a positive view of PE’s employment effect. Concerns about the accuracy and reliability of these studies have provoked fierce debates both in Europe and in the U.S. Professor Lerner presented evidence from his examination of private equity and employment that was unprecedented in its scope. Based on an analysis of 5,000 U.S. transactions from 1980 to 2005 and relying on data from the U.S. Census Bureau, his findings, perhaps unsatisfactory to those looking for black or
white conclusions, offered both PE critics and advocates something to support their perspective.

Tracking employment trends at the facility level at both PE and non-PE backed companies, Lerner found that PE substantially underperformed, primarily due to more layoffs, not because of less job creation. But that isn’t the end of the story. Lerner’s recent work further refines the study he presented under the auspices of the World Economic Forum in 2008. Lerner’s recent analysis shows a wide variation in employment performance depending on transaction type. Divisional buyouts, for example, significantly outperformed in terms of job creation (+2.7%) compared to comparable non-PE backed facilities. By contrast, public-to-private transactions significantly lagged in job creation (-21.2%). One of the most important insights emerging from the workshop – and one with profound implications for policy makers – was that the available evidence is not clear as to whether the employment effects derived from private equity investment are positive or negative. The answer is contingent on numerous variables, including transaction type. The real question may be what would have happened if private equity investment did not exist? If the workshop accomplished little else, it demonstrated that private equity’s effect on employment is complex. Buyout firms are neither demons nor angels. As with most things, the truth lies in between.

While employment may have spawned the most controversial discussion, the panel dealing with systemic risk and private equity investment, led by Per Strömberg, was a close second. Based on data collected from 20 industries in 26 countries between 1991 and 2007, representing a staggering sample of close to 8,600 observations, his analysis revealed that industries where private equity funds have been active in the past five years have grown more rapidly than other sectors, whether measured using total production, value added or employment. He found no evidence that economic fluctuations increase by the presence of private equity investments. In addition, the level of PE activity within a particular industry does not appear to be a critical variable with respect to growth or volatility. In industries with private equity investments, there are few significant differences in the performance patterns between those with a low or high level of private equity activity.

Other key findings presented by Professor Strömberg were the following:

- Activity in industries with private equity backing appears to be no more volatile in the face of industry cycles than in other industries, and sometimes less so. The reduced volatility is particularly apparent in employment trends.
- The patterns are not limited to the U.S. and UK, where private equity has been a prominent feature of the financial landscape for many years. In fact, the findings hold in continental Europe, where concerns about PE have been most often expressed.

- It is unlikely that these results are driven by reverse causality, i.e. private equity funds selecting to invest in industries that are growing faster and/or are less volatile. The results are essentially unchanged if the impact on industry performance of private equity investments made between five and two years earlier are only considered.

The potential negative effects of PE on overall economic growth and cyclicality is one of the motivations behind several of the more extreme reform AIFM Directive proposals leveled at PE funds and their portfolio companies, including minimum investment holding periods and leverage caps both at the portfolio company and fund level, and bans on dividend recapitalizations. Paul Rasmussen, the outspoken former Prime Minister of Denmark, who was invited to the workshop but unable to attend, has argued that PE raises “a major challenge to financial stability,” and unless regulated, is likely to contribute to future crises. Yet, the facts Professor Strömberg offered overwhelmingly demonstrated that industries where PE funds have invested in the past five years have grown more quickly and showed scant support for claims that PE backed industries are more exposed to severe economic shocks – let alone their cause.

The third panel led by John Van Reenen debated the impact of private equity management practices on company performance. A number of workshop participants argued that PE firms undertake financial engineering to increase profits with little “real” improvement – “strip and flip,” as John Monks characterized it – or that

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For more than a year there have been three different legislative bodies within the European Union (the “Commission,” the “Council” and the “Parliament”) working on separate draft texts of a directive aimed at creating a new regulatory framework overseeing European private equity and hedge fund managers. From the private equity industry’s perspective, there is concern each of the three drafts of the directive contains elements that risk saddling private equity fund managers and their portfolio companies with regulatory burdens that could undermine competitiveness and hinder European economic recovery without achieving the aim of enhancing the overall stability of Europe’s financial system in the wake of the international financial crisis of 2008. This article updates our readers on key differences between the competing proposals and on recent developments in the legislative process.¹

Politics and Process
As the member state of the European Union with the largest number of alternative investment fund managers and an interest in preserving London’s position as the capital of Europe’s private equity and hedge fund activity, the United Kingdom has been pushing against the political winds from the European continent (principally from France and Germany) that are giving the directive momentum as it makes its way through the EU’s legislative process. Further attempts to prevent or postpone adoption of the directive in some form appear increasingly futile. Less than a week after the unlikely marriage between the conservative and liberal democrat parties produced the UK’s first coalition government since the Second World War, the newly formed government had to vote on the directive without a meaningful opportunity to influence the debate when its request to reschedule certain European Union committee action on the directive was rebuffed. On May 17, 2010, the Economic and Monetary Affairs Committee of the European Parliament went ahead and approved its version of the text of the proposed directive, and the following day, at a meeting of its Economic and Financial Affairs committee that was attended by European finance ministers (including the new UK Chancellor of the Exchequer), the Council approved its own separate version of the directive’s text.

The two texts differ in several material respects that are discussed in more detail below, and are now substantially different from the first draft text of the directive that was proposed by the Commission in April 2009. Nevertheless, despite continuing differences in the texts, the May votes approving the respective Parliament and Council drafts signal that a unified version of the directive is on its way. The next few months may prove decisive, and be the last chance for the private equity industry to help shape the directive, as discussions (or “trialogues”) and negotiations take place among all three groups (the Commission, the Council committee and the Parliament committee) in an effort to agree on a single text of the directive that can be put to a vote by members of the European Parliament at a plenary session. Although the ambitious goal of calling for a plenary session vote on July 6th appears unlikely to be achieved, alternative investment fund managers should expect that a single joint text of the directive will be approved by all three groups before the year’s end. EU member states would then have about two years to implement the final directive.

Fundraising and Portfolio Company Reporting
Two key issues that the Parliament and Council drafts treat differently are (1) marketing or fundraising inside the EU by alternative investment funds or managers that are established outside the EU and (2) disclosure requirements applicable to funds or managers that acquire “controlling” interests in portfolio companies.

EU Directive on Alternative Investment Fund Managers (cont. from page 7)

EU and (2) disclosure requirements applicable to funds or managers that acquire “controlling” interests in portfolio companies.

Parliament Version – EU Passport
The table below summarizes the basic requirements that must be complied with under the Parliament text of the directive if a fund manager intends to market a fund to “professional investors” (i.e., institutional investors) inside the EU.

The table addresses four different scenarios: (1) a manager based inside the EU raising capital for a fund based in the EU, (2) a manager based inside the EU raising capital for a fund based outside the EU, (3) a manager based outside the EU raising capital for a fund based inside the EU and (4) a manager based outside the EU raising capital for a fund based outside the EU.

The activities of many private equity fund managers based in the United States fall under the last two scenarios, since they advise or operate private investment fund structures using fund vehicles established in jurisdictions such as Delaware, Cayman Islands, Channel Islands (Jersey or Guernsey), England and Wales, Scotland or Luxembourg.

According to the Parliament version of the directive, fund managers based outside the EU would have to comply voluntarily with the directive in order to be able to obtain a “European passport” allowing them to raise institutional investor capital inside the EU. The passport, if obtained, would be useful to such a non-European manager who could then engage in fundraising to institutions anywhere within the EU so long as the funds being marketed were established in the EU or were established in other jurisdictions that satisfied certain conditions (see below).

But how would voluntary compliance with the directive be overseen, and by whom? Under the proposal, the financial regulator of the non-European manager’s home jurisdiction (e.g., in the case of a U.S. manager, the Securities and Exchange Commission) would have to agree to act as the “agent” of the EU financial regulator (the European Securities and Markets Authority, “ESMA”) in its supervision of the fund manager’s compliance with the EU directive. It is far from certain that non-European financial regulators such as the SEC will be willing to accept the responsibility of supervising voluntary compliance with these EU requirements in addition to their responsibilities supervising compliance with their own domestic laws and regulations.

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Brazil is currently one of the hottest destinations for private equity without even crediting the music or the culture. Not only has there been significant growth in private equity capital committed to Brazil over the last few years, but internationally sponsored private equity funds have recently made large investments in Brazil and the world’s largest IPO to date this year is for a Brazilian company. Local private equity sponsors find themselves competing with an increasing number of international private equity houses for investor capital and investment opportunities. In a recent survey of limited partners conducted by the Emerging Markets Private Equity Association in conjunction with Coller Capital, Brazil was rated the second most attractive emerging market for private equity investments and was slated to see the largest increase in new investors over the next two years – 19 percent of those surveyed planned to begin investing in Brazil for the first time during that period.

A number of factors underpin investors’ bullish attitude toward the Brazilian private equity market. Brazil has the world’s ninth largest economy and the fifth largest population, and many are projecting further growth. Inflation problems of the past now appear under control, the capital markets (including the country’s BM&FBovespa stock exchange) are robust, and the government, which over the past couple of decades has been relatively stable, is seen as business- and investment-friendly.

**Fundo de Investimento em Participações**

In the past few years, the Brazilian regulators have created a few investment vehicles designed to facilitate and attract investment through tax incentives and a streamlined regulatory framework. One, the *Fundo de Investimento em Participações* (a “FIP”), is particularly well-suited in many respects for private equity investments, as the FIP can either serve as a fund vehicle (e.g., where local investors require a Brazilian fund vehicle) or as an investment vehicle through which international private equity funds can invest in Brazil. FIPs are designed for investment in Brazilian corporations in which control positions are taken or the investors otherwise participate in the management of the portfolio companies.

FIPs are tax advantaged in that they allow qualifying non-Brazilian private equity investors to make investments in Brazilian corporations (*sociedades anônimas*) without incurring Brazilian capital gains tax in connection with an exit. (In contrast, unless the sale occurs on the stock exchange, a non-Brazilian investor’s sale of shares in a Brazilian company generally is subject to 15-25 percent capital gains tax.) A FIP itself is not subject to tax when it buys or sells assets. In addition, under a special exemption, a properly structured FIP may make distributions to its qualifying quotaholders (FIP interests are referred to as quotas under the applicable statutory regime) without incurring Brazilian withholding tax.

**Structuring Considerations**

While attractive from a tax perspective, sponsors should be aware of other important considerations associated with FIPs, including the following (and that structuring solutions may be available for these considerations, as we discuss further below):

**Portfolio and Ownership Restrictions**

In order to qualify for the withholding tax exemption, a FIP must meet several tests relating to its portfolio and ownership. First, at least 67 percent of a FIP’s portfolio must consist of shares in Brazilian corporations, debt instruments convertible into such shares, and subscription bonuses and no more than 5 percent of a FIP’s portfolio can consist of debt instruments (other than debt instruments convertible into the stock of a Brazilian corporation). Second, no more than 40 percent of a FIP’s quotas can be owned by a single investor and its related...
entities. In addition, the Brazilian authorities maintain a “black list” of jurisdictions that are considered to be tax havens, including the Cayman Islands. Only quotaholders that are not resident in tax havens benefit from the withholding tax exemption. Entities resident or domiciled in black-listed jurisdictions are subject to 15 percent Brazilian withholding tax on distributions from FIPs.

A Regulated Vehicle
FIPs are regulated by the Comissão de Valores Mobiliários (the “CVM”), the Brazilian securities commission. The applicable CVM regulations prescribe certain substantive restrictions on the operation of FIPs, such as dictating the standard of care for the manager and setting forth which matters must be brought to the quotaholders for approval, including conflicts of interest. In addition, there are broad requirements to disclose information to the CVM. FIP managers must, for example, submit to the CVM quarterly and semi-annual unaudited and annual audited financial statements. A FIP’s governing document (referred to as its by-laws or regulations) is also required to be filed with the CVM and is generally made available to the public on the CVM’s website. Finally, to qualify to invest directly in a FIP, non-Brazilian investors are required to register with the CVM and the Brazilian Central Bank, which involves appointing a tax representative in Brazil as well as a representative in Brazil who will be responsible for complying with reporting requirements with the CVM and the Central Bank.

Other Important Aspects
Unlike limited partners in a limited partnership, the global standard private equity fund vehicle, quotaholders in a FIP have unlimited liability for the debts and obligations of the FIP. Also, FIPs do not permit the flexible economics that limited partnerships or limited liability companies allow; each quota entitles its holder to a fixed, undivided interest in the assets and thus the lack of ability to track deal-by-deal sharing percentages at a FIP, the investment proportions of the parallel vehicles must remain the same for each investment. Therefore, if a sponsor wants to avoid the need to use separate FIPs for different investments, extra attention should be given to the excuse, exclusion and default provisions in the fund agreements to give the fund manager flexibility to maintain these proportions.

However, private equity funds seeking capital from investors that are permitted to invest only in Brazilian vehicles, such as Brazilian pension plans, should be prepared to operate a separate FIP in which the plans invest directly and to deal with their particular investment requirements, which currently differ significantly from what international private equity fund investors generally require.

Not for Everyone
Not all forms of private equity investment are suitable for FIPs. For instance, mezzanine and other debt funds are generally not able to invest through FIPs because of the 5 percent limit on debt instruments applicable to the FIP’s portfolio. In addition, Brazilian real
Is the UK Takeover Panel Planning Major Takeover Reform?

On 1 June, 2010, the UK’s Takeover Panel (the “Panel”) published its much-awaited consultation paper on possible changes to the UK’s Takeover Code (the “Code”). The Panel oversees takeover transactions involving UK and Channel Islands’ companies, including providing day-to-day guidance and ensuring compliance by the parties and their advisers with the rules of the Takeover Code. It regularly consults on market and practice developments and aims to ensure that the Code’s rules are kept up-to-date.

Cadbury-Kraft
The Panel initiated the consultation in response to concerns arising out of Kraft’s £11.6 billion hostile takeover of UK confectioner, Cadbury plc, in February 2010. Following the Cadbury takeover, many commentators – including the former Chairman of Cadbury and a number of politicians – have argued that it is too easy for an offeror in a hostile bid to gain control of a simple majority of the voting rights in the target (being the existing required level of acceptances to win control) and that the outcomes of takeover bids in general are unduly influenced by the actions of short-term investors, particularly hedge funds. In the case of Cadbury, the latter are understood to have comprised approximately 30% of its shareholders.

Areas of Consultation
In issuing the consultation, the Panel has confirmed its long-held position that the Code is designed to provide an orderly framework within which takeover bids may be conducted and to ensure that shareholders are treated fairly. The financial and commercial merits of takeovers are for the companies concerned and their shareholders, not the Panel. It has, therefore, taken the unusual step of not making any specific proposals for changes to the Code’s rules in the consultation paper, which instead sets out a series of suggestions for possible reform with a non-exhaustive list of arguments for and against each of them.

The main issues on which the Panel seeks responses are whether:

- the 50% plus one minimum acceptance threshold for an offer to become unconditional should be raised (for example, to 60% or two-thirds of the voting rights in the target);
- shares acquired in a target during an offer period should be disenfranchised from voting/counting towards the acceptance condition for the purposes of such offer;
- target shareholders should be given independent advice, separate from that given to the target board, and whether “success fees” to advisers should be restricted;
- offerors should provide more detailed information in relation to financing of bids and the implications and effects of their proposals for the target;
- the trigger at which dealings and interests in relevant securities should be disclosed at the start of and during an offer period be reduced from 1% to 0.5%; and
- certain aspects of the Code timetable, including “put up or shut up” deadlines, should be shortened or standardised.

Initial Reaction
A number of legal commentators have argued that some of the suggested changes are overly ambitious and that the UK could run the risk of letting the political and media reaction to one controversial takeover have far-reaching and unintended consequences. In particular, the suggestion that short-term investors be disenfranchised has been dismissed by some practitioners as deterring legitimate commercial activity and going beyond the authority of the Panel or the proper purpose of the Code. For these critics, such a disenfranchisement would also cut across the equality of treatment of shareholders principle central to English company law, be difficult to police and could also entrench management of under-performing companies by distilling the balance of power into the hands of a small number of long-term shareholders.

Next Steps
The breadth of the consultation paper has led some commentators to speculate that the Panel is merely paying lip-service to political and media reaction. Moreover, as some of the areas of consultation would require not merely amendments to the Code, but a fundamental rethink of the basis of English company law, major reform would require legislation and possibly encounter resistance from the City at a time when many believe the UK needs to do more to promote private enterprise and encourage inward investment. Whether the UK’s new Coalition Government has either the appetite or the consensus for such a fight remains to be seen.


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Recent and Upcoming Speaking Engagements

May 7, 2010
David H. Schnabel
“Deferred Compensation for Hedge Fund and Private Equity Managers: Carried Interests and Beyond”
Section of Taxation May 2010 Meeting
American Bar Association
Washington, DC

May 10, 2010
Rebecca F. Silberstein
“Funds 101: Introduction to Private Equity Funds”
The Fundamentals of Private Equity and Venture Capital
PEI
New York

May 12, 2010
David H. Schnabel
“Drafting Partnership Agreements for Substantial Economic Effect”
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2010
Practising Law Institute
Chicago

May 13, 2010
W. Neil Eggleston
“The Role of Directors in a Challenging Economic Environment”
Chicago Chapter of the National Association of Corporate Directors
Chicago

May 13, 2010
Gerard Crowley Saviola
“Current Marketing Practices”
12th Annual Global Private Equity Conference in Association with EMPEA IFC
Washington, DC

May 13, 2010
Kevin M. Schmidt
“Special Issues Involved in Acquiring Divisions or Subsidiaries of Larger Companies”
Acquiring or Selling the Privately Held Company 2010
 Practicing Law Institute
New York

May 17, 2010
Gary M. Friedman
“Acquisition and Sale of Brazilian Companies by U.S. Companies”
Joint Meeting of the U.S. and Brazil Branches of the International Fiscal Association
International Fiscal Association
Miami

May 25, 2010
Andrew N. Berg
“Implications of Section 704(c) for Negotiating a Partnership Agreement”
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2010
Practising Law Institute
New York

May 27, 2010
Andrew N. Berg
“Picnic Lunch Program: The Troubled Partnership – Workouts and Debt Restructurings”
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2010
Practising Law Institute
New York

June 4, 2010
William D. Regner
“GP/GP Mergers”
11th Annual U.S. Real Estate Opportunity & Private Fund Investing Forum
Information Management Network (IMN)
New York

June 8, 2010
Andrew M. Ostrognai
“Private Equity”
Columbia Business School Asian Alumni Club Event
Columbia Business School and Debevoise & Plimpton LLP
New York

June 10, 2010
Andrew N. Berg
“Troubled Companies”
25th Annual Texas Federal Tax Institute
Texas Institute of Continuing Legal Education
San Antonio, Texas

June 16, 2010
Paul S. Bird
“Private Equity Today”
9th Annual International Mergers and Acquisitions Conference
IBA
New York

June 16, 2010
David H. Schnabel
“Drafting Partnership Agreements for Substantial Economic Effect”
“Non-Compensatory Partnership Options, Convertibles, Recapitalizations and Similar Transactions”
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures and Other Strategic Alliances 2010
Practising Law Institute
San Francisco

For more information about upcoming events visit www.debevoise.com
Not California Dreamin’: The Golden State’s Proposed Placement Agent Rules

Fueled by a surge in populist sentiment and a desire to address perceived improper behavior by public pension plan board members and investment staff, California has proposed a broad and, in ways, invasive regime to regulate the use of placement agents by private equity fund sponsors looking to raise money from California’s public pension and retirement systems (“California Plans”). California’s proposed placement agent regulations appear to reflect the view that its longstanding and stringent political gift and campaign contribution rules are insufficient to stem the unwarranted influence that third parties may have on the investment decision-making processes of California Plans. Unfortunately, it appears that these legislative actions are overreaching and, therefore, if enacted in their current forms, will have burdensome consequences for private equity firms and their employees.

California’s legislative proposals were precipitated in large part by the “pay-to-play” placement agent scandals that rocked New York State in 2009 (and continue to unfold in 2010). These scandals are now also materializing in California, as evidenced by the California attorney general’s filing of a civil lawsuit on May 5, 2010 against Alfred Villalobos, a former CalPERS board member, and his firm, Arvco, for allegedly cultivating improper relationships with a CalPERS board member, attempting to bribe a CalPERS senior investment officer and failing to be appropriately registered as a broker-dealer. Unfortunately, the California legislature’s bid to increase the public’s confidence that investment decisions made by California Plans are free of bias has resulted in a set of legislative proposals prohibiting private equity firms from paying contingency fees to placement agents (“i.e., fees that are payable based on whether, or how much, a California Plan invests), and potentially causing fund sponsors to become subject to significant ongoing public disclosure obligations in the near future.

Placement Agent Legislation: When and Why?

California passed Assembly Bill 1584 (“AB 1584”) as urgency legislation on October 11, 2009 requiring California Plans to adopt regulations by June 30, 2010 governing the involvement of placement agents in the investment processes of California Plans. To comply with AB 1584’s mandated deadline, CalPERS proposed adopting CCR §559 (the “Regulation”) that would, among other things, require the disclosure of certain information regarding private equity fund employees. Other California Plans, including CalSTRS, have adopted, or are in the process of adopting, policies similar to the Regulation. If adopted, the Regulation will become part of the California Code of Regulations and be applicable to all other California Plans. Furthermore, Assembly Bill 1743, currently making its way through the California legislature (the “Bill”), would subject placement agents to all restrictions, prohibitions and requirements regulating the conduct of lobbyists under California’s Political Reform Act of 1974. The Bill, which requires a two-thirds vote of both houses of the California legislature to pass, recently cleared important hurdles in the Assembly and is making its way to the state Senate for a vote.

Who Do the Legislative Proposals Cover?

In addition to traditional third-party placement agents, both the Regulation and the Bill (together, the “Proposals”) apply to employees of fund managers who act on behalf of such managers to secure an investment from CalPERS (or in the case of the Bill, any California Plan) regardless of whether such employees are compensated in connection with the plan’s investment. Although the Proposals are ambiguous as to which fund sponsor employees would be covered, general partners of private equity funds have reported being informally advised by CalPERS that the Regulation should be interpreted broadly to consider the spirit, as well as the literal text, of the Regulation and that sponsors should err on the side of conservatism in complying with the Regulation. While investment professionals who devote more than one third of their time annually to asset management are excluded, it appears that investor relations, marketing and sales employees of investment firms involved with securing a commitment from CalPERS or another California Plan...

...[T]he California legislature’s bid to increase the public’s confidence...has resulted in a set of legislative proposals prohibiting private equity firms from paying contingency fees to placement agents...and potentially causing fund sponsors to become subject to significant ongoing public disclosure obligations....
would in all circumstances be “placement agents” under the Proposals.

What Do the Proposals Require?

The Regulation imposes an obligation on fund managers to disclose to CalPERS a broad variety of information regarding their use of placement agents (again, including certain private equity firm employees, “Placement Agents”). With respect to each Placement Agent, categories of information required to be disclosed include: (i) agreements with the private equity firm, including any employment agreements; (ii) a description of services performed and compensation received, if any; (iii) resumes; (iv) campaign contributions and gifts made to CalPERS board members; and (v) past affiliations with CalPERS and names of any CalPERS contacts or immediate family members. The Regulation also requires ongoing updates to any changes to the disclosed information that a manager either knows, or should have known, about. The form that CalPERS proposes using to elicit information from private equity sponsors (CalPERS’ Placement Agent Information Disclosure Form) is available on CalPERS’ website. Importantly, all information and documents disclosed by fund sponsors pursuant to the Proposals would become part of the state’s public records and would be accessible by the general public pursuant to the California Public Records Act.

Furthermore, the Bill requires all Placement Agents to register as lobbyists and comply with all California lobbying registration and reporting rules in order to solicit investments from California Plans (although there is some ambiguity, the Bill seems to cover the same set of private equity firm employees picked up by the Regulation). Compliance, of course, comes with a cost and adds further administrative burden. While the Bill does contain a carve-out for certain in-house sales employees, as currently drafted the carve-out seems to be inapplicable to California Plan investments in private funds as one prong of the carve-out requires that the fund sponsor is selected in a competitive bidding process.

Penalties and Consequences of Non-Compliance

The Proposals have teeth. Under the Bill, as with other California statutes, penalties for breach include administrative, civil and criminal penalties. Significant penalties for failing to comply with the Regulation include:

- a return of the greater of (i) CalPERS’ share of management fees paid to the private equity firm during the preceding two years and (ii) amounts paid or promised to placement agents in connection with the plan’s investment;
- cessation of obligations to contribute capital to the fund;
- termination of the investment contract and withdrawal without penalty; and
- a five-year ban on future investments by CalPERS with the fund sponsor.

If the Regulation is enacted, partnership agreements of private equity funds would need to be drafted carefully at the outset to provide for certain of these required remedies (e.g., a withdrawal right) for CalPERS but not for other investors who are not similarly situated. Further drafting considerations arise from the Regulation as well, including the need to modify the management fee offset and capital contribution provisions to account for CalPERS being prohibited from making capital contributions in order for a fund to pay any fees or expenses associated with the use of placement agents (regardless of whether the private equity firm ultimately bears these amounts, which is typical).

Conclusion

It remains to be seen whether the Proposals will be adopted in their current forms or revised further so that only employees of private equity firms who are compensated in connection with a California Plan’s investment will have their employment agreements and arrangements disclosed publicly and be subject to California’s lobbyist regime. Although the Proposals are less than clear, it appears that their expansive definition of “placement agent,” along with California’s commitment to reform the practice of private equity firms using placement agents in connection with California Plans’ investments, will have material implications for how fund sponsors are able to conduct fundraising operations in California. Time will tell as to whether other states will adopt legislation similar in scope to the Proposals. As we go to press, the SEC and at least New York, New Jersey, Illinois, Connecticut and New Mexico have established, augmented or are in the process of establishing placement agent statutes to shield their public pension plans’ investment decisions from actual or perceived unwarranted influence. For now, it is clear that these states will require heightened disclosure regarding the usage of, and payments to, placement agents. When the dust settles we will see whether California and possibly other states will require more.

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Private Equity Is Going Bespoke

Private equity fund managers are increasingly offering custom-made separate accounts as an alternative to traditional private equity funds. Slower fundraising times, intensifying competition among fund managers for investor commitments and increasing investor desire for terms catering to their individual preferences are among the reasons fuelling this rapidly emerging trend.

Indeed, such an account, which would be established for one investor instead of up to hundreds of investors, as in your typical private equity fund, more easily allows for customized structuring, an investment strategy addressing particular investment limitations and goals, tailor-made economics and reporting, as well as other individualized terms fitted for a single investor’s specifications.

However, bespoke accounts are not only a winning proposition from an investor perspective. They can also be a winning opportunity for the fund manager as they often draw significant incremental commitments from prominent private equity fund investors while still providing for attractive economics and other terms to incentivize fund managers.

Taking the Measurements of the Bespoke Account

Custom-made separate accounts are often highly negotiated between the fund manager and the separate account investor. A few central aspects are set forth below.

Structuring. Considerable time is spent on structuring for the individual investor’s need. Separate accounts can, for example, be established as fund vehicles such as limited partnerships or limited liability companies or as purely contractual arrangements. Tax considerations are often given considerable weight in arriving at the appropriate structure. Other considerations include, for example, confidentiality (a separate account investor hoping to remain undisclosed to third parties may prefer an opaque fund structure), liability insulation (a separate account investor with liability insulation as a primary concern may prefer a fund structure with limited liability, but this can be achieved in other manners too), fiduciary aspects (a separate account investor may prefer a fund structure for more well-defined statutory and common law fiduciary duties for the fund manager) and transferability (a separate account investor may prefer a fund structure to facilitate future transfers to affiliates and third parties).

Economics. The profit sharing waterfall may be different from that of the fund manager’s private equity funds (e.g., in terms of the timing for return of capital contributions and the preferred return and catch-up percentages), but the ultimate carried interest split is not necessarily lower. The management fee in separate accounts that invest only in surplus deal flow from the manager’s other funds is sometimes based on invested capital or net asset value rather than capital commitments, both during and after the investment period.

Investment Focus and Limitations. Although some separate accounts allow investors to pre-approve individual investment opportunities presented to the account, the separate accounts that we are discussing in this article generally vest the fund manager with investment discretion. However, custom-made separate accounts can incorporate investment focus and restrictions that are compatible with the investor’s portfolio requirements and investment guidelines. Certain industries, types of investments and geographies may, for example, be excluded.

Reporting Matters. The separate account arrangement may allow the investor to receive reports in its preferred format, but may also impose more extensive reporting requirements than in traditional private equity funds. More information may, for example, be given with respect to portfolio companies, allocation decisions and conflicts matters. Reports may also be given with increased frequency.

Investor Control. Rights to terminate, suspend or slow down the investment period, rights to remove the manager and rights to dissolve the separate account are issues considered at length in separate accounts. Unlike traditional private equity funds with a dispersed investor group, decisions of such nature may be vested with the separate account investor only. Managers of separate accounts will often seek to protect themselves against the separate account investor exercising such rights in the absence of the manager engaging in bad acts. However, in cases where the separate account is established to invest in tandem with a particular fund, the separate account may vote on various matters together with the primary fund.

Defaults. Fund managers will want to consider the impact of a separate account investor defaulting on its obligations to make capital contributions to the separate account. For example, in the case of material defaults, the fund manager may want to have a right to dissolve the account or offer the interest to a third party. The customary laundry list of
Private Equity Is Going Bespoke (cont. from page 15)

default remedies in traditional private equity funds will need to be tailored to the dynamics of a single investor separate account.

**Investment Advisers Act Registration.** The separate account will count as a separate client for purposes of the exemption from registration under the U.S. Investment Advisers Act of 1940, as amended, for advisers that have fewer than 15 clients. Therefore, unregistered fund managers should review their client count before proceeding with this approach. However, if the financial reform legislation package currently being debated in Congress is enacted, within one year this exemption will no longer be available anyway.

**Getting Fitted with Existing Funds**

Of course, no matter how alluring separate account opportunities may be, fund managers need to analyze their ability to establish separate accounts in light of their existing private equity fund arrangements and the views and expectations of current fund investors. The analysis is often driven by the proposed investment strategy of the separate account. For example, the separate account can invest alongside a particular existing fund in each of such fund’s investments or in certain of such fund’s investments, invest alongside several or all of the fund manager’s funds or invest in a completely different set of investment opportunities. Some of the key questions that fund managers need to consider are:

- **Do Parallel Fund or Competing Fund Restrictions Apply?** Parallel funds generally are established for the purpose of accommodating investors who, due to legal, tax, regulatory or certain other considerations, cannot appropriately invest in the primary fund. Parallel funds typically invest in tandem with the primary fund and the governing documents of private equity funds generally impose limitations on parallel funds, including requiring that the terms of any parallel funds be substantially the same as those of the primary fund, except for the legal, tax, regulatory or other considerations that motivated the establishment of the separate account. A separate account established to invest in tandem with a particular fund would often be captured by these restrictions and made-to-measure terms outside such predetermined considerations may require consent from investors in the primary fund. On the other hand, a separate account that will not invest alongside a particular fund in each investment, but that has an investment focus overlapping with existing funds may be caught by restrictions in existing fund documents on competing funds or so called “successor funds.” Competing or successor funds generally may not be established until a significant portion of the capital commitments to the existing funds have been put to work.

- **Any Devotion of Time Requirements Imposed on Key Persons?** Fund managers need to make sure that managing a separate account will not trigger provisions addressing the time commitments of “key persons” of the fund manager in existing fund documents. Such provisions generally require certain key persons to dedicate time to the investment programs of existing funds. Triggering key person provisions may lead to a suspension, and ultimately a termination, of the investment period in existing funds. Fund managers, therefore, need to ensure that the dedication of existing resources to the management of a separate account is permitted. There is heightened pressure on these provisions when the separate account is not investing alongside existing funds.

- **Allocation of Investment Opportunities to the Separate Account Permitted?** The fund manager’s existing fund documents most likely contain procedures for allocating investment opportunities among the fund manager’s various funds. Multi-product fund managers often will have spent considerable time developing allocation procedures and such procedures may also be mandated by applicable regulations (e.g., for fund managers registered as investment advisers with the U.S. Securities and Exchange Commission). Hence, they may already be well-equipped to deal with the complexities of investment allocations among overlapping accounts. Fund managers that specialize on one, or even two, lines of funds, however, may be new to these dynamics. Fund investors and separate account investors take a keen interest in these matters and the solutions vary. Alternatives range from priority for existing funds to pro rated investment proportions based on the capital available for investment by the existing funds and the separate accounts (the latter generally being the solution for separate accounts that invest alongside a particular existing fund in each investment). A middle-ground solution provides flexibility for the fund manager to allocate investment opportunities in a manner that the fund manager in good faith determines is fair and reasonable, taking into account various factors such as availability of capital; the investment focus of the existing funds and the separate accounts; size, nature and type of the investment opportunity; diversification of assets, investment restrictions and other investment guidelines applicable to the existing funds and the separate accounts; and sourcing of the investment opportunity. It should be noted that similar considerations will arise in relation to exits in cases where the exit opportunity is limited.

- **Other Conflicts Matters Impacting the Separate Account?** Other potential conflicts of interest may arise between a Fund manager’s existing funds and a separate...
Disclose or Else: The New FATCA Tax

In March, Congress enacted legislation intended to force certain types of non-U.S. entities (including non-U.S. private funds and non-U.S. banks) to disclose to the U.S. Internal Revenue Service information about their U.S. account holders and U.S. owners. Known as FATCA (or, more precisely, the Foreign Account Tax Compliance Act), the legislation is a response to concerns that some U.S. taxpayers have been hiding assets in non-U.S. accounts. Under prior law, the IRS experienced difficulty in obtaining information from non-U.S. entities about their U.S. account holders. The new legislation is designed to elicit this information by imposing a 30% withholding tax on covered payments (including U.S. source interest and dividends and the proceeds from the repayment of U.S. debt securities or sale of U.S. investment assets) to non-U.S. private funds and banks and certain other types of non-U.S. entities unless the non-U.S. entity enters into an agreement with the IRS to provide the information.

The new rules generally apply to covered payments made after December 31, 2012. There is a grandfathering rule that exempts payments made under obligations outstanding before March 2012, but the scope of this exemption is not clear in all circumstances.

Impact in Private Equity Context
In the private equity context, FATCA will impact three principal areas. First, payments under credit agreements involving U.S. borrowers and non-U.S. lenders will require additional certifications and information from those lenders in order for a U.S. borrower to make interest and principal payments free of the new 30% withholding tax. Provisions addressing the impact of FATCA are now making their way into credit agreements. As noted above, obligations outstanding before March 2012 are generally exempt from the new rules; however, it is unclear how this exemption will apply in the case of revolving facilities or debt that is significantly modified (and therefore treated as “reissued” for tax purposes) after March 2012.

Second, private equity funds organized outside of the U.S. (such as funds organized in the Cayman Islands, Channel Islands, or the United Kingdom) that make U.S. investments will need to enter into agreements with the IRS to disclose information to the IRS in order to avoid the new 30% withholding tax on covered payments. In order to ensure that they can enter into and comply with those agreements, many non-U.S. funds may require their investors to provide any information required to be disclosed to the IRS.

Third, FATCA may affect non-U.S. portfolio companies owned by private equity funds (or non-U.S. subsidiaries of U.S. portfolio companies) that receive covered payments. In order to avoid the new withholding tax, the non-U.S. portfolio company or its non-U.S. subsidiary companies, as applicable, generally would need to (1) if such company is treated as a so-called “foreign financial institution” under FATCA, enter into an agreement with the IRS to disclose information regarding its U.S. account holders and U.S. owners or (2) if such company is not treated as a foreign financial institution, disclose certain information regarding its U.S. owners.

What Payments Are Potentially Covered by the New Withholding Tax?
As noted above, various types of payments are potentially subject to the new 30% withholding tax, including interest, dividends, rents, royalties and compensation from U.S. sources and the proceeds from the repayment of U.S. debt securities or sale of U.S. investment assets. Investment income from non-U.S. investments generally is not subject to the new rules.

What Information Must Be Disclosed?
A non-U.S. entity treated as a foreign financial institution under FATCA (including non-U.S. private funds and non-U.S. banks) will need to enter into an agreement with the IRS to (1) obtain and disclose to the IRS the information necessary to identify its “U.S. accounts” (for this purpose, “accounts” include both customer accounts as well as debt and direct and indirect equity interests in the non-U.S. entity itself), as well as U.S. accounts of any affiliated foreign financial institution, (2) report annual account information regarding each of its and such affiliates’ U.S. account holders and (3) withhold U.S. tax on payments to its and such affiliates’ account holders that fail to provide the information required for the non-U.S. entity to comply with its IRS agreement. A non-U.S. entity not treated as a foreign financial institution will be required to disclose certain information regarding its U.S. owners.

FATCA represents a significant new U.S. compliance regime and will require a significant amount of guidance from the IRS to clarify how a number of concepts will work in practice. The key to non-U.S. entities avoiding the withholding tax under FATCA is reporting and withholding compliance. While the IRS prepares to issue guidance, relevant non-U.S. entities should consider their ability to obtain information and request other actions from their interest holders (for example, under credit or fund documentation) to help ensure reporting compliance and minimize the withholding tax impact of the new rules.

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the fact that the parties and their lawyers did not always fully understand the implications of the RTF structure, the target was able to seek specific enforcement of the buyer’s obligations.

In the second half of 2009, in the thick of the deep freeze of the credit markets, three non-leveraged public-to-private transactions (two of which were structured as tender offers) deviated from this paradigm. In July of 2009, Apax Partners agreed to a reverse termination fee of $570 million, or 100% of the value of the transaction, in its acquisition of Bankrate, Inc. In September of 2009, Advent International and Harbinger Capital Partners each signed deals with no RTF or

<table>
<thead>
<tr>
<th>Date</th>
<th>Sponsor</th>
<th>Target</th>
<th>Enterprise Value</th>
<th>Equity Value</th>
<th>RTF</th>
<th>RTF as % of Equity Value</th>
<th>Specific Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 6, 2010</td>
<td>Thomas H. Lee Partners, L.P.</td>
<td>inVentiv Health, Inc.</td>
<td>$1,100 MM</td>
<td>$922 MM</td>
<td>$55 MM</td>
<td>6.0%</td>
<td>Limited</td>
</tr>
<tr>
<td>May 3, 2010</td>
<td>Silver Lake Technology Management, L.L.C. and Warburg Pincus LLC</td>
<td>Interactive Data Corporation</td>
<td>$3,369 MM</td>
<td>$3,369 MM</td>
<td>$225 MM</td>
<td>6.7%</td>
<td>Full</td>
</tr>
<tr>
<td>April 26, 2010</td>
<td>GTCR Golder Rauner, LLC</td>
<td>Protection One, Inc.</td>
<td>$828 MM</td>
<td>$475 MM</td>
<td>$60 MM</td>
<td>12.6% (Willful Breach: 31.6%)</td>
<td>None</td>
</tr>
<tr>
<td>April 12, 2010</td>
<td>Cerberus Capital Management, L.P.</td>
<td>DynCorp International, Inc.</td>
<td>$1,500 MM</td>
<td>$1,006 MM</td>
<td>$100 MM</td>
<td>10.0% (Willful Breach: 29.8%)</td>
<td>Full</td>
</tr>
<tr>
<td>Mar. 29, 2010</td>
<td>Madison Dearborn Partners, L.P.</td>
<td>BWAY Holding Company</td>
<td>$915 MM</td>
<td>$508 MM</td>
<td>$27.5 MM</td>
<td>5.4%</td>
<td>Limited</td>
</tr>
<tr>
<td>Mar. 8, 2010</td>
<td>CCMP Capital Advisors LLC</td>
<td>infoGROUP Inc.</td>
<td>$635 MM</td>
<td>$468 MM</td>
<td>$25.4 MM</td>
<td>5.4%</td>
<td>Full</td>
</tr>
<tr>
<td>Mar. 5, 2010</td>
<td>ABRY Partners LLC</td>
<td>RCN Corporation</td>
<td>$1,200 MM</td>
<td>$568 MM</td>
<td>$30 MM</td>
<td>5.3%</td>
<td>Full</td>
</tr>
<tr>
<td>Feb. 26, 2010</td>
<td>Thomas H. Lee Partners, L.P.</td>
<td>CKE Restaurants, Inc.</td>
<td>$928 MM</td>
<td>$619 MM</td>
<td>$30.9 MM (lower if financing not available)</td>
<td>5.0%</td>
<td>None</td>
</tr>
<tr>
<td>Dec. 16, 2009</td>
<td>Apollo Global Management</td>
<td>Cedar Fair, L.P.</td>
<td>$2,400 MM</td>
<td>$651 MM</td>
<td>$50 MM</td>
<td>7.7%</td>
<td>Limited</td>
</tr>
<tr>
<td>Dec. 16, 2009</td>
<td>S.A.C. Private Capital Group, LLC, GSO Capital Partners L.P., Sankaty Advisors LLC and Zelnick Media</td>
<td>Airvana, Inc.</td>
<td>$536 MM</td>
<td>$536 MM</td>
<td>$25 MM</td>
<td>4.7%</td>
<td>None</td>
</tr>
<tr>
<td>Nov. 5, 2009</td>
<td>TPG Capital, L.P. and Canada Pension Plan Investment Board</td>
<td>IMS Health Incorporated</td>
<td>$5,200 MM</td>
<td>$4,154 MM</td>
<td>$275 MM</td>
<td>6.6%</td>
<td>Full</td>
</tr>
</tbody>
</table>
other cap on damages in their acquisitions of Charlotte Russe and SkyTerra Communications, respectively. But these three deals were unique for a variety of reasons, most importantly the absence of debt financing, which removed the primary risk that led to the RTF-based remedies regime in the first place.

**After the Freeze: A New Model?**

Demonstrating the unique circumstances surrounding these deals, the trend in the all equity-financed Bankrate, Charlotte Russe and SkyTerra deals has not carried over to the leveraged deals now being done by PE firms. Indeed, as the more recent sponsor-backed public company buyouts show, what constitutes “market” for remedy provisions in leveraged deals appears to have largely returned to the paradigm established during the height of the PE deal market, albeit with higher RTFs and an increased focus on specific performance in most, but not all, deals.

Almost all of the recent public-to-private transactions surveyed have included an RTF in the range of 5% to 8% of the equity value of the transaction (averaging 5.9%, with a median of 5.4%) — double or triple the fees typically seen previously. As was the case at the height of the PE deal market, the RTF in these transactions is the target’s exclusive remedy for the buyer’s failure to close when required to do so, except where specific performance is permitted, in which case the RTF still remains the exclusive remedy for monetary damages for the buyer’s failure to close.1 This increase in the size of RTFs suggests that the market has concluded that the size of RTFs prior to 2008 (1) caused buyers insufficient “pain” to deter them from walking from deals (see, for example, Cerberus’ eventual payment of a 2.5% RTF to avoid the acquisition of United Rentals), (2) failed to compensate sellers for their likely harm if buyers did walk and/or (3) gave buyers too much leverage to re-cut deals if circumstances changed between signing and closing. But while the size of RTFs has increased in today’s market, the RTF construct itself has clearly survived and appears here to stay for the foreseeable future.

It is worth highlighting two recent departures from the one-tier 5-8% RTF structure — Cerberus’ buy out of DynCorp International, Inc., announced on April 12, 2010, and GTCR’s acquisition of Protection One, Inc., announced two weeks later. In both the DynCorp and Protection One transactions, the buyer’s liability for a “financing failure” was capped at the amount of a RTF, but at much higher levels than previously seen — 10.0% of equity value in the case of DynCorp and 12.6% of equity value in the case of Protection One. In addition, both deals provide for a higher second-tier RTF (29.8% of equity value for Cerberus and 31.6% of equity value for Protection One) in the event that the purchase agreement is terminated as a result of the buyer’s “willful breach,” defined in both agreements as a material breach of a material provision resulting from action taken with knowledge that such action would cause a breach. In Protection One, this higher fee is also payable in the event that the buyer’s financing is available and it refuses to close.

The terms of the DynCorp deal may be best viewed not as evidence of an emerging market trend, but rather as the price Cerberus was required to pay in order to get back into the public company buyout market after its very public and contested jilting of United Rentals. The elevated RTF amounts and two-tiered structure in Protection One are not as easily distinguished. One possible explanation is that they are the price GTCR paid for a “pure option” since Protection One completely waived its right to seek specific performance and, therefore, the RTF was the target’s sole recourse for a failure to close. However, as discussed below, Protection One is not the only recent deal in which the target’s ability to obtain specific performance was compromised or eliminated entirely, and none of the other deals had an RTF even approaching the first-tier RTF in Protection One or the much higher “willful breach” fee.

Time will tell whether these two deals...
are truly idiosyncratic or instead suggest a new trend. Our view is that they are likely outliers and that a one-tier structure with a single-digit percentage fee of equity value will continue to prevail for the time being. One problem with the two-tier structure is that sophisticated buyers realize that targets could be very tempted to seek the higher fee by alleging a willful breach, which would force the buyer to litigate the issue or settle somewhere in the middle, neither of which would be very attractive outcomes, particularly in the context of a true financing failure where the buyer’s lenders failed to fund.

Specific Performance – A Shift to a Spectrum
While the market continues to embrace the RTF structure for dealing with the buyer’s monetary exposure in the event it fails to close, the recent PE deal market has seen some qualitative changes to the approach to the availability to the target of a specific performance remedy in sponsored deals. Eight of the 11 recent public-to-private transactions permit the target to obtain specific enforcement of the buyer’s obligations under the merger agreement, to varying degrees. While the availability of a specific performance remedy may not have always been a focus during the ’06-’07 period, most deals back then reflected a binary approach – targets either had a right to seek specific performance of all relevant obligations or, quite often, no right at all. But more recently, particularly in the wake of United Rentals and other busted deals, specific performance has been an area of intensive focus in the negotiation of sponsored deals, with most provisions falling along a spectrum.

At one end of the spectrum are three deals in which the target waives entirely its right to seek specific performance. On the other end are five deals in which the target essentially has a right to seek specific performance of all of the buyer’s obligations (we’ll refer to this as “Full Specific Performance”). In the middle are three deals in which the target is permitted to seek specific performance of the buyer’s obligation to draw on the sponsor’s equity commitment and close the transaction, but is not permitted to specifically enforce any of the buyer’s other obligations, which are predicates to the buyer’s obligation to draw on the sponsor’s equity commitment and close the transaction (we’ll refer to this as “Limited Specific Performance”).

A transaction that many view as leading the recent wave of larger public-to-privates – the acquisition of IMS Health by TPG Capital and the Canadian Pension Plan – permitted Full Specific Performance. As in the other deals featuring Full Specific Performance, IMS had the right to seek specific performance generally but could seek specific performance of the equity commitment letter and the buyer’s obligation to actually close the deal only if (1) all of the buyer’s closing conditions have been satisfied, (2) the debt financing has been funded or will be funded if the equity is funded and (3) the target has confirmed that the closing will occur if the equity financing is provided. (The other recent deals with Full Specific Performance were DynCorp, as discussed above, CCMP Capital Advisor’s acquisition of infoGROUP, Inc., ABRY Partner’s acquisition of RCN Corp, and Silver Lake and Warburg Pincus’ acquisition of Interactive Data Corporation.)

Limited Specific Performance seems to have first appeared in Apollo’s agreement to buy Cedar Fair. Under this approach, the target does not have the right to seek specific performance generally. Instead, specific enforcement is permitted only with respect to the obligation to enforce the equity commitment and close the transaction, and only after satisfaction of essentially the same conditions noted above to the obligation to draw down the equity and close in transactions with Full

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Specific Performance. So, unlike Full Specific Performance, Limited Specific Performance strips the target of any right to obtain a court order requiring the buyer to perform its other obligations which could cause such conditions to be satisfied, e.g., pursuing the debt financing and satisfying closing conditions, such as the receipt of governmental approvals. The target may seek a court order requiring the buyer to close only if all conditions have been satisfied and the debt is available, notwithstanding the target’s inability to ensure that those events occur. (The other deals adopting Limited Specific Performance were Madison Dearborn Partners’ buy-out of BWAY Holding Company and Thomas H. Lee’s buy-out of inVentiv Health, Inc.).

The chart on page 18 of this issue summarizes these 11 deals in tabular form.

The “Value” of Specific Performance

**Full Specific Performance**

While Full Specific Performance provides the target with the complete set of remedies in fending off an unwilling buyer’s efforts to abandon or modify a deal, it must be considered, and perhaps loses a bit of its luster, in the context of a buyer’s actual obligations under a typical PE purchase agreement. For example, a buyer’s covenant to obtain its debt financing in a leveraged transaction is not (and cannot be) absolute, but rather is limited to some specified level of efforts, usually “reasonable best efforts” or “commercially reasonable efforts.” This introduces a substantial level of subjectivity to the implementation of a specific performance remedy. And where the buyer’s commitment papers will expire 60-120 days after signing, as is often the case in today’s market, the target simply does not have much time to litigate the matter, obtain the court order and then actually get the buyer to obtain the financing. Still, these hurdles are not insurmountable, particularly in a fast-moving jurisdiction like Delaware, and thus, Full Specific Performance provides targets with what many perceive as a meaningful remedy to complement the RTF.

**Limited Specific Performance**

Because a target with only Limited Specific Performance cannot seek specific performance until the buyer’s debt financing is available, and cannot require the buyer to perform its covenant to obtain the debt financing, Limited Specific Performance seems at first blush to essentially give the buyer a “pure option.” That is, a buyer can apparently refuse to seek its debt financing, with the target’s only remedy being to terminate for breach and collect the RTF.

Still, there are several reasons why Limited Specific Performance may be of more value to targets than is initially apparent. One falls under the general rule that something is better than nothing. Even if the remedy is exercisable only once all of the other conditions to closing have been satisfied, there is some value to the target in knowing that it does not face the risk of doing all of the work to get to closing only to have the buyer walk away at the last minute. Another is that it is a potential source of leverage for the target in the event the buyer seeks to re-cut the deal. While it would be an uphill battle, the target could conceivably arrange the debt financing without the buyer’s involvement, particularly where the financing relies solely on the target’s assets and business. As much of a stretch as that may be, if the target can make a plausible showing that it is willing and able to go down that road, the buyer – knowing that it will have to close if the target succeeds and will have to live with the financing terms negotiated by the target – will have less leverage to renegotiate the deal. A third reason may simply reflect a judgment in certain deals that the imperfect nature of Full Specific Performance discussed above makes a compromise approach acceptable.

* * *

In looking at the recent wave of private equity transactions, it is clear that the basic remedy paradigm established during the height of the market in 2006-2007 is alive and well, although evolving. There are now three predominant variations of (1) no specific performance or a “pure option,” (2) Limited Specific Performance and (3) Full Specific Performance. We expect that parties will continue to negotiate these provisions heavily and that, depending on leverage and other circumstances, will end up at different points on the spectrum.

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Coming to Grips with the Volcker Rule (cont. from page 4)

a bank holding company with a current commitment to invest in a sponsored private equity fund could be precluded from fulfilling that commitment after the enactment of the Volcker Rule. Since the Volcker Rule specifically bars “enter[ing] into” covered transactions, a better view may be that its affiliate transaction restrictions should be viewed as applying prospectively only and that banking organizations should be able to fulfill pre-existing commitments as they are not “entering into” a new transaction, merely funding a contractual obligation that already exists. Still, the lack of clarity on this issue could limit new investments by a sponsored fund from the date the Volcker Rule passes, even if other provisions of the Volcker Rule conceivably would allow the banking organization to hold an interest in a fund for a multi-year transition period. This would, at least during the transition period, put commitments to affiliated funds on a very different footing than a banking organization’s commitment to fund capital to unaffiliated third-party funds, to which the affiliate transaction rules do not apply.

As stated above, a literal reading of the affiliate transaction prohibition suggests that it may not apply to covered transactions with a nonbank subsidiary of a holding company that does not provide investment advice to a fund. Accordingly, in light of the uncertainty regarding whether the affiliate transaction rules preclude continuing to fund commitments immediately upon enactment of the Volcker Rule, a bank or thrift holding company may want to consider fulfilling its existing commitments to affiliated funds in advance of the Volcker Rule becoming effective, perhaps by pre-funding cash to a nonbank subsidiary so that it may engage in covered transactions with the affiliated fund after the effective date.

It is difficult to overemphasize the extent of the Volcker Rule’s proposed reversal of the ability of banking enterprises to continue their current relationship with private equity and hedge funds. In its present form, not only does the Volcker Rule basically repeal the authority granted to bank holding companies with respect to private equity and hedge funds only a little more than a decade ago under the Gramm-Leach-Bliley Act of 1999 (“GLBA”), but it would not even allow them to make the passive 4.99% voting/24.99% total equity investments in private equity/hedge funds that have been permissible for decades. The impact would be even greater on grandfathered unitary thrift holding companies (i.e., nonbank companies that acquired a single thrift prior to the deadline set forth in GLBA), including insurance companies and brokerage firms with thrift subsidiaries, because these institutions currently have no banking law limits on their ability to operate or invest in private equity or hedge fund.

Given the complexity of the Volcker Rule and the variations as to the types of relationships a banking enterprise may have with a private equity/hedge fund complex, there is no single “silver bullet” to respond to its mandates. As indicated above, some institutions may be able to rely on at least temporary exemptions that may exist within the Volcker Rule itself – for example, if their funds do not rely on 3(c)(1) or 3(c)(7) to remain exempt from the ’40 Act. In addition, control issues potentially could be resolved by transferring control to a friendly but independent manager, as banks did prior to the passage of GLBA. However, assuming the Volcker Rule passes in something like its current form, structural changes will likely be required for many banking and thrift institutions. The remainder of this article is dedicated to some of these possible structural alternatives.

Some Possible Responses to the Private Equity/Hedge Fund Provisions

The two basic approaches an affected financial institution can take to comply with the Volker Rule are (1) to divest or convert its insured bank, or (2) to divest its private equity and hedge fund holdings. As an initial matter, we should highlight that under Federal Reserve precedent a bank holding company moving from a controlling to a non-controlling position in an entity is often difficult. The Federal Reserve has subjected a bank holding company seeking to change its ownership of an insured bank from a controlling to a non-controlling status to more stringent ownership and/or relationship limitations than would have been required if the bank holding company was seeking a non-controlling stake in such insured bank in the first instance. For example, the Federal Reserve has historically limited the ability of a banking enterprise to divest control of a company if it lends the potential acquirors the funds necessary for their purchase, and also limits the amount of equity that a banking enterprise may retain in any transfer. These and other divestiture precedents must be considered in any transaction when a bank holding company is seeking to retain some interest in a bank or manager.

Divesting/Converting the Insured Bank.

The Volcker Rule currently applies only to organizations that control an “insured depository institution” (and foreign banking organizations with a U.S. banking presence). Accordingly, for some non-bank-centric organizations, one possible solution is to divest their banking institution or convert it to a limited-purpose uninsured status. For example, immediately prior to the passage of GLBA, many insurance

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companies, brokerage firms, fund complexes and other financial organizations established a limited purpose federal savings bank to provide trust services, and perhaps ultimately expand into other banking products and services. Federal savings banks must be federally-insured, and thus owners of these institutions would become subject to the Volcker Rule in its current form. If these organizations have substantial private equity/hedge fund (or proprietary trading) operations, then liquidating or selling the thrift may be a viable option. If the thrifts have significant trust relationships that the institutions desire to maintain, then converting the thrift to an uninsured state (or, if preemption is desirable, uninsured national) bank may be a preferable alternative.

A qualification to the foregoing is that the Volcker Rule requires the Federal Reserve to impose additional capital and quantitative limits on nonbank financial companies that the Federal Reserve deems systemically important and that engage in proprietary trading or investing in hedge or private equity funds. As a result, even if a large financial firm disposed of or converted its insured bank as described above, the firm may still find itself subject to some additional burdens under the Volcker Rule. However, these burdens presumably will be less significant than the outright prohibition imposed on those institutions with insured banks or thrifts. Of course, given that a primary target of the Volcker Rule is Wall Street firms, large financial institutions that currently own an insured bank or thrift also may face regulatory reluctance to permit charter conversions or other changes that would allow them to avoid the Volcker Rule.

**Divesting Private Equity/Hedge Fund Holdings**

Depending on an affected banking institution’s level of involvement with private equity and hedge funds, it may be more or less feasible to divest fund holdings to comply with the Volcker Rule. Most banks involved with private equity are either passive investors in private equity and hedge funds, have investments in joint ventures with private equity managers or are themselves fund sponsors. The following are some considerations and recommendations for potentially complying with the Volcker Rule for each of these arrangements.

**Passive Investors**

Absent the possible relief for de minimis holdings discussed above, redemption (for hedge fund interests) or secondary sale (for private equity fund interests) will be the primary means of compliance for banking institutions with respect to passive investments in private equity and hedge funds, and some institutions have started taking these steps already. Hedge funds generally permit periodic redemptions for net asset value, and in the absence of an exit that could arise from unusually long lockup periods, the imposition of gates or required retention of illiquid side pocket investments, exit should be a relatively clear path.

Not so for private equity fund holdings. While there is a private secondary market, the current number of buyers is fairly limited – the lack of a developed open secondary market for private fund interests and the significant restrictions on their transfer (including in almost all cases the need to obtain the consent of the fund’s general partner) create potentially significant transaction costs for disposing of a portfolio of fund interests. Owners of large portfolios often find that a package sale of the entire portfolio makes the most sense: the seller will still need to negotiate terms with each fund’s general partner, but at least it faces only a single buyer. However, the universe of potential large institutional buyers will shrink as a result of the Volcker Rule. In addition, required divestiture by all affected institutions over a relatively short time presents obvious concerns in terms of the purchase prices private equity fund interests will fetch.

In recent years, some sellers have tried to facilitate transfer by securitizing a portfolio of fund interests and selling interests in the derivative product. It is unlikely, however, that such a “disposition” would comply with the Volcker Rule, as the bank would continue to be the owner of record of the interests in the funds.

**JV and “Manager of Managers” Arrangements**

Banks that have invested in private fund managers and general partners, either as joint venture partners or as part of a “manager of managers” strategy, will need to look closely at the substance and structure of their relationships to determine whether and to what extent these relationships will be subject to the Volcker Rule generally, and whether they also trigger the affiliate transaction restrictions discussed above. Even absent an investment (direct or indirect) in the underlying fund, if the bank has “control” over the operations or investment activities of an investee entity that controls a fund, the Volcker Rule will likely apply. Although ownership of 25% or more of the voting securities of the investee entity is one way to evidence “control” under the Bank Holding Company Act, the full package of the banking institution’s rights and obligations will need to be evaluated to determine whether a control relationship exists with respect to a fund, even where the bank has a smaller level of ownership.

**Fund Sponsors**

For banking institutions that directly sponsor or manage private equity and hedge funds that are subject to the Volcker Rule, the most immediate concern will be...
Coming to Grips with the Volcker Rule (cont. from page 23)

understanding whether the affiliate transaction restrictions described above will keep them from satisfying existing contractual obligations and fiduciary duties to the funds and their investors. If the sponsor were prohibited from making its capital contributions or satisfying other significant obligations, the fund’s investment strategy could be thwarted, potentially giving rise to both fiduciary issues and to the exercise by investors of contractual remedies (including termination of the fund or its investment activities or removal of the general partner) that are included in most institutional fund agreements. Absent a grandfathering provision or other transition relief, sponsors would need to seek other solutions, including re-structuring their holdings in a manner that complies with the Volcker Rule (subject to any investor votes or other negotiated terms that are common for such transfers).

Ultimately, if the Senate bill becomes law, these sponsors will need to restructure or divest their fund businesses. While it’s not clear at this time what a compliant fund advisor business might look like, divestiture will likely take the form of a sale to a strategic buyer or a spin-out of the group to create an independent firm. Aside from the challenge presented by the fact that the number of potential strategic buyers will be significantly reduced as a result of the Volcker Rule and the risk allocation, strategic and commercial issues associated with any M&A transaction, dispositions of asset management businesses present certain other unique challenges, some of which may be exacerbated by the application of the Volcker Rule.

Investor Consent
Disposition of a fund business will generally trigger an “assignment” of the fund’s investment advisory agreement from the existing manager to the successor investment adviser. Under the Investment Advisers Act of 1940, advisory contracts must require a consent right for such an assignment, which in practice usually results in a vote of the fund’s investors. For hedge funds, where investors can vote with their feet, this requirement is less complicated than in the private equity fund context, where investors may take advantage of the consent requirement to request significant concessions as a condition to their consent. A common example is the “key person” provision that gives investors termination rights in the event certain of the principals leave the fund sponsor. Many institutionally-sponsored funds do not include such provisions, but investors are likely to request these types of protections as they are no longer investing in the bank sponsor, but are now hiring the particular management team. These concessions, if agreed to, can have a meaningful impact on the value of the business, if it is being sold to a third-party buyer.

Continuing Economics
Private equity fund businesses and, to a lesser degree, hedge fund businesses, tend to be difficult to value on a current basis. The underlying assets are typically illiquid, long-term investments in privately held companies, and the future management fee and incentive income streams are dependent on the performance of those assets over time. As a result, the purchase price for a fund business often includes a component of participation in the future profits of the managed funds. Under the Volcker Rule, the form and substance of that component will require careful scrutiny to ensure that it does not rise to the level of a prohibited investment or participation in management.

This concern is especially evident in the context of a spinout, where the former sponsor typically remains involved for some period while the new firm develops economic and functional independence. Since there is typically no ability to continue to use the name of the firm, the goodwill of the business is not as significant as in some other contexts. In management buyouts, the “purchase price” received by the selling firm is often simply a release from obligations and a continued right to some portion of the distributions the selling firm had previously been entitled to receive. Because the management team generally does not have the means to buy out the sponsor’s funded interest, ongoing economic rights are normally the largest, and sometimes the only, component of the purchase price in a spinout. These rights are often accompanied by some rights for the former parent to protect its interests. Structuring the rights and obligations of the selling institution without tripping over the Volcker Rule’s prohibitions or traditional Federal Reserve divestiture requirements would be difficult indeed, although by relying on a combination of the transition rules and use of a non-banking subsidiary, such an approach may be possible.

* * *

Until recently, many in the banking industry have avoided even trying to evaluate the impact of the Volcker Rule on their businesses, hoping the legislation would fall by the wayside. While that could still occur, as could a modification of the Rule’s provisions before adoption, such a result appears less and less likely as we go to press. As passage of the Volcker Rule becomes more likely, as with any significant change in law, thoughtful preparation will be critical to minimizing adverse impact.

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they do improve firm productivity, but only by improving allocations of labor/capital, including asset spin offs.

Professor Van Reenan’s research of over 4,000 manufacturing firms across Asia, Europe and the U.S. showed that private equity-owned firms have significantly better management practices than firms owned under other ownership models, including government, family, founder and private individuals. They are also better managed than public corporations, although not significantly so.

The results, based on 45-minute phone conversations with plant managers, suggested that PE ownership is associated with particularly strong human capital management practices (hiring, firing, incentives), and has an even stronger link to better operational effectiveness (lean manufacturing, continuous improvements, best practices). There were also significant differences found in the quality of management practices based on geography. The three most highly ranked countries for management practices were the U.S., Germany and Sweden. Along with Greece, India and China had the lowest management scores, perhaps an indication, at least for the latter two countries, of the enormous challenges of pivoting from explosive deal making to post-acquisition portfolio company value building.

The body of research highlighted in each of the three Breugel-PCRI workshop sessions was unambiguous. Private equity, far from being the proximate cause of the financial crisis, may in fact be part of the solution to get economic activity back on track.

Keep in mind, however, that the proceedings took place in Brussels and so, not surprisingly, the evidence did not appear to register with the trade unionists and allied EU policymakers in attendance. Invariably, the direction of the debate at the workshop surrounding the AIFM Directive tilted decidedly against the free flow of capital.

The question for most participants was not whether the private equity industry should be regulated, but how extensively. As Olivier Guersent, Chief of Staff of Internal Market Commissioner Michel Barnier succinctly expressed the syllogism: the G-20 has mandated that all financial actors be regulated; private equity firms are financial actors; therefore private equity must be regulated. In response to the question of why private equity should be regulated when there may be other institutions that pose a far greater destabilizing risk, Mr. Guersent responded somewhat sardonically: “You have to start somewhere.”

Lessons Learned
The Bruegel-PCRI workshop provided two clear messages to the outside world, with particularly troubling implications for the U.S. First, the regulations that the EU may ultimately adopt will reduce the ability of private equity firms, most especially non-EU firms, to operate freely in the EU. And second, since new regulations are bound to come out of the Brussels political process, notwithstanding the desirability of international coordination, the EU may not wait for the U.S. Congress to complete its process of determining how to best regulate private equity. In fact, the EU considers the dismantling of financial industry regulation that occurred in the U.S. and UK in the past as the culprit. Turmoil around Greek and other sovereign debt has only intensified the EU’s resolve to curb financial innovation. If restrictions on PE company leverage and fundraising are adopted, or any of a number of the more than 2,000 regulatory proposals currently being floated by EU parliamentarians become law, the end result could well be a politically-created separate private equity universe.

Faced with the aftershocks of the financial crisis, regulators and politicians around the world naturally feel compelled to act, and to act without delay. In presenting evidence that private equity can be a constructive force in the global economic recovery, the goal of the Bruegel-PCRI workshop was to underline the need for fact-based analyses, particularly as the outlines of the AIFM Directive take final shape over the next few months. It was an uphill fight, but one worth making.

On the other side of the Atlantic, academically rigorous and independent analyses will be equally germane as the U.S. Congress considers a welter of proposals for financial sector reform, including new rules governing PE. In this regard, see “From Long Shot to Likely in Six Months: Coming to Grips with the Volcker Rule and Its Private Equity/Hedge Fund Implications” on page 3 of this issue. Fortunately, the PCRI will be working with the Brookings Institution to continue providing a factual context for U.S. policy makers regarding private equity’s role in the global economy and its capacity to tackle structural inefficiencies.

Stay tuned. ■

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The Parliament draft also provides that fund managers based in the EU (and those based outside the EU that obtain the passport) would be allowed to raise capital in the EU for funds established outside the EU if the country where the fund is established:

- has rules sufficient to combat money laundering and terrorist financing,
- grants reciprocal access to the marketing of EU funds in its territory,
- has agreements in place where marketing is intended with the relevant EU member state on the exchange of information related to taxation and monitoring, and
- recognizes and enforces EU judgments on issues connected to the directive.

If a fund is established in a country that does not meet these criteria, then capital raising for those funds would not be allowed inside the EU. EU member states would be prohibited from permitting the marketing of such a fund on their territory, including under a “private placement” regime. Furthermore, the Parliament draft of the directive goes so far as to ban altogether investment by an EU professional investor in such a fund, whether or not the fund had been marketed in the EU. This investor prohibition, in particular, has been heavily criticised as unduly restrictive on EU institutional investors.

These provisions would not be implemented until three years after the date for implementation of the remainder of the directive in order to give non-EU jurisdictions an opportunity to alter their laws to take account of the directive.

At present it is unclear which countries will be unable to satisfy these conditions and we will probably have to await the more detailed rules that will “flesh out” these conditions which will be made only once the final text of the directive has been established. Therefore, currently there can be no certainty that jurisdictions like the Cayman Islands will be able to satisfy these conditions (if they are included in the final version of the text of the directive).

While both...versions of the directive suffer from certain defects in the way that they propose to regulate fundraising within the EU, the private equity industry associations...generally prefer the passport concept that is part of the Parliament’s approach because it promotes consistency among EU member states....
draft texts require that managers disclose to regulators and investors information about portfolio companies “controlled” by their alternative investment funds, with the Parliament’s version being the more stringent. The disclosure requirements call for information on the portfolio company’s policy regarding communication with employees and plans for preventing and resolving conflicts of interests. Other required disclosure includes notice of any planned divestment of portfolio company assets, information about the company’s performance and details on its use of leverage. There are additional reporting items in the Parliament text, such as identification of the individuals responsible for deciding on business strategy and employment policy, as well as an asset-stripping limitation that applies capital adequacy measures to companies owned by private equity funds.

The Council text establishes certain minimum company size and ownership thresholds below which the portfolio company disclosure rules do not apply. For these purposes “control” means the ownership of 50% or more of a company’s voting interests, which would exempt most alternative investment funds that do not pursue buyout strategies. So-called “small or medium enterprises” (SMEs) are also exempt (i.e., companies with fewer than 250 employees, assets less than €43 million, and annual revenue below €50 million). Therefore the Council text essentially limits portfolio company disclosure to funds that acquire 50% or more of the voting interests of an unlisted company that is larger than an SME. Unfortunately, the Parliament text sets much lower trip wires. Portfolio company notification and disclosure rules would apply to companies with as few as 50 employees and whose voting interests acquired by alternative investment funds cross the 10, 20, 30 and 50% ownership lines. These much lower thresholds potentially capture a much wider range of fund strategies and investments that are not ordinarily viewed as “control” positions.

Degrees of Regulation
The Parliament text recognises that there are different kinds of alternative investment funds (e.g., private equity versus hedge) and allows for the possibility that different levels of regulation are appropriate for different types of funds. The private equity industry was encouraged by the fact that the press release announcing the May vote on the Parliament’s version of the directive specifically stated that private equity funds would be more lightly regulated than hedge funds. Unfortunately the Council text takes a “one-size-fits-all” approach and does not contemplate different levels of regulation based on differences among investment funds. We anticipate that the private equity industry associations will actively support the Parliament’s approach to this issue during the trialogue discussions.

Fund-Level Leverage
Neither the Parliament nor the Council texts adopt the Commission’s original approach that leverage limits be set for alternative investment funds. Instead, the Parliament version obligates a fund manager to set leverage limits that take into account a wide range of factors and to disclose details of the leverage to investors and the fund’s national regulator. As the EU-wide regulator, ESMA would retain the authority to change a fund’s leverage levels if it decides that such action is warranted. The EU Council text requires all fund managers that use leverage on a systematic basis to disclose to their national regulators information about their leverage arrangements and authorizes national regulators to set leverage limits for a fund manager when the regulator deems it necessary to ensure the stability and integrity of the financial system.

* * *

After more than a year, the process of agreeing upon a single text for the European directive on alternative investment fund managers has taken a significant step forward with the approvals in May of the Parliament and Council texts. But there is still considerable uncertainty about what the final text will provide following the trialogue discussions, particularly on issues such as fundraising where the approaches taken by the Parliament and the Council are materially different. Intensive lobbying from industry associations will most likely continue, and intervention by European governments (and possibly non-European governmental organizations, such as the U.S. Treasury Department) cannot be ruled out. The length of the process, the number of interested groups (commercial and political), the range of views held, and the importance of the outcome to the private equity and hedge fund communities mean that industry participants and advisers will continue to be kept in a prolonged state of suspense. After all, once the final text of the directive is agreed, the “real” discussions and negotiations will start on the detail that will be necessary to implement its general principles.

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Coming to Brazil (cont. from page 10)

Estate investments made through Brazilian limited companies (sociedades limitadas), do not qualify as good assets for purposes of the portfolio composition requirements imposed on FIPs. Therefore, real estate funds making such investments do not invest via FIPs, and instead invest directly in Brazilian limited liability companies. In order to eliminate Brazilian withholding tax on exit, funds that do not use FIP structures often seek to sell the non-Brazilian companies through which they hold a Brazilian investment rather than the Brazilian investment itself. However, as an alternative, it may be possible to utilize a sociedade anônima in place of a limitada.

Currency Exchange Tax
Irrespective of Structuring
Notwithstanding structuring and independent of withholding taxes, international private equity investors should note that Brazil assesses an IOF/Exchange tax on inflows of foreign currency into Brazil and outflows of foreign currency from Brazil. The IOF/Exchange rate (which currently ranges between 0% and 25%) is imposed at different rates on different transactions. The rate is set by decree by the Brazilian government, and can be changed at any time. It was recently raised from 0% to 2% for currency inflows into a FIP. Currency outflows from a FIP, however, are currently subject to 0% IOF/Exchange. Since the rate of IOF/Exchange can change at any time, including after an investor is committed to making a Brazilian investment but before such investment is actually made, it adds uncertainty to the costs of making Brazilian private equity investments.

Conclusion
With both international private equity fund managers and fund investors focused on increasing their presence in Brazil, the Brazilian government intent on attracting investment with tax efficient investment structures, and opportunities for private equity capital to be put to work in the region (including in the lead-up to the 2014 World Cup and the 2016 Olympic Games), we expect that Brazil will be profiling itself even further on the international private equity scene and that you will be reading more about Brazilian private equity in these pages in issues to come.

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Private Equity Is Going Bespoke (cont. from page 16)

Account outside the area of investment and sale allocations. Fund managers will be well-served by considering the conflicts of interest provisions in their existing fund documents in connection with establishing separate accounts to be comfortable these provisions provide acceptable procedures for resolving conflicts. In addition, fund managers should make sure that they and their prospective separate account investors are on the same page regarding conflicts of interest procedures.

Disclosure of the Separate Account to Fund Investors Required? Another issue for consideration is whether the separate account needs to or should be disclosed to the fund investors in existing funds or funds currently being raised. Both contractual and regulatory considerations may be at play in making this determination. Fund investor relationship matters are of course also important to take into account in establishing separate accounts. As a general matter, the clearer the provisions in a Fund manager’s existing fund documents relating to the ability to establish separate accounts, the less pressure there should be on making elaborate disclosures surrounding the separate account.

Perfecting the Tailoring
Although tailor-made separate accounts are not new, their increasing popularity of late is likely to lead in the near term to more consistent market terms in this area, both from a fund manager and investor perspective. We also expect that private equity sponsors will increasingly seek to provide in their fund documents for the flexibility to manage such accounts to accommodate this evolving market and that fund investors are likely to require certain limitations and other safeguards thereon.

In short, like any fashionable market, the tailor-made separate account space is fluid, fun to watch and even more fun to help shape. We will continue to do so and be available to discuss how it is being perfected.

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