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New ILPA Principles: What Has Changed?

As most in the private equity industry know, the Institutional Limited Partners Association ("ILPA") recently released an updated and revised version ("version 2.0") of its Private Equity Principles (the "Principles"), which discuss a number of key fund terms from the investors' perspective. ILPA is a non-profit association representing over 240 institutional private equity investors who collectively manage some $1 trillion of private equity assets.

Like the original Principles, which were published in September 2009, version 2.0 states that three guiding principles form the essence of an effective private equity partnership: (1) alignment of interests between investors ("LPs") and fund sponsors ("GPs"); (2) good fund governance and (3) appropriate transparency. Version 2.0 of the Principles goes on to describe in some detail ILPA's "preferred private equity fund terms and best practices" in each of these three areas, noting that version 2.0 was developed after "reflecting on the extensive input" that ILPA solicited from GPs, as well as LPs, in 2010.

Roughly 140 LPs and GPs have endorsed the Principles, including most recently such market leading fund sponsors as Oaktree Capital Management, L.P., Apollo Management L.P., Kohlberg Kravis Roberts & Co. and Warburg Pincus LLC. According to ILPA's website, endorsement of the Principles means that the endorsing firm generally supports the efforts of ILPA and industry supporters to strengthen the

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"That's the report. Now, would anyone like to carp?"

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Letter from the Editor

It's been a long and miserable winter, but perhaps less so for those in the private equity industry, where the combination of a responsive IPO market, accessible financing and investors with available capital have made the weather and the world political environment somehow not as overwhelming as they might be. To celebrate the end of winter, we have an issue packed with articles on some of the topics that will be most relevant to the private equity industry in the coming months.

On our cover, we provide perspective on the latest version of ILPA's Private Equity Principles. Although ILPA's revised list of "preferred terms" demonstrates that ILPA is responsive not only to its members, but also to the market and to the sponsor community, there are still a number of controversial recommendations included in the Principles. Notwithstanding the endorsement of the Principles by a number of leading sponsors, some of the proposed "preferred private equity terms and best practices" will continue to lead to vigorous debate and negotiation between GPs and LPs in future fundraises.

Private equity is going green! In our Guest Column, the Environmental Defense Fund's Audrey Davenport and Thomas Murray describe the successful efforts of several private equity firms and their portfolio companies to develop strategies to improve energy efficiency, reduce waste and water use and cut CO2 emissions. In addition, the EDF and Ernst & Young have piloted a program with private equity funds to expand the focus of environmental due diligence by looking not just at potential liabilities, but also at potential ways to create value using environmental cost savings and waste reduction measures.

Elsewhere in this issue, we discuss two possible avenues of future private equity investment: the insurance sector and the newly invigorated Russian privatization program. Our new partner, Eric Dinallo, former Superintendent of Insurance for the State of New York, explains that many private equity firms have shied away from insurance companies out of an aversion to significant disclosure to state regulators about fund structure and control persons, as well as ongoing multi-jurisdiction regulatory compliance. He suggests, however, that as a result of the financial crisis, insurance regulators may be increasingly receptive to, and flexible with, private equity investors as reliable and sophisticated capital sources. Members of our Russian private equity team outline the Russian government's interest in attracting international private equity capital to its current privatization program and its recognition that in order to do so it will need to adopt more market-driven sales processes.

Our new London private equity transactional partner, David Innes, explores the evolution of equity commitment letters in the UK and puts them in the context of their U.S. counterparts.

We also have several articles focused on exits. We explore the issues surrounding whether a private equity seller should grant exclusivity to a potential bidder under several different sales scenarios, and we remind you of the intricacies and planning that go into preparing a portfolio company for an IPO.

In this issue, we welcome Kevin Rinker, who joins Steve Hertz as one of our Associate Editors. We also want to take this opportunity to thank Andrew Sommer who has served with Steve, as an Associate Editor for the past four years, for his enormous contributions to this *Private Equity Report* and the practice it reflects.

As always, we welcome your ideas as to how we can make the Private Equity Report your go-to guide for the latest legal guidance on issues of importance for the private equity industry.

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Exposure to Pension Liabilities May Be Expanding

The last thing private equity firms need are new concerns about potentially expanding liability for retired workers. Well-settled conclusions about the use of parallel fund structures to protect private equity funds and their portfolio liabilities against the spread of pension liabilities from one portfolio company to another, or to the funds themselves, have been called into question by a recent opinion out of the Eastern District of Michigan, *Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*. In addition, the case is the first in which a court decision has addressed the expansive interpretation of ERISA liability put forth by the Federal pensions regulator, which has taken the position that a private equity fund itself is a "trade or business" and, therefore, subject to ERISA liability. In another troubling development, the court suggested that exposure to ERISA liability may even extend to a fund manager that has no ownership interest in the portfolio company with the pension liabilities. The decision did not technically create new law since it was not a ruling on the merits, but rather a rejection of motions to dismiss, and the parties have since settled the case without a trial or appeal. However, the district court's reasoning will likely provide ammunition to union pension plans and the Federal pensions regulator, the Pension Benefit Guaranty Corporation (or PBGC), in future negotiations with private equity firms regarding controlled group liabilities for pension underfunding.

"Controlled Group" Issues in Private Equity Funds

ERISA, the Federal pension statute, imposes joint and several liability for certain pension liabilities on the employer that sponsors the pension plan and on each member of its "controlled group." In very general terms, a controlled group consists of trades or businesses that are at least 80%-owned by a common parent. The result is that, if, for example, one member of the controlled group sponsored an underfunded defined benefit pension plan that was taken over by the PBGC, or if such member ceased to contribute to a union pension plan (thus triggering a "withdrawal" liability), those pension or withdrawal liabilities could be enforced against any and all trades or businesses within the controlled group.

In the private equity context, concern over controlled group issues has been a fixture for years where a single private equity fund acquires a greater than 80% interest in more than one portfolio company. In this context, the controlled group rules are generally understood to potentially result in a cross-contamination of pension liabilities among separate portfolio companies. (For example, arguments over "ERISA affiliate" issues in credit agreement negotiations are commonplace, as banks often try to protect against their credit to one portfolio company being eroded, or even trumped, by pension liabilities at other portfolio companies.) Most, but not all, practitioners believe that, while the portfolio companies may be at risk with respect to each other's liabilities, the private equity fund is not, because the private equity fund is not a "trade or business" for tax purposes, and controlled group liabilities can only be enforced against trades or businesses. However, the PBGC, which insures defined benefit pension plans, takes the position that the private equity fund itself can be held responsible for these liabilities, along with its 80%-owned portfolio companies, as set forth in a decision of the Appeals Board of the PBGC from 2007. Prior to the *Palladium* decision, the PBGC's view had not been tested in a reported court decision.

Separate from the "trade or business" issue, affiliated fund families structured as separate funds for onshore and offshore investors, or for taxable or non-taxable investors, or for investors with specific regulatory concerns, have a second line of defense from ERISA liabilities. In these fund structures, it is typically the case that no single fund owns more than 80% of a portfolio company, even though they may share a common investment manager, general partner and investment professionals. A structure in which two or more funds each own less than 80% of a portfolio company (even if their combined ownership is greater than 80%) has been considered "safe," and an effective insulation from ERISA liabilities (both with respect to the potential spread of such liabilities to other portfolio companies and to the funds themselves), because the ownership of each fund was insufficient to create a controlled group under ERISA. The *Palladium* decision, however, is a triple

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Exposure to Pension Liabilities May Be Expanding (cont. from page 3)

threat: it calls these "safe" structures into question, while also voicing support for the PBGC's position on the trade or business issue, as well as potentially expanding exposure even further to a fund manager with no ownership interest.

The Palladium Decision

In *Palladium*, the plaintiffs, two multiemployer pension plans, sought to impose the withdrawal liability of a group of bankrupt companies against three private equity limited partnerships and their common fund manager. The private equity funds at issue were part of a multi-fund structure where no one fund owned more than 80% of the group of bankrupt companies.

The plaintiffs argued that the limited partnerships and the fund manager were part of a controlled group with the bankrupt companies and thus liable for the withdrawal liability. In the plaintiffs' view, the limited partnerships and the fund manager, in their ownership and operation of the companies, constituted a single joint venture or partnership whose ownership interests should be aggregated for ERISA purposes. The plaintiffs also argued that each member of the group was a trade or business. Each side moved for summary judgment in its favor on the issues, and the district court denied the motions, finding that the factual record precluded determination of the issues as a matter of law, which suggests that the judge may have believed that (1) the funds should be aggregated for purposes of the 80% test, (2) the funds are trades or businesses and/or (3) the fund manager is not immune to ERISA liabilities even though it is not in the ownership chain. The parties reached a settlement several months later, and, therefore, the case never went to trial for final resolution of these issues.

So the *Palladium* decision is significant in two respects. First, the decision represents the only judicial suggestion that the multi-fund structure, long considered "safe" from a controlled group perspective, may not be impervious to a controlled group challenge. Perhaps even more troubling is that the pension plans sued not only the private equity funds, but also the fund manager itself, which had no ownership stake in the portfolio companies at issue. The district court accepted the inclusion of the fund manager in the liability analysis, noting that, although the private equity firm "did not engage in any investment activities itself, it functioned as the brain for the investment operations of the three [limited partnerships]."

Second, the decision reflects the first judicial endorsement of the PBGC position that a private equity fund with a standard organizational structure can be classified as a "trade or business" under ERISA. Prior to *Palladium*, most practitioners discounted the PBGC position because it was inconsistent with relevant tax authority on the meaning of trade or business. In addition, the PBGC has historically settled these disputes, suggesting to some practitioners that the PBGC was reluctant to test its position in court. *Palladium* provides a judicial endorsement of the PBGC position and may imply a judicial willingness to reach a different result on the question of an entity's status as a trade or business for purposes of ERISA (as distinct from a general tax law analysis). Even if *Palladium* is not a decision on the merits, it may buttress the legitimacy of the PBGC position, providing authority on which the PBGC and union pension plans may rest future arguments in favor of controlled group liability in similarly structured funds.

The *Palladium* decision...is a triple threat: it calls..."safe" structures into question, while also voicing support for the PBGC's position [that standard PE funds can be classified as a]...trade or business...as well as potentially expanding exposure even further to a fund manager with no ownership interest.

Impact of the *Palladium* Decision

We continue to believe that the multi-fund structure should help to insulate portfolio companies from the ERISA liabilities of other portfolio companies, and we also strongly believe that the fund manager, as a non-owner, should have no exposure under a controlled group analysis. Nevertheless, in the absence of a ruling on the merits by a court, private equity firms should expect these challenges to become more prevalent than in prior years, both in single-fund and multi-fund structures. The *Palladium* decision suggests that such claims may be viable in a judicial action, which could make settlement of these claims harder or more expensive. ■

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GUEST COLUMN

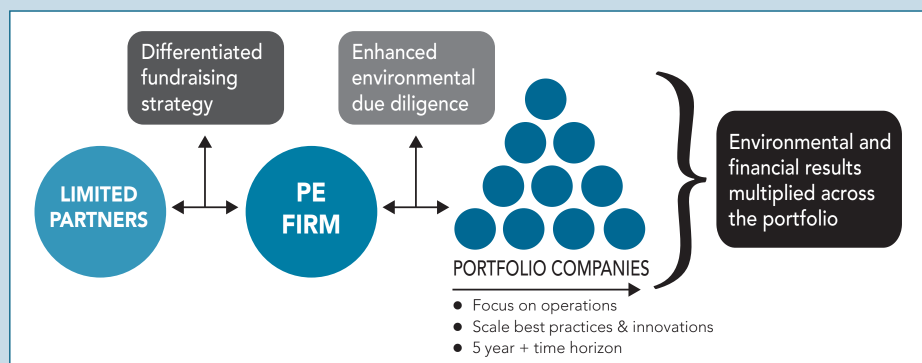
Greener Returns Are on the Horizon

There has been a distinct shift in the conversation over the past year between private equity firms and the Green Returns team at Environmental Defense Fund ("EDF"). The discussion no longer centers around "why" the environment presents an opportunity for differentiation and value creation, but "how" a private equity firm can take advantage of opportunities. From improving energy efficiency to cutting material and packaging waste to reducing water use, environmental management offers numerous opportunities to run leaner, greener companies.

Three diverse private equity-owned portfolio companies all have one very important thing in common — they are saving millions in operating costs through improved environmental management. U.S. Foodservice, a premier foodservice distributor, has saved over $22 million in operating costs and avoided more than 100,000 metric tons of greenhouse gas emissions since 2008 through improved fleet and energy management projects. Diversey, a leading provider of commercial cleaning solutions, is developing data-driven tools to make high return investments in energy savings in order to meet ambitious energy reduction goals. And Dollar General, a leading discount retailer, has saved over $39M since 2008 through improved recycling and waste management practices at its stores and distribution centers.

These savings are particularly compelling in today's changing economy. The private equity industry has been plagued by a number of challenges and so it may seem an unlikely time for the PE sector to embrace new thinking on environmental matters. However, a handful of industry leaders have realized that environmental innovation can be a powerful lever for value creation across the PE investment process. When implemented at scale across PE portfolios, a creative approach to environmental issues can improve due diligence, boost portfolio company performance, present new growth and investment opportunities and build stronger relationships with LPs and other stakeholders (see graphic below). Since PE firms own thousands of companies with millions of employees, these opportunities are almost limitless — yet across the economy, remain largely untapped.

The Environmental Defense Fund's work with the private equity industry began in 2007 through a collaboration with Kohlberg Kravis Roberts & Co. (KKR), Texas Pacific Group and Goldman Sachs to improve the environmental terms of the $45 billion leveraged buyout of Texas-based utility, TXU. This successful collaboration opened the door for further collaboration and led to our partnership with KKR to develop the Green Portfolio Program. Launched in mid-May of 2008, the Green Portfolio Program is designed to measure and improve environmental and business performance across KKR's portfolio companies in five key environmental areas — greenhouse gas emissions, waste, water, forest resources and priority chemicals. Based on a set of analytic tools and metrics designed to help companies identify strategic opportunities in these categories, the program has been incredibly successful to date.



For us, it was truly a "leverage play," with the objective of systematically improving efficiency, cutting costs and reducing environmental impacts at scale across a portfolio of companies. As of June 2010, when we announced the two-year program results, eight portfolio companies were reporting environmental performance through the program and had adopted innovations that resulted in avoiding over $160 million in operating costs, 345,000 metric tons of CO2 emissions, 8,500 tons of paper and 1.2 million tons of waste. At the time of the announcement, KKR strongly endorsed the business case for environmental management.

The momentum has not stopped with KKR, nor with post-closing operating improvements. In March 2010, we announced a new partnership with The Carlyle Group, focusing on identifying and unlocking upside opportunities for value creation during environmental due diligence. "Our goal is to increase returns for our investors while enhancing environmental performance," said William Conway, managing director and co-founder of The Carlyle Group.

The initial result of the Carlyle partnership is an environmental due diligence screen — developed in collaboration with The Payne Firm — that systematically incorporates environmental opportunities to improve operations and create value into the early stages of the

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investment process. The typical environmental due diligence process historically has tended to focus purely on environmental issues from a risk and potential liability perspective. Carlyle and EDF's updated approach aims to set a new industry standard by expanding the narrow focus of environmental due diligence from quantifying downside risks and costs to include identifying upside opportunities and benefits.

Moving forward, Carlyle has committed to implement the new screen in its U.S. and European buyout funds and to share lessons learned with other leading firms. With deal flow beginning to improve, Carlyle expects to put this tool to the test soon to help identify opportunities to improve operations, reduce costs, and strengthen the market position of target companies through steps such as improving energy efficiency, reducing material inputs and waste generation, and developing new environmental products and services.

The TXU deal, KKR's Green Portfolio Program and Carlyle's new due diligence process are a great start, but hopefully just mark the beginning of what might be achieved when best practices for environmental management are rolled out across the entire PE industry. Other industry leaders are already embracing this opportunity and many more seem poised to follow. Growing interest from limited partners (such as Alpinvest and CalPERS), voluntary investor initiatives, such as the UN-backed Principles for Responsible Investment, and evolving regulatory schemes (for example, the UK's CRC Energy Efficiency Scheme, which captures PE-owned businesses) are pushing this topic to the forefront. Major industry conferences are including this as a key topic worthy of discussion, along with other more conventional subjects, including credit spreads, rebalancing LP/GP relationships and the PE industry's need to communicate better.

In an effort to transform this growing interest in environmental management into action, we announced in January of 2011 a new effort with global accounting firm Ernst & Young (E&Y). Together, EDF and E&Y are piloting a new offering for the industry called Green Ops for PE. Green Ops for PE will offer participating PE firms a tailored assessment of the size and nature of environmental opportunities across their portfolio, and provide a clear roadmap for implementation. The approach is intended to help PE firms overcome the major barriers to systemic environmental management by drawing on EDF's strong track record in the industry and E&Y's deep expertise and resources in both private equity and sustainability services.

PE firms' investments represent approximately 10% of the U.S. economy, and PE-backed companies employ more than six million Americans. Imagine if all of those companies and employees recognized that environmental performance and business performance go hand-in-hand? We believe the potential results could far outstrip all our expectations, meeting both the needs and demands of investors, while also helping safeguard the future of our planet. ■

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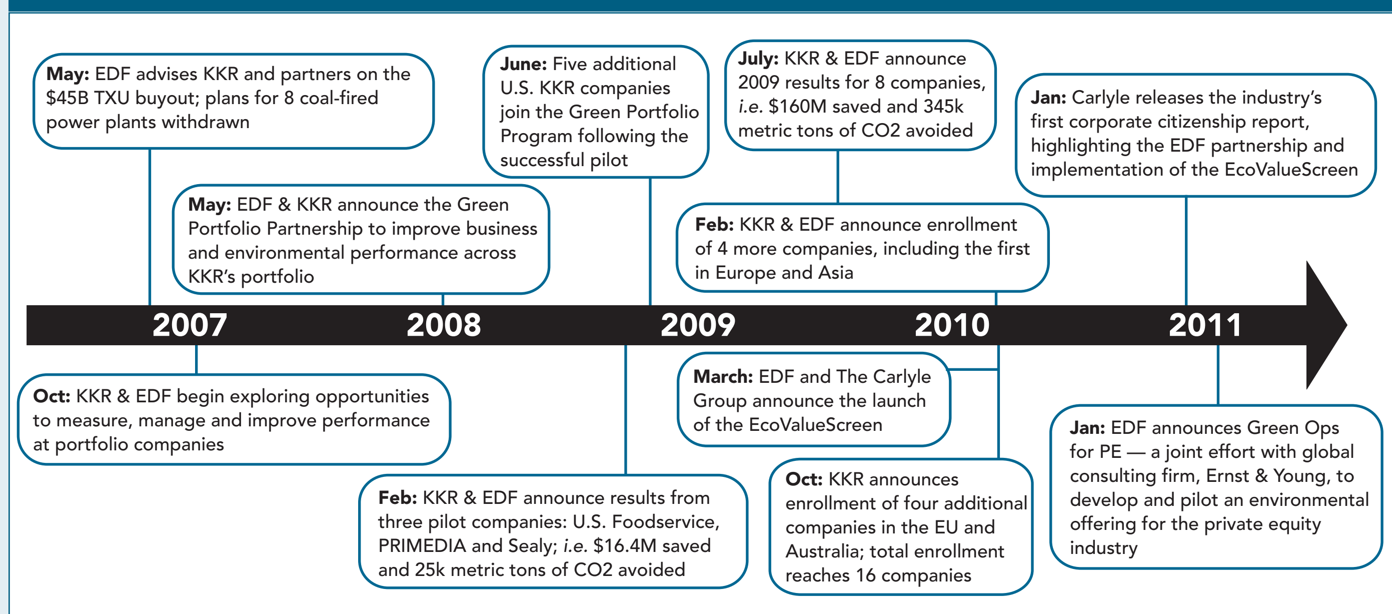
Green Returns Project Timeline (2007-2011)



No Fear of Commitment:

Equity Commitment Letters in UK Transactions

Equity commitment letters have been a well-established feature of both public and private transactions involving private equity sponsors in the U.S. for many decades. Their arrival on the UK private deal scene is much more recent and has developed in tandem with changes in the lending environment. This article examines the evolution of equity commitment letters in UK deals and current market practice for equity commitment letters in UK private transactions.

The Influence of Public Deals

Unlike their public counterparts, closings under UK acquisition agreements for private companies were historically often conditioned on an anti-trust condition (the "Acquisition Condition"), a material adverse change condition ("MAC") and other provisions mirroring the outstanding conditions in the related finance documentation. Although, in practice, if the Acquisition Condition was satisfied, buyers would rarely fail to close a deal, there was a level of uncertainty in both the debt and equity funding until monies were available and closing actually occurred.

In contrast, the "certain funds" concept was long-established in bids for companies governed by the UK Takeover Code, which include companies publicly listed in the UK or which were listed in the UK in the previous 10 years. Under the Takeover Code, if the offer is for cash, or includes an element of cash, an appropriate third party (in practice, the offeror's financial adviser) is required to confirm that resources sufficient to satisfy the cash element of the offer are available to the offeror (termed the "cash confirmation"). Since the party giving the cash confirmation can be required to provide the cash itself, if it has not acted reasonably and responsibly in giving the cash confirmation, it has a vested interest in ensuring that the financing of the offer contains as few conditions as possible and that those conditions are, to the extent practical, within the control of the bidder. Financing for UK public M&A transactions is, therefore, on a "certain funds" basis.

Certain funds became available from lenders to UK private M&A transactions only in the early 2000s, fueled by a competitive lending market and the desire of private equity sponsors to increase the deliverability of their bids by replicating the certainty of debt funding available in public M&A deals. This, in turn, led to the decline of MAC conditions in private acquisition agreements, because such conditionality was no longer required in order to mirror the outstanding conditions in debt documents. In addition, and, more importantly, for private equity sponsors, increased demands for buyers to complete the funding picture by providing equity commitment letters became more common.

Initially, many private equity sponsors refused to provide equity commitment letters, usually on the basis that they had an impeccable track record of never failing to fund an agreed deal. However, influenced by U.S. practice and the relatively loose, formative manner in which such obligations were documented, many sponsors gradually became less resistant to the idea. When equity commitment letters made their first appearance in the UK market, they were brief, often lacked clarity and almost always contained a broad carve-out for the private equity sponsor if debt funding was not provided. In the intervening years, the drafting of equity commitment letters has become tighter and the terms increasingly seller-friendly. In particular, the widespread use of auctions has allowed sellers to exploit competitive tension to achieve stronger equity commitment letters from private equity bidders. It is now common, at the penultimate stage in competitive auctions, for UK non-listed companies (where the number of bidders is reduced to a manageable number of, for example, 4-5) for bidders to be provided with a draft equity commitment letter (as well as a draft acquisition agreement) to mark up, negotiate and deliver with their final binding bids.

Equity Commitment Terms

The sellers' aim is to ensure that, so far as possible, the transaction is conditioned only upon the main Acquisition Condition. Once that is satisfied, the acquisition agreement, together with the debt finance and equity finance documents (including the equity commitment letter) become unconditional. In those circumstances, if a buyer does not close, the sellers will, at the very least, have an action for damages

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[T]he drafting of equity commitment letters has become tighter and the terms increasingly seller-friendly. In particular, the widespread use of auctions has allowed sellers to exploit competitive tension to achieve stronger equity commitment letters from private equity bidders.

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against the buyer (which will have assets because it has received equity funding) or the buying sponsor if it has failed to fund the buyer.

To eliminate as much risk as possible on the debt funding, the buyer is now generally required to deliver to the sellers, at the same time the acquisition agreement is signed, a letter from the funding banks evidencing that all conditions precedent to the debt financing have been satisfied, other than the Acquisition Condition in the acquisition agreement and conditions within the control of the buyer.

Similarly, to eliminate as much risk as possible from the equity funding, the acquisition agreement and the equity commitment letter will be entered into at the same time and together provide that the buying sponsor will:

- on satisfaction of the Acquisition Condition, provide the necessary equity funds to the buyer (and not withdraw them);
- on satisfaction of the Acquisition Condition, require that the buyer take all necessary steps to draw down the debt financing. Occasionally, sellers also ask for a power of attorney from the buyer to enable the sellers to enforce the debt financing documents, but that is usually rejected;
- require that the buyer fulfils its obligations under the acquisition agreement; and
- not take, or omit to take, any actions which are likely to prejudice the ability of the buyer to close the transaction, including amending or terminating the financing documents.

These terms are broader than the typical equity commitment letter in U.S. deals and incorporate provisions that in current U.S. market practice would be more commonly found in the acquisition agreement and guarantee.

Financing Condition in Equity Commitment Letters

The most contested provision in an equity commitment letter is the financing condition, which, if included, permits the private equity sponsor an "out" from its funding obligation if the debt financing is not available. The precise wording is generally fiercely negotiated, and is often the last point on the table prior to signing the transaction documents.

The outcome will depend on the relative bargaining position of the parties, any competitive tension generated in an auction, and the extent of conditionality in the debt financing documents. In very competitive auctions, the financing "out" is often conceded, albeit very reluctantly, by bidders keen to seal the deal. If this provision is conceded, the private equity bidder is obligated, subject to any rarely agreed liability cap, for the entire equity commitment if the debt is not funded.

Credit Crunch

Contrary to expectation, the credit crunch and declining availability of debt financing did not reduce the need for "certain-funds" and equity commitment obligations in private M&A transactions. In fact, auctions for desirable assets are as competitive as ever due to changes in debt/equity ratios, private equity sponsors with large amounts of "dry powder" and a shortage of high-quality assets for sale. Buying sponsors eager to demonstrate the deliverability of their bids continue to negotiate certain funds from banks and provide equity commitment letters to sellers.

Remedies

While liability caps or reverse termination fees have become common in the U.S. market, such fees and liability caps are rare in the UK. However, some UK buyers have successfully argued for caps on the basis that liability under equity commitment letters should be limited to reflect the likely amount of damages that would be payable on a successful claim for breach of contract for failure to close.

Under English law, loss for breach of contract is generally calculated as the difference in value between what the claimant receives, and what the claimant would have received if the breach had not occurred, and the contract had been performed. It is also subject to the duty of a claimant to take reasonable steps to mitigate its loss. If a buyer refuses or is unable to close, the seller still retains the shares in the target and may be able to sell the target to a different bidder. The damages available to a seller are, therefore, likely to be limited to the sale costs incurred by the seller and potentially the loss of profit or loss of value on an alternative deal, which will be significantly less than the consideration contained in the acquisition agreement. Obviously, these amounts would potentially have been much higher when asset values were depressed shortly after the credit crunch than they are at present in a more stable market.

In addition, specific performance of a contract is a more difficult remedy to obtain in the UK than it is in the U.S. It is a discretionary remedy which is usually only available when the courts consider that damages would be an inadequate remedy. That is only likely to be the case in unusual circumstances. As a result, the liability of a sponsor under an equity commitment letter in the UK may be less than in the U.S., where a seller with third-party beneficiary rights against the equity commitment letter would be able to sue

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Exclusivity From the Seller's Perspective

Private equity buyers traditionally attach a lot of importance to proprietary deals or to getting exclusivity in potential transactions. Private equity sellers, however, do not always think that what is good for the goose is good for the gander. As private equity owners think about exiting their investments in negotiated transactions, they will often need to address the difficult and complicated decision of whether to grant exclusivity at some point in the process. That decision will have implications in terms of deal dynamics, but may also have legal consequences. In this article, we explore some of the issues that private equity sellers should consider in handling an exclusivity request, using three different exit scenarios: (1) the sale of a portfolio company to a strategic buyer; (2) an auction process for a portfolio company; and (3) the sale of a public company in which a private equity firm holds a significant equity interest.

Scenario #1

A portfolio company has been approached by a strategic buyer offering a dazzling purchase price and a request for an exclusivity period to conduct due diligence and negotiate a binding purchase agreement.

Assuming the time is right for a sale, the private equity firm must consider whether there are one or more buyers that might pay a higher price and present the same or a better deal with respect to speed, certainty and risk allocation. This analysis involves considering other potential strategic buyers, as well as a sale to another private equity firm. If it seems unlikely that a better deal could be had, or the exercise of finding this out would be unduly time-consuming and distracting for the portfolio company management team, then the exclusivity request should be seriously considered.

First, exclusivity avoids the strain that an auction process can create for a management team, not just in terms of answering questions and providing information, but also uncertainty regarding potential new owners. Second, limiting the negotiations to a single buyer reduces the chances of a leak. The public scrutiny that comes with "being on the block" can lead to inquiries from employees, customers, suppliers and business partners about the company's plans that may prove distracting, even harmful, to the company's operations and business. Moreover, running an effective auction may require sharing competitively sensitive information with multiple parties, which could likewise be harmful to the company's business and, potentially, have a deleterious effect on the initial bidder's view of the company's value. Finally, exclusivity provides the benefit of establishing a moral commitment by the buyer to the process and establishes a concrete time frame for signing a deal, since the potential buyer will be incentivized to reach a binding agreement before the exclusivity period ends.

If, after considering all these variables, the private equity firm is inclined to grant exclusivity, it may want to consider whether the benefit to the buyer of a proprietary transaction should come with a price tag — such as an increase in the buyer's offer price — although any agreement on value at this stage is, obviously, not binding.

Scenario #2

The private equity firm has conducted an auction for a portfolio company. The highest bidder submits a bid letter which "requires" the target company to provide exclusivity as a condition to its offer.

In this scenario, the seller obviously concluded that the pros of an auction process outweigh the cons. As a result, the primary focus of the exclusivity analysis should be the impact on the seller's negotiating leverage and its ability to maximize value. Agreeing to exclusivity would mean effectively freezing out the other bidders. While giving the high bidder exclusivity should incentivize that bidder to work quickly toward signing, the seller needs to be wary of the high bidder feeling so empowered that it begins to negotiate the outstanding deal points more aggressively. (One way to mitigate this problem is to attempt to negotiate the key terms of the transaction, in addition to price, before agreeing to exclusivity.)

On the other hand, while refusing to provide exclusivity may keep the high bidder on its best behavior, it will also mean foregoing the benefit of a deadline that the exclusivity period provides. In fact, the high bidder may feel that time is on its side and try to extend the negotiations with the knowledge that, at some point, the seller will be reluctant to turn to the second-place bidder — either because the seller will have invested so much time with the high bidder that it will want to avoid having to start over with someone else, or because it knows that the second bidder will likely have enhanced leverage, knowing that the seller was unsuccessful with the high bidder (assuming, in each case, that the seller has not been simultaneously negotiating with both parties).

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If it seems unlikely that a better deal could be had, or the exercise of finding this out would be unduly time-consuming and distracting for the portfolio company management team, then the exclusivity request should be seriously considered.

Exclusivity From the Seller's Perspective (cont. from page 9)

In practice, the seller's banker delivers a message to the high bidder that written exclusivity will not be provided but, if the high bidder rebids at a certain level, that bidder will become the front-runner and will have *de facto* exclusivity until a specified date. During that period, the banker will try to maintain a connection with the other bidders so that there are fallback options for the seller.

As both scenarios #1 and #2 demonstrate, the response to an exclusivity request during the sale of a privately-held portfolio company is driven by deal dynamics, not legal considerations. That is because, in the context of a sale of a privately-held portfolio company, the legal exposure associated with granting exclusivity is usually not significant due to the portfolio company's small number of minority stockholders, if any. The analysis becomes more complicated as we move to the public company arena.

Scenario #3

The private equity firm has a significant stake in a public company. A buyer has emerged with an offer at a substantial premium over the current trading price and a request that the target company work exclusively with it toward the signing of a definitive deal.

As with scenario #1, the private equity firm, or, more precisely, the portfolio company board, must consider whether the timing is right and the extent to which the offer is appealing when compared to the company's trading price, financial performance, prospects and long-term strategic plans. In addition, and unlike in the private company context, legal issues play a significant role in the analysis regarding exclusivity. This is because the fiduciary duties of directors of public companies, while not different from those of directors of private companies, raise heightened risks if breached, due to the near inevitability of the shareholder litigation that accompanies public company transactions. In short, if the board decides that the company will be sold, the directors' fiduciary duty is to seek the best price reasonably available.

There are, of course, a number of reasons why a board of a public company might prefer to proceed without a pre-signing market check and negotiate exclusively with one buyer. Not unlike the considerations discussed in the private company context, one of the biggest concerns is the distraction to the business of a public process and the strain on the management team of a protracted process with multiple potential buyers. These concerns are arguably heightened in the public company context where leaks and rumors get more air time and can have greater consequences, such as an impact on the trading price against which the deal price will be measured. Proceeding quickly and without the public spotlight decreases potential disruption and distraction with employees, customers, suppliers and other business partners.

While these are all good reasons for granting exclusivity, they cannot be viewed in a vacuum. Granting exclusivity, even for compelling reasons, comes with legal risks for the target's board as a result of the potential for fiduciary duty claims by stockholders, or in reality, the plaintiffs lawyers that represent them. This does not mean that a public company board cannot grant exclusivity — as Chancellor Laster of the Delaware Chancery Court said in the recent *Del Monte* case, granting exclusivity is a tactical decision that courts "will rarely have cause to second guess" (assuming that the board is independent and active and assisted by non-conflicted advisors). It does, though, mean that the company's board should consider carefully the advantages and disadvantages of granting exclusivity, and should build a record of its evaluation. It also means that, until the company's stockholders have voted on the transaction, the board must be able to consider competing proposals.

This is why public company merger agreements contain "fiduciary out" provisions permitting the target's board to recommend that stockholders vote against a proposed merger if a better deal comes along. That is the case regardless of whether a pre-signing market check has been conducted. However, granting exclusivity is relevant to how easy the board has to make it for competing bidders to enter the process after a deal is signed. A target that chooses to negotiate exclusively with one buyer prior to signing may seek to mitigate its legal exposure by pressing for relatively loose post-signing deal protections. For example, it can (1) insist on a "go-shop" provision allowing active solicitation of competing offers for some period after signing, (2) attempt to set the break fee at the low end of the range and provide for an even lower fee during the go-shop period and/or (3) limit the buyer's matching rights in the context of a competing offer.

Conclusion

The decision to grant exclusivity is a complicated one. We have attempted to cover a number of the considerations in a few different scenarios, but ultimately, the determination will require a careful analysis of the particular facts at hand and a good deal of judgment on the part of the seller. The good news is that private equity sellers and their advisors will have likely been through this drill many times, including on the buy-side, and are, therefore, well-positioned to make a judgment call under a variety of different circumstances. ■

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The 2010 Estate and Gift Tax Law: A "Gift" for Private Equity Estate Planning

The recent changes in the estate and gift tax law may have been an unanticipated "gift" from Congress to private equity professionals. The tax law adopted at the end of last year (the "2010 Act") dramatically reduced transfer tax rates and raised tax exemption amounts beyond what most practitioners had expected, and instituted some long hoped-for reform. This article summarizes the major provisions of the 2010 Act and the significant estate planning opportunities it has created, focusing on those available to principals of private equity funds who have transferred fund interests to family trusts in recent installment sales and for those who may wish to transfer fund interests down the road.

Major Provisions of the Act

Among other things, the 2010 Act:

- Sets the amount exempt from federal gift, estate and generation-skipping transfer ("GST") taxes at $5 million per individual, $10 million for married couples (up from $3.5 million per individual, $7 million for married couples, in 2009).
- Reduces the rate of taxes on amounts above the exemption amount to 35% (down from 45% in 2009).
- Allows for "portability" of the gift and estate tax exemptions between spouses, so that a surviving spouse can now apply any unused estate or gift (though not GST) tax exemption of a deceased spouse to taxable transfers made by the survivor during his or her lifetime or at death.

Absent further action from Congress, the exemption amount and transfer tax rate will revert in 2013 to the levels they would have reached under pre-2001 law ($1 million and 55%, respectively). Most practitioners believe the new rate and exemption will be extended, but few are likely to bet on that — especially given how wrong many of us were in predicting that the temporary repeal of the estate tax in 2010 would never come to pass. In the meantime, with the exemption at an historic high and the tax rate at an historic low, taxpayers have a unique opportunity (at least for the next two years) to make significant transfers to beneficiaries of multiple generations free of tax. For principals of private equity funds, these transfers can take the form of gifts or sales of fund interests or the forgiveness of debt incurred by family trusts in acquiring fund interests.

Enhanced Opportunity for Tax-Free Lifetime Gifts

The increase in the gift tax exemption means, of course, that larger lifetime gifts can be made to anyone free of gift tax — up to an aggregate of $5 million (up to $10 million for married couples). With the increase in the GST tax exemption, gifts can be made completely free of federal transfer tax to grandchildren, great-grandchildren or perpetual "dynasty" trusts. Taxpayers who have used up the old gift tax exemption of $1 million now have an additional $4 million they can give away tax-free, and even if the old $3.5 million GST exemption has been entirely used, there is now another $1.5 million available for GST gifts (again, doubled for married taxpayers). Assuming that the transferred assets rise in value, all the excess appreciation belongs to the donee and is out of the donor's eventual estate for estate tax purposes.

For New York residents, like residents of many other states, lifetime gifts at almost any level are more cost-effective than transfers at death. Many states, including New York, impose an estate tax *but no gift tax*. Thus, lifetime gifts do not trigger transfer tax liability at the state level and also help to reduce the eventual federal and state estate tax by reducing the taxable estate.

Lifetime gifts, whether outright or in trust, have several potential non-tax advantages as well. Recipients of lifetime gifts can enjoy the economic benefit while the donor is still alive rather than waiting for a parent or grandparent to die (and in many estate plans, it is the death of both spouses that triggers benefits to younger generations, creating an even longer wait). A current gift also allows the donor to see how children or grandchildren handle a first installment of wealth or how a trustee manages investments. A donor can then make adjustments where warranted — for example, by changing trustees, coaxing younger family members to become more financially responsible (through the possible use of incentive arrangements) or protecting them against creditors or mismanagement through longer-term trusts.

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[W]ith the exemption at an historic high and the tax rate at an historic low, taxpayers have a unique opportunity (at least for the next two years) to make significant transfers to beneficiaries of multiple generations free of tax.

Application to Estate Planning with Fund Interests

New estate planning transfers. Estate planning transfers of interests in private equity funds have often taken the form of installment sales to family trusts. Such an installment sale typically involves the following steps:

- The fund principal contributes a portion of his or her interest in the fund GP (including a proportionate share of the principal's interest in both carry and capital) to a family limited liability company ("FLLC") or family limited partnership ("FLP").
- The principal sells the economic interest in the FLLC or FLP to a trust for a purchase price equal to the value of the FLLC or FLP interest, as determined by an appraiser, taking into account the present value of the expected future cash flows from the GP and any appropriate discounts for lack of control and lack of marketability. (Although legislative proposals had been made to restrict or even eliminate valuation discounts in intra-family transactions, especially on passive assets, no legislation has yet been enacted. As a result, such discounts are still available, although we do not know for how much longer.)
- The trust pays the purchase price in the form of a cash down payment and a promissory note. If the trust has insufficient resources at inception to engage in the transfer, the fund principal can provide the necessary capitalization of the trust by way of a gift.
- Over time, the trust uses distributions received from the fund GP (via the FLLC or FLP) to pay interest and principal on the note. Principal payments can be back-loaded to accommodate the expected timing of carry distributions from the fund GP. Because the purchasing trust is designed as a "grantor" trust that is ignored for income tax purposes, the interest on the note is not taxable income to the principal, and no gain is recognized on the initial sale to the trust.

In structuring installment sales, cautious planners advise that the trust have net assets (including the down payment) of 15-20% of the purchase price, although some advisors believe that 10% is sufficient, based on ambiguous authority. For those principals who did not already have family trusts with funding in place, the prior $1 million gift tax exemption amount effectively capped the (appraised) value of the fund interests that could be transferred free of gift taxes to $5-$6.6 million (under the cautious approach).

With a $5 million exemption, the value of fund interests or other assets that can be transferred via an installment sale has increased significantly. For example, a married individual could now sell a $50 million asset to a grantor trust, funding the trust with a tax-free gift of $5-$10 million, out of which the trust would then pay the grantor a $5 million down payment along with a note for $45 million at the relatively modest interest rates mandated by the IRS. Of course, there needs to be a realistic expectation of full payment of the note, collateral (often a pledge of the purchased asset) and so forth. The key change after the new tax legislation is that the scale of installment sales can now be much larger by leveraging the larger gift tax exemption.

Alternatively, principals can forego the complexities of an installment sale (which requires, among other things, the preparation of a security agreement and the filing of UCC statements in one or more states) and instead transfer the FLLC or FLP interest by gift. With the much larger gift tax exemption amount, it is now possible that the entire gift could be sheltered from gift tax.

Prior estate planning transfers. Fund principals holding promissory notes issued by trusts in prior installment sales may wish to consider using the additional gift tax exemption to forgive some or all of the amount outstanding. The forgiveness of the loan will be treated as a gift to the trust, which will be sheltered from tax to the extent of the available exemption. Forgiveness of the loan will result in significantly more wealth remaining in the trust for beneficiaries and reduce the amount that would otherwise be repaid to the donor and ultimately included in his or her estate. In addition, forgiving the loan helps to avoid possible adverse income tax consequences that may arise if a donor dies while an installment note is still outstanding. Principals will need to weigh these benefits against the potential disadvantages — including the reduction in cash flow (to the extent principals were counting on the debt service for lifestyle or other needs) and the use of the gift tax exemption on an unleveraged basis.

In considering whether to forgive a loan from a trust, donors should also bear in mind the expected future performance of the trust's assets. For example, if a trust holds only an interest in the GP of a single fund that is unlikely to generate enough carried interest distributions to allow the trust to pay off its installment note, there is little benefit in forgiving the loan. Instead, the trust can be allowed to default on the note, in which case, the GP interest held by the trust will simply be returned to the principal. In that case, the principal can use the gift tax exemption to forgive debt owed by a trust holding an

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Helping Private Equity Play a Greater Role in the U.S. Insurance Market

Although some U.S. private equity funds continue to focus on investments in the U.S. insurance space, many private equity firms have historically shied away from such investments. Since opportunities for such investments are expected to increase as the economy improves, due, in part, to the uncorrelated risk opportunity on the liability side of the balance sheet and the opportunity to leverage investment expertise on the asset side, it may be an opportune time for private equity firms to reevaluate the insurance sector.

While the market is not oversaturated with insurance private equity transactions, there are a number of significant recent transactions, including the $230 million investment by Warburg Pincus in Primerica. Other private equity investments in the broader U.S. insurance space include the approximately $3.1 billion acquisition by Silver Lake Partners and BC Partners of Multiplan, Inc., the largest independent PPO in the U.S., and a $1.1 billion buy-out of Sedgwick Claims Management Services, Inc. by Stone Point and Hellman & Friedman and the Sedgwick management team.

Part of the historical reluctance of private equity firms to invest in insurance assets is the regulatory environment. U.S. insurance companies are generally regulated by state, not federal, law and the acquisition of a U.S.-domiciled insurance company by a private equity fund can require significant disclosure to state regulators about the acquiror's fund structure and controlling persons. In addition, the acquired insurance company will continue to be subject to a comprehensive state-based regulatory regime by its state of domicile and, in certain circumstances, the laws of other states where the insurer is licensed.

State regulation sounds more ominous than is actually the case. Private equity funds proposing well-structured transactions need not necessarily fear state insurance regulation. Speaking from my experience as the Superintendent of Insurance for the State of New York, I recognize that state insurance regulators (and regulators generally) are constantly worried about preventing the next crisis and will generally be appreciative of those interested in providing capital to the industry, including private equity funds. On several occasions during my time as the New York State Superintendent of Insurance, I was relieved to be able to turn to private equity funds as potential solutions to perceived or existing problems — and I was in good company in the regulatory community.

Following the financial crisis, state insurance regulators are more focused than ever on preventing problems and will often be incentivized to welcome private equity funds to the industry as reliable and expert sources of capital. This is especially true when private equity is viewed as a potential rescuer of troubled insurers (which might include insurers in receivership proceedings or close to it, those facing unresolved regulatory issues or needing to shed non-core assets or businesses). In addition to the potential for attractive valuations, transactions involving troubled insurers have the potential to offer a private equity fund a streamlined approval process. The approval process can be streamlined at the discretion of the key regulators. One relevant example was the ability of Berkshire Hathaway to form and nationally license a monoline insurer in approximately 10 weeks, a much shorter time frame than is typical.

Once a potential insurance opportunity has been identified, a private equity investor will face two primary legal and regulatory considerations. The first concerns the structuring of the acquisition itself, which has been adequately covered by our insurance team elsewhere.[1] The second concerns managing the regulatory approval process for the acquisition, as well as understanding the regulatory regime under which the acquired insurer will operate following the closing. The remainder of this article will focus on strategies for successfully navigating the applicable regulatory regime, both in terms of securing regulatory approval for the acquisition itself and owning a U.S.-domiciled insurer following the closing.

Getting from Signing to Closing: Strategies for Navigating the Insurance Regulatory Regime

Acquiring "control" of a U.S.-domiciled insurance company requires the prior

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1 *See "Private Equity Investments in Insurance Companies," by Paul S. Bird, Stephen R. Hertz, Jeremy Hill and Andrew L. Sommer, in Insurance and Investment Management M&A 2010, Debevoise & Plimpton LLP (2010).*

Following the financial crisis, state insurance regulators are more focused than ever on preventing problems and will often be incentivized to welcome private equity funds to the industry as reliable and expert sources of capital.

approval of the domestic state regulator of the insurer and can also require the approval of other state regulators if the insurer is "commercially domiciled" in another state.

What is "Control?"

"Control" for state insurance law purposes is generally defined as the possession of the power to direct the management and policies of a person, through ownership of voting securities, by contract, or otherwise. Most state insurance codes contain a rebuttable presumption that an acquiror will control an insurer if it holds, directly or indirectly, the power to vote, or holds proxies representing, 10% or more of the voting securities of the insurer.

These disclosure requirements can include the filing of biographical affidavits, and in some states, fingerprints, with respect to directors and executive officers of the acquired insurer or controlling person. In addition, in the event that the controlling person of an insurer will be an individual, personal financial statements or a net worth affidavit may be required.

What Must Be Filed?

The application for approval is generally submitted on a "Form A," which often requires disclosure of an acquiror's controlling persons, directors and executive officers, financial statements and business plan for the insurer (often including financial projections). These disclosure requirements can include the filing of biographical affidavits, and in some states, fingerprints, with respect to directors and executive officers of the acquired insurer or controlling person. In addition, in the event that the controlling person of an insurer will be an individual, personal financial statements or a net worth affidavit may be required.

The source of these requirements vary. Some are derived from a state's insurance laws, while others are a function of an insurance department's standard practice. While these requirements may initially appear burdensome and intrusive, in certain cases, an insurance regulator will have the power to exercise significant discretion as to whether a particular item must be submitted in connection with a Form A filing, particularly in connection with a transaction where a private equity firm is stepping in to rescue a troubled insurer. Additionally, confidential treatment for non-public information submitted in connection with a Form A filing is often available. Therefore, private equity firms whose partners are understandably loathe to disclose personal financial information will want to approach the applicable regulators prior to entering into a transaction to gauge the level of disclosure that will be required in their particular case.

In addition to the Form A filing, which is the primary acquisition of control filing, a potential acquiror will need to consider the laws of other states in which the insurance company is licensed to determine what, if any, other filings will be required.

What Will the Regulator Be Focused On?

A potential acquiror of a U.S.-domiciled insurance company will want to be sure to address the primary areas of concern to a regulator reviewing a proposed transaction in preparing the Form A filing and in all other communications with the regulator. The regulator will have a somewhat different perspective on the transaction than the private equity firm's investment thesis. Harnessing facts to address those particular concerns will be essential in motivating the regulator to approve the transaction on a timely and flexible basis. The primary areas an acquiror will want to address in discussions with the regulator are:

- How the proposed acquisition will protect and benefit policyholders (as opposed to investors);
- The financial strength of the target insurer based on statutory valuation metrics (as opposed to internal financial or actuarial models);
- The expertise and experience of the incoming management team (as opposed to the prior management regime); and
- Sensitivity towards the protection of jobs and employees (especially in the insurer's home state).

Additionally, a private equity firm should be aware that many insurance regulators are mandated to (and others choose to) hold a public hearing prior to deciding whether to approve a transaction.

While the regulatory approval process for the acquisition of control of an insurance company can be time-

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ALERT

English High Court Upholds Sponsors' Right to Buy and Vote Portfolio Company Debt

A recent decision by the English High Court demonstrates the importance of carefully crafted loan documents, especially to private equity sponsors who may want to invoke equity cure rights or purchase portfolio company debt in order to prevent lenders from exercising remedies against their portfolio companies. The court upheld the powers granted to majority lenders under an English law facility agreement, notwithstanding that they were affiliated with the equity sponsors. In recognizing the rights of the affiliated lenders who had recently purchased a majority of the debt and then withdrawn a previously-delivered notice making a debt payable on demand, without the consent of the minority lenders, the court explained that it was upholding the "commercial purpose" of the facility agreement. In the same decision, the court held that the borrower could cure a violation of the interest coverage covenant in the loan document by invoking an equity cure clause and incurring additional debt from within its corporate group, without injecting new capital. These holdings demonstrate that English courts remain generally willing to uphold the powers granted to majority lenders even where they are connected with the equity sponsors and the powers are being exercised indirectly for the benefit of the sponsors.

In the transaction leading to the case, a Luxembourg borrower (the "Company") entered into a facilities agreement, under which three entities constituted the majority lenders. Following a breach of the Company's financial covenants, the facility agent, on the instruction of the majority lenders, sent a notice to the Company stating that the Company was in breach and that the facilities were to be placed on demand. The majority lenders subsequently sold their interests to two companies affiliated with the sponsor of the Company. The new majority lenders then instructed the facility agent to withdraw the notice and to waive any breaches of the financial covenants.

Following this, Strategic Value Master Fund ("SVMF"), a minority lender, brought an action against the Company (and the sponsor affiliates) claiming that the purported withdrawal of the notice and waiver were ineffective. SVMF argued that the withdrawal of the notice was an amendment or waiver of a term of the facilities agreement, and moreover, the withdrawal related to the extension of the maturity of the commitment of a lender, which under the facilities agreement required unanimous lender consent. The court concluded that the majority lenders had not waived or amended a term of the facilities agreement merely by waiving their rights and withdrawing the notice, and that, thus, the majority lenders could return the loan to its original payment requirements without unanimous consent.

In addition, SVMF disputed whether the acknowledged breach by the Company of an interest coverage covenant had been cured, as argued by the Company and its sponsor. The sponsor had "round-tripped" funds within the Company's group to cure the interest coverage violation, in essence by rearranging intra-group debt but not injecting any "new money." The court held that this was permissible under the loan documentation, which did not require new money in these circumstances.

Finally, SVMF argued that the Company was insolvent within the meaning of the English Insolvency Act 1986, because the value of its assets was less than the value of its liabilities, and that, thus, there was an existing default under the facilities agreement, which provided that insolvency under any applicable law was an event of default. Despite the facilities agreement being governed by English law, it was held that the English law balance sheet test of insolvency was not relevant for the purposes of the facilities agreement. The "applicable law" is generally the jurisdiction of incorporation (in this case, Luxembourg), but may also include the law of any jurisdiction with the power to wind a company up or to initiate equivalent procedures. The law chosen to govern the documentation, however, may not be "applicable" in this sense.

The case is of particular interest because the High Court analysed several provisions commonly found in European syndicated loan agreements:

- ***Equity Cure rights:*** Equity cure rights in the event of a borrower's non-compliance with financial covenants are now an established part of the European leveraged financing landscape and have survived the adverse market conditions of the past few years. In the U.S., equity cure provisions are also enjoying a resurgence and are now commonly

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Alert: English High Court Upholds Sponsors' Right (cont. from page 15)

included in leveraged facility agreements. It should be noted that, in both the U.S. and Europe, the terms are usually heavily negotiated by lenders who are aiming to restrict their use. Although in this case it was possible to "round-trip" the funds based on the terms of the loan agreement, it is not generally possible to use equity cure provisions without injecting new funds. In addition, there are typically limits on both the number of cures permitted over the life of a loan and the number allowed over consecutive periods. Increasingly, lenders are also requiring that some, or all, of the new funds are used to prepay debt, which should obviously be resisted by sponsors and borrowers where possible.

- ***Disenfranchisement of Sponsor Affiliates:*** The Loan Market Association ("LMA") standard form facilities agreement for leveraged financings now includes restrictions on the voting rights of sponsors and their affiliates who purchase debt, effectively disenfranchising them entirely with regard to debt held by them. Lenders will usually insist on these restrictions, so they are now generally included in European leveraged financing facilities; the SVMF documentation is unusual in not imposing such restrictions. As this case demonstrates, in agreeing to such restrictions sponsors are giving up very real flexibility to manage distressed situations by acquiring and voting debt. In the U.S., there are often caps on the amount of debt that sponsors or their affiliates can purchase and, subject to certain limited exceptions, such sponsors or affiliates are also usually disenfranchised with regard to the debt purchased.
- ***Insolvency Defaults:*** From a sponsor or borrower's perspective, it is important to ensure that an event of default cannot be triggered by a technical insolvency, such as balance sheet insolvency (assets being less than liabilities). The Loan Market Association leveraged form includes an insolvency default based on balance sheet insolvency. Although in the current case the borrower was able to successfully argue that no insolvency event of default had occurred within the meaning of the facilities agreement, this might not have been the case if the language in the LMA form had been used. Accordingly, sponsors should resist the inclusion of the balance sheet insolvency default from the LMA form. If it is included, this should be only following diligence and careful consideration of the risks of such default being triggered.

Most importantly, this case demonstrates the need for private equity sponsors to be mindful of their need to retain flexibility under loan documentation to be best equipped to handle distressed situations. ■

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Equity Commitment Letters in UK Transactions (cont. from page 8)

for specific performance of the full amount of the commitment.

Conclusion

In competitive auctions, sellers are able to negotiate aggressive and tight equity commitment letters from buying sponsors, who have, in turn, negotiated tight debt commitments from their lenders. However, in other situations where the negotiating power lies with the buyer, the commitment is correspondingly weaker and, even in auctions, the precise terms of an equity commitment letter will often be secondary in the mind of a seller to the price offered, as long as the seller is satisfied with the overall deliverability of the bid. It is also worth noting that, in the UK market, there have been no, or very few, instances of private equity sponsors failing to close agreed deals. Sponsors active in both the U.S. and UK markets should understand the different consequences of their equity commitment letters in each jurisdiction and how they interact with the overall risk profile of committing capital to a transaction. ■

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Doing Business with Sovereign Wealth Funds: SEC Launches Foreign Bribery Probe

It may have come as a surprise to some people in the private equity community to learn that the Boston Office of the U.S. Securities and Exchange Commission ("SEC") had launched an investigation into possible violations of the Foreign Corrupt Practices Act ("FCPA") by financial institutions, including private equity firms, that have sought investments from or partnerships with sovereign wealth funds ("SWFs"). Subsequent reports make clear that the SEC's investigation also includes a review of relationships with state-owned pension funds.

Public reports describe the investigation as being in its relative infancy. Some financial institutions have received document preservation letters from the SEC; others, however, have also received subpoenas. These reports suggest that the SEC may be engaged in its latest industry-wide probe, on the heels of investigations of the oil and gas and pharmaceutical industries, among others.

Private equity firms are well-advised to take steps now to get out ahead of any possible inquiry. Firms that have not already done so should conduct a risk assessment to determine whether they have made (or promised) payments, or conferred other benefits, including travel or entertainment, in connection with efforts to transact business with SWFs or foreign, state-owned pension funds. Firms should also review their compliance policies and procedures to ensure that they are designed to prevent violations of the FCPA, whether direct or through indirect dealings via their agents.

General Scope of the FCPA

The FCPA has a far broader scope than many would expect and its prohibitions extend to far more than bribes or classic "pay offs." It prohibits, among other things, payments to "any foreign official for the purpose of inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality." The reach of the statute has been interpreted quite broadly to apply to, among others, individuals that are U.S. citizens or residents and companies that are listed or organized in the U.S. or that have a principal place of business in the U.S.

Although the FCPA has been on the books for nearly 35 years, in recent years we have witnessed an explosive growth in enforcement of its provisions, with fines, penalties, and disgorgement payments in 2010 totaling roughly $1.8 billion, as well as in prosecutions of individuals. In addition, those under investigation often face regulatory inquiries in foreign jurisdictions, shareholder litigation, debarment proceedings, and other collateral consequences.

Private equity firms planning to register as Registered Investment Advisers ("RIAs") as required by the Dodd-Frank Act or otherwise may be called upon to understand and report to the SEC on their dealings with sovereign wealth funds and could come under scrutiny by the SEC, the U.S. Department of Justice ("DOJ"), or both, as a result. The SEC may share with the DOJ information it receives through the RIA registration or reporting process that is relevant to FCPA compliance.

So far, it does not appear from the published press reports that the DOJ has opened its own independent investigation into interactions with sovereign wealth funds, but the DOJ often acts in coordination with the SEC and could undertake such an independent review at any time.

Are Employees of Sovereign Wealth Funds or State-Owned Pension Funds "Foreign Officials" Under the FCPA?

According to the U.S. authorities, "Yes." The FCPA defines a "foreign official" as "any officer or employee of a foreign government or any department, agency or instrumentality thereof." The SEC and the DOJ have long interpreted this definition — specifically, who is an employee of a government "instrumentality" — broadly to cover not just government officials, but also employees of state-owned entities, even if employees or entities do not perform what would commonly be perceived to be government functions. For example, the SEC and DOJ have applied the FCPA to employees of a government-owned bank in

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[Private equity] firms that have not already done so should conduct a risk assessment to determine whether they have made (or promised) payments, or conferred other benefits, including travel or entertainment, in connection with efforts to transact business with SWFs or foreign, state-owned pension funds.

Doing Business with Sovereign Wealth Funds (cont. from page 17)

Argentina, employees of state-owned oil and oil services companies in Nigeria and Angola, and, most recently, employees of a telecommunications company in Malaysia in which the government held a 43% ownership stake. Thus, employees of any enterprise, organization, or firm controlled by a non-U.S. government entity in fact are likely to be viewed as "foreign officials" under prevailing practice.

The Likely Focus of the SEC Inquiry

The SEC appears to be investigating whether banks, hedge funds and private equity firms, in seeking investments from SWFs or state-owned pension funds, made or promised to make payments — directly or indirectly — to SWF and pension fund employees. Payments, as used here, include in-kind benefits, such as travel or entertainment.[1] Indirect payments would include payments to placement agents, consultants or other third parties, while knowing or deliberately disregarding that the payee would pass monies on to a foreign official to secure access to or benefits, such as an investment or an asset purchase, from the SWF. Enabling a SWF or pension fund employee or related party to co-invest alongside a SWF or pension fund could also be considered a payment (or illicit benefit) to that employee.

Next Steps

To the extent that they have not already done so, firms should conduct an immediate risk assessment to determine whether they have made or promised to make payments or conferred benefits in connection with efforts to transact business with SWFs or pension funds. If placement agents or other third parties were involved in the transactions, further inquiry is likely warranted.

If transactions with SWFs are being contemplated but have not been consummated, it behooves firms to ensure that (1) they have conducted sufficient due diligence with respect to any third parties engaged to assist in the transaction, and (2) any third-party contracts contain sufficient anti-corruption representations, covenants, and audit rights needed to provide comfort that monies or other benefits will not be improperly passed on to fund officials.

Finally, firms engaging in transactions with sovereign wealth funds (or other state-owned entities) should have robust compliance programs, including clearly-articulated policies, training, and testing, to reduce the risk of FCPA violations occurring and mitigate any penalties imposed in the event violations do occur. ■

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1 *There is no de minimis exception under the FCPA with respect to travel and entertainment, but for such expenses to constitute a violation, they must have been made "for the purpose of inducing [a] foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality." Reasonable and bona fide expenses incurred to promote or describe a product or to perform under a contract are entitled to an explicit affirmative defense. The bottom line is that firms should avoid any splashy events that could be construed as a quid pro quo.*

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The Return of Sponsor-Backed IPOs: Getting the House in Order

Notwithstanding the recent flurry of large-scale private equity-sponsored IPOs, there are still a host of private equity portfolio companies who are not quite ready to hit the market. Although those companies may not have matured enough to "go public," if a public exit may be on the menu, it is probably not to soon to work through IPO-related "to-dos." We highlight below a handful of matters that should be on the list.

Auditor Independence

The rules for auditor independence can be a harrowing trap for the unwary. SEC rules require a registrant's audit firm to be both currently "independent" and to have been independent during the audit engagement period (generally, the three-year period beginning with the first income statement required to be included in the registration statement). The rules regarding auditor independence are complex for any issuer. But, in the context of a sponsor-backed portfolio company IPO, there is an added twist: a registrant's audit firm may not be independent within SEC rules if it performed non-audit services for an "affiliate" of the registrant, which under SEC rules includes entities that control or are under common control with the registrant. Thus, if an accounting firm audits the financial statements of portfolio company A (the IPO registrant) and also provides a prohibited non-audit service (such as consulting services regarding internal controls) for portfolio company B, if companies A and B are controlled by the same private equity firm, the accounting firm may not be independent within SEC rules with respect to portfolio company A. There is no "cure" for an auditor independence violation, and the consequences for such a violation are potentially severe, because an IPO registration statement would be technically non-compliant, and investors could have rescission rights with respect to purchased stock.

Publicity and Communication Considerations

Communications by a registrant and its affiliates before and after the filing of a registration statement for the company's IPO are restricted by the federal securities laws. Because offers of securities to be sold in the IPO may, as a general rule, be made only via the offering prospectus, any non-compliant offer can run afoul of the securities laws. The concept of what constitutes an offer is very broad and includes most written or oral communications. Therefore, in many instances communications or publicity generated by, or on behalf of, a registrant or its affiliates before or after the filing of the registration statement for its IPO, could be viewed as an illegal offer (commonly referred to as "gun jumping"). The theory is that such communications are an attempt to arouse public interest in the company or in its common stock or to pre-condition the market for the sale of the common stock. The consequences of gun jumping can include significant delays in the proposed IPO, investor rescission rights and civil and criminal sanctions. With this in mind, sponsors and portfolio company IPO candidates should develop communications guidelines that address the following areas: (1) relations with the media, (2) press releases, advertising and other company-related publicity, (3) relations with the financial analyst community, (4) relations with employees, customers and other third-parties, (5) the company website and (6) the use of social media websites.

Internal Control Over Financial Reporting

An annual assessment of internal controls over financial reporting beginning with the registrant's annual report for its first full fiscal year following the completion of the registrant's IPO is required to be made by the registrant's management under SEC rules implementing Section 404 of The Sarbanes Oxley Act of 2002 ("SOX"). In addition, registrants (other than those with a market capitalization of $75 million or less) must also provide an attestation report of its audit firm on its internal controls over financial reporting. Internal controls over financial reporting are designed to provide reasonable assurance regarding reliability of financial reporting and the preparation of financial statements in accordance with GAAP. These include those policies and procedures that: (1) pertain to the maintenance of records that accurately and fairly reflect the company's transactions and dispositions of assets in reasonable detail; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only as authorized by management and the board and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the company's financial statements.

Given the scope of the work necessary to implement effective controls, advance

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The Return of Sponsor-Backed IPOs: Getting the House in Order (cont. from page 19)

work on internal controls over financial reporting is critical and should include: (1) consultation with the registrant's auditor (taking care to avoid independence issues), (2) engaging an independent financial or accounting consulting firm to advise on preparation for SOX 404 compliance and (3) establishing robust systems and controls and an appropriate "tone at the top" to facilitate the development of effective internal controls over financial reporting.

Disclosure Controls and Procedures

SOX and related SEC rules also require public companies to maintain and evaluate the effectiveness of the design and operation of their "disclosure controls and procedures." Disclosure controls and procedures are the controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in its SEC reports is recorded, processed, summarized and reported, in a timely manner. Disclosure controls and procedures substantially overlap with internal controls over financial reporting, with disclosure controls and procedures likely subsuming those aspects of internal controls over financial reporting that relate to the accuracy of financial reporting.

In addition to the suggested actions regarding internal controls highlighted above, to facilitate the development of effective disclosure controls and procedures, the following steps should be addressed: (1) management and the audit committee should discuss and affirm their commitment to full, fair, accurate, timely and reliable public disclosures, (2) the registrant should lay the groundwork for a disclosure committee to assist company executives in evaluating and maintaining disclosure controls, (3) the registrant should consider the respective roles its principal executive officers, audit committee and disclosure committee will play in establishing, maintaining and evaluating the company's overall disclosure controls and procedures, including how those roles might differ from the private equity portfolio context) and (4) the registrant should review its existing internal controls to determine whether they fully and accurately reflect the way the company operates and, if deficiencies are found, new guidelines or procedures should be implemented.

Stockholder Arrangements

Most private equity-sponsored companies embark on an IPO with a myriad of voting, tag-along and drag-along provisions contained in a stockholders agreement entered into at the time of the initial acquisition. If due care is not exercised when restructuring these arrangements for a company's post-IPO existence, parties to the stockholders agreement may find themselves with unwanted reporting obligations under the Securities Exchange Act of 1934 (the "Exchange Act") by virtue of being part of a "group" for purposes of Section 13(d) of the Exchange Act. If the members of the group collectively hold more than 10% of the issuer's equity securities, the SEC takes the position that all members of the group become subject to the reporting and short-swing trading rules under Section 16 of the Exchange Act. Section 16(a) requires the reporting of most share acquisitions and dispositions within two business days, and the short-swing trading rules under Section 16(b) require subject stockholders to disgorge to the issuer any profits from any purchase or sale that is effectuated within six months before or after an opposite-way transaction. This can obviously be very problematic once shareholders are free of holdback restrictions and can sell into the market under Rule 144.

The parties will frequently have also addressed the issue of registration rights at the time of the initial acquisition, commonly providing that sponsors will be entitled to demand registration rights and that minority stockholders will be entitled to piggy-back registration rights. These arrangements should be revisited in anticipation of an IPO to ensure that they still reflect the desired approach to post-IPO liquidity (and still work as a technical matter, notwithstanding any changes in law or practice).

Corporate Governance

The composition of the board and committees of the board after the offering is of key importance and requires attention to both the applicable stockholder arrangements and relevant stock exchange and Exchange Act rules. For example, stock exchange rules will require the establishment of an audit, compensation and nominating/corporate governance committee, with each such committee and a majority of the registrant's board comprised of "independent" directors (subject to applicable transition rules for IPO companies). The NYSE rules provide one notable exception to this rule that is particularly useful to private equity portfolio companies: if the registrant will be a controlled company for purposes of New York Stock Exchange Rules (*i.e.*, more than 50% of the voting power for the election of directors is held by an individual, a group or another company), then only

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Russia's Massive New Privatization Plan May Create Opportunities for Private Equity Investors

The sale of a large portion of the Russian state's interests in a diverse group of Russia's most successful companies is expected to occur within the next one to three years. This highly anticipated new phase of privatizations in Russia should provide significant opportunities for Russian and foreign investors alike. However, enticing foreign private equity firms to participate may require a more buyer-friendly process than the Russian government might like. Whether foreign investors, and private equity investors in particular, will choose to participate will depend on a number of factors, including the way the sales processes are run and the amount of transparency provided to investors.

The recently adopted Russian privatization program specifies the companies and assets that are due to be privatized before the end of 2013, as well as the size of the stake to be sold as part of the privatization. Among those on the list are:

Company	Stake
Rosneft Oil Company (the largest Russian oil company, market capitalization approx. $85 billion)	25 percent stake
VTB Bank (one of the leading Russian state-controlled commercial banks, market capitalization approx. $30 billion)	35.5 percent stake
RusHydro (the largest Russian hydropower generating company, market capitalization approx. $15 billion)	7.97 percent stake
Federal Grid Company of Unified Energy System (the largest Russian electrical power transportation company, market capitalization approx. $14 billion)	4.11 percent stake
Sberbank of Russia (the largest Russian state -controlled commercial bank. Market capitalization approx. $80 billion)	7.58 percent stake
Russian Railways (Russian railways monopoly, not listed yet)	25 percent stake

The exact timing and method of privatization of these companies will be determined by the Russian Government at a later date, likely within the next 6-8 months. Most assets are expected to be sold in public auctions, however, in order to make the privatization process more flexible and investor-friendly, the government may well utilize other methods as well.

For the first time, the Russian government has invited Russian and international investment banks to participate in the privatization process as its advisors. It is expected that involvement of investment banks, especially internationally recognized banks, will increase the transparency of the privatization process and make participation more attractive to foreign investors. Among the investment banks that are expected to assist with the sales are Credit Suisse, VTB Capital, Deutsche Bank, VEB Capital, Merrill Lynch, Morgan Stanley, J.P. Morgan, Goldman Sachs and Syberbank.

The government sale procedures do not typically allow investors to negotiate the terms of the transaction regardless of the privatization method. Moreover, the handling of due diligence may appear unusual to those more accustomed to sales in the private sector. For example, the state may organize a due diligence data room, but it is not required to do so. And even if a data room is utilized, bidders would not typically have the opportunity to request additional documents, ask detailed questions or visit the company's premises and facilities.

The acquisition agreement will likely be governed by Russian law. While there is no explicit requirement that this be so, it is not expected that the state would subject itself to foreign law. The agreements are usually short, simple documents unlikely to include any representations, warranties, indemnities or other protections that would be anticipated by a foreign investor. In general, Russian law and practice is not very buyer-friendly and this is likely to be even more true in the context of the planned privatizations. The documentation will often be more akin to a simple transfer instrument than a full-blown purchase agreement in which the allocations of risks between the buyer and the seller is heavily negotiated.

There is some hope though that the government will be a bit more flexible in at least certain transactions. For example, in the sale of a stake in VTB Bank, which was the first company privatized under the new Privatization Program, there was some evidence that the government recognized the importance of making the process attractive to well-known foreign investors. The first potential investor to confirm its interest in VTB was Texas Pacific Group, which proposed to acquire (together with a number of other funds organized by TPG) a 10% stake for approximately $3.5

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Russia's Massive New Privatization Plan (cont. from page 21)

billon. Presumably in light of the benefits that the participation of a sophisticated investor like TPG could have in terms of encouraging other foreign investors to participate, the Russian Government initially considered an alternative, more buyer-friendly sale process, which would have allowed TPG to acquire the stake in VTB Bank without any auction and under a share purchase agreement governed by English law. TPG was also permitted to conduct relatively extensive due diligence (outside of the officially announced privatization procedure) and was also apparently allowed to negotiate the terms of the potential acquisition directly with the Russian Government.

However, after TPG conducted its due diligence, Merrill Lynch, the investment bank chosen by the Russian state for the VTB Bank privatization, reportedly advised the Russian Government that TPG was having trouble getting commitments from a sufficient number of co-investors. As a result, the Russian Government apparently decided to convert the process from a negotiated transaction with a single buying group to a public offering (SPO) (VTB's share price fell 10% on the news).

With the help of Merill Lynch, Deutsche Bank and VTB Capital, the Russian Government managed to sell global depositary receipts representing 10% of VTB shares for a total of $3.26 billion, down a bit from the $3.5 billion number initially discussed with TPG. Among those who participated were TPG, which bought approximately 1% of VTB shares, together with Generali, and a number of funds from the United States, Europe, the Middle East and Asia.

All in all, the Russian Government is planning to raise approximately $60 billion through the privatization initiative, creating a huge opportunity for foreign investors. And the sale of the VTB stake has illustrated that the government may be willing to structure a transaction to be more appealing to such investors. However, in any event, dealing with the Russian Government and the more structured privatization process is likely to be a bit trickier than a typical M&A transaction. Close consultation with sophisticated advisors on the ground in Russia is therefore crucial to navigating these waters successfully. ■

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The 2010 Estate and Gift Tax Law (cont. from page 12)

interest in a fund that is more likely to be successful, or can save the exemption for estate planning with a new fund.

* * *

For all the changes brought by the 2010 Act, most of the tax rules that drive the structure of estate planning transactions with private equity fund interests remain the same. We still advise that principals transfer a "vertical slice" of all of their interests in a fund in order to satisfy Section 2701 of the Internal Revenue Code, which applies to intra-family transfers of partnership or LLC interests and can result in adverse gift tax consequences unless certain exceptions are met. Transfers of interests in management companies remain potentially problematic because of the "assignment of income" doctrine and other issues.

In recent years, practitioners have developed new transfer techniques in order to avoid some of the constraints of Section 2701, including transfers involving derivative contracts. Although these techniques are not widely used and raise some potential tax issues, they may be useful in situations where particular fund structures make it difficult or impossible to satisfy the "vertical slice" rule. In those cases where transferring a "vertical slice" is not problematic, the increase in the gift tax exemption amount makes the less exotic (but tried and true) gift and installment sale techniques more attractive than ever.

While decisions about estate matters are never easy, the opportunities presented by the 2010 Act are dramatic enough — and may be short-lived enough — that private equity professionals should take a close look at their estate plans and consider possible changes while they can. ■

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New ILPA Principles: What Has Changed? (cont. from page 1)

"alignment of interest" value proposition in private equity, although endorsement does not constitute a commitment to each and every preferred term set forth in the Principles.[1]

Moving the Market

Overall the Principles seem to be an attempt to move the market in a more "LP-friendly" direction, incorporating a wide range of the comments on fund terms that LPs and their counsel often serve up to GPs when negotiating the terms of a private equity fund. This effort is not surprising, given that ILPA represents the interests of institutional LPs that provide a very significant share of the total capital invested in private equity funds. This also is not a new effort; readers may recall the "Mercer Report," sponsored by nine state retirement plans in 1996, which set forth the views of those LPs concerning preferred fund terms. Furthermore, the enumerated principles around which ILPA proposes that GP and LP discussions be organized — alignment of interests, good fund governance and appropriate transparency and reporting — are not controversial.

As always, though, the devil is in the details. Many of the very specific "preferred" fund terms advanced in version 2.0 of the Principles as furthering these three general principles *are* controversial. Vigorous discussion and debate between GPs and LPs over these terms can be expected as private equity fund agreements are negotiated in the years ahead. It is certainly true that several of the preferred terms in version 2.0 are more "GP-friendly" than in the original Principles, such as the acceptance in version 2.0 of the view that GP clawbacks should be "after tax," and that GP clawbacks need not always be backstopped by joint and several guarantees. However, many of the ILPA preferred terms are still more "pro-LP" than the actual terms that we have seen negotiated and agreed upon by LPs and GPs over the past several years. Although described by ILPA as best practices, the Principles continue to be seen by some GPs as a long LP "wish list."

Different LP Perspectives.

GPs are not the only market participants who may take issue with some of the preferred terms included in version 2.0 of the Principles. Not surprisingly, different LPs have different views on certain of the preferred terms. For example, in furtherance of the goal of good governance, version 2.0 of the Principles proposes a prominent role for the LP Advisory Committee, which is described as a "sounding board" for the GP and also as a "voice" for LPs. Yet, some LPs that are not represented on LP Advisory Committees may prefer to rely on the judgment of the GP, or may want controversial matters to be put to a vote of all LPs. They may feel that an overly strong and activist LP Advisory Committee could exert disproportionate influence on the GP, to the potential detriment of the fund as a whole. Even some LPs who do hold seats on LP Advisory Committees may not wish to invest the time and effort (or may not feel they have the expertise) to assume all of the responsibilities described in the Principles, such as approving valuations or valuation methodologies or reviewing allocation of investment opportunities. Other LPs who frequently hold seats on LP Advisory Committees may welcome an enhanced Advisory Committee function, so long as they can act solely in their own interests and are not required to be a voice for other LPs.

Another example of a "preferred" term that might not be in the best interest of LPs in some situations is one of the most controversial of the ILPA proposals, relating to the timing of carried interest distributions to GPs. Version 2.0 of the Principles states that LPs and GPs "must" recognize "as a best practice" a distribution waterfall providing for the return to investors of all capital contributions, plus a preferred return, before any payment of carried interest is made to the fund's GP. This approach, which is quite common in Europe, reduces the likelihood that the GP will be required to make clawback payments and for that reason is favored by many LPs and some GPs. On the other hand, this "return all capital first" approach (as compared to the "deal by deal" distribution model that has been the market standard in the United States for over three decades) has the effect of delaying distributions of carried interest to GPs, often for many years. Such a delay affects GP incentives and could adversely impact the ability of some private equity firms — particularly small and mid-sized firms that do not have multiple products or lines of business — to attract and retain the most talented investment professionals. It also could have the perverse effect of encouraging a more rapid disposition of investments than is appropriate. Some LPs and many GPs could well take the view that, at least for certain firms, the model that ILPA says "must" be recognized as a best practice is not necessarily consistent with the goal (unstated by ILPA) of maximizing investment returns.

What Else Does Version 2.0 Recommend?

Version 2.0 of the Principles recasts some of

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1 *Version 2.0 of the Principles can be found at www.ilpa.org. For more background on the original Principles, see "Institutional Limited Partners Association Releases Private Equity Principles Report Listing Private Equity Preferred Terms" in the Summer 2009 issue of the Debevoise & Plimpton Private Equity Report. For more information on ILPA, see "LPs and the Role of ILPA" in the Spring 2006 issue of the Debevoise & Plimpton Private Equity Report.*

New ILPA Principles: What Has Changed? (cont. from page 23)

the terms included in the original Principles to be more GP-friendly, but also adds new pro-LP terms. Set out below are some of the notable changes proposed in version 2.0 as compared to the original Principles:

- *After-tax GP clawbacks:* The original version of the Principles stated that the GP clawback (*i.e.*, the GP's obligation to return overdistributions of carried interest) should be gross of tax. ILPA now states that an after-tax GP clawback is acceptable. However, the calculation of the after-tax amount subject to being clawed back from the GP must be based on the actual tax situation of the individual GP member and should take into account loss carryforwards and carrybacks, the character of fund income, deductions attributable to state tax payments, any loss resulting from the clawback contribution and any change in taxation between the date of the partnership agreement and the clawback. The use of a single assumed tax rate based on the highest hypothetical marginal tax rate in a designated location, an approach adopted by many private equity funds, is discouraged. Thus, ILPA concedes that after-tax clawbacks are acceptable, but then proposes a clawback calculation that is quite complex and is still more aggressive than the approach agreed to by a majority of LPs in the past decade.
- *Guarantees of the GP's clawback obligation:* The original version of the Principles took the off market view that individual GP members must guarantee the GP clawback obligation on a joint and several basis. Version 2.0 acknowledges that a creditworthy backstop (such as a substantial parent company guarantee or guarantees by a subset of GP members) may be an acceptable substitute for joint and several guarantees, but does not go so far as to accept the market practice of GP members guaranteeing only their *pro rata* shares of the GP's clawback obligation.
- *Interim GP clawbacks:* Version 2.0 recommends that, if a "deal by deal" carried interest distribution waterfall is used in a new fund, then the GP should be subject to interim clawbacks (as compared with a clawback obligation that only applies at the end of the term of the fund), triggered both at defined intervals and upon specific events, such as a key person event or in the event that a fund's net asset value is less than 125% of cost (NAV coverage itself being a new concept for the Principles, and not one generally used for private equity funds other than some venture funds). Interim clawbacks were not discussed in the original Principles and are not customary in today's market.
- *Limits on all-partner clawbacks:* Version 2.0 states that so-called "all-partner clawbacks" (*i.e.*, the obligation of all partners to return distributions to indemnify the GP), which became quite common in the 1990s, should be capped so that the amount subject to clawback does not exceed 25% of committed capital. Version 2.0 also states that only amounts distributed to LPs in the preceding two years (or some other "reasonable period") may be clawed back by the fund. This 25% cap and the "two years after distribution" limitation have been frequently requested by LPs over the years. However, these terms have been vigorously (and often successfully) resisted by many GPs, who argue that such restrictions make it much less likely that the all-partner clawback will work as designed (*i.e.*, to protect the GP from bearing more than its share of fund liabilities). Instead, GPs have frequently obtained agreement to higher caps on amounts subject to clawback (*e.g.*, up to 50% of distributions) and to longer periods during which such amounts are subject to clawback (*e.g.*, until the second or third anniversary of the end of the fund's term). All-partner clawbacks were not discussed in the original version of the Principles.[2]
- *GP contribution to be in cash:* Version 2.0 states that the GP's commitment to a fund should consist entirely of cash, as opposed to being contributed in whole or in part through a management fee offset mechanism. The original version of the Principles required a "high percentage" of the GP commitment to be in cash.
- *Required vote for no fault suspension of investment period:* Version 2.0 proposes that the investment period of a fund may be suspended or terminated on a "no fault" basis following a vote by two-thirds in interest of LPs, compared with the majority in interest vote in the original version of the Principles. This pro-GP change will be embraced, we expect, by some LPs who disliked the prior formulation because it allowed only a simple majority in interest of the LPs, without any showing of cause, to shut down the fund's ability to invest.

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2 *For more information on the clawbacks described in this and the preceding three bullet points, see "Clawbacks: Protecting the Fundamental Business Deal in Private Equity Funds" in the Fall 2000 issue of the Debevoise & Plimpton Private Equity Report.*

New ILPA Principles: What Has Changed? (cont. from page 24)

- *Required vote for no fault GP removal:* Version 2.0 proposed that the GP may be removed, or the fund may be dissolved, on a "no fault" basis following a vote by three-quarters in interest of LPs, compared with the two-thirds in interest vote in the original version of the Principles. Like the change discussed in the preceding bullet point, we expect that this pro-GP change will be embraced by some LPs who disliked the prior formulation because it allowed only two-thirds in interest of the LPs to take the extraordinary step, without any showing of cause, of removing the GP or dissolving the fund.
- *GP removal, or fund termination, for cause:* Version 2.0 provides that a majority in interest of LPs should have the ability to vote to remove the GP, or terminate the fund, for cause. This issue was not addressed in the original version of the Principles, although for cause removal provisions (often with a majority or two-thirds in interest LP vote requirement) are standard in fund agreements.
- *Disclosure of certain LP conflicts:* Version 2.0 states that if a member of the LP Advisory Committee has a conflict of interest, that conflict should be disclosed to the other LPs on the Advisory Committee. The following are given as examples of conflicts of interest: (1) if the LP is co-investing with the fund, (2) if the LP holds an interest in the GP or an affiliate or (3) if the LP has received preferential economic terms. This issue was not addressed in the original version of the Principles.
- *Notice of liabilities, breach:* Version 2.0 states that the GP should immediately notify the LPs if there is a breach of the fund's limited partnership agreement, or if any material contingency or liability arises. It appears that the Principles are referring to fund-level liabilities or contingencies, although this is not explicitly stated. Version 2.0 does not address situations where such disclosure would be contrary to the best interest of the fund, nor does it address the potential liability of the GP to the LPs if the GP's judgment as to materiality or the existence of the breach, contingency or liability is made in good faith but proves to be incorrect. This is a new term.
- *Annual reports, focus on risk management:* Version 2.0 states that annual reports should be provided to LPs within 90 days after the end of the relevant annual period, rather than within 75 days as provided in the original Principles. Version 2.0 also adds a new reporting requirement: annual reports should include information on material risks and how they are managed, at both the fund and portfolio company level. Such risks include concentration risk, foreign exchange risk, leverage risk, realization risk (*e.g.*, change in exit environment), reputation risk and ESG (environmental, social and governance) risk.
- *Quarterly projections:* Version 2.0 states that the GP should provide estimated quarterly projections for capital calls and distributions. This is new.
- *Approval of term extensions:* Version 2.0 proposes that extensions of a fund's term must be approved by a majority of the LP Advisory Committee or by the LPs; the GP may not unilaterally extend a fund's term. The original Principles did not discuss the approval process for extensions.
- *Liquidation timing:* Version 2.0 provides that a fund must be fully liquidated within a year after the fund's term has ended, unless LPs otherwise consent. This is a new term, and addresses LP concerns that dispositions are too often delayed and/or that management fees are charged during the extended liquidation period. However, this requirement also could require GPs to dispose of assets more quickly than they believe is prudent.

Standardization

Along with version 2.0 of the Principles, ILPA published standardized forms of capital call notices and distribution notices. ILPA has announced that it plans to release more such templates in the future, including proposed standardized reporting packages that tie into the recommendations contained in the Principles.

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[O]ne of the most controversial of the ILPA proposals...states that LPs and GPs "must" recognize "as a best practice" a distribution waterfall providing for the return to investors of all capital contributions, plus a preferred return, before any payment of carried interest is made to the fund's GP.

New ILPA Principles: What Has Changed? (cont. from page 25)

What's Next?

The Principles have been the subject of much discussion in the industry and are often mentioned in the context of GP/LP negotiations of fund terms. Some of the terms that the original Principles advanced (for example, the insistence that larger percentages of transaction fee income accrue to the benefit of the LPs, and several of the terms concerning the role of the LP Advisory Committee) have been adopted by a number of GPs. We expect that certain of the version 2.0 proposals concerning clawbacks (*e.g.*, the use of interim clawbacks) and fund reporting will also be adopted (or increasingly adopted) by GPs. We also expect, however, that GPs will continue to resist strongly a number of the ILPA preferred terms, and that LPs will continue to hold differing views on the relative importance of certain of the preferred terms and their impact on fund performance and governance.

Private equity firms, of course, come in many shapes and sizes; one size does not fit all (as ILPA acknowledges in the introduction to version 2.0 of the Principles). We will continue, as we have for the past 30 years, to engage with our clients and with other industry participants — including both GPs and LPs — on these issues, watching with interest as the private equity fund market continues to evolve. ■

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Helping Private Equity Play Greater Role in U.S. Insurance Market (cont. from page 14)

consuming, it need not inhibit private equity funds from considering investments in the U.S. insurance space. In many situations, concerns about obtaining regulatory approval can be minimized by approaching the regulator prior to signing to discuss potential transaction structures, required disclosures and any potential pitfalls. An early and proactive approach can provide the state insurance regulators with the information needed to properly consider the proposed transaction and can result in a smoother regulatory approval process that can then yield a strong relationship between the acquiror and state regulators going forward.

Post-Closing: Understanding the Applicable Regulatory Regime

In addition to the regulatory approval process, a potential acquiror of a U.S.-domiciled insurance company will want to focus on the regulatory regime applicable following the closing. U.S.-domiciled insurance companies are subject to a range of state regulations, but the most critical from the perspective of a private equity investor are often the investment rules and dividend restrictions. Additionally, following the financial crisis, the National Association of Insurance Commissioners (the "NAIC") has recently adopted amendments to its model laws that, if enacted into law by the states, would give state insurance regulators additional powers to regulate affiliates of an insurance company. Though potentially burdensome to private equity firms, as discussed below, these new requirements may also provide an opening for private equity firms to work with regulators to educate them in an area in which many regulators will have little expertise.

What Are the "Investment Rules?"

State insurance investment laws may be of particular concern to private equity funds and other potential acquirors looking to maximize value through aggressive management of a domestic insurer's assets. Generally speaking, these laws require an adherence to a prudent insurer standard when making investments and also contain limitations on investments, both in certain types of assets and in single issuers. Additionally, if an insurer will seek to engage in derivative or similar transactions, additional restrictions may apply. State insurance investment laws are specific to U.S.-domiciled insurance companies and generally do not apply to a private equity owner or an insurer's other affiliates.

In many cases, state insurance regulators retain the flexibility to permit an insurer to make investments that are either not contemplated by, or would otherwise be prohibited by, the insurance investment rules. Therefore, establishing a dialogue with the regulator with respect to proposed investment strategies, both during the initial Form A approval process and after the closing, is key.

Finally, investment management or similar agreements entered into between the acquiror or an affiliate and the acquired insurance company must be fair and reasonable and are generally subject to prior regulatory approval. This may be of particular concern if a private equity investor also has portfolio companies or other related parties which are investment management businesses.

What Are the "Dividend Restrictions?"

State insurance laws generally restrict the amount of dividends a domestic insurer can pay without prior regulatory approval.

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Dividends subject to regulatory approval are referred to as "extraordinary dividends." Typically, regulatory approval is required to pay a dividend or distribution of cash or other property whose fair market value, together with other dividends and distributions, made within the last 12 months exceeds the greater of (lesser of in New York): (1) 10% of the insurer's policyholders' surplus as of the preceding December 31, or (2) the net income of the insurer for the 12-month period ending the preceding December 31. These dividend restrictions, together with other factors, including the subordination of lender claims to policy claims in an insurance receivership proceeding, restrictions imposed by New York and some other states on an insurer's ability to pledge its assets and restrictions in respect of insurance companies directly issuing debt or guaranteeing debt issued by affiliates, has generally led to U.S. insurance sector buyouts being less leveraged than is the case in other industries.

What Are the Recent "Holding Company Act Developments?"

As noted above, the NAIC has recently adopted amendments to its model laws that, if enacted into law by the states, would give state insurance regulators new powers to regulate not just insurers, but members of insurance holding companies. Among the amendments most relevant to private equity acquirors of U.S.-domiciled insurers are new requirements that acquirors of a U.S. insurer file reports identifying and describing risks that could pose "enterprise risks" to the acquired insurer. Although these developments do have the potential to require additional disclosure, private equity funds active in the U.S. insurance space also will have an opportunity to be proactive and to educate insurance regulators about how the structure of their funds can mitigate enterprise risk.

Other Transactions in the U.S. Insurance Space

The requirements outlined above apply only to the direct or indirect acquisition and post-closing operation of a U.S.-domiciled insurance company. There are, of course, many other ways for a private equity investor to access the U.S. insurance markets through businesses that involve less regulatory oversight. These include forming or acquiring an offshore reinsurer that would assume U.S.-originated business, acquiring insurance distributors or other insurance-related businesses, acquiring a minority stake in a U.S.-domiciled insurance company that does not result in the direct or indirect acquisition of 10% or more of the insurer's voting securities or investing in insurance sidecars, catastrophe bonds or other insurance-based capital markets-based transactions.

* * *

Private equity funds seeking to invest in the U.S. insurance market will want to be proactive in formulating a plan to both navigate the regulatory approval process and comply with applicable post-closing regulatory requirements. The continued increase of private equity participation is recognized by U.S. insurance regulators as an important source of capital, and private equity firms will benefit from working with regulators to reinforce that perspective. ■

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Recent and Upcoming Speaking Engagements

February 11, 2011

Michael P. Harrell
"Private Equity Funds — Terms and Trends"
Maples Investment Funds Forum 2011
Maples and Calder
Grand Cayman, Cayman Islands

March 22, 2011

Alan V. Kartashkin
"What Opportunities Are There For Larger Deals?"
Private Equity and Venture Capital in Russia Forum
BVCA
London

June 9-10, 2011

Kevin M. Schmidt
"Special Issues Involved in Acquiring Divisions or Subsidiaries of Larger Companies"
Acquiring or Selling the Privately Held Company 2011
Practising Law Institute
New York

For more information about upcoming events, visit www.debevoise.com

The Return of Sponsor-Backed IPOs: Getting the House in Order (cont. from page 20)

the audit committee need be fully independent. There are also tax implications related to committee composition. In order to maintain the deductibility of performance-based compensation for named executive officers that exceeds $1 million, such compensation must be approved by a committee comprised if at least two "outside directors."

Since a classified board is one of the most effective anti-takeover techniques, careful thought should be given as to whether to create a classified board (as well as how to create "classes of directors"). Another topic of crucial importance is determining whether to opt out of the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which is perceived to give a board more control over managing an ultimate exit to an unfriendly suitor.

Cheap Stock

One accounting issue that frequently causes problems for sponsors and their portfolio companies is the so-called "cheap stock" issue. Under applicable accounting rules, the fair value of an equity award is recorded as a non-cash compensation expense. This is most relevant where there is a large discrepancy between option exercise prices and the IPO price, and the option has been granted with an exercise price of less than the grant date fair value of the underlying common stock. The SEC has historically carefully scrutinized the sufficiency of non-cash compensation expenses, particularly for awards granted within the year-period preceding the filing of the IPO registration statement with the SEC. Disagreements with the SEC over the non-cash compensation expense may lead the registrant to have to restate its historical financial statements. There are a number of things that a registrant can do, short of eliminating equity awards prior to the IPO filing, to help it steer clear of cheap stock issues, including (1) having an independent valuation firm contemporaneously value the equity awards at the time of grant, (2) disclose the process and substance related to the registrant's equity awards in the registration statement and (3) maintain a file of valuation materials and information regarding the grants themselves, which may be helpful in responding to any SEC comments.

Non-GAAP Financial Measures

While not quite as controversial as they once were, non-GAAP financial measures included in IPO prospectuses and other public disclosure are still a focus for the SEC. The SEC will typically comment on disclosure regarding non-GAAP financial measures and request additional and/or clarifying (1) disclosure as to the reason for their inclusion (*i.e.*, why does management believe the disclosure is important for investors) and (2) footnote disclosure around the line-items that comprise the reconciliation of those measures to the most closely-related GAAP measure. Registrants and sponsors, in consultation with underwriters and counsel, should carefully consider what non-GAAP financial measures the company intends to disclose, ensure that the measures are adequately defined so that that they will remain useful to the company and investors going forward and anticipate SEC comments by including fulsome disclosure to address potential concerns.

Management/Consulting Agreement Arrangements

It is common for a private equity portfolio company to have entered into a management or consulting agreement with the sponsor at the time of the initial acquisition. Under these arrangements, a sponsor will typically provide, among other things, advisory, consulting and other services to the portfolio company in exchange for a periodic fee. These arrangements may terminate by their terms at the time of the IPO or may be terminable by the Company at its option. Sometimes, the termination involves the payment of a fee. It is also important to note that fees paid under these arrangements and the size and terms of the fee and the related arrangements may have an impact on the independence of the sponsor's board designees under applicable stock exchange rules.

* * *

The IPO process is a long one, and is often complicated by foreseeable issues that create speed-bumps. By getting a head-start on IPO preparation, the universe of such issues can be reduced significantly, thus shortening the timeline and increasing the chances of a successful offering. ■

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