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Imitation Is the Sincerest Form of Flattery: Continued Use of Private Equity Technology in Acquisitions by Strategic Buyers

Private equity buyers sometimes worry that their financing, particularly its impact on timing and conditionality, puts them at a competitive disadvantage vis-à-vis strategic buyers. While strategic buyers must also at times rely on debt financing, historically they have been willing to bear the financing risk by accepting uncapped monetary damages and unlimited specific performance remedies for breaches caused by a financing failure. But times have changed, and provisions relating to allocation of financing risk have become some of the most hotly contested deal terms in both strategic and private equity transactions alike.

We published an article in the Spring of 2009 highlighting a then emerging trend in which strategic buyers had begun borrowing private equity technology in the form of reverse termination fees, or RTFs, to limit their exposure in the event of a financing failure (and sometimes in other circumstances as well).[1] In light of the recovery of the capital markets in the more than three years since that article was written, we decided to take a fairly

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[1] *See the Spring 2009 edition of the Debevoise & Plimpton Private Equity Report, "Something Old, New, Borrowed, and Blue: Have Strategics Borrowed Conditionality from the Private Equity World?"*

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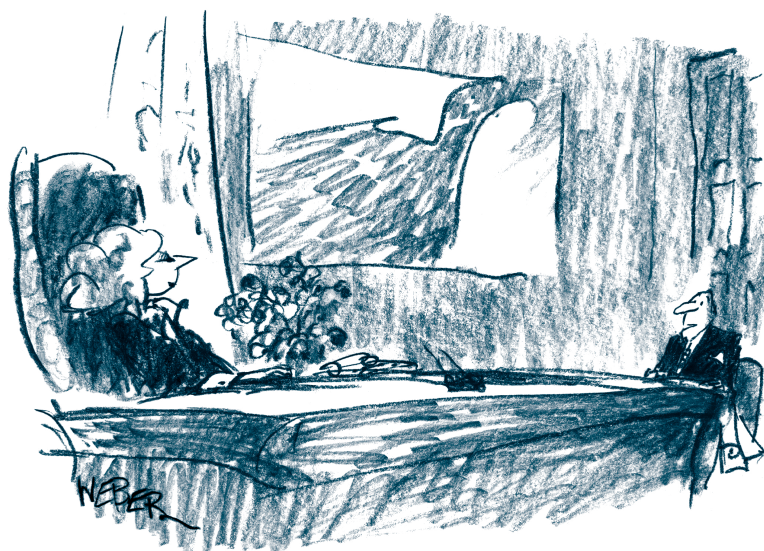

"You seem to know something about law. I like that in an attorney."

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Letter from the Editor

You would need to have been asleep for months not to bemoan the fact that the election cycle has brought heightened and often negative scrutiny to the private equity industry. Private equity bashing has become a popular sport, except, of course, for those of us involved in the industry and familiar with its many benefits to the economy.

Ironically, many of the issues that have dominated the political campaigns this season are ones that are currently both challenging and creating opportunities for the private equity community. These include uncertainty over China's next stage of development and its role in the global economy, healthcare reform in the United States, calls for greater legislative oversight of the financial markets in many jurisdictions, and concern about the future of the Eurozone markets. But one thing is certain: despite the negative press, private equity continues to draw interest from investors around the world by virtue of its strong performance. This double issue of the *Private Equity Report* represents the breadth and scope of the industry today.

On our cover, we discuss how private equity technology has "moved the market" as strategic buyers continue to adopt private equity deal terms like reverse termination fees to shift risk in their leveraged acquisitions.

Co-investment transactions have become increasingly popular as investors search for yield and sponsors seek to differentiate themselves for their next fund-raising cycle. These transactions are hardly cookie cutter and, in a nod to popular fiction, we highlight the many shades of approaches utilized in co-investment transactions.

We also share insights into the state of private equity in China, where the old-style minority investments popular in the early days of private equity seem poised to be replaced with "control" investments or sales of entire businesses. In one of our articles focusing on the Chinese market, we caution investors about the continuing obstacles to doing "Western"-style deals in this complicated market. In another article, we highlight new opportunities for Chinese insurers to invest in RMB-denominated private equity funds organized in China.

In our Guest Column, Steve Judge, President and CEO of the Private Equity Growth Capital Council, reviews the efforts of the PEGCC to correct the misconceptions that abound in the media and in Congress about the fundamentals of private equity.

Elsewhere in this issue, we report on a host of other issues relevant to private equity professionals, including continued developments in the UK Takeover Code, recent scrutiny by the SEC of employee equity repurchases, diligencing the potential increased costs of employee healthcare in acquisition transactions, proposed German legislation with potentially serious impact for non-EU hedge and private equity funds, and a recent IRS action making amending debt potentially more expensive than anticipated because of the creation of COD income.

After 12 years, I am stepping down as Editor-in-Chief of the *Private Equity Report*. In our first issue, we articulated a goal of using our new publication to provide practical guidance to private equity professionals on the ways in which evolving legal, political and transactional developments impact private equity firms, funds and portfolio companies. We also hoped to remind you of the breadth and depth of Debevoise & Plimpton's global private equity practice. I hope we have succeeded in meeting that goal; I know that I have learned a lot and have thoroughly enjoyed my role with the *Private Equity Report*. During those 12 years, our private equity practice has grown in tandem with the growth in the industry and we have published, along with two books, almost 50 issues of the PER in which over 100 Debevoise lawyers have authored more than 400 articles.

We have created an Editorial Board comprised of *Private Equity Report* veterans to guide the *Private Equity Report* in the years ahead. The Board's members include Michael Harrell, a funds lawyer who co-heads our firm's Private Funds and Investment Management Groups, Steve Hertz, a seasoned private equity transactional lawyer with vast experience in the insurance sector, and Kevin Rinker, a broad-guaged M&A lawyer with extensive experience in the media, technology and health care sectors. I know that you will find their perspectives thoughtful and informative as the *Private Equity Report* continues to strive to bring you practical guidance to assist you in structuring and executing private equity investments and fundraisings.

Franci J. Blassberg
Editor-in-Chief

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Impact of Health Care Reform on Employers: Two Years In

Regardless of your political perspective, the impact of the Patient Protection and Affordable Care Act ("PPACA," and commonly referred to as "health care reform" or "Obamacare"), on a business's health care costs is something every buyer and owner of businesses should strive to understand. This article briefly summarizes how private equity firms should think about health care reform when looking at acquisition targets and monitoring their portfolio companies and points out some red flags.

For purposes of this article, health care reform has three important mandates, which are currently scheduled to become effective on January 1, 2014.

All citizens should have health care—the "individual mandate." PPACA mandates that all United States citizens have health care coverage. To that end, PPACA imposes fines on individuals who are not covered. To assist citizens in obtaining coverage, PPACA contemplates that states will set up "exchanges" where coverage may be purchased from participating insurers. In addition, lower-income citizens who purchase coverage through an exchange may be eligible for subsidized premiums.

Employers should continue to be the main source of health care for individuals who work. While there is no requirement that employers provide health care at specific levels, or at all, PPACA imposes fines on employers who do not offer health care to their employees. Specifically, if (1) an employer employs at least 50 full-time equivalent employees during a calendar year and does not offer coverage to all full-time employees and (2) at least one of the employer's full-time employees receives subsidized insurance on a state exchange, the employer must pay, on a monthly basis, a nondeductible tax of $2,000 per full-time employee per year For this purpose, a "full-time employee" is an employee who works at least 30 hours per week. So a large penalty could be triggered by only one full-time employee obtaining insurance through a state exchange and receiving a subsidy.

Employer health care should be affordable and provide good value for the money. If an employer offers coverage to its full-time employees but that coverage is not "affordable" and does not provide "minimum value," the employer must pay a nondeductible tax of $3,000 per year for each full-time employee who obtains coverage on a state exchange and qualifies for the premium subsidy. This tax is also payable on a monthly basis. Note, although this $3,000 penalty tax is higher than the $2,000 penalty tax described above, the $3,000 tax is not applied per full-time employee—it is only applied with respect to each full-time employee who receives subsidized coverage from a state exchange. Coverage will be "affordable" if the employee's contribution to the health plan for employee-only coverage does not exceed 9.5% of the employee's household income. "Minimum value" means that the plan must cover at least 60% of the plan's total allowed costs (*e.g.*, copays, deductibles, coinsurance, etc.) on an actuarial basis (*i.e.*, taking the entire population as a whole) or another method approved by the IRS.

There are two points that should be highlighted with respect to the three health care mandates described above. First, PPACA does not require an employer to offer health insurance at all, as long as the employer is willing to pay the penalty tax. And, it is conceivable that for some employers paying the tax will be cheaper than offering coverage, although to our knowledge no large employer has yet stopped providing coverage. (AT&T made headlines in 2010 when an internal powerpoint presentation surfaced that purported to show that dropping coverage would cost the company $600 million per year in penalty taxes (albeit nondeductible), while providing coverage would cost over $4 billion per year.) Second, the requirements of affordability and minimum value do not require the employer to offer any specific levels of coverage. Thus, it appears that an employer could comply with PPACA by designing a low-cost plan with extremely limited coverages. To our knowledge, no large employer has yet taken this step either.

In light of these mandates, private equity firms should be on the lookout for the following red flags during their diligence review of acquisition targets and

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Impact of Health Care Reform on Employers: Two Years In (cont. from page 3)

in monitoring portfolio companies:

Part-Time Employees. PPACA defines a "full-time" employee as one who works 30 or more hours per week on average, as determined on a monthly basis. Proposed IRS rules would provide that 130 hours in a month is full-time and that full-time status includes up to 160 hours of paid time off for specified periods. For many companies, this definition of "full-time employee" will depart from how the part-time workforce has typically been viewed. Many employers have employees classified as "part-time" who, periodically or on a seasonal basis, work at levels that would be deemed full-time under PPACA. Many employers also do not have computer systems that track hours on this basis with specificity. If an employer classifies employees as part-time but PPACA classifies them as full-time, and one of them obtains subsidized coverage on a state exchange, the penalty tax will be triggered for all full-time employees. However, proposed regulations do offer some relief for seasonal workers hired for only a few months. Compliance with these rules is likely to be both imperative and costly at some acquisition targets and portfolio companies, as a single mistake could trigger a massive penalty tax.

[N]early all employers affected by health care reform have already undertaken studies of the costs of health care reform and available alternatives, either by management or by third party experts....For a private equity buyer, paying attention to these lurking costs now ahead of 2014 is a necessary feature of any diligence process and the related development of the investment case for the acquisition.

Changes in Projected Employee Costs. We expect that many employers will need to restructure their health plans to provide for more levels of coverage than may have been provided historically. Thus, an employer who previously offered only very expensive coverage (*i.e.*, high employee premiums, or coverage that is simply expensive when compared with employees' wages) may need to (1) establish more levels of coverage so that lower-wage employees can find an affordable coverage option and (2) bear more of the costs of the coverage so that the plan provides minimum value. Both of these changes are likely to increase health care costs of the employer. This increase is likely to be seen in particular at employers with lots of low-wage workers, as PPACA also phases out annual and lifetime benefit limits between now and 2014. There is some indication that enrollment has already begun to rise because of some of the aspects of health care reform that are currently in effect (*e.g.*, coverage of dependent children until age 26).

Low Historical Employee Uptake. In light of the individual mandate and the very serious question as to how successful the government will be in establishing the state exchanges, it is likely that more employees who have historically opted out of an employer's coverage will begin to accept the employer's coverage. This is especially true at employers that adjust their plans to provide for affordable coverage options at minimum value. Thus, diligence and cost projections as to historical trend rates on uptake by employees may need to be closely examined, as future enrollment may be greater than historical enrollment. Another feature of health care reform—required automatic enrollment, which begins in 2014—should further increase employee uptake.

What Peer Companies Are Doing. As noted above, while many employers are discussing dropping coverage or imposing very low-cost alternatives, to our knowledge, no large employer with a national reputation has yet done so. Private equity sponsors should consider whether they want to be "first movers" on these matters, in light of the inevitable negative publicity that would follow. In addition, an employer who does not offer coverage, or who offers low-cost coverage, may be at a competitive disadvantage in recruiting and retaining talent. In this regard, the strategies of competitors should be closely followed. These strategies may include improving coverage; dropping or decreasing coverage and increasing wages; reducing headcount; or increasing headcount but strictly enforcing limitations on hours worked. Because the tax penalties for non-compliance are nondeductible while health care costs and wages generally are deductible, the tax impact of the different strategies would also need to be taken into account.

Maintaining or Losing Grandfathered Status. Certain provisions of health care reform not described in the article, but which nonetheless have an impact on cost, do not apply to "grandfathered" plans. A grandfathered plan is one that was in effect as of March 2010 (when PPACA was enacted) and that is not materially modified after that date. Loss of grandfathered status may occur because of changes that form part of the private equity sponsor's investment case or

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Navigating New Waters:

The Evolution of Private Equity Investment in China

The ways in which private equity investors participate in the Chinese economy may be poised to shift from minority and non-control investments to control investing. As in many developing economies, private equity investment in China has been dominated by minority investments that have provided growth capital and pre -IPO funding to founders not willing to fully "cash out" or cede control of their high growth businesses. The slowing Chinese economy and the generational shift in Chinese business owners suggest to many deal professionals in China that there is likely to be a new wave of transactions in which control and possibly even complete sales of Chinese businesses will become prevalent.

As private equity firms contemplate participating in this new phase of Chinese deal activity, they will need to recognize the cultural, legal and economic factors that influence the deal scene in China and create a number of obstacles to doing "Western"-style deals. This article will focus on those obstacles insofar as they relate to three key issues in Western private equity transactions: debt financing, purchase price adjustments and exits.

Debt Financing

Historically, Chinese enterprises were prohibited from taking out loans, and Chinese banks were prohibited from extending loans, for the purpose of funding M&A transactions. However, in December 2008, the China Banking Regulatory Commission (the "CBRC") issued guidelines that lifted this ban, as part of the Chinese government's efforts to strengthen financing support for M&A transactions and to promote outbound investment by Chinese companies. Under the guidelines, banks are permitted to grant loans to domestic enterprises in connection with M&A transactions, subject to various requirements.

Despite this pro-lending shift in regulation, the effect on the availability of debt financing for onshore M&A transactions has been limited. According to a study by Deloitte, M&A lending by Chinese banks for the first two years after the Guidelines were issued totaled around RMB 85 billion (approximately US$13 billion). By comparison, according to data released by Standard & Poor's, M&A lending in the U.S. reached US$234 billion for the year 2010 alone.

There are numerous possible explanations for the lack of a robust market in M&A lending by Chinese banks, including that:

- The guidelines are vague in certain areas and there is no clear guidance on how they will be interpreted.
- The guidelines contain strict requirements, such as having a dedicated team for conducting M&A loan-related due diligence investigations and risk assessments.
- Due to political considerations and relatively low risk tolerances, Chinese banks have historically focused primarily on making loans to state-owned enterprises, leaving many private sector businesses without relationships with lenders, and lenders without familiarity with many private sector businesses.
- The guidelines require that the borrowers must obtain "actual control" of the target company as a result of the M&A transaction (which term is not defined). As discussed above, that likely makes most of the private equity investments made in recent years ineligible, which makes the absence of a sizeable market for lending into private equity transactions not surprising.

However, as the number and size of M&A deals in China grows, and the trend towards control investments gathers steam, the demand for acquisition financing is likely to reach the critical mass needed to push lenders to overcome these obstacles. There are already some early signs of this. For example, according to a report in August 2011 by China Venture, a leading investment consulting organization, Industry and Commercial Bank of China signed strategic agreements with various local equity exchanges to allocate more than RMB 60 billion (approximately US$9.5 billion) to finance M&A deals that are facilitated by such local exchanges.[1]

Purchase Price Adjustment

Purchase price adjustments are a common feature in U.S. private equity M&A.

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[1] Chinese banking regulations do not prohibit "offshore" loans (i.e., by non-Chinese banks), but other regulations restrict the ability of Chinese companies to pledge their assets as collateral in support of such offshore loans. This presents a significant obstacle to the development of the type of debt financing that is common in the U.S. and other western markets, the central element of which is usually a fully-secured credit facility.

As private equity firms contemplate participating in this new phase of Chinese deal activity, they will need to recognize the cultural, legal and economic factors that influence the deal scene in China and create a number of obstacles to doing "Western"-style deals.

The Evolution of Private Equity Investment in China (cont. from page 5)

They often play a critical role in transactions by ensuring that the target company has a certain level of working capital or net worth at closing, protecting the buyer against the seller siphoning off value and allocating the benefits and burdens of the business between signing and closing, among other things. In an acquisition of a Chinese company in an "onshore" deal,[2] however, there are considerable obstacles to utilizing this mechanic.

An acquisition by a foreign investor of shares or assets of an onshore Chinese company will require, among other things, approval from the Ministry of Commerce ("MOFCOM") or its local counterparts, and registration with the State Administration of Foreign Exchange ("SAFE") or its local counterparts. The MOFCOM approval will include, among other things, the purchase price and SAFE will only allow the foreign purchaser to remit into China the amount of foreign exchanges equal to the purchase price approved by MOFCOM. MOFCOM generally only stipulates a fixed price, not a pricing formula or a variable price and MOFCOM only issues one approval per transaction. That is obviously at odds with the use of a purchase price adjustment, which results in the ultimate purchase price not being determined until some time after the closing.

One possible solution is to structure a portion of the purchase price as an offshore payment. However, this requires careful navigation of Chinese tax and foreign exchange control regulations and is only an option if the offshore payment has commercial significance (beyond simply being a means to evade the regulations), which would typically require that a portion of the target business be conducted offshore. Otherwise, the payment could be characterized as a tax evasion scheme (assuming the seller does not pay tax in China on it) and/or a violation of China's foreign exchange control regulations, which require that the proceeds of the transaction be remitted onshore.

A second solution involves converting the purchase price adjustment into a closing condition. This is a significant departure from the way purchase price adjustments are implemented in the U.S., but it achieves most of the benefits. To avoid the obstacles described above, rather than one party making a payment to the other, this solution requires the seller to deliver the target company with the previously-agreed level of assets and liabilities—typically, a target working capital amount and no cash or debt. The purchaser has the right to appoint an accountant to review the amount of working capital and the net debt position of the target and does not have to close until it is satisfied that the amounts are as agreed. This approach may not be practical in deals in which the seller does not, for example, have sufficient resources to fund the debt payoff or a working capital shortfall. It also will not be as precise as a traditional purchase price adjustment, since it does not allow for a post-closing confirmation that the estimates used for purposes of closing were accurate.

A third possible solution requires cooperation from MOFCOM and SAFE. Based on our conversations with local MOFCOM officials in Beijing and Shenzhen, the officials appear to understand the commercial need for purchase price adjustments and the obstacles that their regulations create. One possible construct to which they appear receptive would be for MOFCOM to approve the purchase agreement, which contains the purchase price adjustment mechanism and a fixed base price.[3] The parties would close on the basis of that price. Once the amount of any purchase price adjustment has been determined after the closing, the parties would apply to MOFCOM for the issuance of a "confirmation letter" approving of the payment of the price adjustment, determined in accordance with the

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Historically, Chinese enterprises were prohibited from taking out loans, and Chinese banks were prohibited from extending loans, for the purpose of funding M&A transactions.... Despite...[a recent] pro-lending shift in regulation, the effect on the availability of debt financing for onshore M&A transactions has been limited.

[2] *An acquisition of a company incorporated in mainland China. This contrasts with an "offshore" deal, in which the target company is held by a non-Chinese holding company that has all its operations in mainland China.*

[3] *A possible limitation is that MOFCOM might only be willing to approve upward adjustments through this process, since downward adjustments would require that the excess purchase price be transferred out of China.*

Chinese Private Equity Opens Up to Chinese Insurers

The Chinese private equity market is one of the fastest changing in the world. Significant private equity activity in China has been going on for scarcely a decade, and in that short time there have been dramatic changes in the way that the market is regulated and in the way that it functions. Debevoise has been active in this market since its inception, and in this article we continue our examination of topics of interest to Chinese and non-Chinese fund sponsors and investors interested in the Chinese private equity market. In the discussion below we examine the rules governing investment by Chinese insurers in renminbi-denominated private equity funds organized in China[1] ("RMB funds"), including recent new revisions to the rules that would greatly expand the ability of Chinese insurance companies to make such investments.

RMB fund sponsors, whether organized under Chinese law or the laws of another jurisdiction, often complain about the scarcity of institutional limited partners in China. Insurance companies organized in China, which are subject to supervision by the China Insurance Regulatory Commission (the "CIRC"), have recently attracted much attention because they are seen as potentially an important source of institutional capital for RMB funds. According to the CIRC, as of the end of August 2012, the total assets held by Chinese insurance companies stood at RMB 6.64 trillion (approximately US $1.06 trillion).

The 2010 Temporary Rules and the 2012 Liberalization

Like insurers in many other jurisdictions, the insurance industry in China is highly regulated, and the types of investments that Chinese insurance companies may make are limited. Only two years ago, the CIRC issued the first set of temporary rules governing investment by Chinese insurance companies in private equity (the "Temporary Rules"). The Temporary Rules authorize Chinese insurance companies to invest their assets in the equity of non-publicly traded companies in China, either directly in private equity transactions or indirectly through RMB funds. However, under the Temporary Rules such investments are subject to significant conditions that may be difficult for some investors to satisfy. To date, only a handful of investments by Chinese insurance companies in RMB funds have been reported.

In July 2012, the CIRC issued a new notice (the "2012 Notice") containing a series of changes to the Temporary Rules, as well as changes to rules governing investment by Chinese insurance companies in real estate. In general, the 2012 Notice relaxed some of the restrictions in the Temporary Rules, including with respect to the types of Chinese insurance companies that are allowed to make private equity investment, the types of RMB funds in which eligible insurers may invest, and the types of investments that such RMB funds may make. Below is a summary of several key aspects of the rapidly evolving insurance regulations relating to Chinese insurance companies' investment in RMB funds.

Which Chinese Insurance Companies Are Permitted to Invest In RMB Funds?

Not all insurance companies in China may invest in RMB funds.[2] For an insurance company to be qualified to invest in private equity, it must, among other things:

- have net assets of no less than RMB 100 million (approximately US $16 million) as of the most recent fiscal year-end;
- have a solvency adequacy ratio of no less than 120% as of the end of the last quarter before the time of investment; and must adjust its investment strategies if the ratio falls below 120% after any private equity investment is made;
- have at least two employees, with at least three years' experience each, in private equity investing; and
- meet certain additional requirements, such as having sound corporate governance, management systems, decision-making processes and internal controls, having established asset custody arrangements and not having violated

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1 *For purposes of this article, "China" refers to mainland China, i.e., excluding Hong Kong, Macau and Taiwan.*

2 *The Temporary Rules generally are drafted such that they apply not only to Chinese insurance companies' investment in RMB funds, but also to their direct investment in unlisted companies. So, for example, the qualification requirements that apply to Chinese insurance companies investing in RMB funds are generally similar to those applicable to their direct private equity investing.subscription agreement with respect to the RMB fund being tested. However, again, the rules are not entirely clear on this point.*

applicable law in any material respect in the most recent three-year period.

What Approvals Are Required Before a Chinese Insurance Company May Invest in an RMB Fund?

Until recently, it was not clear whether CIRC approval was required before a Chinese insurance company could invest in an RMB fund. The Temporary Rules did not expressly require prior approval; although the Temporary Rules did provide that a filing must be made within five business days after the execution of a subscription or other investment agreement. However, in practice it had been widely reported and understood that a "private equity license" of some kind was required for a Chinese insurance company to invest in an RMB fund—and that it could take a substantial period of time to obtain such a license. For example, in 2011 it was reported that it took one prominent insurer about one year to obtain such a "private equity license."

Like insurers in many other jurisdictions, the insurance industry in China is highly regulated, and the types of investments that Chinese insurance companies may make are limited….The Temporary Rules authorize Chinese insurance companies to invest their assets in the equity of non-publicly traded companies in China, either directly in private equity transactions or indirectly through RMB funds.

This uncertainty concerning the CIRC filing and approval process was significantly reduced by a September 20, 2012 document issued by the CIRC and titled "Certain Explanations re: Filing by Insurance Companies Relating to Equity Investments and Real Estate Investments" (the "Filing Guidance"). The Filing Guidance makes clear, for example, that a Chinese insurance company may only invest in an RMB fund after it has made a filing with the CIRC, and the CIRC has reviewed and accepted the filing. This filing most likely will need to include copies of documents relevant to the insurer's decision to invest, which could potentially include key fund documents such as the partnership agreement and subscription agreement, but the Filing Guidance is not clear on this point. The Filing Guidance also makes clear that the CIRC may reject any such filing if it determines that the Chinese insurance company does not meet all the qualification requirements outlined above.

Interestingly, the Filing Guidance also seems to suggest that an insurance investor may be able to obtain a "blanket" private equity license, which presumably would reduce the burden of obtaining a separate approval in connection with each private equity investment. However, further clarification on this point is needed. How this will play out in practice remains to be seen.

In What Kinds of RMB Funds May Chinese Insurance Companies Invest?

A Chinese insurance company may not invest in an RMB fund unless both the fund sponsor (the fund manager or adviser) and the fund itself meet certain tests.

Qualified fund sponsors. The fund sponsor generally must (1) have adequate capital, *i.e.*, at least RMB 100 million in *either* registered capital or capital commitments, (2) employ a stable and experienced management team that satisfies certain tests, *e.g.*, a team that includes at least ten professionals with relevant experience and that has made and exited at least three prior investments, (3) have at least RMB 3 billion in assets under management and (4) satisfy a number of additional conditions.

According to the 2012 Notice, for purposes of the test in clause (3) above, "assets under management" refers only to amounts of capital or assets in China, denominated in RMB and having been paid in. This test could prove very difficult for most private equity firms to satisfy, and it remains to be seen how the CIRC will interpret this requirement and apply the test.

Qualified funds. As for the RMB fund itself, in addition to being sponsored by a qualified sponsor, it must also satisfy a list of requirements relating to, among other things, fund size (no less than RMB 500 million), custody arrangements and disclosure.

Approved investment strategies. RMB funds also must have investment strategies approved by the CIRC. Approved investment strategies include growth capital investing, investing in buyouts, investing in "upcoming industries" (such as financial services, senior care and health care) and investing in modern agriculture and low-income housing. Another approved investment strategy is investing (through a fund of funds) in funds pursuing the approved strategies described in the preceding sentence. On the other hand,

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GUEST COLUMN

Washington Update: Politics, Policy and Private Equity

The presidential election has brought unprecedented attention to private equity. Political rhetoric of a campaign often leaves facts and dispassionate analysis by the wayside. Unfortunately, this comes at a critical time for the private equity industry. It is anticipated that the frenzy of the presidential election will abate and transition quickly to a potentially consequential lame duck session of Congress. Regardless of who wins the election, the stakes could not be higher for private equity and growth capital firms. There is pressure to address fundamental fiscal issues, and the political currents may be right for a Grand Bargain. Moving beyond a lame duck and into next year, dramatic tax changes, including the appropriate treatment of carried interest, the taxation of passthrough entities and limitations on interest deductibility, could be on the table during tax reform. In addition, new regulations and rulemakings by the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and other agencies are pending.

Politics and Private Equity

Never has it been so important for private equity to explain what it does, how it works and whom it benefits. Since the start of the general election, President Obama's campaign and allied groups have spent $38.4 million for almost 78,000 television spots, focused in a few swing states, about Bain Capital and private equity. And the attacks have not been limited to the Democratic side; during the Republican primaries earlier this year, private equity was attacked by Newt Gingrich and Rick Perry. While press coverage of private equity-related issues has slowed somewhat compared to last spring and the summer, these persistent negative attacks have allowed an anti-private equity narrative to seep into the perceptions of the electorate.

While the polls change day to day, the presidential race will clearly remain tight through Election Day. Most observers believe it will be decided in a small number of swing states, including Ohio, Florida, Virginia, Colorado and Wisconsin, and by a slim percentage of the popular vote. It is possible that party control of the House and Senate will not change. While the leadership may not change, we will be looking at more closely divided chambers after the election. This means that one of two things will happen: either Congress will become even more polarized and nothing will happen until external events force a hasty resolution to the fiscal situation; or leadership of both parties will capitalize on the growing concern about long-term fiscal problems and move towards a Grand Bargain. Either way, issues important to private equity will be up for debate and possible change.

It is in this political context that the private equity industry must be extra vigilant in explaining its positions. As part of tax reform, some policy makers have openly called for changes to carried interest, current partnership taxation rules and the deductibility of interest. At the same time, rulemakings to implement the Dodd-Frank financial reform legislation and the Foreign Account Tax Compliance Act, among others, are proceeding. These are important issues. The facts matter. But much of the media coverage of private equity demonstrates how highly charged assertions and incorrect characterizations can impact the environment in which important policy decisions are made.

Communicating the Facts About Private Equity

When policy makers are evaluating legislative changes or promulgating regulations, it is essential to the private equity industry and the investors in private equity that those policymakers are working off accurate information, not misperceptions about the asset class. The Private Equity Growth Capital Council (PEGCC) is diligently working to ensure that policy makers have the information they need and that the industry speaks with a unified voice.

Knowing that there is a real lack of

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Knowing that there is a real lack of understanding about private equity, what it does and whom it benefits, the PEGCC launched a campaign...called Private Equity at Work...[,which] helps to set the record straight and foster a receptive environment for private equity on Capitol Hill.

Washington Update: Politics, Policy and Private Equity (cont. from page 9)

understanding about private equity, what it does and who it benefits, the PEGCC launched a campaign in February called Private Equity at Work. Anchored by the campaign website, www.PrivateEquityAtWork.com, the PEGCC provides credible and easily accessible information about the industry and its proven record of strengthening companies, creating jobs and delivering impressive returns to pension funds, charitable foundations and university endowments. The Private Equity at Work campaign helps to set the record straight and foster a receptive environment for private equity on Capitol Hill.

Through the campaign, we have, for the first time, created a repository of information about the private equity industry freely available to the general public in the form of industry fact sheets and info graphics. The PEGCC has also created a series of video and written case studies chronicling specific private equity and growth capital investments. The private equity-backed companies profiled on our website are just a few examples of the thousands of companies that private equity has helped to strengthen—for the long term. We also feature animated whiteboard videos explaining what private equity is, how it works and who benefits from it. The website also features a blog with current content.

It is hard to imagine a time when the private equity and growth capital industry is going to be more in need of an organization solely focused on protecting the image of the industry and advocating its policy positions to key stakeholders in Washington, DC.

By using the campaign as a backdrop, the PEGCC has briefed over 80 national and political reporters on the private equity industry, and been quoted or mentioned in over 350 articles, many times the number of articles during all of 2011. While we cannot hope to compete with the advertising of a presidential campaign, our efforts have influenced the increased volume of coverage to incorporate more accurate reporting of private equity and growth capital. We also have established the PEGCC as the go-to resource for reporters looking for information about the industry.

Our campaign is but one way the PEGCC looks to shape public policy. The PEGCC has worked to develop the intellectual foundation of our policy positions, which include maintaining carried interest flow through of capital gains, opposing the establishment of an entity level tax on passthroughs, and supporting the maintenance of full interest deductibility. Through commissioned studies, including a study on interest deductibility and passthrough taxation that was published in a peer reviewed journal, the PEGCC provides the basis for opposition to policies that will hurt the industry and the economy. The PEGCC has also facilitated more than 50 visits between private equity portfolio company CEOs and members of Congress. During a visit to a member of Congress, typically a CEO from a company in that member's state or district tells his or her company's story and how private equity enabled the company to grow its business and create jobs. Policy makers are able to see, firsthand, how private equity strengthens business in their districts, and how private equity benefits all 435 congressional districts in all 50 states.

Finally, we have been an active participant in the implementation of Dodd-Frank and shaping regulations that affect the industry. The PEGCC's comment letters and meetings with relevant agencies have resulted in significant improvements to proposed regulations. Our success has been achieved through active participation from our member firms and the tireless work of our lead outside counsel, Debevoise & Plimpton LLP.

It is hard to imagine a time when the private equity and growth capital industry is going to be more in need of an organization solely focused on protecting the image of the industry and advocating its policy positions to key stakeholders in Washington, DC. Our active membership has been essential to our efforts and provided us with superb video case studies of successful private equity investments, portfolio companies with stories to share, data and, of course, funding for our efforts. I would love to hear your ideas about how the PEGCC can better represent the industry or how we could work with private equity firms and investors to present a unified voice for private equity and growth capital investment in this country. ■

Steve Judge
President and CEO
Private Equity Growth Capital Council

The Many Shades of Co-Investing

Co-investment transactions have become increasingly popular as investors search for yield. Unlike club and consortium deals among private equity sponsors, or even between private equity firms and strategic partners, in which the terms of the arrangements have become increasingly standardized, co-investment transactions come in many different shades, depending on the equity splits between a lead sponsor and the co-investors (who typically hold in the aggregate 10-25 percent), the identity of the co-investors (*e.g.*, limited partners of a lead sponsor, other private equity firms with different profiles, or even strategic investors), and a variety of other factors including deal origination, sector expertise and the jurisdictions of the co-investors.

Co-investment transactions serve a number of important purposes for their participants. For lead sponsors, co-investors can help plug holes created by tight debt markets, reduce risk exposure, and/or bring additional industry or regional expertise or simply a brand-name to an investment. They can also serve as an important tool to build and cement a lead investor's relationships with third parties, particularly with a sponsor's limited partners. For co-investors, these opportunities offer diversification, a chance to achieve better net investment returns and the acceleration of capital deployment. They also can help deepen institutional relationships and give the co-investor the opportunity to piggy-back off of the insight and expertise of the lead investor.

But, while co-investments offer their participants these various benefits, they also present some unique challenges for deal participants, as each is bespoke, and there is no one-size-fits-all template for the governance arrangements in these transactions. Opportunities for creative structuring abound. This article discusses some important process matters and common issues that arise in these types of deals, and identifies typical negotiating positions of sponsors and co-investors on these issues.

Structuring

It is in the interests of both lead sponsors and prospective co-investors to consider carefully and clearly communicate their expectations for a co-investment opportunity before any definitive documentation is produced. Initial discussions of the proposed structure of a co-investment often represent a good early opportunity for sponsors and prospective co-investors to determine how their expectations are aligned.

A sponsor typically sets up co-investment programs on a deal-by-deal basis. Depending on the size of the investment and anticipated number of co-investors, a sponsor may be more or less flexible in accommodating structuring or other requests from individual co-investors. The potential iterations that a sponsor may choose from are varied, *e.g.*, a single sponsor-controlled limited partnership that will invest in the sponsor's acquisition vehicle, a series of sponsor-controlled limited partnerships each holding the interests of individual co-investors, direct investment by co-investors into a sponsor's acquisition vehicle or some combination of the above.

From a sponsor's perspective, the structuring of a co-investment is important to enable it to dictate the "rules of engagement" for co-investors and manage expectations of the respective roles of the sponsor and co-investors in the governance of the investment. From a co-investor's perspective, while it cannot (except in highly unusual circumstances) dictate structure, it should review any proposed structure to make a judgment promptly as to whether it meets the co-investor's tax needs (an important threshold question) and whether it is likely to meet its expectations in terms of minority investor protections, post-closing funding obligations and exit options. Co-investors may also want to consider a sponsor's ability to change the structure in the future, and whether such changes would be acceptable (*e.g.*, continue to meet the co-investor's tax needs).

Diligence and Documentation: Trust, but Verify

In a typical co-investment process, co-investors do not have the opportunity to (or may not want to devote the resources to) conduct their own fulsome due diligence on an acquisition target and instead must (or may choose to) rely on the sponsor's diligence. Co-investors considering an equity co-investment or syndication will typically, though not invariably, wish to review the lead investor's formal diligence materials (*e.g.*, professional advisors' reports), and also have the opportunity to evaluate the sponsor's experience with, and approach to, the diligence process, so that co-investors are able to get comfortable not

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[W]hile co-investments offer their participants these various benefits, they also present some unique challenges for deal participants, as each is bespoke, and there is no one-size-fits-all template for the governance arrangements in these transactions.

simply with the findings of the diligence, but also with the manner in which it was conducted. To the extent a co-investor has particular diligence needs, such as in the areas of tax or corporate social responsibility, it should raise these issues as early as possible with the lead sponsor so the parties can decide if additional diligence is warranted.

Similarly, unlike many club and consortium deals, co-investors in deals of this type rarely have any direct involvement in, or control over, the underlying M&A deal subject to the investment, as it is often important to the sponsor's underlying M&A deal that any such co-investor involvement in fact be very limited. Co-investors are well-advised, of course, to review all of the deal documents to ensure that any structuring issues of the kind discussed above are properly addressed, to understand the financial arrangements and key risk allocations in the deal and to identify any elements of the deal arrangements that may affect their interests uniquely. They also sometimes strategize with the lead investor, but are not directly involved with the negotiations or the preparation of the underlying deal documents. As with the diligence process, a trust but verify orientation is the norm here.

Lead sponsors believe, with reasonable justification, that they will ultimately bear responsibility for the success (or failure) of the underlying acquisition. Accordingly, most sponsors do not concede governance rights to co-investors that would inhibit the sponsor's ability to take the kinds of actions that it deems necessary or appropriate to maximize the value of the investment.

The Investor Arrangements: Maintaining Alignment

Lead sponsors believe, with reasonable justification, that they will ultimately bear responsibility for the success (or failure) of the underlying acquisition. Accordingly, most sponsors do not concede governance rights to co-investors that would inhibit the sponsor's ability to take the kinds of actions that it deems necessary or appropriate to maximize the value of the investment.

While approaches vary widely, our clients, both on the co-investor and sponsor sides, often find the most efficient and mutually acceptable means to ensure sufficient minority protections for co-investors is not through a cumbersome negotiation of an extensive or detailed list of co-investor "veto rights," but rather by seeking to maximize the alignment of interests between sponsors and co-investors and developing a set of parameters in the principal equity deal documents that allow sponsors sufficient control to manage the investment as they see fit, while also protecting the economic interests of co-investors from disproportionate value erosion due to unilateral sponsor actions (intended or unintended). In this regard, the following provisions are typically negotiated in transactions of this type.

- *Pari Passu and No Fee/No Carry Investment.* To keep sponsor and co-investor economic incentives as aligned as possible from the outset of the transaction, co-investors typically seek to invest (directly or indirectly) in the same type and mix of securities as the sponsor on a no-fee (or very low fee)/no-carry basis.
- *Anti-Dilution.* Also to maintain economic alignment, co-investors often seek reasonable minority investor consent rights (usually on the basis of a majority of the securities held by all co-investors) with respect to new issuances of equity or debt securities and/or a pre-emptive rights in connection with such new issuances (subject to possible carve-outs for pre-approved syndications by the sponsor, issuances in distress situations, issuances in connection with acquisitions or joint ventures and other typical exemptions). Many lead sponsors are unwilling to grant any kind of investor consent or pre-emptive rights with respect to debt instruments, as sponsors view that piece of the capital structure to be fully within their domain. In any event, co-investors should take into account tactical considerations if they have to choose between consent rights and pre-emptive rights. While pre-emptive rights can provide protection against dilution, they are of little value to a co-investor who does not wish or otherwise have the capacity to invest additional funds into the investment platform in question.
- *Amendments to the Terms of the Equity Documents.* Documents such as the main shareholders, partnership or LLC agreement and the related constituent documents of the co-investor vehicle set out the legal basis for the essential economic agreement to which all parties agree at the time of the investment. Co-investors are,

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Something New: The Partial Section 338(h)(10) Election

Careful vetting of relative tax benefits and costs has generally been key in a private equity firm's decision as to whether to request a section 338(h)(10) election in the acquisition of a U.S. subsidiary from a U.S. tax group. But the decision rarely offers much room for creativity. The basic analysis (which may be complicated) is whether the benefit of the step-up to the buyer exceeds the tax cost to the seller. A recent private letter rule confirms that more innovative approaches can be used to maximize the tax benefits on exit. These may be particularly attractive in situations where a private equity firm is buying a target with two businesses and anticipates exiting the businesses separately.

By way of background, when buying the stock of a U.S. target corporation from a U.S. consolidated group, one of the first issues that needs to be addressed is whether a section 338(h)(10) election will be made to step up the tax basis of the target's assets. Traditionally, there has been an all or nothing aspect to making a section 338(h)(10) election: the election is made to step up the tax basis in all of the target's assets when the benefit of the step-up to the buyer exceeds the tax cost to the selling consolidated group. If the tax cost to the seller exceeds the tax benefit to the buyer, a section 338(h)(10) election is not made, and the target corporation's tax basis in its assets carries over.

The recent private letter ruling issued by the IRS (PLR 201213013) allows for a more tailored transaction. The transaction blessed by the ruling (or a variant of that structure) is likely to prove useful in cases where the tax cost of a section 338(h)(10) election is prohibitive, but it is important to the buyer that the tax basis in certain assets be increased to their fair market value. This can occur, for example, where a private equity fund is buying the stock of a target corporation that holds more than one business, and the sponsor believes that the businesses held by the target may eventually be sold to separate buyers.

What is a Section 338(h)(10) Election? A section 338(h)(10) election refers to an election under section 338(h)(10) of the federal tax code. If various conditions are met, the election allows the parties in a sale of stock of a corporation to treat the transaction for federal income tax purposes as if it had been structured as an asset sale. In effect, the parties are treated (purely for applicable tax purposes) as though (1) the buying corporation established a new corporation ("New Target"), (2) New Target purchased the assets of the target corporation ("Old Target") and assumed its liabilities and (3) Old Target liquidated in the hands of the seller. A section 338(h)(10) election is available only where the target corporation is a member of a U.S. consolidated tax group or is treated as an S corporation for federal income tax purposes.

In the consolidated group context, the gain (or loss) in the target's assets arising from a section 338(h)(10) election passes up to the selling consolidated group, and the tax on that gain is payable by the selling consolidated group. The selling consolidated group is generally not taxed on the deemed liquidation of the target. Thus, if a section 338(h)(10) election is made, the selling consolidated group's tax is based on the gain inherent in the target's assets; if no section 338(h)(10) election is made, the group's tax is based on the gain inherent in its target stock.

Suppose, for example, the selling consolidated group has $150 of tax basis in the stock of a target corporation, the target corporation has $100 of tax basis in its assets and the stock of the target is sold for $200 to a single buying corporation. If a section 338(h)(10) election is made, the selling consolidated group would have $100 of gain. If a section 338(h)(10) is not made, the group would have $50 of gain.

What is the benefit to the buyer of a Section 338(h)(10) Election? If a section 338(h)(10) election is made, the tax basis in the target's assets will be reset to equal their fair market value. In cases where the assets (including goodwill) of the target have appreciated, a section 338(h)(10) election will typically result in a step-up (increase) in the overall tax basis of the target's assets. A higher tax basis can provide a variety of tax benefits. First, if an asset is later sold by the target, the higher tax basis will reduce the tax gain on the sale. Second, if an asset is depreciable (or amortizable) for tax purposes, a higher tax basis will result in greater depreciation (or amortization) deductions for tax purposes.

Continuing with the example above, if a section 338(h)(10) election is made, the buying corporation would acquire a corporation with $200 of tax basis in its assets. If a section 388(h)(10) is not made, the buying corporation would acquire a corporation with $100 of tax basis in its assets.

When will a Section 338(h)(10) Election be made? As noted above, a section 338(h)(10) election is typically made when the benefit of the election to the buyer exceeds the tax cost of the election to the selling consolidated group. The benefit to the buyer is typically driven by how much built-in gain exists in the target's assets and how quickly (through sales, depreciation or amortization) the buyer would realize the benefits of a step-up in that tax basis. The tax cost of a section 338(h)(10) election to

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the selling group is typically driven by the difference between the amount of gain inherent in the target's assets and the amount of gain inherent in the stock of the target and whether the selling group can readily shelter the gain or can otherwise be compensated for bearing the tax on any additional gain.

A More Tailored Transaction

Suppose that a target corporation (valued at $200) operates two businesses of equal value (Business A and Business B). Suppose further that the selling consolidated group has $140 of tax basis in the stock of the target corporation (with $60 of gain inherent in the target stock), that the target's tax basis in Business A is $50 (so there is $50 of inherent gain in Business A) and the target's tax basis in Business B is $0 (so there is $100 of inherent gain in Business B). (This basic fact pattern can arise whenever the stock of the target corporation was originally purchased by the selling consolidated group with no section 338(h)(10) election).

If a buyer purchases the stock of the target and a section 338(h)(10) election were not made, the selling consolidated group would have $60 of tax gain and, after closing, the target would continue to have $50 of inherent gain in Business A and $100 of inherent gain in Business B. In order to eliminate this built-in gain, the buyer could request that a section 338(h)(10) election be made to step up the tax basis of each business to $100. However, this would increase the selling group's gain from $60 to $150 and the selling group would demand a higher price to compensate it for the cost of the election (*i.e.*, the tax on $90 of additional gain). On these facts, it seems likely that the tax benefit of a section 338(h)(10) election to the buyer would be less than the tax cost of the election to the selling group and, therefore, a section 338(h)(10) election would not be made.

Suppose, however, that (1) the buyer was an LLC taxed as a partnership (rather than a corporation), (2) the buying LLC brought Business A directly (or bought the stock of a subsidiary owning Business A) for $100 and (3) the next business day, the buying LLC bought the stock of the target corporation (owning just Business B) for $100. The selling consolidated group would have $50 gain on the sale of Business A. Under the consolidated return regulations, this gain generally would increase the selling group's tax basis in the stock of the target. As a result, the selling group would have only $10 of gain upon the subsequent sale of the stock of the target. Thus, the selling consolidated group would have $60 of gain in total (the same amount it would have recognized on a straight sale of the target stock). However, the buying LLC would receive a tax step-up in the tax basis of Business A (or the stock of the subsidiary owning Business A).

The IRS blessed this transaction in PLR 201213013 (the actual facts of the ruling are more complicated and involved an add-on acquisition by an existing portfolio company). The private letter ruling holds that the selling group will be required to recognize the gain on the sale of Business A and that the buying LLC's step-up in Business A will not be limited under the so-called asset consistency rules (see below). The IRS required a variety of representations of the taxpayers, including that Business A would be operated by the buyer as a distinct business separate from Business B.

One of the primary issues in these transactions is whether the step-up in tax basis of the assets being sold is disallowed under the so-called "asset consistency rules." Those rules are designed to deny a step-up in the tax basis of an asset where the gain recognized by the selling group in the transaction that gives rise to the step up reduces the group's gain on a sale of stock of the corporation that sold the asset. While this is exactly what happened in the private letter ruling, the asset consistency rules generally apply only if there is a purchase of the target stock by a corporation, which was not the case in the private letter ruling.

The structure at issue in PLR 201213013 is not new but has not been used frequently. Moreover, in certain circumstances, it may be possible to achieve similar results with somewhat simpler structuring. The favorable treatment afforded in the ruling can be expected to increase the use of these structures, either with or without a private ruling, and to provide a significant tax benefit when a target corporation operates two or more businesses and the buyer expects to dispose of the businesses separately. ■

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Employee Equity Repurchases Draw SEC Scrutiny

A recent SEC investigation gives a new spin to the old adage of *caveat emptor* in the context of employee stock repurchases by private companies. Virtually all portfolio company management equity arrangements contain "call rights"—*i.e.*, the rights that allow a portfolio company (or, often, the private equity sponsor itself) to repurchase shares held by an employee on termination of employment. Typically, call rights are exercisable for a limited period of time following the termination at "fair market value." Without the benefit of a public market for the stock, fair market value is usually established by the board of directors, with varying degrees of discretion, and sometimes based on a valuation received from an independent valuation firm. Though distinquishable from customary private equity portfolio company practices in a number of important respects, a recent lawsuit filed by the SEC against Stiefel Laboratories, Inc. and its former CEO, Charles Stiefel, is a reminder to boards of directors of portfolio companies that determining fair market value can be risky, especially if the business is sold shortly after the employee's termination.

The SEC's complaint in the Stiefel Labs matter alleges that, from 2006 to 2009, Stiefel Labs repurchased common stock from a significant number of its employees (both inside and outside of a tax-qualified plan) at far below fair market value. More importantly, the SEC alleges that this conduct amounted to securities fraud on the employees. According to the SEC and related court cases, the disparities between the repurchase prices and potential fair market values were dramatic:

- In late 2006, at a time when Stiefel Labs was repurchasing the employees' common shares at a "fair market value" of $13,012 per share, the company was fielding five offers from third party investment firms to invest in the company at valuations that were 50–200% higher than the valuation used for employee repurchases.
- In August 2007, Blackstone purchased a 19% preferred stake in the company for $500 million, valuing Stiefel Labs' equity at approximately $2.6 billion (which, according to a related court case, implied a valuation of roughly $60,000 per common share). TA Associates had also offered to invest and valued Stiefel Labs' equity at approximately $2 billion. At the same time, Stiefel Labs was valuing the employees' shares at a value that equated to a $786 million valuation of the company.
- Between November 2008 and April 2009, Stiefel Labs was valuing the employees' shares at a price which equated to a $877 million valuation of the company. At the same time, Stiefel Labs was trying to sell itself. During this process, the company was told that it could expect bids of between $2.25 billion and $5 billion for the company. After an auction, Stiefel Labs ultimately agreed to be acquired by GSK for $2.9 billion in cash, the assumption of $400 million of Stiefel Labs debt and a $300 million earnout. This resulted in a payment of roughly $68,000 per share to the employee shareholders who had not sold their stock earlier.

Not surprisingly, private suits from current and former employees who had sold shares in 2008 and 2009 immediately followed GSK's acquisition. These suits make claims under a variety of theories, ranging from securities fraud to breach of fiduciary duty under ERISA. Some plaintiffs were dismissed from these suits as a consequence of having signed general releases of claims after selling their shares; others were permitted to continue because the releases they signed did not cover prospective claims. In May 2012, the first of these suits reached a verdict, with a former employee winning a $1.5M judgment.

The SEC joined the chorus in December 2011, when it filed its civil fraud suit against Stiefel Labs and Mr. Stiefel. The SEC's suit seeks (among other things) disgorgement from the company and Mr. Stiefel of an estimated $110 million of profits from the alleged fraudulent activity. Stiefel Labs and Mr.

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Though distinquishable from customary private equity portfolio company practices in a number of important respects, a recent lawsuit filed by the SEC against Stiefel Laboratories, Inc. and its former CEO, Charles Stiefel, is a reminder to boards of directors of portfolio companies that determining fair market value can be risky, especially if the business is sold shortly after the employee's termination.

Employee Equity Repurchases Draw SEC Scrutiny (cont. from page 15)

Stiefel have filed an answer, admitting uncontroversial facts and otherwise generally denying the SEC's allegations. A recent news reports suggests that the case is currently in mediation.

Because the only facts we currently have regarding this case are from the SEC's complaint, it is difficult to know what conclusions private equity firms should draw from the SEC's action, other than the obvious conclusion that valuations in this context are a risky business. For example, we know that Stiefel Labs used an independent appraiser for valuation purposes, but the SEC does not say who the appraiser was—a storefront in Yonkers or a national firm—although a newspaper article identifies the appraiser as a CPA firm in Rhinebeck, New York. (A related case by the employees charges the CPA firm as neither independent nor competent to conduct valuations.) We know the method that the appraiser is said to have used—a valuation by reference to Stiefel Labs' financial performance against public company peers (presumably without regard to hypothetical control premiums)—but we do not know what information Stiefel Labs provided to the agent as part of this process. The SEC alleges that Stiefel Labs did not inform the agent of any of the non-plan transactions that could be seen to affect valuation (*i.e.*, the pending third party offers, Blackstone's actual investment or the decision to auction the company and related valuation guidance). The SEC also points to e-mail traffic that (in its view) indicates that the CEO and others were aware that Stiefel Labs was purchasing shares from employees below any reasonable estimate of fair market value.

Nevertheless, there are steps that private equity firms can take to mitigate the risks associated with fair market value determinations of employee equity:

Obtain Informed Periodic Appraisals. Periodic appraisals by a well-informed and "brand name" independent appraiser should go a long way to undermining potential claims by employees. The SEC takes great pains in its complaint against Stiefel Labs to portray the independent appraiser as lacking all of the relevant facts, and we expect that both the valuation activities of the independent appraiser and communications between Stiefel Labs and the appraiser will be a crucial dispute in the case. In addition, the SEC points out that Stiefel Labs performed valuations only once per year and then used that same valuation throughout the year. A customary approach in private equity would be to obtain an annual valuation, with the portfolio company board updating that valuation on a quarterly basis based on developments during the year (or more frequently during volatile periods or as the portfolio company moves closer to an exit event or an IPO).

Consider Expanding Blackout Periods. Many portfolio company equity plans provide up to six months for repurchases to occur. This period might be sufficient time for valuation-influencing events to resolve themselves, either by coming to fruition or dying on the vine. While it is not a common practice currently, it may be advisable to consider permitting a portfolio company to further toll repurchase events if it decides that a repurchase would create excessive risk of employee claims. It can be particularly difficult for a portfolio company board to consider how to take into account offers from third parties to purchase minority stakes or the company as a whole, especially if unsolicited. These offers are usually preliminary and subject to legal and financial diligence, and, as noted throughout the SEC's complaint, they can vary considerably. Often, the right answer is that these offers should not influence value at all. The SEC seems to anticipate this argument by emphasizing the number of offers that Stiefel Labs received in 2006—five—and that one of the offers, Blackstone's, was ultimately consummated at a price well above the price that Stiefel Labs was then using. One must wonder how strong the SEC's case would be if neither the Blackstone investment nor the sale of the company had actually been consummated.

Get Releases from Departing Employees. At least one court has dismissed claims against Stiefel Labs by employees who signed releases that covered the share repurchases. While it is not clear that all courts in all states (or outside of the United States) would enforce releases under these facts, obtaining releases from employees in connection with share repurchases should create a valuable defense to subsequent litigation. Better yet (but also less frequently obtained), a repurchase agreement with a departing employee could specify that the repurchase price is an agreed-to price that may or may not be fair value.

Be Clear About Discounts. In the SEC complaint, there is a cryptic reference that the independent appraiser, after performing an initial calculation of fair market value based on financial information, applied a 35% discount to the result. One assumes that, in discovery, this will be shown to

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ALERT

New UK Takeover Code Consultation: Key Points for Private Equity Bidders

Additional modifications to the framework for UK public takeover transactions, known formally as the City Code on Takeovers and Mergers (the "Code"), are expected to come into force early next year subject to the responses to the Consultation Papers published by the UK Takeover Panel on July 5, 2012 setting forth these modifications. These changes are not as significant as the recent changes to the Code that made public transactions more complicated for private equity bidders, but there are nonetheless several key "take aways" for private equity bidders.

Some of these changes, such as enhanced rights for pension trustees, have been proposed to further the aims articulated in the reforms undertaken last year in response to the Cadbury/Kraft deal. Other changes, such as the increase in the number of public companies subject to the Code, are "tidying up" points that have been under consideration for some time, but were delayed whilst the Cadbury/Kraft reforms were being implemented. For further background on the other recent changes to the Code, see "Reform of the UK Takeover Code: The End of the Affair," the *Debevoise & Plimpton Private Equity Report*, Fall 2010, and "Dealmaking in the UK Has Gotten Tougher: Impact of Takeover Reform" and "More on the UK Takeovers Code: Increased Debt Financing Disclosure," the *Debevoise & Plimpton Private Equity Report,* Winter 2012.

While the proposed changes to the Code have broad consequences for deal activity in the UK generally, the key points to note for U.S. private equity bidders under these consultation papers published by the UK Takeover Panel are summarized below. ■

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Increased Rights for Trustees of Defined Benefit Pension Schemes	• Trustees of defined benefit pension schemes would be given rights similar to those currently enjoyed by trade unions to provide an opinion on the proposed transaction and have it included in the offer document. • Bidders would be required to disclose their intentions regarding future pension provisions for employees in the offer document and would be expected to honor these commitments for at least 12 months following closing. • Funding arrangements (*e.g.*, in relation to funding shortfalls in a defined benefit scheme) would need to be disclosed by bidders in the offer document; currently these details are not required to be disclosed.
Increase in Number of Public Companies Subject to the Code	• AIM-listed companies which are managed outside the UK, Channel Islands or Isle of Man would become subject to the Code for the first time.
Increased Disclosure in Relation to Profit Forecasts and Merger Benefit Statements	• Strict reporting requirements in relation to profit forecasts would continue with some updating; the party making the forecast would continue to need a supporting report from its accountants and financial advisers. • Merger benefit statements which quantify the financial benefits of the transaction would now be subject to the same reporting requirements as profit forecasts plus enhanced requirements to disclose the basis on which such estimates were made.
Expanded Obligation to Update Material Changes to Published Information	• Under the current Code regime, there is no requirement for unlisted bidders to announce changes to previously published information until the next public document is released (although the target may have independent announcement obligations under the UK Listing Rules or AIM Rules). • New proposals in the consultation papers introduce stand-alone announcement obligations on all parties — including unlisted bidders—to announce material changes to published information as soon as they materialize.

ALERT

Non-EU Hedge and PE Firms Would Be Banned From Marketing to German Investors Under Proposed Legislation

The German Ministry of Finance recently released a discussion draft of legislation to implement the EU's Alternative Investment Funds Managers (AIFM) Directive in Germany. The proposed legislation would eliminate the existing German private placement regime under which foreign private equity, hedge fund and other alternative investment firms currently market their funds to professional investors in Germany. The proposed legislation would replace the current marketing rules with a new set of rules that include conditions on non-EU alternative asset managers that extend far beyond the uniform provisions in the AIFM Directive. We are working with private equity industry trade associations and clients to urge the German Ministry of Finance to retain the current private placement regime—or at a minimum to eliminate the most draconian and onerous of the newly-proposed rules. This effort has included drafting letters to the German Ministry of Finance and to U.S. regulators.

Of greatest concern to many U.S., Asian and other non-EU alternative investment firms, the legislation as currently drafted prohibits them from marketing their private equity, hedge and other alternative investment funds to professional investors in Germany unless (1) the alternative investment firm (the fund manager) and the funds that it manages are subject to public supervision (regulation/registration) in the same jurisdiction, and (2) the private equity firm and the funds that it manages are located in the same country. However, in the United States, for example, only the firm, and not its funds, are registered under the Investment Advisers Act of 1940, so most U.S. firms could not satisfy condition (1) above. Also, many funds are organized in jurisdictions (*e.g.*, the Cayman Islands) other than the jurisdiction (such as the U.S., Hong Kong or Singapore) where the firm (the fund manager) is organized, so many firms could not satisfy condition (2) above either. As a result, the draft legislation would effectively ban U.S. and many other non-EU alternative investment firms from marketing their funds to investors in Germany.

As noted above, we have helped trade associations and individual firms raise these concerns with the appropriate regulators. While it is too early to predict how the draft German legislation will evolve, early signs are promising and we are hopeful that the most onerous provisions will be revised. If the legislation is not substantially changed, it will pose serious market access and compliance problems for our U.S. and other non-EU clients, as well as for German investors wishing to invest in funds managed by those firms. We will continue to monitor the situation. ■

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New IRS Rules MakeTaxable COD Income More Likely in Debt Modifications and Restructurings

During the course of the financial crisis, many private equity professionals learned a bitter tax lesson—if the terms of a debt instrument are modified while the debt is considered "traded on an established market" for tax purposes, the issuer of the debt can have immediate taxable income if (and to the extent that) the face amount of the debt exceeds its trading price. Many fortunate taxpayers were able to escape large tax bills by concluding that the debt instrument being modified did not meet the tax law's definition of "traded on an established market."

Last month the IRS changed the applicable rules so that going forward pretty much every debt instrument (including bank debt) held by unrelated parties will be considered to be "traded on an established market" (unless the principal amount of the debt does not exceed $100 million). These changes are likely to cause more companies to recognize "cancellation of indebtedness income" ("COD income") when restructuring (or even modifying) their debt outside of bankruptcy. Further, these changes make it more likely that taxpayers will recognize COD income when a bridge loan is exchanged for more permanent financing.

Some Background

If a taxpayer satisfies a debt instrument for an amount less than the "adjusted issue price" of the debt, the taxpayer has COD income equal to the difference. When the debt is satisfied with cash, the calculation is easy. For example, if a taxpayer satisfies $100 of debt with $80 of cash, the taxpayer has $20 of COD income.

When debt is satisfied with property other than cash (including the issuance of another debt instrument), the analysis is more difficult because the value of the property must be determined. Years ago, Congress adopted a simplifying convention that was designed to avoid valuation disputes: If the debt being satisfied or the property being used to satisfy the debt is "traded on an established market," the tax law will generally treat the debt as having been satisfied for an amount equal to the trading price. However, if neither the debt nor the property is "traded on an established market," the tax law will generally treat the debt as having been satisfied for an amount equal to its face amount.

Suppose, for example, that a taxpayer has $100 of outstanding debt that is trading at $80 on an established market. If the debt instrument is exchanged for a "new" debt instrument with a $100 face amount, the "old" debt will be generally treated as having been satisfied for $80 (meaning the issuer will have $20 of COD income) and the new debt will generally be treated as having been issued for $80 (meaning there will be $20 of OID on the new debt instrument). While the OID on the new debt instrument will generally match the COD income, the deductions for the OID may be deferred or disallowed under the so-called AHYDO rules if the yield exceeds the "applicable federal rate" plus 500 basis points.

If neither the "old" debt nor the "new" debt is traded on an established market, the tax law will generally treat the old debt as having been satisfied for an amount equal to the face amount of the new debt (which, assuming the same face amount, would typically mean that the issuer has no COD income as a result of the exchange and that there would be no OID on the new debt).

If there is a "modification" to the terms of a debt instrument and the modification is considered economically significant, the debt instrument will be treated for tax purposes (including the COD income and OID rules described above) as having been satisfied in exchange for a new debt instrument. Suppose, for example, that a significant modification is made to a $100 debt instrument. The tax law would deem there to be an exchange of the "old" (pre-modification) debt instrument for a new (post-modification) debt instrument. If the debt was trading for $80 on an established market, the issuer would generally have $20 of COD as a result of the deemed exchange and the "new debt" would generally have $20 of OID (possibly subject to the AHYDO rules). By contrast, if the debt were not traded on an established market, the "old debt instrument" would generally be treated as having been satisfied for $100 (meaning no COD income) and the new debt instrument would be treated as having been issued $100 (meaning no OID).

Various types of changes to the terms of a debt instrument can create a deemed exchange of the debt instrument, including even modest changes to the timing or amount of any payments and changes to the collateral or priority of the debt instrument.

The New Definition of "Traded on an Established Market"

Under the new regulations, debt will be treated as traded on an established market if, within an applicable time period, there

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New IRS Rules MakeTaxable COD Income More Likely (cont. from page 19)

is either a sales price for the debt or there is a quote (either firm or indicative) available from at least one broker, dealer, or pricing service. The applicable time period for which a sales price or quote must occur is any time during the 31-day period ending 15 days after the issue date. In the event there is more than one sales price or quote, the issuer may use any reasonable method to determine the fair market value of the debt and must consistently apply such method in similar circumstances.

The IRS has not defined the term "available" for these purposes. However, if calling one banker and receiving a quote counts as "available," then virtually all debt is likely to be treated as traded on an established market.

Under the new regulations, the issuer is expressly required to determine whether a debt instrument (or other property) is traded on an established market and, if so, the fair market value. Further, if the issuer determines that a debt instrument is traded on an established market, the issuer is required to make that determination (as well as the issuer's fair market value determination) available to the holders of the debt instrument in a commercially reasonable fashion within 90 days. The regulations also generally require that the issuer and the holders report the issue price consistently on their tax returns.

The new rules for determining when debt is treated as traded on an established market apply to debt instruments issued on or after November 13, 2012. However, the new regulations do not apply to any issuance of debt if the outstanding stated principal amount of the debt does not exceed $100 million at the time the determination is made. ■

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Continued Use of Private Equity Technology (cont. from page 1)

methodical look back at how the market for financed strategic transactions has evolved since then. We surveyed publicly available, leveraged strategic deals involving U.S. targets that were announced between January 2009 and June 2012, had a transaction value of at least $300 million and provided for payment of an RTF (28 transactions met these criteria). The chart on pages 22-23 highlights some of the key financing-related terms in these agreements.

Back in 2009, some observers had predicted that the use of RTFs by strategics to reduce their financing risk was simply a short term product of the extreme paralysis in the financing markets during that period and would disappear once the financing markets rebounded. However, the results of our study have confirmed our own experience over the past few years—that the convergence was not an isolated development. Rather, the emerging trend we highlighted back in 2009 did in fact represent the beginning of a movement towards a greater use by strategic buyers of private equity technology. The consequence for private equity firms is that they are now, in many cases, on more equal footing with strategic buyers when competing for assets.

Background

In the three-year period leading up to the financial meltdown in 2008, financial sponsors and strategic buyers utilized different structures to allocate the financing risk inherent in leveraged transactions:

- In strategic acquisitions, the buyer would effectively bear all of the financing risk, with the acquisition agreement (1) containing no financing condition, (2) providing the seller with unrestricted rights to specifically enforce the buyer's obligation to close (even if the contemplated debt financing was not available at the time of the required closing) and (3) providing the seller with the ability to sue for uncapped monetary damages in the event that the buyer failed to close when required.
- In the typical financial sponsor transaction, the acquisition agreement would include an RTF structure with the following key characteristics: (1) a requirement that the debt financing be available prior to the seller being able to force the buyer to close (or, in many cases, no ability for the seller to specifically enforce buyer's obligation whatsoever (known as the "pure option" formulation)) and (2) a fixed RTF (often in the range of 3% to 4% of the purchase price) payable in the event of the buyer's failure to close when required or other significant breach, which payment would generally serve as the seller's sole monetary recourse against the buyer.[2]

Unlike the strategic model, the private equity formulation provided (and continues to provide in today's market) the buyer with the comfort of knowing up front what its maximum monetary exposure would be if the anticipated financing were not available at closing. Private equity buyers have also been able to limit the specific performance remedy to situations where the debt is available, so that a buyer does not have to worry that it will be forced to close with all equity in the event of a financing failure. The combination of these two features results in a sharing of the financing risk with the seller.

Prevalence of RTF Structures in Strategic Deals

The chart below shows the number and approximate percentage of all publicly available, leveraged transactions involving U.S. targets and strategic buyers with a transaction value of at least $300 million during the period from 2009 to June 30, 2012 that contained RTF structures (according to the Practical Law Company's surveys).

The general downward trend in the percentage of deals including RTF structures from roughly half in 2009 to between one quarter and one third today indicates that the strategic deal market is not moving towards a widespread and complete adoption of the private equity RTF model. However, the number of strategic deals that have continued to utilize RTF structures is not insignificant, illustrating that such a structure is a viable option for strategic buyers that are unwilling to bear all of the financing risk. We think this trend benefits private equity buyers to some extent, both by beginning to level the playing field in auctions and by further conditioning sellers to more of a risk sharing model.

It is worth noting that almost one-third of the transactions we surveyed involved a portfolio company buyer in

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Year	Number of Transactions	Percentage of Applicable Deals with RTF Structure
2009	6	50%
2010	7	28%
2011	10	22%
2012 (through June)	5	36%

2 *The average size of RTFs as a percentage of purchase price has increased since 2009, with current private equity RTFs generally ranging between 5% and 7% of purchase price.*

Continued Use of Private Equity Technology in Acquistions (cont. from page 21)

Summary Of Certain Financing and Remedies Provisions In Select Strategic Transactions[6]

Transaction	Equity Value	RTF as % of Equity Value (and Absolute Amount)	Monetary Recourse Beyond RTF	Cap on Damages	Specific Performance to Force Closing[7]	Buyer Required to Sue Lenders?
WBG – PSS Holdings' acquisition of **Collective Brands**; May 1, 2012	$2B	4.2% ($84M)	No	N/A	Conditional	Not Explicitly Addressed
Hologic's acquisition of **Gen-Probe Incorporated**; April 29, 2012	$3.7B	5.4% ($200M)	Yes	Uncapped	Conditional	No
WideOpenWest Finance's acquisition of **Knology**; April 18, 2012	$1.5B	4.3% ($65M)	No	N/A	Conditional	Yes
SXC Health Solutions' acquisition of **Catalyst Health Solutions**; April 17, 2012	$4.4B	6.4% ($281.5M)	Yes	Uncapped	Full	Yes
Zayo Group's acquisition of **AboveNet**; March 18, 2012	$2.2B	4.6% ($100M)	Yes	Amount of RTF	Conditional	Yes
Opal Holdings' acquisition of **Winn-Dixie Stores**; December 16, 2011	$560M	13% ($72.9M)	Yes	Amount of RTF	Conditional	Not Explicitly Addressed
United Rentals' acquisition of **RSC Holdings**; December 15, 2011	$4.2B	2.6% ($107.5M)	Yes	Uncapped	Conditional	No
Metropolitan Health Networks' acquisition of **Continucare Corporation**; June 26, 2011	$416M	2.88%, up to 3.25% ($12M, plus expenses up to $1.5M)	No	N/A	Conditional	Not Explicitly Addressed
GCS Software Holdings' acquisition of **Lawson Software**; April 26, 2011	$2B	5.8% ($115M)	Yes	Amount of RTF	Conditional	Not Explicitly Addressed
Monex Group's acquisition of **Tradestation Group**; April 20, 2011	$411M	Expenses up to 0.36% ($1.5M)	Yes	Uncapped	Full	No
Rightmark Holdings Limited's acquisition of **China Security & Surveillance Technology**; April 20, 2011	$581M	3.4% ($20M)	Yes	Uncapped	Full	Not Explicitly Addressed
Level 3 Communications' acquisition of **Global Crossing**; April 10, 2011	$3B	2.3%, increased to 4.0% for willful breach ($70M/$120M)	Yes	Uncapped	Conditional	Yes

6 *Publicly available strategic U.S. deals announced between January 2009 and June 2012 having a transaction value of at least $300 million and providing for payment of an RTF in the event of a financing failure.*

7 *"Full" specific performance grants the seller unconditional specific performance rights to force the buyer to close in the event of a financing failure. "Conditional" specific performance requires the satisfaction of certain conditions customary in private equity deals (e.g., availability of the debt financing and a confirmation from the seller that is able and willing to consummate the sale) for the seller to be able to specifically enforce the buyer's obligation to close.*

8 *RTF decreased to $57.5M (2.4% of EV) if the sole reason for Buyer's failure to close was the Company's failure to have $175M in cash on hand at closing.*

9 *Amount of RTF is decreased by 50% of certain specified financing expenses that Buyer is required to pay; additionally, in the case of a financing source's "willful and material breach" of its obligations under the commitment letter, the $70M RTF is increased by any amount recovered by Buyer against the financing sources in excess $70M up to a maximum RTF of $120M.*

Continued Use of Private Equity Technology in Acquistions (cont. from page 22)

Summary Of Certain Financing and Remedies Provisions In Select Strategic Transactions

Transaction	Equity Value	RTF as % of Equity Value (and Absolute Amount)	Monetary Recourse Beyond RTF	Cap on Damages	Specific Performance to Force Closing[7]	Buyer Required to Sue Lenders?
Cumulus Media's acquisition of **Citadel Broadcasting Corporation**; March 9, 2011	$2.5B	2.4%, increased to 3.2% for willful breach ($60M/$80M)	No	N/A, but agreement explicitly includes a cap at amount of RTF	None, but conditional specific performance to force equity funding	Yes
Kindred Healthcare's acquisition of **RehabCare Group**; February 7, 2011	$1.3B	4.8% ($62M)	Yes	Uncapped	Conditional	Yes
Alpha Natural Resources' acquisition of **Massey Energy Company**; January 28, 2011	$8.5B	4.2% ($360M)	Yes	Uncapped	Conditional	Not Explicitly Addressed
AGL Resources' acquisition of **Nicor**; December 6, 2010	$3.1B	3.7% ($115M)	Yes	Uncapped	Full (but Buyer may terminate in the event of a financing failure not resulting from Buyer's breach)	Not Explicitly Addressed
Attachmate Corp.'s acquisition of **Novell**; November 21, 2010	$2.2B	5.5% ($120M)	No	N/A, but agreement explicitly includes a cap at amount of RTF	Conditional	Yes
Reynolds Group Holdings Limited's acquisition of **Pactiv Corporation**; August 16, 2010	$6B	4.2%, increased to 8.4% for willful breach ($250M/500M)	No	N/A	Conditional	Not Explicitly Addressed
Genco Distribution System's acquisition of **ATC Technology Corporation**; July 18, 2010	$513M	Expenses of 0.39% ($2M)	Yes	Uncapped	Conditional	Not Explicitly Addressed
Aon Corporation's acquisition of **Hewitt Associates**,; July 11, 2010	$4.9B	4.6% ($225M)	Yes	Uncapped	Conditional	Not Explicitly Addressed
Grifols' acquisition of **Talecris Biotherapeutic Holdings Corp.**; June 6, 2010	$4B	9.4% ($375M)	Yes	Uncapped (but breaches that could trigger RTF are capped at amount of RTF)	Conditional	Yes
MSCI's acquisition of **RiskMetrics Group**; February 28, 2010	$1.6B	6.25% ($100M)	Yes	Uncapped	Conditional	Yes
JDA Software Group's acquisition of **i2 Technologies**; November 4, 2009	$396M	7.6% ($30M)	Yes	Uncapped	Full	No
Denbury Resources' acquisition of **Encore Acquisition Company**; October 31, 2009	$4.5B	6.7% ($300M)	Yes	Uncapped	Conditional	Not Explicitly Addressed
Xerox Corporation's acquisition of **Affiliated Computer Services**; September 27, 2009	$6.4B	5.1% ($323M)	Yes	Uncapped	Conditional	Yes
Merck & Co.'s acquisition of **Schering-Plough Corporation**; March 9, 2009	$41.1B	6.1% ($2.5B)	Yes	Uncapped	Conditional	Yes
Pfizer's acquisition of **Wyeth**; January 26, 2009	$68B	6.6% ($4.5B)	Yes	Uncapped	Conditional	Yes
Autonomy Corporation's acquisition of **Interwoven**; January 22, 2009	$775M	3.2% ($25M)	Yes	Uncapped	Full	Yes

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which a financial sponsor committed to provide additional equity financing in connection with the add-on acquisition. It is, of course, not surprising that companies controlled by financial sponsors, who are providing equity, would have more success negotiating for the inclusion of an RTF structure given the hybrid nature of portfolio company acquisitions and the sponsors' familiarity with the RTF model.

The other point worth making is that it seems, at least anecdotally, that RTF structures are more likely to be found in transactions where there is meaningful financing risk and where the buyer has a good argument for why the seller should bear some of the risk. For example, you are more apt to see this structure in a deal where there is significant leverage or where the target company represents a meaningful component of the overall credit underlying the financing. In these circumstances, a seller may be willing to share more of the risk since the financial performance and prospects of the company it is selling has a larger impact on the availability of the financing. Conversely, if a large, investment grade public company is acquiring a relatively small target, there is less financing risk to be shared (and less justification for sharing it) because the buyer may have numerous potential sources of financing, including issuing debt or equity securities at the parent company level or drawing down on an existing facility. The availability of financing in that case depends more on the creditworthiness and overall performance of the buyer, not the target.

In comparison to the typical private equity formulation, the RTF provisions in most of these agreements do not provide the strategic buyer with the same level of comfort with respect to monetary exposure that financial sponsors are accustomed to receiving in their acquisition agreements.

Strategic Deal RTF Terms

Amount of RTF

The average size of the RTFs in our study was approximately 5% of the equity value of the target, which is a bit lower than the average private equity RTF during the same period, likely reflecting the stronger alternative remedies available to the seller in most leveraged strategic deals (*e.g.*, monetary damages for willful breach, often uncapped) and the relatively lower financing risk in most strategic acquisitions. Three of the transactions included a two-tier RTF structure, with one fee payable in the event of a true financing failure through no fault of the buyer and a higher fee payable in the event of a willful breach by the buyer.[3]

Monetary Recourse

The 28 acquisition agreements we reviewed fall into three categories in terms of monetary recourse:

- Only six agreements (including two of the three two-tier RTF deals) provided that the RTF was the sole and exclusive monetary remedy (*i.e.*, the seller had no ability to recover any monetary damages other than the RTF even for willful breach);
- Eighteen agreements provided that the RTF was the sole and exclusive remedy, except in limited circumstances where the RTF is not payable and the seller can then sue for damages for "willful breach" (capped at the amount of the RTF in four of the agreements, but uncapped in the other fourteen); and
- The remaining four agreements allowed the seller to choose whether to accept payment of the RTF or sue for willful breach with uncapped damages.

In comparison to the typical private equity formulation, the RTF provisions in most of these agreements do not provide the strategic buyer with the same level of comfort with respect to monetary exposure that financial sponsors are accustomed to receiving in their acquisition agreements. Although we are aware of a few private equity deals in which damages beyond the RTF are permitted for willful breach, the vast majority cap exposure at the amount of the RTF.

Specific Performance

Only 5 of the 28 acquisition agreements permitted the seller full and unconditional specific performance remedies to force the buyer to close in the event of a financing failure. The vast majority of agreements (22 of 28) first required satisfaction of certain conditions that have become customary in private equity deals (*e.g.*, availability

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[3] *The average size of the lower-tier fee was approximately 3% of the equity value, while the average size of the upper-tier fee was approximately 5.2% of the equity value.*

Continued Use of Private Equity Technology in Acquistions (cont. from page 24)

of the debt financing and confirmation from the seller that it stands ready to close. One agreement allowed specific performance of certain specified buyer obligations (*e.g.*, the use of reasonable efforts to obtain the financing), but interestingly did not permit the seller to force the buyer to actually close the transaction.

Requirement to Sue Lenders

Of the 28 acquisition agreements, 13 explicitly required the buyer to go as far as suing its lenders as part of its obligation to use reasonable efforts to obtain the financing, while four agreements explicitly provided that the buyer would not be forced to sue its lenders. The remaining 11 agreements did not expressly address the issue one way or the other.

Conclusion

Financial sponsors competing with strategic buyers in an auction should be aware that the large majority of them are still willing to accept the entire financing risk and thus will be providing greater deal certainty to the seller. However, the current market provides support for the use of an RTF structure in a strategic acquisition if the buyer has significant negotiating leverage or if otherwise warranted in light of the deal dynamics. Additionally, the strength of the debt markets and other factors relating to the certainty of the financing could affect the appropriateness of an RTF structure in a particular transaction.

It will be interesting to see where the market settles out over the next few years, both in the strategic and private equity arenas. Will the majority of strategic buyers continue to bear most, if not all, of the financing risk in leveraged transactions? Will there be a significant increase or decrease in the number of strategic transactions that borrow the private equity RTF framework? Will there be further convergence of terms? Our view is that terms relating to the allocation of financing risk—in both the private equity and strategic markets—are unlikely to remain static and will instead continue to evolve through active and focused negotiation. ■

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Impact of Health Care Reform on Employers: Two Years In (cont. from page 4)

because of normal course changes at the portfolio company. However, not all modifications to plans will cause them to lose their grandfathered status.

Consequently, sponsors should take care in understanding whether plans are grandfathered and what the costs associated with loss of grandfathered status may be, as the costs of losing that status would be incremental to the cost of the contemplated plan changes.

In our experience, nearly all employers affected by health care reform have already undertaken studies of the costs of health care reform and available alternatives, either by management or by third party experts. Thus, most targets and portfolio companies are able to speak knowledgably about the potential changes to their businesses now, even though full effectiveness of the matters described in this article is over a year away. Some employers are making only the minimum required changes to their plans, and are putting off any large-scale planning until after the presidential election, although the rationale for waiting is now weaker in light of the recent Supreme Court decision upholding PPACA. For a private equity buyer, paying attention to these lurking costs now is a necessary feature of any diligence process and the related development of the investment case for the acquisition. Private equity sellers should also plan on potential acquirers doing the same with respect to their current portfolio companies. ■

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The Evolution of Private Equity Investment in China (cont. from page 6)

mechanism in the purchase agreement previously approved by MOFCOM. The use of a confirmation letter, rather than an approval letter, allows the transaction to proceed without obtaining a second approval from MOFCOM—as noted above, MOFCOM may only issue one approval per transaction. The parties could then use that confirmation letter to apply to SAFE for permission to remit additional foreign currency to cover the price adjustment payment. As far as we are aware, this approach has not been implemented in any transaction. Also, it is important to note that the position of MOFCOM officials may vary from locality to locality or even from one official to another. But with careful planning, it may be a workable option for overcoming these obstacles.

IPO

A viable path to a successful exit is obviously critical for private equity investors, and many times the preferred exit is an IPO. For a financial investor that owns a controlling stake in a Chinese onshore company, there are three possible routes to an IPO, each presenting its own challenges.

One route is to list the offshore investment vehicle that made the investment in the Chinese company on an overseas stock exchange, such as the New York Stock Exchange ("NYSE") or the Hong Kong Exchange and Clearing Limited ("HKEX"). This route would not require Chinese government approval. However, marketing such an IPO may be difficult if the foreign investor has a Chinese minority partner in the investment, because a Chinese partner will have considerable difficulty under applicable Chinese law flipping its interest in the onshore Chinese entity into the IPO vehicle. Therefore, the onshore Chinese entity, which would be the only asset of the IPO vehicle, would likely have to be partially owned by the Chinese partner. The existence of the downstream investor could create "noise" that might impair the success of the IPO. In addition, a Chinese partner would likely resist such an arrangement, because it would have difficulty obtaining liquidity under such a structure.

A second route would be to conduct an IPO and listing of the onshore Chinese company at an overseas stock exchange, such as NYSE (commonly referred to on the market as an "N Share Listing") or HKEX (an "H Share Listing"). Unlike the path described above, approval from the China Securities Regulatory Commission ("CSRC") would be required for an IPO following this route, and CSRC has typically granted approvals only to large Chinese state controlled companies.[4] In fact, CSRC so far has not approved any foreign controlled Chinese company to conduct an IPO following this second route. Moreover, shares owned by Chinese minority shareholders are not permitted to be listed and traded on an overseas stock exchange, so this route would not provide liquidity to Chinese minority shareholders.

A third avenue is to pursue a domestic IPO and listing on one of China's Shanghai or Shenzhen Stock Exchanges (commonly referred to as an "A Share" offering). This route requires CSRC approval and, based a review of companies that have been approved by CSRC to conduct IPOs since 2010, it appears that no approvals have been granted to companies controlled by private equity investors. A possible explanation for this is rooted in the Chinese regulators' bias in favor of continuity of control of IPO candidates, which is viewed as supporting the consistency and sustainability of the issuer's business and operations. In China, the controlling stockholder of an IPO candidate cannot have changed during the three-year period leading up to the IPO (two years for an IPO and listing on the Growth Enterprise Board of the Shenzhen Stock Exchange) and cannot change for another three years after the IPO. CSRC's reluctance to approve private equity-controlled companies for listing may reflect a view that financial investors are likely to run for the exit once the three-year lock up period has expired. Therefore, convincing the CSRC to rely on continuity in senior management, as opposed to ownership, may be necessary to pave the way for domestic IPOs by private equity-controlled companies.

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Purchase price adjustments are a common feature in U.S. private equity M&A....In an acquisition of a Chinese company in an "onshore" deal, however, there are considerable obstacles to utilizing this mechanic.

[4] *In fact, there is an unwritten rule informally enforced by CSRC that the minimum capital to be raised by the issuer through an H share IPO and listing shall be no less than US$1 billion. A senior CSRC official, however, stated at the beginning of 2012 that CSRC is planning to lower the thresholds for private-owned Chinese companies to pursue an overseas IPO and listing.*

The Evolution of Private Equity Investment in China (cont. from page 26)

Conclusion

China is an increasingly important jurisdiction in the global M&A market, but it also presents many unique challenges. As more Chinese businesses become available for sale, the ability to identify and work creatively to meet these challenges will be key to developing and implementing a successful investment strategy. Many of the tools in the U.S. M&A professional's toolkit will be useful in that effort, but not all of them will translate seemlessly. ■

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Chinese Private Equity Opens Up to Chinese Insurers (cont. from page 8)

Chinese insurance company money may not be invested in "start-up, venture" funds, or in fund sponsors.

Approved securities. The types of securities in which RMB funds with Chinese insurance company investors may invest are also regulated. Prior to the 2012 Notice, under the Temporary Rules a Chinese insurance company was permitted to invest, directly or indirectly through qualified RMB funds, only in the equity of non-public (unlisted) companies. The 2012 Notice, however, expanded the types of permitted investments so that, today, Chinese insurance money also may be invested in RMB funds (with buyout strategies) that have the ability to invest not only in unlisted companies, but also in shares of listed companies; however, these investments in shares of listed companies may only be made in certain ways that generally do not constitute "trading." It is not clear whether RMB funds that have Chinese insurance company investors may invest in debt or debt-like securities issued by Chinese companies.

Requirement regarding target portfolio companies. Finally, the CIRC has authority to restrict the types of portfolio companies in which RMB funds with Chinese insurance company investors may invest. Thus far, in general, the main requirement in this respect seems to be that target portfolio companies should have the potential to generate favorable returns to the insurance company investors. This vague standard could be clarified, and additional requirements could be imposed, by the CIRC in the future.

General Private Equity and Fund-Specific Investment

A Chinese insurance company may invest up to 10% (but not more than 10%) of its total assets, calculated as of the most recent quarter-end, in private equity, including direct investments and investments in RMB funds. The rules do not specify what happens if, at any point in time, a Chinese insurance company's investment exceeds this 10% limitation due to, for example, a reduction in the value of the company's non-private equity assets.

Furthermore a Chinese insurance company's investment in any single RMB fund may not exceed 20% of the "total size" of such fund; and if the insurance company is an insurance holding company, the aggregate investments made by the such holding company and its insurance subsidiaries may not exceed 60% of the "total size" of the fund. It is not clear under the rules whether the term "total size" refers to capital commitments, invested capital or some other test.

Reporting Requirements; Inspection

After making an investment in an RMB fund and during the term of the investment, a Chinese insurance company is required to provide certain information (including periodic reports) to the CIRC, and the fund sponsor also is required to submit an annual report concerning the fund to the CIRC. However, these reporting requirements are vague, and it is difficult to be certain how much

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Chinese insurance companies are not yet expressly permitted to invest in offshore private equity funds. However, it has been reported in recent months that the CIRC is likely to issue more detailed rules on offshore investments that will broaden the scope of permitted investment, and that this permitted investment might include investments in certain qualified offshore private equity funds.

Chinese Private Equity Opens Up to Chinese Insurers (cont. from page 27)

information must be reported to the CIRC. These reporting obligations—as well as other regulatory requirements, such as investment restrictions concerning a fund's investment scope and objectives—typically will be requested by Chinese insurance investors to be reflected in the relevant subscription, partnership or other investment agreements or in side letters between the insurance company investor and the RMB fund.

The CIRC has the authority to inspect each RMB fund in which a Chinese insurance company has invested and may impose penalties on non-complying fund managers. Such a penalty could include adding a non-complying fund manager to a "black list" of fund managers with whom insurance companies are prohibited from doing business. It is not clear in practice how these inspections will be carried out. Similarly, the full extent of the penalties that might be imposed for non-compliance also is not clear.

Other Types of Permitted Investments

Real estate funds. Under Chinese insurance regulations, Chinese insurance companies are allowed to invest in real estate and "real estate-related financial products." The definition of "real estate financial products," together with other rules issued by the CIRC (including the Temporary Rules and the 2012 Notice), seem to suggest that Chinese insurance companies should be able to invest in real estate funds. However, we are not aware of any specific case where a Chinese insurance company has received CIRC approval to invest in a real estate fund, although this could be due to the unsettled state of the relevant regulations, as well as the recent tight government control of the Chinese real estate industry in general.

Offshore funds. The CIRC has issued separate regulations concerning offshore investments by Chinese insurance companies. (An investment in an offshore private equity fund typically would be considered an "offshore investment" even if the fund invests in China.) Since August 2010, Chinese insurance companies have been permitted to make certain types of offshore investments, such as investments in money market instruments, fixed income products and certain equity products in developed offshore markets as part of the "Qualified Domestic Institutional Investors" scheme.

Chinese insurance companies are not yet expressly permitted to invest in offshore private equity funds. However, it has been reported in recent months that the CIRC is likely to issue more detailed rules on offshore investments that will broaden the scope of permitted investment, and that this permitted investment might include investments in certain qualified offshore private equity funds. And in fact, just as this issue of the *Private Equity Report* went to press, we learned that the CIRC is likely to issue regulations shortly concerning investment by Chinese insurance companies in qualified offshore private equity funds. We will report on these developments in the next issue.

Asset managers. Lastly, Chinese insurance companies may outsource their investment management functions to specialized asset managers. The CIRC has issued separate rules concerning such asset management arrangements. Based on publicly available reports, a number of major Chinese insurance companies have set up their own asset management divisions. Will third-party asset managers be able to take over a large share of the market or will insurance companies' asset management subsidiaries dominate the market? It is difficult at this time to predict in which direction the market will move.

* * *

The 2012 Notice and the recent Filing Guidance from the CIRC have provided much needed and long-awaited rulemaking and clarification concerning investment by Chinese insurance companies in RMB funds. However, the rules are still vague in a number of respects. Many important questions remain unanswered. We will continue to monitor development in this exciting and quickly changing market. ■

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The Many Shades of Co-Investing (cont. from page 12)

therefore, likely to take the position that a sponsor should not be able to alter those agreements without co-investor input (again, typically on the basis of a majority of the securities held by all co-investors). A sponsor will typically seek carve-outs to such restrictions to the extent any alteration does not materially or, alternatively, materially and disproportionately, impact co-investors (sometimes as compared to the lead sponsor only) and other carve-outs that allow it to implement other specific transactions otherwise permitted by the co-investor agreements, such as raising distressed capital, taking a target public or effecting a sale or liquidation of the target.

- *Affiliate Transactions.* Co-investors often worry that affiliate transactions can represent an open "back-door" opportunity for sponsors to extract value from the target without sharing it with co-investors, whether it is through preferential consulting or management arrangements, lending, transactions between the underlying target, on the one hand, and a separate entity owned by the lead sponsor, on the other hand, or by other means. Accordingly, broadly speaking, co-investors often take the position that all affiliate transactions should be subject to minority consent (again, typically on the basis of a majority of the securities held by all co-investors). Many lead investors are quite resistant to any such restrictions, however, whereas others may consider accepting such a limitation subject to carve-outs for pre-agreed consulting arrangements, transactions conducted in the ordinary course of business, consistent with past practice, or transactions on arms'-length terms (established in a variety of different ways on a deal-by-deal basis).
- *Creating Exit Incentives.* Co-investors will typically have little, if any, control over exit opportunities, but will seek to maintain economic alignment by including low-threshold or no-threshold tag-along rights and piggy-back rights in the investor agreement. Conversely, lead sponsors will also seek low-threshold or no-threshold drag-along rights, IPO rights and other orderly sale provisions in their favor. Exit provisions typically also stipulate the type(s) and mix of consideration acceptable to co-investors as well as negotiated limitations on warranties, indemnities and exit cost-sharing. Lead investors and co-investors sometimes have differing views as to what type of exit event should lead to the termination of the rights of the co-investors under the governance arrangements, with sponsors typically seeking earlier sunset triggers (*e.g.*, any IPO of any kind) and co-investors often wanting to preserve their negotiated investor rights (or at least a sub-set of them) until a more complete exit by the sponsor.
- *Most Favored Nation.* In a co-investment that is structured as a sponsor-controlled limited partnership, co-investors often have more circumscribed options to maintain alignment with the sponsor. Co-investors in such an indirect structure can still seek to achieve the same kinds of controls outlined in the bullets above, albeit this is generally through limited partner consents for certain actions to be taken by the general partner. But, because a limited partnership agreement can be modified by individual side letters between the general partner and specific limited partners that may not be known to other limited partners (in contrast to a shareholders agreement, which is typically visible to all shareholders), one of the key provisions to ensure desirable and predictable outcomes of negotiations on fundamental governance and economic points is a "Most Favored Nation" clause. As with structuring, the type of MFN agreed upon can have a significant impact on outcomes. Some sponsors favor a

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Given the varying shades of these types of co-investment deals, the tactical approach to negotiations of them can be as important as the inherent negotiating leverage and substantive precedents of the various parties. This is particularly true given the typical negotiating dynamic, in which the relationships between a sponsor and co-investors are usually multi-dimensional and not limited to simply a one-off co-investment transaction and each co-investor negotiates the co-investor related arrangements with the lead sponsor separately.

The Many Shades of Co-Investing(cont. from page 29)

“commitment based” approach (*i.e.*, the rights offered to co-investors vary based on the level of their commitment) similar to what one might use in raising a main private equity fund. Co-investors tend to prefer a “rights-based” approach (*i.e.*, any preferential rights offered to one co-investor must be offered to other co-investors who have negotiated an MFN clause), though depending on appetite for control and maintaining the limited liability status, co-investors may agree to limit their MFN to rights impacting economics or other issues of particular import to them.

- *Expenses.* Although rare, and frequently resisted by lead sponsors, some co-investors invoke the alignment of economic interests principle to seek reimbursement of expenses incurred in connection with the initial investment, add-on investments and/or exit transactions to the same extent the sponsor’s expenses are reimbursed, or alternatively, agreement that each party bear its own expenses.
- *Reporting Obligations.* A co-investor also typically ensures that it has information rights to allow it to (1) meet its tax filing requirements, (2) monitor its investment and (3) distribute information about the target’s performance impacting the co-investor’s investment to its own investors (which may require exceptions to confidentiality provisions in the governing documents).

Note also that sponsors and their advisors should carefully assess corporate law minority protections, which will vary based on entity type and jurisdiction, as these may afford co-investors greater power at critical junctures than the parties generally contemplate in the deal documents, *e.g.*, through per capita voting procedures or supermajority voting requirements.

* * *

Given the varying shades of these types of co-investment deals, the tactical approach to negotiations of them can be as important as the inherent negotiating leverage and substantive precedents of the various parties. This is particularly true given the typical negotiating dynamic, in which the relationships between a sponsor and co-investors are usually multi-dimensional and not limited to simply a one-off co-investment transaction and each co-investor negotiates the co-investor related arrangements with the lead sponsor separately. ■

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Employee Equity Repurchases Draw SEC Scrutiny (cont. from page 16)

be either a minority discount or a marketability discount, or both. It does not appear that Stiefel Labs ever made known to the employees that this discount would be applied and, to the SEC, this lack of disclosure appears to have been part of the alleged fraud. It would be advisable for portfolio companies to consider making clear to employees the discounts that will be applied in the valuation process and to so provide in the definition of "fair market value" in any relevant agreements. Reading the Stiefel Labs complaint, it appears that, if these discounts were not applied to the employees' shares, the valuation of the independent appraiser would likely have been within (or close to) the range of the five investment firms' indications of interest in 2006, albeit at the low end. Discovery in the case may ultimately show that the economic and/or governance terms of the Blackstone securities made its preferred stock materially different from the common stock held by the employees, therefore justifying a higher valuation.

Consider Using Formula Definitions. Some private equity sponsors use formula prices to define fair market value in their portfolio companies' stock incentive plans (*e.g.*, X times 12 months' trailing EBITDA). Use of a formula price should be helpful in defeating employees' claims because the employees' contractual rights in a repurchase would be determined by reference to the formula. However, formula prices raise issues of their own, including complicated tax issues if the application of the formula is waived outside of the IPO context, and so they should only be used after careful consideration of the pros and cons.

Avoid Having Private Company Stock in Qualified Plans. It appears that most of Stiefel Labs' repurchases occurred under a tax-qualified stock bonus plan, which requires that employees be provided with periodic put rights. These plans generally require broad-based employee participation, including employees with little or no sophistication as to ownership of private company stock. Consequently, Stiefel Labs' use of the qualified plan, which was surely intended to motivate employees to achieve positive company performance, also exposed Stiefel Labs to lawsuits from literally hundreds of its employees. In addition, some of the employees' claims arose under ERISA, the federal employee benefits statute, which protects plan participants by (among other things) imposing expansive fiduciary duties and disclosure obligations.

Add Valuation Issues to the Diligence Checklist. When considering new acquisitions of private companies, private equity sponsors should diligence the target's valuation and repurchase activities, particularly in light of the price to be paid for the target and with a special emphasis when the target is owned by a private equity firm. One of the hardest questions to emerge from the Stiefel Labs complaint is whether the customary method of valuing a portfolio company by reference to the financial performance against public company peers (without regard to hypothetical control premiums) is now problematic. It shouldn't be, but it is a fairly common fact pattern for a private equity buyer to pay a price above (and sometimes well above) recent valuations made by the target for compensatory purposes. If there is a risk that employees may make similar claims as those made against Stiefel Labs, that risk should be expressly allocated between the parties.

Be Aware of Conflicting Fund Valuations. Private equity sponsors should also monitor, and have a ready explanation for, any differences between valuations at the portfolio company made in connection with employee repurchases and valuations at the fund level.

For now, it is not clear how the SEC's decision to sue Stiefel Labs will turn out. While the facts alleged by the SEC seem egregious (especially the disparity between the price paid to the employees for their stock and the prices paid by Blackstone and in the ultimate sale to GSK), cogent explanations for these facts may eventually emerge during discovery and at trial. However, in light of the publicity that the case has generated, coupled with the SEC's recent announcement that it intends to focus more closely on valuations by private equity funds of their portfolio investments, private equity sponsors should expect, and actively plan for, greater scrutiny of valuation activities in the future. ■

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