DEBEVOISE & PLIMPTON

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Covering Your Assets: The Upside and Downside of Products Liability Due Diligence

Litigation due diligence has always been an important part of the acquisition process, but it has never been more critical than it is today. Multi-million dollar products liability verdicts have become routine, and plaintiffs' counsel have become increasingly well-funded, aggressive and inventive. Although asbestos, pharmaceuticals and tobacco have long been the darlings of the organized plaintiffs' bar, products liability litigation over the past several years has grown to encompass a seemingly endless list of products that includes medical devices, lead paint, tires, gasoline additives, black mold, mercury, herbicides and many others. In today's litigation environment, a private equity firm must be especially mindful of the possibility that an acquisition target that is the apple of its eye does not contain a litigation worm that will ruin the investment. Because buyout firms typically leverage acquisitions, such firms require a high degree of financial predictability on both sides of the balance sheet. Depending on the size of the target, a several-million-dollar-a-year swing in litigation-related payments can make the difference between returns that meet investment criteria and losses on the investment. The key from the buy side is fully understanding the actual or potential liability – not only the worst-case downside risk, but also the best-case upside potential.

Of course, many buyers have acquired companies with actual or potential products liability problems and been glad they did. Indeed, a target with products liability exposure may, for that reason alone, be significantly undervalued and may present an excellent investment opportunity. A target's management may have ignored the company's products liability issues, focusing exclusively on maximizing operating income at the expense of minimizing litigation-related payouts. A buyer that properly evaluates the litigation and develops a plan to manage it year over year to a predictable and acceptable financial outcome can turn a troubled target into a winning investment. In other words, products liability due diligence can be critical not only to understanding the exposure but to evaluating the overall quality of the investment, including the presence of unrealized value. But to do so, the buyout firm must become educated about the target's litigation issues to determine the scope of the problem and whether some combination of better management and sophisticated lawyering can release that unrealized value. Because a term sheet may contain terms relating to litigation risk, counsel should be consulted early in the process to prevent the inclusion of terms that will be harder to unwind or work around as the negotiation of the agreement matures.

A. What Questions Should a Private Equity Firm Ask?

The types of information that are necessary to evaluate the risk can be broken down generally into three categories: first, what is the target's litigation history, if any, with regard to the product or products at issue? It is often the case that products litigation involving multiple cases takes on a life of its own, without a tight causal relationship to the target's actual past

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letter from the editor

We extend our deepest sympathies to all of those who have been personally affected by the recent tragedies and turmoil in our world and express our concern for the personal and economic challenges that so many of our clients, friends and colleagues currently face. We are committed to helping face these challenges in whatever ways we can.

With this issue, we mark the one-year anniversary of the Debevoise & Plimpton Private Equity Report. It has been a year that has seen tremendous changes for Debevoise, including the opening of a new office in Frankfurt, Germany and our move to new offices in New York.

It has also been a year that has witnessed increasing uncertainty in world markets and challenges in the private equity fundraising and investment environments. We do believe, however, that there is still some good news in the private equity world. First of all, long-term private equity investors have not abandoned the market. In fact, this summer Yale University decided to maintain its very high allocation of assets to private equity, and Calsters recently announced that it was increasing its private equity allocation. In another boost for the private equity community, Jack Welch, former Chairman and C.E.O. of General Electric, decided to spend part of his retirement as a special limited partner in a private equity firm. In explaining his decision, Welch noted that "the biggest thing to help America in the 1980s was the fact that we had buyout firms... that gave the capital markets a chance to get rid of entrenched and uncompetitive businesses." We expect the private equity community will play a pivotal role in business development in this decade as well.

We are pleased to have George Anson, Managing Director of HarbourVest Partners (U.K.) Limited, an internationally recognized expert in European venture and buyout funds, as our guest columnist for this issue. George reminds us that, in light of the changes in business culture and increasingly pro-investment legal regimes throughout Europe, the current uncertainty in world stock markets and in Europe in particular should be considered an opportunity rather than a danger sign for private equity investment. In this issue's "Trendwatch" column, we continue our analysis of fees by focusing on what happens to director's, transaction and breakup fees received by private equity funds or their sponsors from third parties.

In the cover article, Mark Goodman, one of our Litigation partners, suggests that there may be investment opportunities for private equity firms in unlikely places. A target may be undervalued simply based on the perception of its products liability exposure. Mark also notes that careful products liability due diligence is essential in assessing actual and potential liability, especially in the face of recent multi-million dollar verdicts. In light of the events of this fall and notable changes in Delaware case law, we also offer some insight into the current importance of material adverse change provisions in acquisition agreements.

In our last issue we focused on how the FASB's elimination of pooling and changes in accounting for goodwill will effect recapitalizations as a deal structuring tool for financial sponsors. In this issue, Paul Brusiloff takes a closer look at how the end of goodwill amortization will affect financing agreement covenants of existing portfolio companies. Also in this issue, Adele Karig, of our Tax department, reports that individual investors in private equity and venture funds may be entitled to special tax benefits afforded by two rarely used provisions of the Internal Revenue Code. In addition, we analyze the legal issues concerning the enforceability of shareholder agreements and describe the considerations to keep in mind when using platform companies to implement consolidation strategies with portfolio companies.

We hope that this first year of the Debevoise & Plimpton Private Equity Report has proved a useful and informative source of practical guidance on legal issues for private equity funds and their investors.

Franci J. Blassberg
Editor-in-Chief

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Don't Forget Your MAC

Over the years, Material Adverse Change clauses – or MACs – have gotten lots of attention from participants in M&A transactions. That's because they give the buyer an important escape hatch: if there has been a MAC, the buyer can refuse to close. Not surprisingly, sellers have a strong interest in trying to keep that escape hatch as narrow as possible. Recently, because of a volatile stock market and some interesting Delaware case law, the battle over who will bear the risk of bad things happening before closing has become more intense than ever.

Meet the MAC. With a MAC clause, a selling party promises the buyer that there has been no material adverse change to the business being sold since a specified date – often the date of the business's most recent financial statements, but sometimes the date of the acquisition agreement. The absence of a MAC is frequently a condition to closing – giving the buyer the right to walk if a MAC has occurred.

Those negotiating MAC clauses tend to devote only a limited amount of firepower to arguing over what must be materially adversely affected before the buyer can walk – a typical list might include some or most of the following: the business, condition (financial or otherwise), results of operations, properties, assets, liabilities or prospects of the business and its subsidiaries, taken as a whole. The one exception is with respect to the inclusion of the word "prospects," which is often heavily negotiated. A compromise approach is to exclude the word "prospects" but to expand the MAC clause to cover not only events or occurrences that have had a material adverse effect, but also events or occurrences that are "reasonably expected to result" in a material adverse effect.

Most of the heavy artillery is reserved for arguments over exceptions to the MAC. We frequently see exceptions for material adverse changes resulting from general economic, stock market or industry conditions, not specifically attributable to or disproportionately affecting the company being sold. In M&A transactions, sellers will often propose additional exceptions, depending on the business being sold and the identity of the buyer, such as carve-outs for material adverse effects resulting from announcement of the transaction itself – such as loss of customers or employees.

Interestingly, MAC clauses have traditionally been narrower in M&A agreements than in underwriting agreements, where *force majeure* concepts are more commonplace. After the events of this autumn, we expect that exceptions for *force majeure* events, including acts of terrorism and acts of war (both declared and undeclared), will become part of the negotiation over MAC clauses in M&A agreements, especially in certain industries.

Financial sponsor acquirors often get the benefit of two MACs. Most acquisition agreements between financial sponsors and sellers of businesses have financing conditions that excuse the financial sponsor from closing if its financing is not obtained and substitute financing on substantially similar terms cannot be arranged. As a result, the MAC condition in the sponsor's financing is incorporated in the acquisition agreement, creating another MAC condition for the seller to fret about. The seller to a financial sponsor needs to understand the MAC clause contained in the sponsor's financing arrangements in order properly to evaluate the risk of non-completion. A seller may negotiate a very favorable, narrow MAC provision in an acquisition agreement, but it won't provide much practical benefit if a broader MAC clause in the seller's financing agreement prevents the seller from obtaining financing – and the buyer is thereby excused from closing.

Will I know a MAC when I see it? When the dust settles after the negotiation of the MAC clause, notwithstanding carefully drafted exceptions, the scope of the MAC clause may still be subject to a great deal of interpretation. A "Material Adverse Change" is usually defined, rather circularly, as a material adverse change. There is comparatively little case law interpreting MAC clauses. And parties often will disagree about what is, in fact, material. Context will always be important in determining the existence or non-existence of a MAC – a point underscored in a recent Delaware case in which Tyson Foods, Inc. was ordered to complete its merger with IBP, Inc.

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guest column

A Case for European Private Equity Investment

The many advantages of venture capital and private equity investment are well documented. Besides non-correlation, this alternative asset class carries the trademarks of diversification and long term outperformance of public markets. Without straying too far from home, U.S. investors – especially those pioneers in the asset class – have done very well investing in both technology opportunities and private equity over the last few years.

Why invest in Europe? Private equity is under-funded in Europe relative to the United States. A perhaps inexact measure for the scope of growth in private equity markets in more developed economies is to examine the aggregate amounts invested in private equity within a given country, measured against that country's GDP. This simplistic but relevant measurement suggests that in 2000 total private equity investments in the U.S. represented 1.79% of 2000 GDP, while total private equity investments in the U.K. only represented 0.86% of 2000 GDP. Among the other major European economies, Germany and France have economies of comparable size to the U.K., and yet have private equity markets which, in 2000 as a percentage of GDP, were less than one-half the size of the U.K. A similar pattern exists for Europe's other larger economies, including Italy, the Netherlands and Spain.

In the year 2000, $165 billion was committed to U.S. venture and buyout funds in 2000, but only €57 was committed to European venture and buyout funds. Europe's aggregate GDP and population are greater than the United States, with an aggregate stock market capitalization falling well behind that in the United States. Surely this sets the scene for a longer term investment opportunity for the venture investor.

There are a number of factors driving the European venture and buyout marketplaces. The entrepreneurial culture is now at last taking hold, and role models are emerging in all major economies. This is encouraging operating managers to take risks and develop new products. There is continued corporate restructuring, including divestments and consolidation, in all industry sectors driven by the advent of the Euro, the focus on shareholder value, and a return to core corporate competencies. The improvement in the European capital markets infrastructure is another positive factor, creating opportunities for raising growth capital and exit options.

Governments and politicians have also become much more favorably disposed to the role that venture capital and private equity can play in job creation, reviving moribund industries, and the redistribution of wealth. Long term tax incentives for both investors and entrepreneurs alike are creating a more fertile environment for investment.

Germany's successful introduction of changes to the capital gains tax for the disposition of corporate shareholdings highlights the quantum shift in European economic policy. This measure alone is likely to initiate a wave of corporate divestitures as companies heighten their focus on shareholder value. Among other countries, France has improved laws relating to stock options, recognizing the importance of providing strong incentives to entrepreneurs to create businesses and employment. Similarly, Europeans are looking to the enlightened example of Ireland, which has implemented a highly attractive ten percent corporate income tax rate for firms establishing operations in the country. Technology companies ranging from Microsoft to HarbourVest's portfolio company, Trintech, have benefited from this policy measure that has helped create highly skilled employment and collateral economic growth in Ireland.

Some have argued that the state of the European private equity market in 2000 was similar to that of the U.S. in the early 1990s. In any event, the industry should be poised for strong returns over the medium term as the pre-conditions for future success – capital, risk takers and liquidity – are solidly in place.

But the sector is not without its risks. Some of the concerns present in the marketplace today center around the Atlantic drift of the U.S. technology hangover that has started to infect Europe. Many of the nascent European growth markets (Neuer Markt, Nuevo Marche, etc.) are all trading well below their highs of 2000, and more bad news appears daily. However many European venture managers have small portfolios of investments to manage, and funds with significant uninvested cash to take advantage of buying opportunities at much reduced valuations. Buyout managers are still able to exit their larger deals through either the public markets, leveraged recapitalizations, or secondary buyouts. Wherever there is change, especially brought on by uncertainty, then historically private equity has been a major beneficiary.

Institutional investors should not confuse the current uncertainty in world stock markets with a reason not to consider European private equity investment, but recognize it as the perfect time to begin a commitment to the marketplace of European venture and private equity investment opportunities that will unfold over the next three to five years. ▢

— George Anson
Managing Director of HarbourVest Partners (U.K.) Limited,
the London-based subsidiary of HarbourVest Partners, LLC

What the End Of Goodwill Amortization Means for Finance Agreement Covenants

The end of goodwill amortization has been heartily endorsed by the business community, mostly because of its likely effects on reported earnings and on M&A activity in a post-pooling environment. Few, however, have addressed how this fundamental change to the treatment of goodwill will affect financing agreements – primarily credit agreements and bond indentures – which use financial statement measurements in a variety of ways. We believe that all companies with such financing agreements should carefully consider the impact of this major change in accounting practice.

By way of brief background, the fundamental change to the treatment of goodwill derives from SFAS 142, released last June, and now beginning to take effect. More specifically, SFAS 142 changes the treatment of goodwill by eliminating the amortization of goodwill and replacing it with more rigorous periodic testing of goodwill for impairment The statement makes the change applicable to fiscal years starting after December 15, 2001, including unamortized goodwill from prior transactions. In some cases, the change applies to goodwill arising from transactions completed after June 30, 2001.

In order to evaluate whether the change in accounting for goodwill will impact a financing agreement, a borrower should consult the specifics of the financing agreement and, in many cases, their financing lawyers and accountants as well. Although the change may not impact common financing covenants which are EBITDA-based, the change may substantially affect other types of financial covenants, and even where it does not, it may well result in making existing agreements far more burdensome to administer. We believe, however, that a borrower's ability to comply with many financial covenants should remain unaffected for the following reasons:

- For existing agreements with "Frozen" GAAP, changes to GAAP (including the end of goodwill amortization in SFAS 142) do not apply.
- Even before SFAS 142, many covenants based on EBITDA excluded the effect of amortization and often excluded the effect of an impairment of goodwill.
- Compliance with many covenants does not depend on earnings or asset values.

Unaffected Financial Covenants

Here, in more detail, is why the change from amortization to periodic testing of goodwill should not affect a borrower's obligations under many common financing covenants:

1. *For existing agreements with "Frozen" GAAP, changes to GAAP (including the end of goodwill amortization in SFAS 142) do not apply.*

Borrowers and lenders often "freeze" GAAP, so that the borrower calculates covenants without regard to changes to GAAP. Doing so helps avoid unpleasant surprises later. Therefore, to create more certainty at the time of executing the financing agreement, borrowers and lenders alike agree to forego the possibility of future advantage (resulting from a change in GAAP) and to take the risk of future inconvenience (from having to keep track of "old" GAAP).

If an agreement has frozen GAAP, covenants keyed to financial performance are unaffected – by definition– even after the change takes effect.

As we noted above and discuss in further detail below, the borrower will have to calculate financial covenants under the old standard. ("Old" GAAP for the frozen agreement, "new" GAAP for everything else.) As a result, a company with frozen GAAP may be required to maintain two sets of books – one to track covenant compliance and one for financial reporting purposes.

Even if a credit agreement or an indenture does not have frozen GAAP, there are at least two additional reasons why obligations under most leveraged financing covenants could remain unaffected.

2. *Even before the end of goodwill amortization, EBITDA excluded the effect of amortization and often excluded the effect of an impairment of goodwill.*

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Tax Benefits for "Qualified Small Business Stock"

There are two little-used provisions of the Internal Revenue Code that can provide significant tax benefits for individual investors in venture capital and other funds that make portfolio investments in start-ups and other small businesses. First, if stock in the portfolio company meets certain "qualified small business" requirements, certain individuals and other non-corporate investors (including the members of the general partner) may be eligible to pay tax at the rate of 14% (rather than 20%) on their share of gain from the sale of such stock. Second, these investors may be able to elect to defer some or all of their share of the gain from the sale of such stock by purchasing stock of another qualified small business.

Reduced Capital Gain Tax Rates

Section 1202 of the Internal Revenue Code was enacted in August 1993 to encourage investments in new ventures and small businesses. It currently provides for an effective tax rate of 14% (in lieu of the regular 20% rate) on gain from the sale of qualified small business stock ("QSBS") if the investor has held the stock for more than five years and certain other conditions are met. (When originally enacted, the capital gains rate was 28%, and the Code provided a flat exclusion of 50% of the gain from the sale. Today, the Code provides for the same 50% exclusion, but imposes the old 28% tax rate on the 50% of the gain that is recognized, resulting in the blended rate of 14% on the gain.) For investors subject to the alternative minimum tax, the effective tax rate for gain on stock the holding period for which began before January 1, 2001 is 19.88% (not much of a break from the regular 20% rate!); for taxpayers whose stock was purchased after December 31, 2000, the effective tax rate is a slightly lower 17.92%. The rates are further reduced if the corporation conducts its business within an "empowerment zone" (designated distressed urban neighborhoods and rural areas). For each investor, the amount of gain eligible for the reduced rate is limited to the greater of (i) ten times the investor's basis in stock of that issuer disposed of during the taxable year and (ii) a total for all taxable years of $10 million per issuer of small business stock.

The Code provides for flow-through treatment in the case of QSBS held by venture capital funds and other "pass-thru entities" (partnerships, S corporations, regulated investment companies and common trust funds). In that event, the limitation of ten times the investor's basis in the stock described in clause (i) above is applied by taking into account the investor's proportionate share of the adjusted basis of the fund in the stock. However, the investor must have held his interest in the fund during the entire period the fund held its interest in the QSBS, and gain received from a fund is not eligible for the reduced rate to the extent that the partner's interest in the fund at the time of sale exceeded the partner's interest in the fund at the time the entity acquired the stock. (It is unclear how this rule would apply to the general partner's carried interest, which may fluctuate over time.) In addition, although in most cases stock is only QSBS in the hands of the taxpayer who acquired the stock at original issuance, QSBS distributed in kind by a fund can continue to qualify as QSBS in the hands of non-corporate investors who were

What is Qualified Small Business Stock?

To be qualified small business stock, all of the following must be true for the applicable period:

- The corporation had gross assets not exceeding $50 million at all times after August 10, 1993 until the time of stock issuance;
- The corporation is a domestic "C" corporation;
- At least 80% (by value) of the corporation's assets are used in the active conduct of a trade or business (other than certain excluded businesses including banking, insurance, financing, leasing, investing, personal services, farming, and operating a hotel or restaurant) or is a "specialized small business investment company;"
- The stock was originally issued after August 10, 1993;
- The stock was acquired by the taxpayer at its original issue in exchange for money or other property (other than stock) or for services; and
- The corporation agrees to submit such reports to the IRS and to its shareholders as the IRS may require (to date the IRS has not required any reports).

Numerous rules and exceptions apply; for example, parent and subsidiary groups are treated as one corporation with combined assets, and certain redemptions by the corporation of its stock can cause the stock to fail to qualify.

partners at the time the fund acquired the stock.

The reduced rate applies automatically-no election need be made-but the investor must report the gain as qualifying for the exclusion. Generally, this means that the fund must determine whether any of its stock sold or distributed in kind qualifies as QSBS-which requires it to get information from the portfolio company or have the portfolio company make the determination. Unfortunately, some of the rules for qualification are complex (in particular, the active business requirement), and it may be difficult or costly for some small businesses to determine whether their stock qualifies (or they may not have maintained the necessary records). Venture capital funds, particularly those with few individual investors who could benefit from these rules, may want to weigh the costs of establishing qualification against the benefits to be obtained. In addition, funds may not have the right to compel their portfolio companies to do the necessary analysis. Funds contemplating an investment in a company that may be a qualified small business may wish to consider asking the company to make an annual determination as to its qualification and to agree to comply with the QSBS reporting requirements (if and when they become applicable).

Several senators and congresspersons, suggesting that the Section 1202 exclusion has not been effective because of complex and cumbersome requirements and that its benefit has been reduced due to the cut in the capital gains rate from 28% to 20% and the increasing applicability of the alternative minimum tax, have introduced legislation to simplify and broaden Section 1202. Their proposals include, among other things, raising the exclusion to 75% or even 100%, lowering the stock holding period from five years to three years, removing the exclusion as a tax preference item under the alternative minimum tax, increasing the $10 million ceiling on excludable gain to $20 million or repealing it entirely, and even extending the exclusion to corporations. Bills including these proposals have been referred to the relevant committees, and at this time no further legislative action has been taken.

Rollover of Gain

Enacted in August 1997 in order to make more capital available to the new, small businesses important to the long-term growth of the economy, Section 1045 of the Internal Revenue Code generally allows individuals to elect to "roll over" gain on the sale of QSBS that was held by the individual for at least six months if replacement QSBS is purchased within 60 days of the sale. Unlike the Section 1202 exclusion, which from the date of enactment applied to investors holding stock interests through flow-through entities, applicability of this provision to individuals who held their stock through venture capital partnerships and other flow-through entities was uncertain until July 1998, when a technical correction extended the provision to all non-corporate taxpayers and incorporated by reference the pass-through entity rules of Section 1202 into Section 1045 (although many questions remain).

In the wake of the technical correction, the IRS announced that a partnership may make a rollover election if it sells QSBS held for more than six months and purchases replacement QSBS within 60 days, and that the benefit of deferral flows through to the non-corporate partners who were partners for the entire period during which the partnership held the QSBS. In the same announcement, the IRS also stated that if a partnership sells QSBS held for more than six months,

> *Funds contemplating an investment in a company that may be a qualified small business may wish to consider asking the company to make an annual determination as to its qualification [for the reduced rate] and to agree to comply with the QSBS reporting requirements...*

an individual who was a partner during the entire period in which the partnership held the QSBS and who purchases replacement QSBS within 60 days of such sale may make the election with respect to the individual's share of any gain on the sale that the partnership does not defer. These situations were given merely as examples of the application of the flow-through rules, and the announcement did not address other possible situations-for example, where an investor sells QSBS that it has held for six months, and then a fund in which the individual is an investor purchases QSBS within 60 days, or whether investors in several venture capital funds may match up sales by one venture fund with purchases by another venture fund. To date, no regulations have been issued implementing these rules. In May of 2001, several senators joined in a letter to the Treasury Secretary O'Neill urging Treasury to promptly issue regulations under Section 1045 addressing how the rollover provisions apply in the partnership context, to permit venture capital funds and their investors to take advantage of these provisions.

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Are Shareholder Agreements Enforceable? Yes, But...

Documentation for many private equity investments includes an agreement among shareholders on matters such as voting of shares, transfer restrictions, tag and drag along rights, registration rights and similar matters. Although in many traditional deals the shareholders are limited to the sponsor and management, more and more transactions now have institutional mezzanine investors, strategic partners, selling shareholders and other participants having divergent interests, often resulting in complex shareholder agreements. Although such agreements generally are enforceable, the enforceability of some of the more esoteric provisions can't be guaranteed. Also, there is a fair amount of law and lore on the subject, and right ways and wrong ways to document the deal.

Summary of Law

Historically, courts have been reluctant to enforce shareholder agreements, other than the most benign provisions. Many older cases strike down various transfer restrictions as "unreasonable restraints on alienation of personal property" or reject special voting arrangements as "vote-buying" or "sterilizing" the board of directors. Fortunately, most modern courts take a more enlightened view and are likely to enforce typical first refusal rights, agreements on electing directors and supermajority or veto rights. However, given the checkered history of such agreements, it is not clear how a given court would react to the more exotic provisions often found in shareholder agreements today, particularly if a provision benefited a shareholder to the detriment of the company or harmed a minority shareholder to the benefit of the majority shareholder.

Some states, most notably Delaware, have revised their corporate laws to override the older court decisions and generally to favor the enforcement of shareholder agreements, especially with respect to close corporations. The Revised Model Business Corporation Act, which is followed in whole or in part by a number of states, also favors the enforcement of shareholder agreements. However, these statutes as well as the courts interpreting them often inject uncertainty as to enforceability by putting into the mix some type of a "reasonableness" or "best interests of the corporation" test. As a result, it is hard to state with certainty that a particular provision will be enforced as drafted. Delaware corporation law without question provides the most protection to those parties seeking a fully enforceable shareholder agreement, expressly recognizing the validity of many, but not all, transfer restrictions as well as the validity of voting and other corporate governance arrangements as applied to close corporations. (Even under Delaware law, however, there is conflicting case law as to whether even transfer restrictions expressly permitted by the statute are subject to an over-arching requirement that they be "reasonable" or in the "best interests of the corporation.")

Although [shareholder] agreements generally are enforceable, the enforceability of some of the more esoteric provisions can't be guaranteed.

In the case of non-U.S. companies, enforceability issues often arise, and it is often difficult for foreign counsel to give unqualified legal opinions on certain provisions. In many civil law countries, form is important and in order to be enforceable shareholder agreement provisions must be set forth in the corporate organizational agreements of the company, and approved (or not rejected for filing) by the local authorities. For example, in Brazil, shareholder arrangements for one type of corporate entity, a *sociedada anonima*, are generally enforceable while enforceability is less certain for another type of corporate entity, a *limitada*. Certain restrictions on transfer or voting of shares may be unenforceable in certain countries, although there may be other ways to achieve the same purpose. The absence of significant case law and the need to rely on outdated statutory provisions often makes enforceability uncertain. In some cases, shareholders have interposed (with the blessing of tax counsel) a Cayman Islands or United States holding company in order to have a more predictable law apply.

Structuring Points

Use Delaware Law. If at all possible, the portfolio company ought to be a close corporation incorporated under Delaware law, the shareholder agreement ought to be governed by Delaware law, and exclusive jurisdiction for dispute resolution ought to be in a Delaware court or before another panel (such as a New York federal court) experienced in Delaware corporate governance matters. If incorporation in Delaware is not possible, local counsel should review the shareholder agreement to point out those provisions that might be of question-

able enforceability under applicable state law and to suggest ways to strengthen their enforceability (including, especially in the case of foreign transactions, the feasibility of interposing a Delaware holding company).

Use Supermajority Voting. With respect to voting arrangements, it generally is possible to work within the applicable statutory framework to achieve the desired result. In most cases, the simplest and most direct means of providing a minority shareholder with some measure of control over certain corporate actions is to assure the shareholder adequate representation on the board and then to require unanimity or a supermajority vote for board and often, shareholder action. Most state corporation statutes and the Revised Model Business Corporation Act permit the corporation to establish a vote requirement for board or shareholder action higher than that set forth in the statute. However, a few statutes authorize such provisions only if placed in a particular instrument, (e.g., only in the charter or only in the bylaws), or if other technical requirements are met.

Get the Details Right. There are a number of technical things that can be done to increase the likelihood that a shareholder agreement will be enforceable. All shareholders and their transferees must execute or agree to be bound by the agreement. The agreement should indicate when it terminates, and which provisions, if any, remain effective once the company has publicly traded stock. To ensure enforceability against third party transferees, the share certificates should contain a detailed legend indicating that the shares are subject to a shareholder agreement. Also, consideration should be given to include key provisions of the shareholder agreement in the certificate of incorporation of the company and close corporation status should be elected.

Qualify as a Close Corporation. Many state corporate statutes have special provisions for close corporations that strongly favor the enforceability of shareholder agreements for such entities. Although the definition of a "close" corporation varies from state to state, it is generally defined as a corporation having somewhere between 30 and 50 shareholders that has no publicly offered stock and which has elected to be treated as a close corporation under state law. (It should be noted that the limitation on number of shareholders could preclude companies from qualifying if they have extensive management shareholdings.)

Provide a Clear Choice of Law. Questions relating to shareholder agreements usually have been determined under the law of the state of incorporation of the entity pursuant to the "internal affairs" doctrine. However, if the agreement does not specify a choice of law, some states (including New York) may not always follow the internal affairs doctrine. From a drafting standpoint, the shareholder agreement should provide for clear choice of law.

Draft Clearly. The shareholder agreement should be drafted clearly, leaving nothing open to interpretation by the court. Given their historical reluctance to embrace comprehensive shareholder arrangements, absent a statutory provision a court simply could throw out the entire provision rather than try to sever the offending term and interpret the parties' intent. A "strict constructionist" approach has been used to interpret transfer restrictions as not applying to pledges, involuntary foreclosures, bequests, inter-vivos gifts, mergers and similar transactions unless specifically provided in the shareholder agreement or charter. (This is why the definition of "Transfer" in a shareholder agreement can be three lines long and contains every synonym imaginable.)

Delaware corporation law without question provides the most protection to those parties seeking a fully enforceable shareholder agreement...

Get Local Counsel Involved. Local counsel should be informed as early as possible in a transaction about the need to deliver an enforceability opinion at closing, so that counsel can point out potential problems early in the negotiation process. It is unlikely that counsel will give a clean legal opinion on enforceability. Exceptions and qualifications in local counsel's opinion are to be expected but nevertheless should be reviewed closely and discussed with such counsel.

Read the Agreement Carefully. Shareholder agreements contain long, complicated and boring provisions that many people don't want to read. Often buried in the boilerplate are provisions that, when parsed through, can subtly shift the balance of power between majority and minority shareholders. The best advice is also the most obvious: read the agreement carefully.

— John M. Vasily

Consolidation 101

In highly fragmented industries with high growth potential, pursuing an industry consolidation strategy is an attractive option for financial sponsors. This may be especially true as valuations have fallen and the opportunity to build scale can be accomplished at an attractive price. Typically, the financial sponsor and a founding management team structure the consolidation, or "build-up," by creating or acquiring a platform company that serves as a vehicle through which to pursue strategic add-on acquisitions. The creation of the platform company, and the subsequent acquisition strategy, involve many legal and practical considerations, including financing subsequent acquisitions and planning for integration and expansion.

Source of Funding for Subsequent Acquisitions. Several alternatives exist for funding add-on acquisitions, including internally generated cash, third party borrowing in the form of senior credit facilities or mezzanine financing, loans from the seller of the target business ("seller paper") and additional equity from the financial sponsor or from co-investors. If the platform company will incur debt, the sponsor needs to work with the lenders to create loan documents that will permit, and provide automatic funding for, additional acquisitions. Any seller paper must be deeply subordinated to provide for flexibility on refinancings and future mezzanine financings. If additional equity from the financial sponsor will be a source of funding, the sponsor should consider whether it wants to make a pre-commitment to contribute additional equity, perhaps at a discount from fair market value. However, funding that equity for each acquisition separately, with one or more co-investors is another option, in which case the equityholder arrangements should allow for the flexibility to bring in additional co-investors.

Consideration for Subsequent Acquisitions. The sponsor needs to determine what form of consideration the platform company will use for add-on acquisitions: cash, stock of the platform company or a combination of the foregoing. Using stock as consideration raises a number of legal issues:

First, the impact of federal and state securities laws is critical. For example, it is possible that at least some of the selling stockholders will be unaccredited investors. Perhaps in that circumstance there will be few enough unaccredited investors, and their level of sophistication will be sufficient, for a valid Section 4(2) private placement. If not, they will need to be cashed out, or, in the absence of another available exemption, compliance with Regulation D will be necessary, which will require, among other things, delivering an offering memorandum that is tantamount to a S-1 registration statement.

Second, even if all of the selling stockholders are accredited investors, if the platform company will be issuing shares, the selling stockholders should receive an offering memorandum relating to the platform company. A properly drafted offering memorandum is prepared on a pro forma basis, giving effect to the acquisition being considered. This creates the problem of obtaining the necessary disclosure from the target company before the acquisition agreement has even been signed.

Third, sponsors need to develop a strategy for presenting the platform company equityholder arrangements to selling stockholders, e.g., a summary term sheet with non-negotiable master agreements and simple joinder agreements for signature.

Fourth, if structured properly (in general, at least 50% of the consideration in stock), stock consideration received by the sellers will be tax deferred. It is necessary to work closely with tax lawyers to obtain a successful "tax-free" reorganization since seemingly commonplace events, such as a pre-closing dividend of available cash to the selling stockholders, could destroy the "tax-free" nature of the deal.

Fifth, the platform company currency must be valued. So long as the platform company is privately held, there is no alternative other than valuations by the board or management or a third party appraisal. Since the company has presumably made, or is considering, various acquisitions, the extent to which the valuation should reflect the prospective synergies and earnings enhancement as a result of prior, and currently contemplated, acquisitions must be addressed.

Structure of Subsequent Acquisitions. In planning for add-on acquisitions, a decision needs to be made as to whether the platform company will create a new subsidiary for each acquisition or whether some or all of the target companies will be acquired

directly by the platform company. The creation of separate subsidiaries allows the platform company to isolate liabilities of an individual target company from the rest of the group and facilitates selective sales or spin-offs of particular businesses. Moreover, by merging each target into a newly-organized Delaware subsidiary, you can standardize the domicile, charters and by-laws of each subsidiary. (One disadvantage of this "forward merger" is that it may lead to a greater number of third party consents and governmental re-permitting applications.) If acquisitions are being structured as "tax-free" reorganizations, the target companies must be held directly by the company which issues the stock consideration; that is, the platform company cannot create an intermediate holding company.

Acquisition Strategy in Light of a Public Offering. If a public offering is feasible, consulting with counsel regarding SEC regulations and no-action letters concerning integration of private placements (i.e., the issuance of stock to target company stockholders) and subsequent public offerings should be part of the planning process. In addition, when and how pending acquisitions would need to be disclosed in the registration statement should be a high priority item. Subsequent to the public offering, an acquisition shelf registration may be filed, subject to compliance with SEC regulations and no-action letters, to facilitate further acquisitions.

Organization of Platform Company. If the platform company is a Newco, it can be structured as a corporation or a limited liability company. A corporation is still the more customary vehicle, and investors and management employees are usually familiar with stock and stockholders agreements. A corporate form is also necessary to make an initial public offering. On the other hand, the LLC structure offers greater flexibility in providing varying profits interests to equity participants and employees and potentially offering favorable capital gains treatments with respect to management equity incentives.

When forming a platform company, the sponsor and management team must also decide whether the consolidation strategy involves attempting to build brand recognition for the platform company name. In some cases, the individual target companies will have strong name recognition and building a global brand will not be desired, but if the platform company name is expected to be branded, selection of the name becomes important. Among the issues to consider are: whether the name can be trademarked, the availability of associated domain names and the availability of the name with the respective secretaries of state in the jurisdictions where the company will conduct business.

Integration. One of the most challenging issues with any acquisition strategy is successfully integrating the acquired businesses. This involves, among other issues, the assimilation of new personnel, the integration of the acquired business' equipment, technology, financial and information systems, the coordination of sales and marketing efforts, the centralization of certain functions to achieve cost savings and to promote cooperation and sharing of resources and generally the maintenance of common standards, controls, policies and procedures. To further integration efforts, it is useful to issue options based on the performance of the overall company, not individual subsidiaries or business units. Also, former CEOs of small closely-held target companies may not be accustomed to reporting to a board of directors. As a result, it is very useful to develop a policy for acquired companies that stipulates the issues that need to be taken to the parent company board.

Accounting Matters. Many consolidators have been the victim of unknown accounting irregularities in their target companies which have ultimately required write-downs or impacted their exit strategy. We therefore urge sponsors to carefully assess accounting issues in connection with build-up strategies.

These general considerations present only some of the many important decisions for the financial sponsor contemplating using a platform company consolidation strategy. Although not all decisions need to be made before the process starts, it is advisable to discuss these and other considerations with experienced counsel, accountants and other advisors in order to maintain flexibility during the "build-up" process. ▢

— Margaret A. Davenport and Felicia A. Henderson

Alert: Good News from the IRS on Section 83(b) Elections and Carried Interest

General partners of private investment funds may no longer need to file 83(b) elections. In order to determine whether an election is still appropriate in a particular situation, some history and analysis is necessary.

It is well accepted that the members of the general partner of a private investment fund are generally not currently taxed upon the receipt of a share of the carried interest. This was not always the case. During the 1970s and 1980s, the IRS occasionally asserted that the receipt of a carried interest resulted in ordinary income to the recipient. Then, in 1993, the IRS issued a public announcement stating that, in most situations, the IRS would not seek to tax the receipt of a carried interest. This favorable IRS treatment was conditioned upon the transferred interest representing a mere "profits interest"– i.e., an interest in future profits only, that would result in no distributions to the recipient if the fund assets were liquidated at fair market value (measured immediately after receipt of the interest).

Uncertainty remained, however, as to how the 1993 announcement* applied in cases where the carried interest was subject to vesting. The uncertainty stemmed from the fact that, under general tax principles, if property is transferred subject to vesting and a "section 83(b) election" is not made, the recipient is essentially taxed as if he or she received the property at the time the property becomes vested. Because a share of the carried interest would typically no longer constitute a mere "profits interest" at that time – assuming the fund's assets have appreciated in value – the announcement arguably did not protect the recipient from ordinary income treatment at the time the interest vested. By contrast, if a section 83(b) election was made at the time the carried interest was received, we believed it was relatively clear that the announcement did protect the recipient from ordinary income treatment. This is because a recipient who makes a section 83(b) election is treated as receiving the property on the actual transfer date, rather than the vesting date. Given the relative ease of making a section 83(b) election and the dramatically different potential tax consequences, we recommended that section 83(b) elections be made.

Last August, the IRS issued a second public announcement that "clarifies" the 1993 announcement. According to the IRS, the favorable treatment afforded by the 1993 announcement generally will apply in cases where the carried interest is subject to vesting, whether or not a section 83(b) election is made. Therefore, we believe that section 83(b) elections are no longer generally required in cases where shares of the carried interest are granted to the members of the general partner of a private investment fund.

It is important to recognize, however, that both announcements are subject to a number of important exceptions and do not apply in all situations. For example, they only apply if the carried interest is received in exchange for the provision of services to or for the benefit of the partnership in which the interest is received and only if the carried interest is retained for at least two years. As a result, we recommend that participants in leveraged employee co-investment plans still generally make section 83(b) elections, because in this context the recipient typically does not provide services to or for the benefit of the employee securities company. In addition, members of the general partner of a private investment fund may wish to continue to make section 83(b) elections as a protective measure in case one of the exceptions were found to apply. ■

— Andrew N. Berg, Adele M. Karig and David H. Schnabel

**Both announcements were issued in the form of IRS revenue procedures. An IRS revenue procedure is a "statement of procedure" that affects the rights of taxpayers under the Internal Revenue Code. Although IRS revenue procedures do not constitute substantive tax law, tax practitioners generally agree that the IRS would be hard-pressed to take a contrary position.*

conduct. Second, what are the facts concerning the target's corporate conduct? And third, does the target possess insurance coverage, can it get insurance going forward and/or is it indemnified by a third party so that it is protected, at least partially, against present and future liabilities? Absent reliable answers to these questions, buyers can find themselves in serious trouble: in October, Federal-Mogul Corporation filed for bankruptcy to escape asbestos liabilities stemming largely from its 1998 purchase of the British company T&N (formerly Turner & Newell), which was revealed to have much larger asbestos liabilities than was believed at the time of the acquisition; and, in July of this year, Berkshire Hathaway appears to have been blind-sided when USG Corp., the country's largest wallboard manufacturer, filed for bankruptcy protection from its asbestos liabilities only nine months after Berkshire Hathaway had invested over $100 million dollars in the company.

1. Litigation History: Past As Prologue.

As to the target's litigation history, while the target may want to believe (and, more importantly, want the potential acquiror to believe) that the litigation risk is behind it, or that it has adequately reserved for any future risks, things in the products liability world often get worse before they get better. In order to evaluate the risk, the acquiror must first obtain an accurate profile of the target's litigation experience. This aspect of the process should focus on ascertaining facts such as the number and quality of the cases pending against the target, the number of potential future cases, the strength of the liability case against the target, the number and average value of settlements and verdicts against the target, a detailed description of the way in which the target has managed the litigation, and the various other issues referred to in the sidebar.

By analyzing the responses to these questions alone, experienced products counsel may well be able to (i) predict the most likely trajectory of the litigation, (ii) identify areas in which the target can save money on defense and/or indemnity costs, and (iii) propose strategies by which the target's litigation liability can be structured to provide higher levels of certainty and predictability over the probable life of the investment.

2. The Liability Case: Is the Target's Conduct Defensible?

A potential buyer will also want to understand precisely what the target is alleged to have done (the "liability case"), and to gain an understanding of how the alleged conduct can reasonably be defended. With regard to the target's liability, there are a series of issues that should be the focus of due diligence. At the outset, the acquiror should have a complete understanding of the product that is the subject of actual or potential litigation, and of the context in which the product was designed, manufactured and distributed.

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What is the Target's Litigation Experience and Profile?

- How many cases are pending against the target?
- How many potential additional plaintiffs are there (that is, what is the population of people who used or were otherwise exposed to the product at issue, and when did the use or exposure occur)?
- How strong is the liability/corporate conduct case against the target?
- How does the safety of the product at issue compare to the safety of similar products manufactured by other companies?
- What sorts of injuries do plaintiffs typically allege?
- What are the legal theories on which plaintiffs typically rely?
- Has the target settled cases or taken cases to verdict, and, if so, how many and how much did the target pay?
- Has the target been held liable for punitive damages?
- Who are the plaintiffs' firms bringing cases against the target?
- In what jurisdictions have cases been filed?
- What are the target's legal defenses and how often have they been successful, either in the form of dispositive motions or at trial?
- Who are the codefendants, if any, in the litigation? How has the target organized and managed the litigation?
- How good is the law firm defending the target?
- What is the ratio of the target's defense costs to its indemnity costs?
- How has the target managed other products litigation, and how experienced is it in managing litigation matters generally?
- Does the target have employees who can provide in-house expertise concerning the issues in the litigation and who can testify if needed?

What was the product's function? Was the product in fact dangerous? Did it cause injury when used as intended, or only when misused? Over what period did the target manufacture and/or distribute the product? Was the product distributed to retailers or directly to end-users, or both? Was the product used in industrial or residential settings, or both? How many units of the product were distributed and over what period of time were they sold? Does the target continue to manufacture the same or a similar product? What other companies manufactured the same or similar products, and have they been sued in connection with such products?

The buyer will also want to know, to the extent possible, what the target understood about any dangers associated with its product, when it developed that understanding, and what it said internally and did once any such dangers were understood. Are there internal company documents that describe the danger? Were the dangers disclosed to customers or others? Did the target seek to downplay or hide the dangers? During the production period, was the target sued by anyone injured by the product, or did the target receive any workers' compensation claims relating to the product? Did the target communicate about the problem with government authorities, other producers of similar products, trade associations and the like? Did the product's design, including any safety features, represent the state of the art at the time it was produced-in other words, was the product as safe as science could make it at the time? What kind of internal safety research or human factors research did the target undertake? What benefits, if any, did the product provide to the target's customers or to society as a whole? Did the product's packaging contain warnings? If so, were they timely, complete and accurate? Was the product removed from the marketplace? If so, was the removal voluntary or was it required by a state or federal agency? Are there renegade former employees who give damaging testimony against the target? Do target employees have a plausible story to tell, are they willing to tell it, and, if so, are they effective witnesses?

The buyer will also want to understand what medical science has to say about the product, whether in the context of or outside of the litigation. Are there medical/ epidemiological studies of the product's impact on users? Is medical causation generally accepted in the scientific community? Is there, as is the case with the inhalation of asbestos fibers, for example, a latency period between the time of exposure to or use of the product and injury? If so, what is the typical latency period? Does the amount of exposure to the product affect the likelihood and severity of injury? What have medical experts testified to in any cases brought against the target? Can the types of injury typically caused by the product be treated successfully?

This is not an exhaustive list, but it should provide a sense of the many questions about the product and the target's conduct in relation to the product that should be asked and answered as part of any products liability due diligence exercise. While the questions are straightforward, lawyers with products liability experience can use the answers to such questions to advise an interested buyer as to the risks presented by the liability case against the target company.

3. The Legal Underpinnings of the Litigation. The answers to these questions are essential because a knowledge of the target's litigation experience (if any) combined with a knowledge of the target's actual conduct (the liability case) are the keys to a successful due diligence assessment. Another important ingredient is the legal theories that have been alleged by plaintiffs – or would be available to future plaintiffs – in cases brought against the target. The theories available to plaintiffs will define the standards by which a judge or jury will evaluate the target's conduct and the likelihood of a successful defense. Products liability cases are generally based on theories of negligence, breach of warranty, strict liability, or some combination of all three. To prevail on a negligence claim, a plaintiff generally must show that the defendant (the manufacturer, distributor or retailer) failed to exercise reasonable care in the design, manufacture or marketing of its product. To prevail on a warranty claim, a plaintiff generally must show that the defendant breached an express or implied contract pursuant to which it had agreed to sell a product that was free of defects and was fit for its intended purpose. By contrast, to prevail on a strict liability claim, the plaintiff must prove that the product was defective in design or in the manner in which it was manufactured – i.e., that some aspect of the product rendered it more dangerous than the finder of fact determines it should have been – and that the defect caused the plaintiff's injury. In some circumstances, strict liability can also attach for failure to provide adequate warnings. In a strict liability case, the focus typically is on the dangerousness of the product or the absence or presence of warnings. If the person conducting products liability due diligence understands the product at issue and knows what theories have been used or would likely be used by plaintiffs, he or she can ask the right questions and properly evaluate the risk.

The acquiror will also want to evaluate all legal defenses that are reasonably available to the target (particularly those that have already been tried in the litigation, but also those that might not have been used), keeping in mind that, in a courtroom, the quality of the defense must always be balanced against the severity of the harm caused. In other words, even the best, most credible legal defense may not prevail where the plaintiff is highly sympathetic and the defendant has a deep pocket.

That having been said, the person conducting the due diligence will want to know the answers to questions such as: are the injuries alleged by plaintiffs typically the result of unforeseen misuses of the product? Do plaintiffs who are injured typically engage in post-sale modifications of the product? Was the person who used the product a sophisticated user and/or did the person who was injured rely on an intermediary to provide adequate warnings and instructions as to proper use? Did the users of the product assume the risk? Is a government contractor defense available?

This type of information will further assist a buyer in evaluating the litigation risks and, in particular, in evaluating whether legal mechanisms can be used to limit such risks.

B. Does the Target Have Collateral Financial Protection? Of the many issues that must be addressed during products liability due diligence, one of the most important is the extent to which the target's litigation-related liabilities will be covered by insurance or by a third-party indemnitor.

Because of the highly leveraged structure of most transactions, a buyout firm will need to understand not only the amount of confirmed and unconfirmed insurance coverage available, but also how that coverage is accessed and the schedule on which it is likely to be paid. This will enable the prospective buyer to project insurance payment streams and to determine its ability to weather a storm if unanticipated costs are incurred. Most targets involved in the manufacture and distribution of a product giving rise to litigation liabilities will have insurance of some kind. For a highly leveraged transaction designed on a financial model, the scope of insurance coverage and the timing of its availability are crucial data. While complex insurance issues are beyond the scope of this discussion, there is no question that an analysis of available insurance coverage is an essential part of any products liability due diligence review. Any such review should include an analysis of whether the target has insurance, how much insurance it has, how and when the layers of coverage are accessed, whether there are per-occurrence limits, whether the target is self-insured up to certain levels and whether defense costs are counted against or are in addition to the policy limits. A financial buyer might also want to know whether the policy coverage could be bought out in a lump sum transaction and whether the target could obtain, at a reasonable price, additional insurance to cover future liabilities (sometimes referred to as tail-end liabilities) above certain trigger points. Additionally, the buyer will want the due diligence effort to include a review of the solvency of the insurance carrier and the carrier's payment practices and history, if any, with respect to other companies that have similar coverage and are involved in similar litigation.

Finally, a buyer will want the due diligence to focus on any potential contractual indemnification to which the target is entitled. Manufacturers are sometimes indemnified by purchasers for liabilities that arise after a product has left the manufacturer's control, or by suppliers of certain component parts of a product. Of course, even with a contractual indemnification in place, the target can and probably will be sued directly by an injured party. But, depending on the terms of the indemnification in place, the target may be in a position to demand that the indemnifying party take responsibility not only for any liabilities, but for the defense of any cases as well. Unfortunately, as with insurance coverage, contractual indemnification is only as good as the indemnitor providing it. Accordingly, a comprehensive due diligence process will include an evaluation of the solvency and financial wherewithal of the indemnifying party.

In a courtroom, the quality of the defense must always be balanced against the severity of the harm caused. In other words, even the best, most credible legal defense may not prevail where the plaintiff is highly sympathetic and the defendant has a deep pocket.

Conclusion Products liability exposure has never been greater. But that does not mean that any target with such exposure should automatically be removed from a private equity firm's target list. Firms can and should look at targets with products liability exposure as representing both unique risks and unique opportunities. By focusing on minimizing downside exposure and maximizing strong litigation management and financial predictability, buyers can transform litigation risk into such opportunities.

— Mark P. Goodman and Steven D. Greenblatt

Perhaps the most common yardstick in financing agreements today is EBITDA (and not EBIT). EBITDA adds amortization back to earnings. Therefore, EBITDA – by definition – already excludes the effect of amortization of goodwill. In addition, EBITDA often adds other non-cash charges back to earnings. Under those circumstances, EBITDA will exclude the effect of an impairment to goodwill and, as a result, the change from amortization to periodic testing of goodwill should not impact the calculation of EBITDA. (If the specific agreement's definition of EBITDA does not add back other non-cash charges, however, the change could substantially affect the calculation of EBITDA after an impairment.) The change generally should not affect borrowers' obligations under the following EBITDA- based covenants:

(assuming non-cash charges are added back)

Covenant	Variations	Where typically found
Leverage Ratios	Total Debt to EBITDA Senior Debt to EBITDA Funded Debt to EBITDA	Credit agreement maintenance tests Some indentures
Coverage Ratios	EBITDA to Interest Expense EBITDA to Fixed Charges	Indenture incurrence tests Credit agreements
EBITDA Maintenance		Credit agreement maintenance tests

3. *Compliance with many covenants does not depend on earnings or asset values.* Many covenants in financing agreements address matters not related to financial performance. For example, negative covenants relating to limits on business changes and restrictions on affiliate transactions are typical in many private equity transactions. Obligations under non-financial covenants should remain the same after the change. The change in GAAP, however, could nevertheless impact such covenants indirectly because exceptions to non-financial covenants are often expressed as a percentage of earnings or net worth.

Potentially Increased Burdens and Potentially Affected Obligations

Even though a borrower's ability to comply with many obligations should remain unaffected, the change from amortization to periodic testing could make administering some existing agreements more burdensome and may impact some common financing covenants. Here are some specific examples.

The change could require more effort to maintain a set of frozen GAAP books.

Frozen GAAP does protect borrowers from unforeseen changes to GAAP. But the borrower *will* have the additional burden of reconciling its financial covenant calculations to the old GAAP standard. Because covenant compliance under a credit agreement is generally required to be calculated on a quarterly basis, the burden of reconciliation on a regular basis may become relatively routine. Since most indenture covenants are incurrence rather than maintenance covenants, borrowers with frozen GAAP in their indentures will generally only have to create the frozen GAAP calculations when incurring debt, paying a dividend or taking some other potentially prohibited action (unless, of course, their credit agreement already requires making the calculation on a quarterly basis).

Borrowers should remember that under a frozen GAAP agreement, total earnings, assets and stockholder's equity may be lower than indicated on the borrower's GAAP balance sheets. A borrower that neglects to keep a set of frozen GAAP books could be unaware of a breach in its financial covenants.

The change could trigger re-negotiation clauses in some credit agreements.

Credit agreements sometimes provide that parties will renegotiate covenants affected by changes to GAAP. To eliminate future uncertainty and unforeseen consequences, borrowers and lenders alike may wish to begin that process promptly.

The change could affect covenants with earnings-based and balance-sheet tests.

For agreements that do not freeze GAAP, the change from amortization to periodic testing may affect covenants relating to net income, net assets or stockholders' equity. Without amortization of goodwill, all three will remain higher until there is an impairment. But the effect of an impairment, depending on its size, could be dramatic and result in unwelcome surprises to borrowers and lenders alike.

Balance Sheet Tests. Without amortization of goodwill total assets and stockholders' equity will not decrease automatically, making easier the ordinary-course compliance with balance sheet tests found in credit agreements, such as maintenance of net worth and maintenance of debt-equity ratios. However, an impairment of goodwill will decrease total assets and shareholders' equity, which would make a borrower's maintenance of net worth and maintenance of debt-equity ratios more difficult. A sudden impairment could come as an unwelcome surprise with far-reaching consequences under a credit agreement. From a lender's perspective, the higher asset values created by the disappearance of amortization might mask credit issues that

original covenants were sized to uncover. In addition, the change could also affect restrictions on mergers and a variety of balance-sheet based exceptions to covenants, particularly where dollar amounts are expressed as a percentage of net worth.

Earnings-Based Tests. High yield indentures typically impose limits on restricted payments (i.e., limits on investments and on payments on equity or subordinated debt). Under certain circumstances, these covenants do permit a borrower to make a restricted payment from a percentage of cumulative earnings. (The calculation typically adds 50% of earnings and 100% of loss.) Increasing cumulative earnings (by reducing amortization) would increase the size of the restricted payments basket, permitting higher than anticipated dividends and the like. (If the agreement's definition of earnings excludes the cumulative effect of a change in accounting principles, as some agreements do, companies should consider how the change resulting from SFAS 142 will fit the exclusion in the context of the specific agreement and the particular borrower's financial statements.) Earnings-based tests may also appear in a variety of exceptions to other covenants, particularly when dollar amounts are expressed as a percentage of earnings.

Some Action Items As the practice of amortizing goodwill ends and SFAS 142 becomes effective, a borrower should consult both its accountants and financing lawyers about the effect the change will have on specific financing agreements and consider the following courses of actions:

- For agreements with "frozen" GAAP, always calculate covenants by reference to GAAP in effect at the time specified by the agreement.
- For agreements without frozen GAAP, although the change from amortization to periodic testing for impairment will not likely affect EBITDA-based covenants, check all covenants, especially those relating to earnings, assets and equity.
- The change may advantage or disadvantage a borrower or lender to an agreement, depending on the operation of the particular covenant.
  - For existing credit agreements, which are generally not as hard to amend as indentures, consider renegotiating affected provisions.
  - For agreements currently under negotiation, bear in mind potential effects of SFAS 142, and consider freezing GAAP (with the application of SFAS 142 specifically included), to reduce uncertainty and alleviate the burden of keeping a set of "special" frozen pre-SFAS 142 adoption GAAP books. ▫

— Paul D. Brusiloff

Tax Benefits for "Qualified Small Business Stock" (continued)

If rollover treatment is elected, gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement QSBS. The cost basis in the replacement QSBS is reduced by the amount of the rolled-over gain. Realized gain in excess of the amount permitted to be rolled over must be recognized, but may be eligible for the reduced capital gains rate under Section 1202 discussed above. Investors may defer gain indefinitely by making elections upon subsequent sales and repurchases of QSBS. Proposed legislation (included in the bills regarding Section 1202 discussed above) would increase the rollover period from 60 to 180 days.

Venture capital funds, particularly those with a substantial number of individual investors (direct or indirect), should consider whether it makes sense for them to examine their stock holdings (and stock recently sold) and request information from their portfolio companies to determine whether any of their stock might qualify as QSBS – and if so, to alert their investors to enable them to take advantage of these tax benefits. Funds contemplating an investment in a company that may be a qualified small business may want to ask the company to agree to maintain and furnish the information necessary to make a QSBS determination and to comply with the reporting requirements (if any are ever issued). Funds in the formation stage might consider addressing the rights of their partners with respect to Section 1045 elections. These rules are complicated, there are many pitfalls and written guidance is sorely lacking – consult your tax advisers! ▫

— Adele M. Karig and Amanda Buck Goehring

> Some venture capital funds are concerned about the effects on the fund if an investor makes a rollover election with respect to QSBS held by the fund. For example, if an investor sells QSBS it held directly and elects to treat as replacement QSBS its pro rata share of stock purchased by the fund (assuming such an election can be made), is the fund's tax basis in the replacement QSBS adjusted? These and other concerns (such as recordkeeping requirements) have caused some venture capital funds to address in their partnership agreements the right of their partners regarding rollover elections with respect to stock held by the fund.

Don't Forget Your MAC (continued)

Knife the MAC? In *IBP v. Tyson*, the Delaware chancery court rejected Tyson's argument that IBP had suffered a MAC entitling Tyson to back out of its merger agreement. During due diligence, Tyson learned of accounting problems at an IBP subsidiary, but agreed to a $3.2 billion merger anyway. The merger agreement contained a MAC clause, but IBP's representation as to the absence of undisclosed liabilities had a carve-out for the accounting problem – a problem that eventually required IBP to take a $60.4 million write-down. Tyson claimed that this write-down, coupled with IBP's poor performance in 2000 and the first quarter of 2001, constituted a MAC.

The court, based on the specific facts of the case and applying New York law, disagreed, finding that the MAC clause should be interpreted in light of disclosures in the merger agreement itself and in IBP's financial statements. According to the court, the MAC clause "is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner." In the context of the IBP deal – a long-term strategic transaction – and given IBP's volatile earnings history, the court was not persuaded that a MAC had occurred. The court, rejecting Tyson's other claims, took the extraordinary step of ordering Tyson to complete the merger.

The MAC clause in the Tyson-IBP merger agreement was broadly drafted, without any carve-outs for general economic conditions. The court felt that construing the broad language of the MAC clause as addressing only "fundamental events that would materially affect the value of a target to a reasonable acquiror" would eliminate the need for negotiating detailed MAC clauses with numerous carve-outs and qualifiers. We have not yet detected widespread agreement with this sentiment on the part of practitioners. In fact, quite the opposite has occurred. We have noticed that buyers of businesses are even more cautious than they might previously have been about the likelihood of their success in relying on a MAC clause to excuse their performance under an acquisition agreement. As a result, they are trying to negotiate MAC clauses which can be easily distinguished from the one in the IBP/Tyson agreement. In addition, when acquisition agreements provide for a bringdown of the representations and warranties – i.e., a closing condition that the reps and warranties made at signing are also true at closing – we have noticed a reluctance on the part of buyers to allow the condition to be limited to breaches of reps and warranties that would cause a MAC.

Hey, MAC! A buyer should not assume it has a walkaway right just because something bad has happened to the target company – even if the buyer has negotiated a favorable MAC formulation. Deciding whether a MAC has occurred takes careful consideration – not only of what a reasonable buyer would think is material, but also of what the buyer actually knew about the business when agreeing to the deal. ▢

— Franci J. Blassberg and William D. Regner

Upcoming Speaking Engagements

November 8-10

Paul S. Bird
Public Company M&A: Deal Structures, Execution and Related Issues
New York, NY

November 29-30

Michael P. Harrell
Venture Capital and Private Equity Investing
New York, NY

January 11-12

Michael P. Harrell
Fund Formation and Private Equity Investing
Steamboat, CO

January 18

Andrew N. Berg
Tax Issues for Private Investment Funds
New Orleans, LA