You are the general partner of a private equity fund, and have just signed a definitive purchase agreement with respect to the leveraged acquisition of a limited liability company. Now that the contract is signed, you start going through the agreement to determine your obligations pre- and post closing. There is a financing out – your fund will not be obligated to close on the transaction unless it has obtained the necessary debt financing. The seller had asked for a covenant from the fund that it would use its “best efforts” to obtain the financing; you eventually agreed that the fund would use “commercially reasonable efforts” in this regard.

Elsewhere, the seller has agreed to use its “best efforts” to operate the business of the LLC in the ordinary course until the closing. That sounds good. Further on, both parties have agreed to use “reasonable best efforts” to satisfy the conditions to closing, including obtaining Hart-Scott-Rodino clearance and some third-party consents.

You begin to think about structuring the target following the closing. Should it remain an LLC? You know that the managers of the business have expressed a strong preference for the target to remain an LLC so that they can use the losses it will continue to accrue in the next few years. However, your partnership agreement contains an undertaking from you that you would use your “best efforts” to avoid causing your limited partners to recognize unrelated business taxable income, or “UBTI.” Confused and knowing that you will likely be asked what your fund is obligated to do under these provisions, you call outside counsel.

As your lawyer will tell you, even though these differing standards are utilized frequently by contracting parties in almost all types of commercial agreements, they are not well-tested in the courts. Indeed while some general principles can be gleaned as to how a “best efforts” standard might be interpreted by a court, there is by no means any settled law as to precisely what these two words really mean. Moreover, we are not aware of any case that interprets “commercially reasonable efforts,” or even “reasonable best efforts” as distinct, less stringent standards than “best efforts.” The few cases that have analyzed a contracting party’s behavior in light of a “reasonable best efforts” clause often simply ignore the word “reasonable” and interpret the provision as a “best efforts” standard, rather than some lesser performance standard. And while common sense would suggest that a single contract, where one section requires “commercially reasonable efforts,” another requires “reasonable best efforts” and a third requires “best efforts” would be construed as imposing differing, and progressively more onerous, performance standards, there is no clear guidance as to how a court would interpret such a contract.

Here is a review of some of the more interesting case law on “best efforts” clauses and some suggestions as to how to approach these and similar clauses in practice.

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Against the backdrop of troubling times throughout the business community, we focus in this issue of The Debevoise & Plimpton Private Equity Report on the increasingly popular mezzanine fund as an alternative source of leverage for private equity acquisitions.

We look at mezzanine funds from several angles. Jennifer Burleigh spotlights what makes a mezzanine fund different from the perspective of a potential fund investor. Adele Karig, a Tax Partner in our Private Equity Funds Group, and her colleague Peter Furci analyze the special tax issues implicated in mezzanine investing and offer guidance on how alternative structures can be built into fund documentation to avoid nasty tax surprises later on.

The Trendwatch column in this issue describes whether and in what manner the terms of mezzanine funds differ from the terms of traditional buyout funds. In the Guest Column, Philip Borel, Managing Editor of Private Equity International, looks at the state of the very robust mezzanine market in Europe.

In our cover story, Steve Hertz and Josh Targoff try to clear up some of the confusion among the various “best efforts” standards commonly found in acquisition and financing covenants and offer some practical recommendations on using these clauses in practice. Our cartoon highlights the misunderstandings these terms create in even the most ordinary context.

Holly Nielsen, a Counsel in the firm’s Moscow office, provides an intriguing introduction to private equity investing in Russia, outlining both the historical and current issues and offering a prognosis for the future. Finally, Jeff Rosen briefly outlines the increasing use of insurance in transactions as a way of resolving difficult risk allocation issues between buyers and sellers.

In an effort to ensure that the publication continues to provide practical insight into issues of relevance to private equity professionals and their advisors, included with this issue is a response form which you can use to indicate those features of the Private Equity Report you find most useful and informative and what topics you would be interested in hearing on from us in the future. Feel free to use the form to update your mailing and distribution information as well.

Franci J. Blassberg
Editor-in-Chief
Mezzanine funds have recently become an increasingly popular vehicle on the private equity landscape. Even the most casual observer of the private equity marketplace can explain part of that phenomenon – a precipitous decline in the senior debt market for leveraged financings, the volatility of the high yield debt market, and the vast amount of uncommitted equity capital raised by sponsors primed to effect leveraged transactions. At the same time, average private equity fund investment returns have receded, and many investors now see in mezzanine funds an opportunity to achieve relatively strong risk-adjusted returns. In addition, because the mezzanine funds marketplace is not oversaturated, mezzanine providers have the luxury of negotiating favorable terms and of selectivity.

Mezzanine funds, however, differ from traditional private equity funds in some significant ways. This article highlights some special issues mezzanine funds raise for sponsors and investors.

What is Mezzanine Financing?
A typical mezzanine investment consists of a debt or debt-like instrument, paired with an equity “kicker.” The equity component of the investment gives the mezzanine lender upside potential, while the debt component – which generates steady interest payments and ranks senior to the company’s common stock – provides a measure of downside risk protection. The most common formulation is a note which may provide for both current-pay cash interest and pay-in-kind, or PIK, interest, paired with warrants to acquire stock of the borrower. Mezzanine investments can be made using other types of securities as well, such as with preferred stock in place of a debt instrument.

What Makes Mezzanine Funds Different?
From a fund investor’s perspective, mezzanine fund terms are generally similar to those of buyout funds. But there are a few basic differences that may affect an investor’s appetite for investment in this asset class.

Current Income. A typical mezzanine fund will generate significant amounts of current income for its investors (from interest payments on the debt) during the entire life of the fund, starting soon after the first investment is made. Buyout funds, on the other hand, almost never generate income on an investment until it is sold, often years after its purchase. This principal difference between mezzanine and equity funds accounts for most of the novel issues investors will encounter when they invest in mezzanine funds.

Interest income (whether current-pay or PIK) is not eligible for capital gains tax treatment, which may be important to some taxable investors. Also, taxable investors will be taxed on all interest payments – even if the interest is not payable currently – and may find themselves without sufficient cash to pay the tax. Taxable mezzanine investors need to weigh these risks against the protection afforded by investing in debt as opposed to equity.

Non-U.S. investors in a mezzanine fund may confront additional issues relating to withholding taxes on the receipt of current income, which may be mitigated by tax treaties between the U.S. and their home countries. For an in-depth discussion of the tax issues arising from mezzanine fund investments, see “Mezzanine Funds: Selected Tax Structuring Considerations” elsewhere in this issue.

Current income can also complicate the distribution mechanics of a fund agreement. Whereas proceeds from the ultimate disposition of an investment will generally be distributed in the same way as they would be in a buyout fund (return of capital followed by a preferred return in the neighborhood of 8% for limited partners; then a catch-up to the general partner and an 80%-20% or 85%-15% split of all remaining profits), there is no true market standard for the distribution of current income for mezzanine funds. Some general themes hold true, however. For example, it is common for current income to count first towards the fund’s preferred return rather than towards a return of capital. This approach makes intuitive sense, since the fund’s invested “capital” is the principal amount of the loan, which is repaid as the principal is repaid, whereas interest is priced with the investor’s return on the investment. Some funds match interest on a particular investment to the preferred return on the investment, while others count all current income towards a fund-wide preferred return.

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Mezzanine Funds: Selected Tax Structuring Considerations

The number of mezzanine funds (and the amount of committed mezzanine capital) has increased significantly in recent years, and a growing number of sponsors are involved in forming mezzanine funds and structuring their investments. Although mezzanine funds raise many of the same tax issues as leveraged buy-out (“LBO”) and venture capital (“VC”) funds, there are also a number of special tax issues implicated by the nature of mezzanine investing of which sponsors and investors should be aware. Most of these tax issues can be solved by careful (albeit complex) structuring, including in many cases the use of alternative investment vehicles or blockers. Recognizing the potential problems and baking the flexibility to solve them into the fund documentation can avoid nasty tax surprises.

Investing vs. Lending. The typical mezzanine fund investment consists of a debt security (paying both cash and “pay-in-kind” interest) and warrants to purchase equity in the borrower company (which warrants frequently have a strike price that is less than the value of the underlying shares). Less frequently, preferred stock is used to produce the desired mix of downside protection and upside participation.

Because mezzanine funds are in a sense “originating” debt securities, some tax practitioners have raised the question of whether mezzanine funds could be viewed as engaged in a lending business for U.S. tax purposes rather than merely investing in securities, with the result that foreign investors in the fund would be subject to net basis U.S. income tax (at the same rates as those applicable to U.S. residents) on their share of the fund’s income. (By contrast, if the fund is viewed as investing in securities, foreign investors would generally not be subject to any U.S. tax on gains, and would generally be subject to 30% withholding tax on dividends and interest unless a treaty or the “portfolio interest” exemption applied.)

Although the law in this area is scarce, the prevailing view in the market is that mezzanine funds should not be viewed as engaged in a lending business, but instead should be viewed as investors in securities. This is based on several factors: mezzanine funds engage in a relatively small number of transactions over a finite period of time; much of the expected investment return is derived from the “equity kicker” component of the security; mezzanine funds acquire their securities in a highly specialized market rather than from the public; and the subordinated position of the mezzanine debt exposes the fund to greater risks than are customarily assumed by commercial lenders. Thus, on balance, a mezzanine fund resembles an equity investor more than a commercial lender.

Phantom Income. Because mezzanine funds purchase most of their securities in “strips” (i.e., debt and warrants issued in a single transaction), mezzanine funds often realize significant amounts of “original issue discount” income on their debt securities. As an illustration, let’s say that a mezzanine fund pays $100 for a bond with a face amount of $100 and a “penny warrant” to acquire $20 worth of stock for a nominal strike price. The U.S. tax rules would allocate the $100 purchase price between the two securities in the strip based on their respective values, in this case $80 to the bond and $20 to the warrant. The $20 difference between the price paid for the bond and its face amount is original issue discount (or “OID”) that is taxed to the bondholder on a constant yield basis over the term of the bond, with out regard to when cash payments are received. The existence of a pay-in-kind feature would also give rise to OID.

As a result, mezzanine funds generate substantial “phantom income” (that is, taxable income without cash). Although mezzanine securities also typically provide for significant current cash interest, so that investors could use that cash to satisfy their tax liabilities, OID would generally continue to accrue on a bond even if the borrower defaulted on the cash interest. Of course, if the fund is not required to distribute the cash interest to investors (for example, because it uses the cash interest to provide leverage or make additional investments) the investors would have to fund payments of the tax on the “phantom income.”

UBTI/ECI. As with LBO and VC funds, mezzanine funds may have U.S. tax-exempt entities as investors. Such tax-exempt investors are sensitive to the receipt of so-called “unrelated business taxable income” (or “UBTI”) because they are taxed on UBTI (but not on non-UBTI income). In the mezzanine fund context, UBTI typically arises in one of two ways. First, the mezzanine fund may use leverage in its investment strategy, in which case a portion of the fund’s income allocable to the borrowing will be treated as UBTI. Some mezzanine funds address this by permitting tax-exempt investors to invest in an offshore feeder or parallel fund that is treated as a cor-
poration for U.S. tax purposes (thus “blocking” any UBTI). However, such a “blocker” corporation would be subject to U.S. withholding tax on dividend income and interest income received from the portfolio company (subject to the discussion below of portfolio interest) and net basis income tax on U.S. trade or business income (see below). In some cases, the net tax cost incurred by tax-exempt investors that invest in the blocker would be greater than if such investors had invested directly in the mezzanine fund.

UBTI can also arise if the mezzanine fund acquires equity in an operating entity that is treated as a partnership for U.S. tax purposes (such as an LLC). Such investments can also give rise to income that is effectively connected with a U.S. trade or business (known as “ECI”), with the result that foreign partners in the fund will be subject to net basis U.S. income tax and return filing requirements with respect to their shares of the fund’s ECI (and possibly even other income not derived from the fund). This is because a partner in a partnership is treated as carrying on the business activities of the partnership for purposes of determining whether such partner has income from an “unrelated trade or business” (for UBTI purposes) or a “U.S. trade or business” (for ECI purposes). As mentioned above, mezzanine funds often purchase warrants to acquire equity in borrowers for a nominal strike price. Tax practitioners often worry that such “penny warrants” issued by an LLC would be viewed as an actual equity interest in the LLC, giving rise to UBTI for tax-exempt investors and ECI for foreign investors. Although there are a number of structuring devices that can be utilized by mezzanine funds that invest in LLCs (including restructuring the form of the “equity kicker” or providing in the fund documents for the creation of a parallel fund structure to make the equity investment where the tax-exempt and foreign investors invest through a blocker corporation), all of these devices involve a fair amount of complexity and require careful structuring.

Portion Interest. As one might expect, mezzanine funds typically derive a significant portion of their income in the form of interest. In general, a foreign limited partner’s share of any interest paid to the fund by U.S. borrowers is subject to 30% withholding tax (subject to reduction or elimination by treaty) unless the exception for “portfolio interest” applies. In order to qualify as portfolio interest, the debt must generally be in “registered” form (meaning that transfers can only be evidenced by actual surrender and exchange or book-entry, as opposed to a bearer obligation), the amount of the interest cannot be based on revenues, income, profits, property value fluctuations or equity distributions, certificates of non-U.S. status must be obtained from foreign debtholders, and the person receiving the interest cannot be a 10% equity owner of the borrower.

While the other requirements are usually easy to satisfy, the last requirement is sometimes subject to question. Some tax practitioners are concerned that the exception will not apply where the fund owns 10% or more of the borrower’s equity (or warrants to acquire such equity). However, the prevailing view appears to be that the 10% test should be applied at the partner level, treating each partner as owning its ratable share of the fund’s equity stake, in which case it will be extremely unlikely that any particular partner in the fund will own 10% of the borrower’s equity.
Private Equity in Russia

Who would have thought Illya Kuryakin would spend his “second career” managing a private pool of equity capital in an office overlooking the Kremlin? While in the U.S. vast amounts of capital overhang the private equity marketplace making it a challenging arena for investors looking for deals, the scene in Russia provides an interesting contrast. Not yet overcrowded, the site of increasing fundraising and full of challenges, the Russian marketplace represents a bold new frontier for private equity investing.

Russia’s market economy is ten years young this year, and has matured from a shaky transitional economy to a growing emerging market. The federal budget posts a surplus; public debt has been reduced from 94% of GDP in 1999 to 52% in 2001; and the economy has enjoyed sustained growth of between 5.1% and 8.3% for each of the past three years. Since July 1994, more than 70% of the country’s economy has been in private ownership (today the figure is about 80%), and the government continues each year to sell off its remaining stakes in major companies. Under the energetic leadership of President Putin, the legislature has adopted a favorable Tax Code, the government has approved a corporate governance code and is pursuing judicial reform and difficult structural reform of the natural monopolies. Russia’s accession to the WTO seems likely to occur next year.

On a micro-economic level, Russia has the most developed equity capital market among the countries of central and eastern Europe, and will be the region’s financial center. The Russian equity market accounts for 10% of the Morgan Stanley Capital International index (MSCI), compared with a 5% weighting for Poland, 3% for Hungary and 1% for the Czech Republic. Russian equities have a market capitalization of about $73 billion and daily trading volumes are reaching $800 million – eight times the level of Poland’s stock market. The RTS (Russian Trading System) index was up 91% in dollar terms in 2001, and is up a further 43% for the first four months of 2002, making the Russian stock market one of the best performing markets in the world.

Because of these positive economic statistics and maturation of the Russian market, the level of interest in private equity and venture capital is up sharply this year. Baring Vostok Capital Partners, a subsidiary of Dutch ING Baring Group, closed a $205 million private equity fund in January this year. Finartis Group of Switzerland has announced a $150 million fund to be financed by Russian institutional and private investors. Both of these funds are earmarked for investments primarily in Russia. The European Bank for Reconstruction and Development (EBRD) has plans to launch up to four additional private equity funds for Russia. For the first time, individual Russian investors are making significant contributions to private equity funds and there is growing interest among domestic Russian financial institutions in sponsoring funds.

History
An early surge of investment fund activity followed the end of Russia’s mass privatization program in 1994, which lasted until 1997 raising approximately $3 billion, of which roughly $1 billion remains uninvested. There are currently about forty Russian direct equity funds, with an average size of approximately $100 million. Of these funds, about one-quarter were formed with public or quasi-public funds, such as the eleven regional funds created by the EBRD, and the $440 million US-Russia Investment Fund established in 1995 with funds provided by the U.S. Congress. The remainder of these funds have private sponsors such as Paine-Webber Mitchell Hutchins (now Russia Partners), SUN Group, AIG, ING Barings Group, Framlington and Daiwa. These funds target investments in a wide variety of sectors, including natural resources, wood and paper, communications, media, high-tech, consumer goods, pharmaceuticals, transport, distribution, real estate and services.

Not all of these funds have been equally successful, but some managers claim to get average annualized returns as high as 70% on a significant number of their investments. An IRR in the range of 20%-30% may be realistic over the next decade for the best managed Russian direct equity funds.

Issues
The challenges for Russian private equity funds are significant. The first challenge is finding companies that meet investment standards. Although business opportunities in Russia seem unlimited, few companies have experienced managers, business plans, audited (or even unaudited) financials prepared in accordance with GAAP or IAS, transparent ownership structures, organized corporate records, or even properly documented title to their assets or contractual arrangements with suppliers, vendors and customers. The business environment of the early 1990s in Russia encouraged capital
flight, tax evasion and “grey-market” operations. Ten years of market experience and international market integration, consolidation of ownership, accounting reform and a new Tax Code have begun to make a difference, but identifying investment targets and completing due diligence is still a time-consuming exercise.

There have been plenty of ownership disputes and corporate governance horror stories over the years in Russia. Company law and securities regulation are now comparatively well-developed and progressive in their protection of minority shareholders. In April 2002, the Russian Securities Commission and the government adopted and published a Corporate Governance Code, which will provide another stimulus for increased transparency and better management. However, bureaucratic corruption, the mentality of secrecy and a less-than-independent judicial system remain. Mentalities are evolving as businessmen learn the value of high stock prices, and the President has announced ambitious plans for reforming the judiciary and the civil service. These reforms will all take some time.

Exits are also a challenge. Despite its relative importance vis-à-vis other central and eastern European financial markets, liquidity is still limited on the Russian capital markets. Out of about 250 companies listed on the RTS, only ten stocks are actively traded. IPOs are still rare – only five Russian companies have listed securities on the New York Stock Exchange, and one additional listing on the London Stock Exchange is planned for later this year. There may be two or three additional IPOs during 2003. Although IPOs and management buy-outs will provide some avenues for exit, the most realistic exit strategy in the short to medium-term is sale to a strategic investor.

Foreign private equity funds that enjoy little competition in central and eastern Europe face tough competition in Russia from domestic industrial groups which often play the role of venture capitalists. Russian private funds also face stiff competition for foreign institutional monies from hedge funds investing in portfolios of non-control positions in Russian public companies. More than twenty Russia-invested portfolio funds were created in the mid-1990s which now range in size from $5 million to $432 million under management. At least six of these are open funds listed on the New York Stock Exchange. During 2001, these funds had annual returns ranging from 47% to 124%.

Structure

Russian laws related to investment funds are not yet developed sufficiently in their substance or in practice to make domestic funds attractive to foreign sponsors and investors. Russian private equity funds have all been established in jurisdictions other than Russia. The most popular jurisdictions have been Guernsey and Jersey for European sponsors and Bermuda or Cayman Islands for U.S. sponsors. A few funds (or parallel funds) have been formed under Delaware law for marketing to U.S. institutional investors.

The most typical structure is a partnership formed in a reputable, tax-advantaged jurisdiction; having a general partner and possibly a manager incorporated in the same jurisdiction; and a local investment advisor which is a Russian company or a foreign company with a branch office located in Moscow. Very often, investments will be made through investment companies established in countries such as Cyprus or Germany, which have favorable tax treaties with Russia minimizing the withholding tax on dividends, interest and capital gains.

The average investment for a Russian fund ranges from $5 million to $50 million, and involves buying at least a “blocking stake” (25% plus one share) and often controlling interest. Experienced direct equity groups are able to manage the risk and increase the value of target companies through injection of new management, technologies and know-how.

The range of fund products available to investors remains extremely limited. To date, unrelated funds have invested in common or preferred equity of Russian companies. Management buy-outs have not been common, although there is a generation of young managers who will want to buy out the privatized companies they run. Acquisition finance has not yet developed in Russia, although there are no financial assistance restrictions or other legal inhibitions to impede its development.

Prognosis

The challenges of private equity investing in Russia also bring opportunities for adding value. By injecting new management and training existing management, adding new technologies and know-how and providing much needed capital, private equity funds can significantly impact the profitability of a Russian business. As direct foreign investment continues to grow, opportunities for exit will also multiply. A small group of direct investment fund sponsors have developed experienced Russia teams with track records, who are now investing a second generation of funds. This circle no doubt will widen over the next couple of years as new foreign and domestic sponsors enter the market. — Holly A. Nielsen
European mezzanine providers are understandably surprised by their own success in recent years. Only a couple of years ago, as a telecom-driven high yield market seemed poised to achieve market dominance quickly, many European practitioners considered mezzanine finance a fading source of middle tier capital.

Today the table has turned and mezzanine has bounced back. High yield is struggling to recover from investors’ fundamental loss of confidence in the product, while corporate financiers continue to lament its regularly referenced lack of flexibility within financing structures. Indeed, high yield financing’s relative decline has been such that today some mezzanine providers claim that vendor financing poses a more serious threat to their deal flow.

European mezzanine has unquestionably come of age, and it is confidently looking to do business in parts of the market that in the past had seemed beyond its reach. Although no exact statistics exist as to how much funding capacity there is at present, mezzanine fundraising over the past 12 months has been significant, adding to an already sizeable, and increasingly liquid, capital pool.

There is an expectation among European mezzanine specialists that sooner rather than later, large LBOs will emerge with as much as €300-400m of mezzanine sitting in the capital structure. The main reason why this hypothesis has yet to be put to the test isn’t so much that the mezzanine houses have been reluctant to put their money where their mouth is, but rather that sufficiently large buyouts remain so thin on the ground. But at some point this shortage of deals is bound to give way to a more buoyant market (most commentators are pinning their hope on the first quarter of 2003). If at that point mezzanine succeeds in playing a key role in deals of this size, it will indeed have pulled significantly ahead of high yield and become part of the financing mix of choice.

For the time being, however, lenders’ immediate ambitions are being thwarted by the dearth of deals that make it through to completion, as economic uncertainty continues to cause frustration. European practitioners complain that the ongoing recession is a “funny” one, i.e. one that, unlike the bear market of the early 1990s, has failed to sufficiently motivate sellers and knock vendors’ price expectations back to a level where buyers can actually commit. As a result, those willing to lend continue to sit on large amounts of dry powder.

But although patience is an important trait to possess in the current climate, there is more to do for mezzanine houses than simply playing a waiting game. They have been busy participating in their traditional forte of smaller buyouts, and they have also enjoyed success in winning mandates to provide acquisition capital for mid-size companies and turnaround financing for businesses struck by economic hardship. One of Europe’s most established players, London-based Intermediate Capital Group, closed five deals in February 2002 alone, thus finishing on a high a quarter that was among the European market’s poorest on record in terms of deals reaching completion.

As news of the mezzanine opportunity spreads, it is largely the boutiques (as opposed to the captive mezzanine operations within the banks) that are taking a lead role in helping the market to mature. To these firms, such as ICG, GSC Capital Partners, PRICOA, Mezzanine Management, Indigo and Euromezzanine in Paris, mezzanine is the core product. Theirs is a proposition that investors are also receptive to, as was illustrated recently by GSC which in June closed Europe’s first ever €1bn mezzanine fund. Geographic expansion is also a popular theme among mezzanine firms ready to demonstrate their confidence. Germany and France, where traditional funding providers are losing their dominance – particularly in the middle market where
many banks are presently retreating – are attracting considerable attention from mezzanine providers at present. One London-headquartered house, Mezzanine Management, is even looking beyond Europe’s industrial heartland, confident that now is the time to be pioneering a move into Eastern Europe where they see a buyout market is gradually taking shape. Mezzanine Management has just held a first closing at £75m for a first fund dedicated to the region, and declares itself ready to embark on an undertaking that is certain to be watched closely by the competition.

New players are also looking to enter the mezzanine market. One example is Nordic LBO firm EQT, which recently announced plans to add an in-house mezzanine element to its product mix. An altogether more high profile project to have got underway is Hutton Collins, led by a combination of one of London’s most well-known debt financiers (Matthew Collins) and the former head of Morgan Grenfell Private Equity (Graham Hutton). Both are driven by a belief that mezzanine in Europe has not even begun to fulfill its full potential. To prove their point, Hutton Collins are looking to raise €600m to add to Europe’s mezzanine pot.

Given the optimism that is currently so widespread among practitioners, it should be no surprise that the investment banks are also keen to make forays into mezzanine. They are increasingly eager to underwrite and subsequently syndicate mezzanine product to a market where there is more and more buy side appetite to cater to, especially among the fast-growing band of European CDO funds. And they have already distinguished themselves by focusing on warrantless mezzanine, a product whose return structure does not include an equity participation for the lender and which is expected to perform well particularly in deals that use large tranches of subordinated debt.

To what extent warrantless mezzanine can grab market share from its more conventional counterpart remains to be seen. What is certain is that expectations are high for a product that, given its apparent decline in the late 1990s, could be forgiven for being taken aback by its own success. As more businesses are willing to incorporate mezzanine in their funding plans, as equity sponsors are equally receptive to the mezz proposition, and as investor appetite holds firm, European mezzanine looks set to remain a growth industry for some time.

— Philip Borel is managing editor of Private Equity International in London. Robin Burnett, who has over ten years of experience in European leveraged finance, is a regular contributor to the magazine.
One response to these challenging cross-currents has been an increasing tendency for one or the other (and sometimes both) parties to a transaction to look to insurance as a way of bridging risk-allocation gaps. Not surprisingly, the insurance industry is responding with a variety of products ranging from policies that provide protection for a specific risk (a tax structuring uncertainty, an environmental liability, a piece of litigation) to broad representation and warranty policies that can provide an alternative to escrows or indemnification arrangements for the full panoply of risks covered by an acquisition agreement.

Five years ago, at least outside of the environmental field, insurance policies were largely unheard of as a device for addressing risk allocation issues in purchase and sale transactions. In the past twelve months, in contrast, this firm has encountered a number of M&A transactions that seriously explored, and some which ultimately resorted to, insurance policies as a way of bridging what otherwise might well have been deal threatening risks. This article briefly outlines the widening use of insurance in the transactional context, provides several examples of transactions in which insurance was proposed as a method for facilitating the resolution of risk allocations issues, and incorporates the views and experiences of some insurance professionals on this evolving area.

The Risk Allocation Context in M&A Transactions

The numerous steps in the process of purchasing and selling a business force an examination and allocation of risks. This starts at the diligence and pricing stages, where the buyer seeks to understand the business, assay existing contingent liabilities, and make a judgment as to ongoing risks and liabilities. Throughout this process (and the related preparation and negotiation of provisions of the agreement that allocate risks — representations, warranties, liability assumption provisions and indemnities) there is typically a more systematic sifting of information and identification of risks than would be the case during normal operation of an ongoing business. In addition, the fact of doing a transaction may interject new, transaction specific risks. Finally, by incurring substantial leverage, the transaction may increase the business’s risk sensitivity, both because it will be less tolerant of significant swings in performance or unexpected costs and because the substantial indebtedness and interest expense may create a situation in which the target is not a taxpayer and cannot benefit from the fact that in the event of extraordinary costs or any fall off in performance it would at least save tax dollars.

Taken as a whole, then, the M&A process is likely to identify and focus considerable attention on at least the following kinds of risks:

- One time contingent liabilities arising out of past activities — financial risks, tax liabilities, discrete pieces of litigation, environmental or product liability problems associated with discontinued operations, etc.
- Contingent liabilities or unaccounted for costs of an ongoing nature (that is, where there is a liability for acts or conduct in the past that are continuing and can cause costs or problems in the future) — processes or products that cause continuing environmental or product liability problems, ongoing defects in title to assets or intellectual property, ongoing non-compliance issues or employee problems are all examples.
- Risks associated with the change of control itself — assignability of licenses, permits and contracts, increased leverage, customer relations, etc.
- Transaction structure risks — key tax planning or structuring issues and, perhaps, regulatory structuring gambits.

One of the key roles of M&A lawyers and their colleagues from many disciplines is to identify, mitigate, negotiate and allocate these various kinds of risks among the parties. But often, when that has been accomplished, particularly in shaky economic times, there will remain some group of risks that neither party is willing to bear. For the buyer they render the deal too risky or marginal; for the seller they render the proceeds...
too contingent. Neither is confident that the process of ultimately resolving and settling the problem will be consummated in a manner that is in their interest and, particularly in an age where every decision is second guessed, everyone is too risk averse. Insurance is the irresistible answer.

**Reports from the Front**

In recent months, Debevoise & Plimpton lawyers have had the following three encounters with transaction risk insurance.

**Single Issue Tax Risk**

One company (“Buyer”) was to acquire all of the stock of another company (“Target”). Some years earlier, Target engaged in a taxable transaction but the gain was deferred under the consolidated return regulations. The proposed acquisition would terminate Target’s consolidated group and, unless an exception applied, trigger the deferred gain for tax purposes. The Target took the position that it qualified under one of the prescribed exceptions. However, because there was no “on-point” authority that the exception was applicable to Target’s facts, there was some underlying risk that the acquisition would trigger the deferred gain.

The amount of potential tax was substantial relative to the size of Target and Buyer. As a result, the Buyer was unwilling to assume the potential liability or even to “price” the potential liability by reducing the purchase price. The question of whether the acquisition triggered the deferred gain would not be resolved for at least seven years, and the seller was unwilling to agree to an escrow for such a long period.

Ultimately, Target obtained insurance for the risk that it could be required to restore the deferred gain as a result of the acquisition. Because the Buyer was concerned that any insurance proceeds would themselves be taxable, the total liability under the policy was increased to reflect a gross up. The policy also covered interest and penalties. The insurance carriers hired their own tax counsel to evaluate the tax risk.

**General Representation and Warranty Risk**

A private equity firm (“Seller”) sought to sell a complex and highly regulated business to a new sponsor group (“Buyer”) at a price that reflected a reasonably robust auction process. Financing had been arranged by the Seller, which was looking forward to a substantial realization event. The Buyer, buffeted by now familiar post-September 11, post-Enron concerns over the state of the world in general and contingent liabilities in particular, and nervous over compliance issues that it feared might prove worse than anticipated, sought a significant escrow. The Seller obtained a quote for general representation and warranty insurance at a price equal to about 6% of the negotiated cap on indemnification and agreed to bear the cost of the insurance as well as the first 4-5% of the losses.

Buyer was unwilling to rely on the insurance rather than an escrow. It asserted that it had investigated such products and been informed that no claim had ever been paid and that insurance carriers routinely refused payment. It also noted, with some force, that it would have more negotiating leverage if there were funds tied up in escrow. Finally, it voiced the concern that the mere presence of insurance would cause the Sellers to be less rigorous in making representations and warranties and crafting schedules.

**General Representation and Warranty Risk – Revisited**

A private equity firm (“Seller”) controlled a public company that it sought to sell to a private purchaser (“Buyer”). Seller and the target took the position that the transaction was a “public deal” and there should be no survival of representations or warranties and no indemnities. Buyer viewed the fact that the target was public as incidental and insisted on an indemnity from the controlling stockholder. Ultimately, Buyer obtained a representation and warranty insurance policy to bridge the gap and get the deal done. Negotiation of the policy between the Buyer and the insurer focused on the deductible and the limits of liability; exclusions to the policy (defects as to which the Buyer had knowledge and which had already been priced into the deal); and conditions to coverage (the absence of fraud, various procedural protections for the insurer and a requirement to arbitrate any disputes).

**Does Insurance in M&A Transactions Really Work?**

Insurance professionals tend to group these transaction-based risk insurance products into three general categories:

- Loss mitigation. These are policies written to cover a particular identified risk — a specific piece of litigation, or all litigation arising out of a specific series of facts or products or processes, or a particular environmental problem. Policies covering shareholder securities litigation are an increasingly common example – both in the transactional

continued on page 19
What Does “Best Efforts” Really Mean? (continued)

Representative Case Law
Courts have generally interpreted “best efforts” and similar clauses as creating an obligation to act reasonably and in good faith under the applicable circumstances. As a result, the clause has generally been held to have different meanings in different commercial contexts. For example, an agreement of a licensee to use its best efforts to sell a licensor’s products will be measured differently from a covenant by an LBO fund to use its “best efforts” to raise financing to consummate an acquisition. As one New York case put it, the clause “necessarily takes its meaning from the circumstances.” Perma Research & Development v. Singer Co. (308 F.Supp. 743, 748 (S.D.N.Y. 1970))

Courts frequently look outside the four corners of a contract to find appropriate standards to interpret a “best efforts” clause in a particular context. These outside sources can include testimony from industry experts, and possibly even testimony about the promising party’s behavior in similar transactions in the past.

Most of the case law interpreting best efforts provisions has arisen in the context of a licensee or distributor being accused of not using its “best efforts” to make sales of the licensor’s, or principal’s, products. Few cases involve transactions similar to the ones private equity funds enter into on a regular basis. Nevertheless, there are a few cases which are instructive for private equity professionals. It involved a dispute over an earn-out. Falstaff Brewing Corp. had purchased Ballantine Ale from Bloor, and had agreed to pay Bloor a percentage of the profits on sales of Ballantine for a certain period of time following the closing. Falstaff agreed in the acquisition agreement to use its “best efforts” to maintain a high sales volume for Ballantine during the period, so as to maximize the value of the earn-out to Bloor. When the sales volume of Ballantine began to slip following the closing, Falstaff did little to stop the slide. Instead, it focused on its other, more profitable business lines, and Bloor sued, alleging that Falstaff was not using its “best efforts” to maintain a high sales volume of Ballantine, as promised in the agreement. The Second Circuit agreed that Falstaff’s neglect was a violation of the “best efforts” clause. It stated that while a duty of best efforts “does not strip the promising party of a right to give reasonable consideration to its own interests,” it did impose an obligation to act with good faith in light of one’s own capabilities or, at least to “perform as well as the average prudent comparable performer.”

In another case whose context will be familiar to experienced private equity pros, In Re Valuevision International Inc. Securities Litigation (896 F.Supp. 434 (E.D.Pa. 1995)), Valuevision had entered into a merger agreement with National Media Corporation pursuant to which it would acquire National Media in a tender offer followed by a back-end merger. The acquisition was contingent on Valuevision obtaining requisite financing. Not surprisingly, the agreement also contained a covenant, whereby Valuevision agreed to use its “reasonable best efforts” to obtain the necessary financing. In the tender offer documents, along with press releases, the reasonable best efforts covenant was emphasized as one of several reasons that shareholders of National Media should tender their shares. When Valuevision eventually terminated the merger agreement because it found the debt markets too expensive, tendering shareholders and other purchasers of National Media stock sued Valuevision, alleging that they had been materially misled about Valuevision’s commitment to consummate the transaction. The Pennsylvania district court refused to dismiss the complaint, finding that a “reasonable investor” could conclude that the covenant to use reasonable best efforts to obtain financing suggested a “strong willingness to conclude financing arrangements without imposing any limitation on the type of financing [Valuevision] would accept.”

Two points about this case are worth emphasizing. The first is that the court did not appear to give any weight to the use of the word “reasonable” before “best efforts” in the covenants, and examined the case as if “best efforts” had been the standard.

Second, while the case does provide some rare insight into how a court might interpret covenants to obtain financing, this was not a contract law case. The court’s obvious desire to protect the public stockholders of National Media does not necessarily bear on how that – or any other – court would have ruled in a
lawsuit between the two sophisticated contracting parties. One can easily imagine the stockholders’ lawyer arguing that while the parties to the merger agreement may have understood that Valuevision was not going to accept any and all terms for its acquisition financing, public stockholders not represented by counsel would not necessarily draw the same inference from a “reasonable best efforts” clause. Nevertheless, the case is at least an important reminder as to the necessity of adequate public disclosure and possibly also an important potential precedent in judicial interpretations of covenants to obtain financing in a transaction involving public stockholders.

The 1998 New York Supreme Court case, Showtime Networks Inc. v. Comsat Video Enterprises Inc. (reported in the August 10, 1998 New York Law Journal), on the other hand, plainly demonstrates the potentially open ended nature of a “best efforts” undertaking, at least in certain circumstances. In Showtime, the court was called upon to interpret Comsat’s obligation to use “best efforts” and “reasonable business efforts” to promote Showtime’s programming in various ways (“best efforts” was to be used in signing up new customers; “reasonable business efforts” to be used in maintaining those customers). Comsat had allegedly failed to do so, arguing that it had no obligation to take actions that would cause it to sustain disproportionately large losses.

The court was not sympathetic, refusing to grant Comsat summary judgment on the breach of contract claim. It held that whether “best efforts” or “reasonable business efforts” had been used was a question of fact to be determined by a jury, and that Comsat’s argument that it could not be obligated to incur substantial losses was not convincing. It wrote: “difficulty of performance occasioned only by financial difficulties, even to the extent of insolvency, does not excuse performance of the contract,” and “the cost of providing the Showtime programming and its unprofitability does not excuse [Comsat’s] performance of this provision.” While this case falls outside of the vast majority of cases interpreting “best efforts” and similar clauses, it nonetheless demonstrates the potential risks posed by agreeing to these clauses, and has accordingly made lawyers very reluctant to agree to them in practice.

Recommendations

Here are some recommendations concerning the use of “best efforts” and similar clauses in practice.

It should not be used as a Guarantee of Performance. Despite Showtime, one should not conclude with confidence that a “best efforts” clause will be interpreted as akin to a guarantee, or a near guarantee, of performance. Accordingly, if you want to require your counterparty to produce a particular commercial result, you should impose a flat obligation to do so, rather than agreeing to a performance obligation qualified by “best efforts” or some similar standard.

Don’t assume it won’t be deemed a Guarantee of Performance. On the other hand, in light of the Showtime case described above, one also should not assume that a “best efforts” clause will not be interpreted as similar to a guarantee, or a near guarantee, of performance, at least in some circumstances. Accordingly, while it may sometimes be beneficial to be the recipient of a “best efforts” undertaking, particularly in circumstances where the other party refuses to agree to a flat obligation and where it is otherwise impractical to spell out the nature of the other party’s performance obligation with more precision, it is ill-advised to provide one unless you are prepared to be held to a very high level of performance. This is particularly true in the private equity arena given the dearth of case law interpreting “best efforts” or similar clauses in the context of obtaining financing, avoiding UBTI and other commercial contexts where these clauses are frequently used by private equity sponsors.

Use the lower standards – but be careful. Given the uncertainty associated with “best efforts” clauses, it is often tempting to utilize some seemingly lesser variation thereof, like “reasonable best efforts,” or “commercially reasonable efforts,” as a compromise formulation. But while these alternative standards would appear to create less stringent performance obligations than a “best efforts” undertaking, the absence of helpful case law interpreting distinctions among these differing standards makes it difficult to be certain that these distinctions would be recognized by a court. Even if they were, it is not at all clear how the lesser standards would...
be applied to contexts of relevance to private equity professionals. Still, in many circumstances, these alternative lesser formulations will probably be the most practical means for parties to reach agreement on the scope of these type of performance obligations.

*Define what you mean – where appropriate.*

The best way to create more certainty as to how a “best efforts” or similar clause would be interpreted by a court is for the parties themselves to specify what they mean, to the greatest extent practicable. For example, it may make sense in some deals to provide that an established private equity sponsor’s obligation to use its “reasonable best efforts” to obtain financing for a transaction will be deemed satisfied if the sponsor exercises a level of effort comparable to effort it has exercised in obtaining financing in similar transactions in the past. Similarly, it may be desirable to make clear that a sponsor’s obligation to use its “best efforts” to avoid causing its limited partners to recognize UBTI will be deemed satisfied if the sponsor exercises the same level of effort in this regard as is customarily exercised by similarly situated sponsors. Another approach along these lines is to specifically include or exclude certain actions from a particular performance undertaking, such as specifying that a buyer’s obligation to use “reasonable commercial efforts” to obtain third-party consents in connection with a closing will not require it to pay any consent fees (perhaps above a certain nominal level.) Whether these kinds of refinements are appropriate for individual transactions will of course depend on the circumstances of each deal, including the relative negotiating leverage and sophistication of the parties and other tactical considerations. But any decision to forego them should be made with a recognition of the inherent imprecision associated with the mere use of a “best efforts” or similar standard to establish the scope of a performance obligation.

—Stephen R. Hertz and Joshua L. Tangoff
As a general matter, however, the fund’s “major” distributions – those that result from the disposition of investments – tend to overtake these differences in the treatment of current income, making them important more as a matter of timing than of significant economic impact.

**Leverage.** More aggressive mezzanine funds often use leverage in an attempt to boost returns. Leverage can make a mezzanine fund more competitive with straight equity funds, and can reduce investors’ tax exposure to current income. The fund sponsor can use all or a portion of the fund’s current income to pay interest on the fund’s borrowings, and thereby reduce the amount of current income being distributed to limited partners. Leverage increases risk, however, and may also result in unrelated business taxable income, or “UBTI,” to tax-exempt investors. A prospective investor will want to consider whether a fund’s proposed borrowings are consistent with the investor’s appetite for risk and tax objectives.

**ERISA Issues.** To facilitate investment by private pension plans and other ERISA investors, private equity funds typically commit to qualify as “venture capital operating companies,” or VCOCs. Mezzanine funds are no different. However, because mezzanine funds invest principally in debt, and because their investments are usually small relative to the portfolio companies’ overall capitalization, the management rights they need to qualify as VCOCs tend to be harder to come by.

To be a VCOC, a fund must have qualifying “management rights” in at least 50% of its investments, valued at cost. An equity fund that makes a control investment in a company will almost invariably get representation on the company’s board of directors (which is widely acknowledged as sufficient to qualify the investment for VCOC purposes). However, a debt fund that supplies financing for the same transaction may need to seek a number of other, lesser means of influencing management in order to achieve the required level of management rights. Normally, this takes the form of a combination of rights to appoint a board observer, to advise and consult with management, to inspect the company’s books and records, and other similar rights. How much is enough to make the investment a qualifying VCOC investment will depend on the facts and circumstances of each deal. Notably, in a recent Department of Labor (“DOL”) advisory opinion the DOL concluded that contractual rights including the right to receive extensive financial information about the company, the right to access and copy any documents about the company, the right to visit and inspect the company’s properties and examine the company’s books, and the right to consult with and advise the management of the company and its subsidiaries constituted management rights because they were “more significant than those normally negotiated by institutional investors with respect to investments in established, credit-worthy companies.” Mezzanine funds therefore must be vigilant about achieving the required level of rights, and ERISA investors may want to inquire closely about a mezzanine fund’s status as a VCOC.

**Conflicts for Captive Funds.** Some private equity sponsors form so-called “captive” mezzanine funds – funds that will invest a significant percentage of their assets in transactions in which the sponsor’s buyout fund is making an equity investment. These funds can be attractive to investors who believe in the quality of the sponsor’s portfolio and management skills – investing in the mezzanine fund gives them another way to benefit from the sponsor’s strengths. However, all parties need to be aware of the potential for serious conflicts of interest that can arise if an investment goes bad. In a bankruptcy or workout situation, debtholders and equityholders have competing desires, and almost any decision made by the sponsor will necessarily disadvantage one or the other of its funds. Investors should understand what the sponsor’s obligations are to the mezzanine fund investors before investing in a captive fund.

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Mezzanine funds present certain challenges to sponsors and investors accustomed to more traditional buyout funds. By staying attuned to these differences, however, both sides can make fund formation a smoother, more efficient process.

— Jennifer J. Burleigh

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**Mezzanine funds... must be vigilant about achieving the required level of rights, and ERISA investors may want to inquire closely about a mezzanine fund’s status as a VCOC.**
options are not in substance an actual stock interest), the options would be treated as exercised for purposes of determining whether the foreign company was a CFC, but the fund itself would not be subject to the CFC rules until exercise. If a mezzanine fund anticipates acquiring 10% or greater equity stakes in foreign companies, it can generally avoid CFC issues by organizing as a foreign (e.g., Cayman Islands) limited partnership instead of in Delaware, or, for funds already formed in the U.S., by making the foreign investment through a parallel "alternative investment vehicle" organized offshore.

The PFIC rules apply to U.S. persons that acquire equity in foreign corporations with "passive" income (such as dividends, interest, rents, royalties, etc.) or assets that produce passive income exceeding certain thresholds, and could apply to U.S. partners of a mezzanine fund whether the fund is organized in Delaware or offshore and regardless of how small a percentage of the PFIC the fund owns. Although the PFIC rules were originally intended to apply to U.S. shareholders of offshore mutual funds and similar investment companies, they have a much broader reach and can apply in unexpected places. For example, start-up companies that have not begun to receive operating revenues may have interest income that, even though relatively insignificant in amount, constitutes a sufficiently high percentage of the start-up’s overall gross income so that the start-up satisfies the PFIC “income test.”

The PFIC rules treat all gain derived on a sale of PFIC shares as ordinary income and impose an interest charge (calculated as if the gain had been taxable on a ratable basis over the entire holding period of the PFIC shares, a potentially onerous result). These rules can be avoided if a “qualified electing fund” (“QEF”) election is made, in which case the U.S. investor would instead be taxed currently on its pro rata share of the PFIC’s ordinary income and capital gains (and would preserve the opportunity for capital gains on a sale of PFIC shares).

Because mezzanine funds often acquire their “equity kickers” in the form of options (such as warrants), the PFIC rules can present a potentially disastrous trap for the unwary. This is because the PFIC rules do not generally permit QEF elections for options, but nonetheless apply the disadvantageous ordinary income and interest charge treatment to a sale of the option. In addition, for purposes of determining the application of the interest charge to a sale of the PFIC stock acquired on exercise of the option, the holding period of the stock is deemed to include the period the option was held. Mezzanine funds that make investments in foreign companies should carefully consider the application of the PFIC rules. In the event that a mezzanine fund invests in a foreign company that is or might be a PFIC, fund sponsors would generally be well advised to structure the equity kicker as an actual issuance of stock (perhaps with vesting or forfeiture provisions to parallel the proposed economics) thereby allowing the QEF election to be made, as opposed to structuring that investment with warrants or options. It should be noted that a QEF election can only be made if the issuer agrees to provide certain financial information to the fund on an annual basis, which some foreign companies may be unwilling to do, particularly if the mezzanine fund is a minority investor. If the mezzanine fund wants to be able to make the QEF election, it will be advisable to discuss this with the issuer before committing to invest, and to include in the investment documentation contractual provisions requiring the issuer to provide the necessary information.

In conclusion, mezzanine funds offer sponsors and investors the potential for attractive returns with a more conservative risk profile than LBO or VC funds. However, mezzanine investing raises a number of tax issues that will often require careful planning in order to maximize the after-tax return to investors. — Adele M. Karig and Peter A. Furci

Because mezzanine funds often acquire their “equity kickers” in the form of options (such as warrants), the PFIC rules can present a potentially disastrous trap for the unwary.
Can Transaction Based Insurance Solve Deal Jitters? (continued)

context and where the insured simply seeks to reassure the market that it has capped its exposure.

- Tax risk. These policies protect one or the other party from a particular tax risk. They can focus almost entirely on a question of law or interpretation, as in the earlier example involving the potential triggering of deferred gain, or they can be considerably more fact driven, as would be the case for insurance covering the existence or utility of net operating loss carryforwards, where issues such as continuity of business activity, prior ownership changes, or the past deductibility of various items are relevant.

- Representation and warranty. This is the most novel and open ended form because it is, by definition, insuring against the unknown.

We have observed that representation and warranty insurance is becoming increasingly common – at least where a negotiating gap cannot be bridged in another way. According to insurance brokers we have worked with, including those at Aon and Marsh, such insurance, although largely a creature of the last couple of years, is on the rise. In a typical case, pricing is about 4-8% of the maximum exposure, and the carriers prefer situations where the insured has some risk as well – either through a significant deductible or through coinsurance arrangements. Because of the open ended nature of the risks, the carriers place significant emphasis on the quality of the professionals (lawyers, accountants, consultants) involved in the transaction and the quality of the diligence that buyer and seller have conducted.

From the perspective of the parties in a transaction seeking to bridge a significant negotiating gap, the insurance generally works best if the buyer is the insured party, insurance professionals suggest, because the carrier is likely to have fewer defenses to a claim by the buyer and buyer insurance allows the seller to walk away without contingencies. In terms of process, we understand that the seller often seeks the policy and negotiates its rough parameters before shifting it to the buyer for final negotiation and signing.

And what about the $64,000 (in 1950s dollars) question. Do carriers pay under these policies? We are assured that the answer is yes. Our industry sources are aware of cases where payment has been made or is being made. But the products are very new and there is not much history.

From the M&A lawyer’s perspective, transaction based insurance can inject a number of new issues into the deal. Where insured risks involve actual or prospective third party or governmental claims there is often a “roadmap” issue: Will the fact of insurance, or the amount of coverage, or the disclosure made to the carrier, or the policy terms, put potentially adverse parties on notice as to facts or resources which one would prefer to keep in confidence? There is often a concern in negotiating an acquisition agreement that highly detailed indemnification or disclosure provisions can be a lightening rod for plaintiff actions or tax audits or other undesirable events. Insurance can magnify the problem. A related issue is the extent to which disclosure of the details of buyer’s legal diligence to insurance carriers deprives that diligence of the attorney client privilege.

Another issue relates to the interplay of contract law and insurance law and practice. M&A lawyers believe they generally understand how principles of causality, and measurement and mitigation of damages, and remoteness of injury would apply to a claim for indemnification under a contract they have negotiated. A seller’s representation and warranty insurance would likely piggyback on the terms of the acquisition agreement and on those same principles – that is, the Seller’s claim against the carrier would be the amount of the Buyer’s indemnifiable loss, reduced by any deductible or co-payment feature in the insurance. A buyer’s representation and warranty policy, in contrast, can bypass the need for an adjudication of buyer’s claim against seller under the contract (or for a settlement of such a claim against a backdrop of a potential adjudication). Buyer’s counsel may with justification fear that less expansive damage measurement principles would govern his stand-alone claim for recovery against the carrier.

As these products become more common, and the early ones are tested by the passage of time, we anticipate that the market for transaction based risk insurance will mature and some of the uncertainties that now surround it will recede. But it already seems likely that, notwithstanding questions about payment practices, defenses, and exclusions, and despite choppy pricing and some administrative headaches, these products will become an established feature of the M&A landscape.

— Jeffrey J. Rosen
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