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INTERNATIONAL FINANCIAL LAW REVIEW

Buying into Brazil
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Comparing UK and Scandinavian codes

Restructuring leverage
The effect of buying debt back

Private equity and venture capital review

October 2008

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Editorial

Profitable boredom or academic stimulation?

"This is an incredibly exciting time to be a private equity lawyer," says the partner as I sit in his Manhattan office. The statement takes me by complete surprise. Did I mishear or does this senior partner of an international law firm not understand the current economic climate?

Private equity is suffering. The glory days of leverage at a ratio of 10 or 11 have been replaced by stretches to 3.5 at the very most. And that is if you are lucky. As a result, the big acquisitions and multi-party auctions are a thing of the past. They have been replaced by cautious stake building and tentative joint ventures. This cannot be enjoyable for private equity lawyers.

Or so I thought. "We are still doing deals", he continues. "And we are burning up a lot of brain cells in structuring some innovative transactions."

He concedes that the work is not as frequent or profitable as previously, but to a certain extent it satisfies his academic side more. For example, the partner recently helped structure a four-way joint venture where the seller retained a 50% stake.

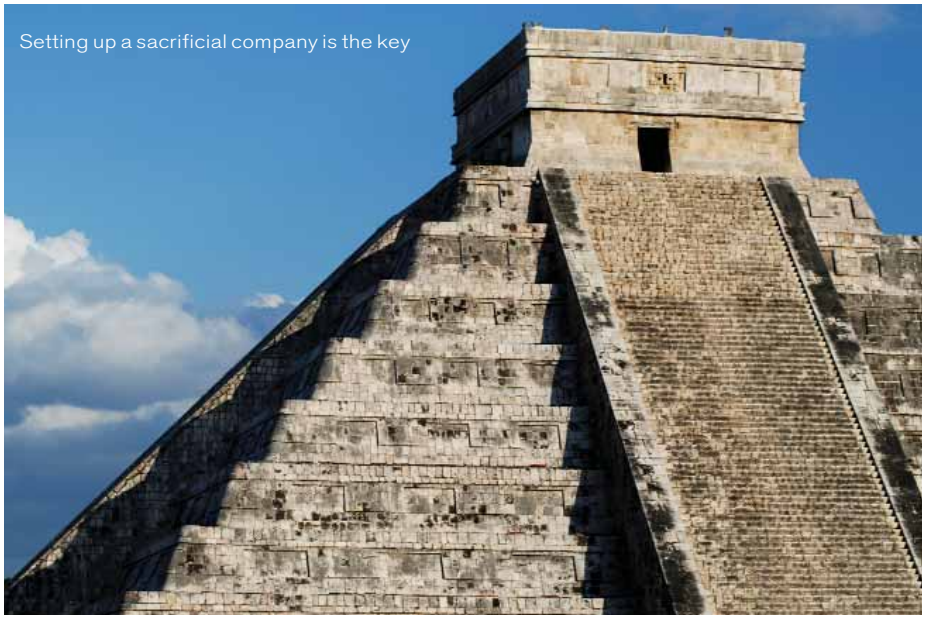
A private equity house bought 25% and two strategic investors integrated some of their existing assets into the new venture in return for the other 25%. Eighteen months ago, the private equity house would have put in an irresistible 100% bid and this kind of intricate contractual relationship would never even be considered.

"The auction process took over so much that it became the playbook and, to be frank, it was getting boring," the partner concludes. "But the playbook is now out the window. I guess challenging times bring about innovation. I for one enjoy brain twisters that take a while to figure out."

It would be interesting to see if the law firm's senior management agreed with the partner's comments. I'm sure they would prefer a return to profitable boredom.

Nicholas Pettifer

US private equity breaks into banks


Setting up a sacrificial company is the key

Private equity houses will follow JC Flowers' lead after it found a way to bypass legislation to invest in distressed banks.

The Bank Holding Company Act states that investors of over 24.9% in a US bank must register as a bank holding company, which comes with its own restrictions. One is that bank holding companies cannot own more than 5% of any company outside of the financial services sector – an obvious problem for diversified private equity funds.

In August, it was reported that JC Flowers' chairman Christopher Flowers set up an independent fund in his own name to get around the regulation. This was the first move from an industry that has been planning ways to invest in struggling banks for months.

"There was a time when the private equity community was lobbying for a change in the law, but this was unrealistic," said an M&A partner at a US firm. "So over the course of the year it has been talking quite aggressively to the Federal Reserve Board about new kinds of structures."

Although the structure of the JC Flowers fund is confidential, it seems the key is to set up a new entity that is a sacrificial bank holding company – its sole purpose is to invest in the chosen bank.

But the 25% rule applies to this holding company, and indeed any company that invests in it, too. So the ownership of the sacrificial company must be structured so that means no investor has an impermissible stake in it. In a simplified example, five investors in the sacrificial company could each hold 20% and thereby stop the 25% rule from applying to them as well.

This can be done by spreading the stakes in the sacrificial company across a club of private equity houses or across a number of limited partners from the same house. The former is easier to structure, but may prove less popular as the profits are diluted across many funds.

The latter requires more structuring:

"Under this option, the general partner of the private equity house still owns 100% of the voting power, so would have to register as a bank holding company. This isn't ideal as private equity houses like to use the same general partner for all its funds," said the partner.

"One solution is to create a brand-new special-purpose general partner who registers as another sacrificial bank holding company."

To add further complexity, there is another threshold that funds may want to consider. At 25% there is a legal presumption that the investor controls the bank and therefore must register as a bank holding company. At 10%, there is a rebuttable presumption:

"Different people have different risk profiles on the 10% rule, but the most popular approach is to go to the Federal Reserve Board and get them to bless it. Not because you need their approval, but because you don't want them to challenge you later on," said the partner.

Private equity funds may therefore want to consider complicating their structures further by catering for the 10% rule.

"When you get down to the weeds of solving this problem [with private equity investing in banks], solutions vary based upon the business objectives and the internal structure of the investor," said the partner. "Some are easier to solve than others." **NP**

IMF persists with pointless sovereign wealth "code"

The IMF has persuaded 26 sovereign wealth funds (SWFs) to agree to voluntary transparency guidelines. But doubts remain over the impact this will have.

"I just don't see the point of these guidelines," said bankers' counsel in London. "Protectionist governments will still block SWF activity in sensitive areas if it wants to regardless of whether a fund complies with the IMF or not."

The Generally Accepted Principles and Practices were discussed by funds and the IMF in Santiago, Chile in September.

The principles are reported to advocate that funds should disclose their investment plans to foster trust and confidence.

But the principles will not be monitored. The IMF's proposal to monitor compliance was refused by funds led the Abu Dhabi Investment Authority and the Government of Singapore Investment Corporation in Chile.

Also, critics are still disappointed that the principles are voluntary.

"A strict, compulsory code would go a long way to relieving protectionist concern, but instead the IMF has come up with something half-hearted," said a private equity partner in London. "Personally, I wouldn't want a strict code, but I can't see the point of creating one at all if it has no impact."

Governments that worry about the intentions of SWFs will probably resort to their own methods to stop sensitive industries falling into foreign hands (for example, Cfius in the US and the recent German foreign investment bill). For this to change, SWFs would have to be forced to comply with extremely strict rules on accounting and disclosure.

But SWFs do not want to be controlled. This was evident in Chile by the SWFs refusal to be monitored and their reluctance to call the guidelines 'rules' or 'a code'.

Voluntary, unmonitored principles will not stop the inevitable protectionism that would surround a large SWF investment in a sensitive industry. And the completion of smaller purchases (or non-sensitive acquisitions) continues without the need for guidance.

"What exactly is the IMF trying to achieve here? I can't work it out," said the private equity partner. **NP**

Germany must use protectionism sparingly

Will sovereign wealth join private equity on the autobahn?

Foreign investors should not fear Germany's legislation to monitor foreign investment, but the government has a responsibility to apply its new powers conservatively.

In August, the German cabinet approved a bill that gives the state power to scrutinise acquisitions of more than 25% by entities based outside the EU or EEA. The Ministry of Economics and Technology (BMWI) will be able to prohibit acquisitions that it considers a risk to the public order or security of Germany.

"The concept of a national interest is the key issue," said a German corporate partner. "If it is applied too frequently, then I would oppose it. I would prefer a more liberal system, but I can see why we may need something for more extreme cases."

The danger is that the BWMI could meddle in lots of deals, slowing the investment process for foreign companies. This protectionism may discourage investment and damage the German economy.

But Johannes Perlitt, partner at Clifford Chance, is confident this will not be the case:

"If we'd had the law for the past 50 years, it would only have been used once or twice and no one would question it. It is just reassuring to have something in place, to have weapons in case they are needed."

Indeed, many countries have similar systems in place. Most prominent is the US Cfius process, which is triggered at lower thresholds. So Germany can argue that it is bringing itself into line with peers.

The timing of the legislation may create problems, though. It seems to have been created in response to the furore over sovereign wealth funds (SWFs) earlier this year. Many SWFs have been working hard to be more transparent and may resent Germany's action.

But Perlitt is sure that investors will not be put off, comparing any political reaction to SWFs to Germany's vocal response to private equity:

"There was lots of coverage on German opinions on private equity last year. But if you are on the autobahn and stop in a restaurant, it is now owned by private equity and no one cares. Politically it is sometimes useful to take a strong line, but I don't think this new law will change foreign investment much."

It will be a while before the concept of national interest is defined, but in the meantime investors in sensitive sectors should talk to the BMWI before finalising deals.

In ongoing cross-border transactions, it may be sensible to carve-out German subsidiaries to avoid delays. Restrictions can then be dealt with in separate transactions at a later date. NP

Unusual "Mac" clause saves TPG

TPG Capital's withdrawal from buying a stake in Bradford & Bingley relied on a specifically drafted termination clause. Its targeted nature demonstrates how these clauses are being used as specific break-up weapons.

"When you get specific with Macs (material adverse change clauses), it is easier to see where the trigger point is," said a partner close to the deal. "Here, TPG could walk away if Bradford & Bingley's credit rating fell by two notches. Everyone could see when that had happened and there was no debate – TPG was free to go."

The clause in question was technically a specific termination event, not a Mac. Both types of clause are usually drafted next to eachother in contracts which is why termination clauses are often called Macs when they are not.

TPG entered negotiations with Bradford & Bingley to buy a 23% stake for £179 million ($353 million) at the start of June when the UK bank restructured its rights issue and was desperate for investment.

"TPG had to move quickly and so wanted a little more protection for reduced diligence," said the partner. "So they added a non-standard clause. This was a smart move by TPG: 'What are we afraid of?' Let's counter it.'"

Other lawyers agree. "This sort of clause is not standard in the UK. But you wouldn't raise eyebrows if it was put on the negotiation table. It was a clever decision to include it," said one corporate partner.

The first part of the trigger came the day after TPG agreed to invest in Bradford & Bingley. On June 3, Moody's cut the bank's rating due to rising arrears and an uncertain outlook. The second notch came later when Moody's revealed plans to downgrade Bradford & Bingley's senior unsecured and long-term debt ratings from A3 to Baa1.

"This is very important," said a rival lawyer close to the deal. "Purchasers will now push for these clauses to be added to contracts and sellers will push against them as they can see the damage that can happen."

Interestingly, the underwriters had the same termination rights as TPG. Indeed, it has been suggested that TPG took the idea of adding the two notch ratings clause directly from the original underwriting agreement for the parallel £258 million rights issue for Bradford & Bingley. But due to the fact Citigroup and UBS had already threatened the UK bank's capital raising before by disrupting the first planned rights issue, they were under more pressure to keep the deal alive.

"The underwriters were told by the FSA: 'Look, you've thrown your toys out of the pram once, don't do it again," said the partner close to the deal. "The FSA has more influence over the underwriters than it does TPG."

When asked to comment, the UK FSA admitted talking to all parties, but denied exerting extra pressure on anyone in particular.

Specific termination events and Mac clauses have become more prominent during M&A negotiations this year. Companies are realising the importance of defined exit routes to avoid litigation. NP

A basket of benefits

Christopher Meyn of Gávea Investimentos explains why Brazil is the place to invest in Latin America

Nicholas Pettifer
Staff writer

At the International Bar Association conference in Buenos Aires this week, there is a discussion on Latin American private equity and hedge funds. Christopher Meyn is a partner at Brazilian firm Gávea Investimentos and is he speaking at the session. Here, he previews what he is likely to add to the debate and reveals reasons why he feels Brazil is the best country in Latin America for private equity houses to invest into.

"There is no delinking from the global economy and there will be volatility here like everywhere else"

Have you had some pre-discussions about what you are going to talk about in your session?

I'm going to talk generally about the private equity environment in Brazil. There are two of us coming over from Brazil and that is a pretty traditional speech topic. It's a country that (right, wrong or indifferent) is perceived as a bit buffeted and delinked from a lot of what we are seeing right now globally. It's not true. It is a very attractive market, and there are fundamental reasons why it has become more attractive for private equity. But, like anywhere else, it is not magic: there is no silver bullet, there is no delinking from the global economy and there will be volatility here like anywhere else.

So I'm going to talk about Brazil – what the environment is like, what we see happening right now and what we think the outlook will be for the next two or three years. We have our own impression and people usually like to hear it, but whether it's correct or not is up to the audience.

You mentioned existing legislation that makes Brazil attractive.

There are certain market friendly, investor friendly changes that have been implemented over the last few years. You've got to take them as a basket of positive regime changes – any one by itself is really not enough, but as a group the results are interesting. Tax incentives for foreign direct investment, including vehicles domestically and abroad that can be used to reduce or eliminate taxes for foreign investors, including private equity. The streamlining of capital flows back and forth between countries has been important. Prior to the early 2000s, foreign exchange flows were processed with quite a lot of bureaucracy – arcane registration processes to get your money flows approved. That led to some less than perfect mechanisms for capital flows here – it stimulated parallel markets (as do the very high tax burdens in Brazil). But that has all been simplified and it is now fluid. It is no different having our money abroad and bringing it in than it is in any other developed economy.

What rules in particular have helped?

Law 2689 allows for capital gains and financial transaction tax exemptions on stock market investing for foreign investors.

More importantly, for direct investing in companies such as under private equity, you can use newly created and regulated investment vehicles. For example, the FIP (*Fundo de Investimento em Participações* – a fund of investments structured like a limited partnership or a corporation) is a vehicle that investors can make investments in private entities through on a capital gains tax-exempt basis, including allowing for washing of gains and losses among investments in the same fund.

These structures and vehicles are gaining popularity and the lawyers involved do a good job. Tax haven domiciles change a lot here and if you're not careful you can end up paying more tax than the basic rate. If you find yourself in a locally classified tax haven, capital gains are not exempt and in fact increased from 15% to a 20% rate. You have to be in tune with what is happening while you are structuring both the fund and the investments. Some things are just irreversible, so you want to avoid making mistakes by keeping your eye on the ball. We certainly spend a lot of time on tax planning and investment structure internally.

Have there been any developments in the capital markets that have increased attractiveness of companies to investors?

I would certainly point to the creation of the Novo Mercado, which is the special listing designation within the Brazilian Stock Market (Bovespa). It was created in 2000 and now there are more than 100 companies listed. This designation is reserved for companies with the highest level of corporate governance and transparency within the stock market. So you can file to become a Novo Mercado company, and you must meet an advanced level of both shareholder friendly and market friendly characteristics.

Such as a minimum float of 25%, one class of shares with tag along rights for all minorities, etc. So you align interests of all shareholders, no longer having the game of isolating minority shareholders or creating a control group, an "us versus them" mentality inside the company.

And this is attractive to investors.

Yes, there has been a great premium for the companies that have adhered to this set of requirements and you can actually start tracking that. The companies that comply have performed very well relative to the broader market. There has been, as I recall up to a 30% average premium in valuation for Novo Mercado companies. Whether that is statistically or purely linked to the Novo Mercado, who knows. But it is the right kind of movement for an investor – it's a private equity mentality.

The transparency helps too. That has helped stimulate a confidence that (and this goes hand-in-hand with a better macro economic environment for the long term) a sense that the equity markets are real. It's not just a capital game for the controlling shareholders to play with and jam the little guy at the end of the day. It has helped drive a lot of foreign investment into the stock market here.

Have there been any new legislative changes that have helped?

The relatively new bankruptcy law in Brazil has been quite beneficial. It sounds crazy to say, as it does nothing more than implement a European or American style bankruptcy system where none existed before. But it does now provides a chance to have a controlled recovery process versus an arbitrary judge-ruled bankruptcy/ liquidation proceeding.

Before, you would be bankrupt and some guy without any link to the business in some far away city would decide the life of the company for debtors and creditors. And it wouldn't always be rational. Today, creditor groups are formed, the recovery plans are submitted and negotiated, and there is a waterfall of seniority in claims. This gives you a clear and better judicial system for resolving problems. There has always been a good judicial system in Brazil, albeit a little bit slow; but this has helped create certainty for investors.

And all of these things together add up to a better environment for private equity investment?

Taken together as a whole, these legislative and structural changes have created a much better investment environment over the last five to seven years. None of these can match the most important thing though – simply a better economic environment. Brazil has turned itself around and positioned itself to be very, very stable for the long term, which hasn't really happened since the seventies.

Why Brazil? It's a much bigger country, it's very western thinking and consumption habits are very much American. That can be good or bad. Good if you're selling Big Macs! Seriously though, there is more of a habit of adopting credit and therefore being a consumer in the truest sense. You will spend your earnings, you will take on credit and you will increase your consumption as your spending power increases. This is something we are used to seeing in the western world, but we don't really see it happening in the same model elsewhere in emerging markets. Here, it is happening. So you can play themes that work in other markets, you just need to time them right.

It's really hard to strip out one thing that has increased Brazil's attractiveness, but high interest rates create opportunity. They also create a challenge for private equity in terms of more expensive capital, but it keeps valuations down. So I view that as an opportunity if you are comfortable with risk. Leverage is not a significant option with high rates and because of that you are doing a lot of things on a pure equity basis. Leveraged buyouts are tough to execute here and will continue to be so until debt is more creative and cheaper.

Are there any structural differences to deals in Brazil that make them stand out from other Latin American countries?

I'm very Brazil-centric, but anecdotally I understand the judicial system here is clear and direct. It works. It may not work in the same time frame you were hoping it would, but it works and there is clarity to the law.

There is political stability too. Historically, Brazil tried all the tricks in the book to get itself out of problems. Price controls, tax regime change, nationalisation of assets – none of it really works and the average Brazilian won't accept any new gimmicks. So prudent politics, steady economic policy and a very free media are certainly important contributing factors.

Do you know of any future legal developments that will help promote investment in Brazil?

I don't think we will see any significant legislative changes in the near future. There is an election in a year and a half and there is never a great urge to shake the tree. The economy is humming along and so far any real softness in the economy seems to be lagging the global crisis enough.

So, what you worry about here is a change in the micro-environment in terms of capital markets and liquidity. That's going to happen. I hate to tell everyone that, but it is going to be rough for some folks out here in Brazil.

But you are confident of your long-term investments?

We have always had confidence in Brazil. A little patience, a little cold blood and trying not to get emotional is the key.

"The bankruptcy law gives you a clear and better judicial system for resolving problems"

"A little patience, a little cold blood and trying not to get emotional is the key"

Codes compared

The self-regulation of private equity in Denmark, Sweden and the UK shows how different codes suit different countries. The European Commission should take note

Political and media debate about the merits of private equity have reached a fever pitch – not just in Europe, but in the US and elsewhere around the world. Many of the industry's critics have been calling for greater regulation.

Much of the debate has been misinformed, and it is clear that the buyout industry has to communicate more effectively with the wider public. But the private equity community has responded positively to criticism, and has acknowledged that some calls for greater openness and disclosure have merit. In particular, the national private equity and venture capital associations of the UK (BVCA), Sweden (SVCA) and Denmark (DVCA) have all now published guidelines to promote increased transparency and openness in their national private equity industries. In addition, the AFIC in France (*Association Francaise des Investisseurs en Capital*) has issued a voluntary charter which sets out several basic values and responsibilities for private equity firms.

The early success of Sir David Walker's pragmatic, principles-based recommendations in the UK helped to stave off calls for more black letter law: 32 buyout groups and 55 portfolio companies have so far signed up, despite some not falling within Walker's scope. It also provided the model for the Danish and Swedish reports.

Although purporting to do very similar

The three private equity codes in detail

	BVCA guidelines	DVCA guidelines
Which private equity houses are covered?	- UK based; - authorised by FSA; and - managing or advising funds that either own or control one (or more) UK companies which meet the size criteria below.	- DVCA members with total commitments in excess of DK 500 million.
Which portfolio companies are covered?	Companies which were: - acquired in a public to private transaction for more than £300 million (approx. €380 million); or - acquired in a secondary or other non-market transaction with an enterprise value of in excess of £500 million; and which have, - at least 50% of its revenues generated in the UK; and - at least 1,000 fulltime UK employees.	Danish companies with: - revenue in excess of DK238 million (€32 million); - assets greater than DK119 million (€16 million); and - over 250 employees.
What are they required to do: Private equity houses	- Publish in an annual review or on their website information about: • how the FSA authorised entity fits into the house; • its history and investment strategy; • key executives and procedures to deal with conflicts of interest; • a description of the UK portfolio companies it owns; and • a description of investors including breakdowns by type and geographic location. - supply relevant data to the BVCA; - communicate actively with "stakeholders".	- Publish on their website: • information about themselves, their funds and strategies, and their investors and origins; • a link to the management company's accounts; • where the carried interest programme for general partners departs significantly from the market standard, a general description of the programme is to be given; • their policy on corporate social responsibility; • information on assets and companies under management. - Provide data to the DVCA
Portfolio companies	- Publish enhanced annual reports and accounts on their website within six months, which give: • the identity of the private equity house(s) which owns the company, along with the executives that oversee its management; • the board composition and identity of those members who are representatives of the private equity house(s); and • a business review which substantially conforms to that required by section 417 of the Companies Act 2006, including those provisions relating to quoted companies. - publish a mid-year update; and - contribute data to the BVCA.	- Publish an annual report to supplement the statutory one, which is to include: • operational and financial developments; • corporate governance; • financial and other risks; and • employee matters. - Provide data to the DVCA

things, the different recommendations vary considerably in the way they go about achieving their goals.

Code comparisons

Framed against a backdrop of less comprehensive private company law than in some other European countries, Walker's UK guidelines perhaps had to be more prescriptive than their Scandinavian counterparts. They are weighty and comprehensive. Whereas the Swedish recommendations seem intended as much to educate as to tie firms into rigid reporting requirements. For instance there is one page of recommendations, and seven pages explaining what private equity is.

The Danish guidelines occupy the middle ground: a softer focus than Walker's guidelines but a more prescriptive form than the Swedish equivalent. However, in various ways both the Swedish and the Danish rules go further than Walker. All three envisage a streamed approach to reporting requirements – at firm level, at fund level and at industry level.

SVCA Recommendations

- SVCA members; and either
  - invest equity in companies in which they hold a majority or minority share; or
  - act as investment advisor to funds which undertake such investments.
- Any company headquartered in Sweden.

- Publish on their website information to include:
  - the general fund and its structure;
  - the key executives;
  - investment strategy;
  - information about each portfolio company;
  - applicable guidelines for portfolio valuation and reporting to investors;
  - policies regarding the handling of potential conflicts of interest;
  - policies regarding CSR and environmental issues.
- Participate in data gathering by SVCA.

- Publish on their website information about:
  - their operations and turnover;
  - their ownership;
  - board composition;
  - some financial reporting and data;
  - information about significant events, ownership changes, changes in management and board composition or other events of substantial financial importance;
  - policies regarding CSR and environmental issues.

To whom do they apply?

The UK guidelines apply specifically to UK, FSA-authorised private equity houses that are managing or advising funds that either own or control one or more UK companies (or who have a designated capability to engage in such investment activity), but only if the companies are covered by the enhanced reporting guidelines for portfolio companies. This two-limbed approach singles out those at the top end of the buy-out market (those that were the focus of the most criticism) and attempts to prevent the onerous reporting requirements being imposed on smaller firms for whom the cost and administrative burden would be disproportionately large.

The SVCA has a wider and more generic entry threshold. The private equity firm must be a member of the SVCA and either invest equity capital into portfolio companies in which they hold a majority or minority stake, or act as investment advisors to funds which undertake such investments. This is far wider than the scope of the UK or Danish guidelines and covers all members of the SVCA. The Walker guidelines apply to no more than 15% of the BVCA membership, while the Danish regulations only apply to DVCA members with committed capital of at least DKr500 million ($142 million). Private equity houses whose ultimate parent company is registered in a country other than Denmark fall outside the full scope of the regulations.

The same themes are repeated for portfolio companies. Sweden applies its guidelines to any companies headquartered in Sweden, while the Danish guidelines have a *de minimis* threshold based on Danish company-law size classifications: Class C (large) companies, which are categorised as those with revenue in excess of €32 million, assets in excess of €16 million and more than 250 employees. Unlike the UK criteria, the portfolio company does not have to be owned by a private equity fund that falls under the Danish guidelines. Instead, it is sufficient that a fund has a decisive influence over the company, and that fund may be Danish or foreign.

Walker's guidelines take a more targeted approach and apply to public-to-private transactions where the equity value of the company on acquisition was £300 million ($562.4 million) or more, or other acquisitions where the enterprise value was at least £500 million. These values are intended to be roughly equivalent; one referring to equity value and the other to enterprise value. They were designed to catch companies of equivalent size to those in the FTSE 350. The UK guidelines also only apply to companies that have 50% or more of their revenue generated in the UK, and employ over 1000 UK full-time employees or equivalent. The UK thresholds are therefore much higher than those in Denmark, perhaps reflecting the different average sizes of deals.

"The Swedish recommendations sit within a more stringent statutory company reporting regime than in the UK or Denmark"

The reporting obligations

The SVCA offers a more thematic set of recommendations, suggesting topics to be covered, rather than formally specifying disclosure requirements. In many ways this mirrors the approach taken in the UK for reporting by private equity houses, highlighting those areas and themes that should be covered. It then leaves it to the private equity house and the portfolio company to decide how this information is to be presented. The difference stems from the fact that the Swedish recommendations sit within a more stringent statutory company reporting regime than in the UK or Denmark, with greater emphasis on employee participation. As the SVCA report states, Sweden and the Nordic region differ from other parts of the world in those respects.

Given the lack of a statutory role for trade unions or similarly strict reporting requirements for UK private companies, the Walker guidelines offer more detailed recommendations for the content of portfolio companies' reports. The focus is on substance over form and on economic reality rather than legal structure. The guidelines require portfolio companies to produce an annual report which identifies the ownership and board structures, and includes a business review substantially similar to that required by section 417 of the Companies Act 2006 for quoted companies. In particular, this requires firms to produce a report which details: the main factors affecting the future development

"Sweden's code is one page of recommendations, and seven pages explaining what private equity is"

of the business; information on employees, environmental and social and community issues; and information on those persons with whom the company has essential business arrangements. There is also a requirement to produce a mid-year update.

The DVCA also emphasises the more rigorous Danish requirements for company's annual reports. Under the Danish Financial Statements Act, companies must include a detailed management report in their annual report and so the guidelines aim only to supplement these legislative provisions. The Danish guidelines go further than Walker's in several respects. Most notably, a statement on employee turnover (including terminations, recruitment and the like), company constitution and related matters (among other things; responsibilities and duties, board member remuneration and shareholdings). Interestingly, in public-to-private transactions the guidelines require that portfolio companies continue to make interim and financial reports in accordance with OMX Nordic Exchange Copenhagen's rules for the first year of business as a delisted entity. Thereafter, an interim report is to be prepared that describes whether the company is pursuing the general aims published in the annual report for the previous year.

The role of national associations

All three provide for an increase in the role of the various national private equity and venture capital associations. Their role evolves from simple industry body to data collector and disseminator, and in the case of the British and Danish bodies, quasi-regulators. The associations are required to take responsibility for collecting and consolidating the information reported to it under the relevant guideline provisions.

That data will be aggregated on an industry-wide level with a view to providing a general account of the trends in the industry. The DVCA guidelines specifically state that to ensure consistency, their analysis will be developed in close collaboration with the Walker Working Group and the BVCA.

In taking the role of quasi-regulator, the BVCA and DVCA have set up committees to review and adapt the guidelines as they are implemented by the industry. The committees' membership structures vary slightly, but a common thread of informed independence runs through both. The Walker Guideline Monitoring Group is composed of an independent chairman and two other independents along with two private equity representatives. The DVCA committee is composed of the DVCA chairman, a state authorised accountant and an independent industry representative.

Pan-European guidelines

April 2008 saw the publication of two draft reports by the European Parliament relating to private equity, one of which was subsequently finalised and published as an official opinion at the end of May. These include some alarming and dangerous proposals and also urge the Commission to provide a legislative response. They will increase pressure for a co-ordinated pan-European response to the industry's critics.

The industry must resist the urge for knee-jerk blanket regulation, and it will have to do that even more strongly when a new European Commission is appointed in 2009. But, as the BVCA, DVCA and SVCA guidelines all demonstrate, that must be done without losing sight of the fact that each country has its own legal and political framework, which would make one-size fits all guidelines inappropriate.

If external regulation runs the risk of hampering an industry that contributes tens of billions of euros to the EU annually, then these voluntary guidelines have an important job to do. But policy makers have to give the guidelines time to work. At least one business cycle will be required before judgements can be made. And the industry must embrace both the letter and the spirit of the guidelines enthusiastically. The early signs are good, but sustained effort is essential.

By Simon Witney and James Bromley of SJ Berwin

Let the good funds roll

US banks need capital. This can come from private equity funds, but regulation needs to be liberalised

It would be a gross understatement to say that the United States banking industry has a substantial need for capital. Every quarter, and often more frequently than that, comes news of additional asset writedowns at US banks, particularly those with extensive exposure to the housing market. Analysts predict continuing writedowns and a corresponding need for capital. One source of such capital is private equity firms, which, over the last decade, have been extremely successful in attracting funding from a wide variety of sources. Although every bank regulator will say that capital is king in times of stress, current Federal Reserve Board (FRB) regulations and interpretations pose obstacles to contributions from private equity firms to the US banking industry. These regulations and interpretations can be modified without sacrificing bank safety and soundness or the policy concerns behind the Bank Holding Company Act.

Regulations

In the first instance, it is necessary to understand the statutory schemes relevant to private equity investments in US banks and thrifts. Which scheme (and which regulator) is relevant depends on the type of charter of the institution. If the institution is an FDIC-insured or state-chartered bank, the relevant statute will be the Bank Holding Company Act of 1956 and the relevant regulator the Board of Governors of the Federal Reserve System (FRB). If the institution is a thrift (a federally-chartered savings bank, an FDIC-insured state-chartered savings and loan association or state-chartered savings bank), the relevant statute will be the Savings and Loan Holding Company Act and the relevant regulator the Office of Thrift Supervision (OTS). US banks and thrifts alike have recently needed substantial capital infusions. Good examples are National City Corporation, the holding company for an FDIC-insured national bank, National City Bank, and Washington Mutual Inc, the holding company for Washington Mutual Bank, an FDIC-insured federal thrift.

For a private equity firm, both the Savings and Loan Holding Company Act and the Bank Holding Company Act are of serious concern because no private equity firm wants to be regulated as a holding company under either statute. In addition to the intrusion of being subject to supervision by the OTS or FRB and mandated restrictions on private equity activities, holding companies for banks and thrifts can be called on by their regulators to be a source of strength to their subsidiary depository institutions in times of trouble. Historically, particularly with respect to bank holding companies regulated by the FRB, the source of strength doctrine has been open-ended, leaving a bank holding company with no ability to predict what resources it may be called on to commit to support its bank subsidiaries.

Interpretations

Whether a private equity firm becomes a bank holding company or a savings-and-loan holding company depends on whether it has control of a bank or a thrift according to the FRB's interpretation. The Bank Holding Company Act defines control as: (i) directly or indirectly owning, controlling or having the power to vote 25% or more of any class of voting securities of a bank or bank holding company; (ii) controlling in any way the election of a majority of directors or trustees of a bank or bank holding company; or (iii) directly or indirectly exercising a controlling influence over the management and policies of a bank or bank holding company. The Savings and Loan Holding Company Act's definition is very similar.

There are substantial differences, however, in regulatory interpretations of what constitutes a controlling influence over the management and policies of an investee company. In practice, the FRB will generally find that the following factors constitute control: (i) 10% or more voting share ownership if the investor has a right to appoint a director to the bank or bank holding company's board; (ii) total equity (voting and nonvoting equity, including as equity any subordinated debt) ownership of more than 24.9% even in the absence of a director right; and (iii) depending on the circumstances of the investment, ownership of more than 14.9% or, in rarer circumstances, 19.9%, total equity if the investor has a right to appoint a director to the bank or bank holding company's board.

The OTS's control regulation, by contrast, speaks in terms of rebuttable presumptions of control that allow for greater flexibility in structuring investments. For control to be presumed, an acquirer must: (i) either acquire more than 10% of any class of voting stock, or more than 25% of any class of stock, of a thrift or its holding company; and (ii) be subject to a control factor such as being one of the two largest holders of any class of voting stock, holding more than 25% of total stockholders' equity, holding more than 35% of combined debt securities and stockholders' equity, or being able to appoint more than one member to the board of directors. Because these presumptions are rebuttable, a private equity firm can acquire more than 10% of the voting shares of a thrift holding company, have the right to a director on the company's board

"Current regulations and interpretations pose obstacles to contributions from private equity firms to the US banking industry"

"Capital is king at times of distress, but it's hard to think of a good reason to deprive banks of important sources of US domestic capital even in good times"

and be one of the two largest voting shareholders, provided that it enters into an agreement with the OTS under which it agrees to be a passive investor. FRB practice generally imposes a hard stop at 9.9% voting share ownership if the investor has the right to a board seat, which private equity firms generally do require.

Restrictions

The FRB has frequently imposed other restrictions that undercut an investor's flexibility when structuring an investment. Warrants exercisable into voting stock are often counted as the latter for purposes of the 10% voting stock test, no matter how far out of the money they are. Non-voting shares that are convertible at the holder's option at a later date or upon a future event are often counted as voting shares from the inception of the investment. When determining share percentages, the FRB often counts the warrants of the investor as voting shares, but identical warrants held by other investors will not be counted as such. Finally, veto rights by the investor company must be substantially limited. If permitted at all, they are most often restricted to matters that the FRB considers those on which an equity holder may vote without its interest being deemed voting. That is, matters traditionally permitted to preferred shares under state statute for matters that would significantly and adversely affect the rights or preferences of the interest, such as the issuance of additional amounts or classes of senior securities, the modification of the terms of the investor's security or the dissolution of the bank or bank holding company.

Other similarly conservative interpretations of the statute that would pose difficulties for a private equity fund seeking to come to the aid of a distressed bank or bank holding company are also theoretically possible. For example, one way for a private equity fund to obtain greater flexibility to hold additional voting or non-voting stock is to separate the investment into two (or more) independent co-investments. That is, the fund itself makes an under-10% voting share investment in the bank or bank holding company (with perhaps additional non-voting shares) and separate vehicles not controlled by the fund but holding the interests of certain fund shareholders make similar investments, with the separate vehicles retaining independent rights to vote and transfer their shares. From publicly available information, such a structure was implemented in the case of the JC Flowers Fund's investment in HSH Nordbank, a German bank regulated as a bank holding company as a result of its US branch office. The investment comprised shares that were entitled to more than 25% of the votes, and the structure allowed the Flowers Fund to avoid regulation as a bank holding company.

In implementing such a structure, it is important that no fund shareholder that owns 25% or more or otherwise controls the separate vehicle be seen as controlling the private equity fund itself. Otherwise, the shareholder will be understood to be making an aggregated investment through the separate vehicles, the private equity fund and the independent vehicle. Going back to the FRB's control interpretations, consider the likely result if a fund shareholder that can be said to control the separate vehicle owns more than 9.9% of the private equity fund. One might perhaps take solace in the view that the shareholder's interests in the fund are non-voting, because generally such interests are limited partnership or limited liability company interests that are entitled to vote on very little. But one cannot take such solace: if the fund shareholder can vote on nothing other than the replacement of the fund's general partner, the fund interests will be considered voting. As a result, if the shareholder that controls the separate vehicle owns more than 9.9% of the fund, one then has to consider whether other connections between the shareholder and the fund itself raise concerns about the shareholder's control.

It is therefore apparent that the FRB imposes a conservative view of control: in determining whether such an approach should prevail, one must consider the reasons for the control tests under the relevant statutes. The purpose of the Bank Holding Company Act is to separate banking and commercial activities in the US, based on the view that a concentration of banking and commercial resources poses dangers to the economy as a whole. If a company controls a bank or bank holding company within the meaning of the Bank Holding Company Act, it must register as a bank holding company with the FRB and its nonbanking activities are restricted. It may not make investments in commercial companies except 5% or less voting share investments (with some additional non-voting equity also permitted), or, if the company qualifies as a financial holding company, up to 100% voting share investments as long as it disposes of the investments within a reasonable time (10 to 15 years) and does not routinely manage or operate the commercial companies invested in.

What, then, about the Savings and Loan Holding Company Act? Until 1999, it was permissible for a holding company, as long as it controlled only one savings association, to be engaged in any form of commercial activity. However, this so-called unitary thrift holding company loophole was closed (subject to grandfathering) in 1999. As of that date, thrift holding companies have been subject to the same restrictions on commercial company ownership as bank holding companies. The statutes, therefore, have the same fundamental purposes.

Private equity funds are, in a crucially fundamental way, different from purely commercial companies in that they do not seek to hold their interests in commercial companies for an extended period of time. A private equity fund seeking to make a capital contribution to a FRB-regulated bank holding company does so with the hope of selling its interest at a profit before the end of the fund's life (which may be in as little as five years). This is a very different situation than that of a nationwide retailer seeking to acquire an FDIC-insured bank so that it may have banking

offices in every store or, for example, a car manufacturer acquiring an FDIC-insured bank in order to make car loans nationwide. The most recent and fundamental revision to the Bank Holding Company Act (in 1999) recognised precisely this point: the Gramm-Leach-Bliley Act determined that, when conducted within certain limitations, private equity activities are not commercial activities but rather activities financial in nature. Significant financial institutions regulated as bank holding companies can now all make investments in commercial companies as long as they do not engage in the routine management and operation of those companies and dispose of their investments within a reasonable time. Private equity properly understood, therefore, does not lead to an improper mixing of banking and commerce, in Congress's view.

Possible reforms

With this in mind, what reforms could the FRB implement for private equity firms in its control interpretations? It could allow a private equity firm to have more than 10% voting shares of a bank or bank holding company and one director in appropriate circumstances, as long as a proper passivity arrangement were entered into. It could allow a private equity firm to have 9.9% voting share ownership and 24.9% total equity and one director, in appropriate circumstances. In addition, the FRB could: (i) liberalise its views and treat warrants as voting shares only when there is a reasonable probability of an investor exercising them; (ii) apply a more flexible approach to shares convertible into voting shares (if they are optionally convertible but only on the occurrence of certain events, they should be treated as voting shares only on the occurrence of those events); and (iii) treat every investor's (not just the private equity firm's) warrants as exercised when calculating voting share percentages. In terms of investments structured as separate co-investments, the FRB could agree not to treat fund interests as voting interests unless they have substantially more voting power than simply over replacing the general partner or managing member of the fund, as this would allow private equity funds much greater flexibility when deciding which of their investors to solicit when making an independent co-investment in a bank or bank holding company. Finally, the FRB could consider viewing private equity vetoes over certain fundamental, non-ordinary course business transactions as consistent with non-control, notwithstanding that votes on such matters are generally not given to preferred shareholders under state corporate law.

Liberalise it

Because this is a troubled time for banks and thrifts, it will be tempting as a matter of regulatory policy to rein in any such liberalising interpretations to situations involving a distressed depository institution. However, careful thought should be given before yielding to any such temptation. Although capital is king at times of distress, it is hard to think of a good reason to deprive depository institutions of important sources of US domestic capital even in good times.

There is another policy justification for such a liberalisation in terms of maintaining and increasing competition in the US banking industry. In the last decade, there have been many successful US banks, usually at the local or regional level, that have been sold to larger institutions. With each sale, portions of experienced business and management teams decline to move to the acquiring institution, but they have a wealth of experience that can be drawn on. Matched with understanding private equity investors, these experienced bankers can create new depository institutions, providing consumers and businesses with increased choice. In doing so, many of the other policies of the Bank Holding Company Act recognised by the FRB in its regulations (avoiding the concentration of financial resources, increasing competition and promoting gains in efficiency and consumer convenience) would be advanced. These benefits to the public argue in favour of welcoming private equity in good times as well as bad. There is no good reason, once private equity investments in banks are recognised as consistent with the separation of banking and commerce, to interpret the Bank Holding Company Act as undercutting its other key policy goals.

By Arthur S Long of Davis Polk & Wardwell

A role reversal for banks

Private equity is buying up acquisition finance so enthusiastically that it may end up leading its own deals in the next cycle, cutting out the banks

The credit crunch has left many banks with large amounts of debt on their balance sheets. The traditional investor pool of banks, hedge funds and CDO and CLO funds has resisted inducements to syndicate credits – original issue discount, upfront fees, Libor floors, increased pricing, retranching debt and changing currencies (to sell into overseas markets). Secondary trading opportunities for these traditional investors, direct and indirect pressures to preserve capital, and a collapse in the securitisation market have depleted the pool for new syndicated credits and these hangover credits. So banks are looking for alternative exit strategies from existing credits. One possibility is allowing private equity funds and equity sponsors to purchase debt, in a departure from conventional practice.

Above the threshold

Private equity funds are taking advantage of the steep discount, pricing increases and other incentives being offered to purchase large positions in 2007's multi-billion dollar acquisition financings. These busted deals have proven intractable even for the best syndication desks. The twist is that in many cases, the selling lead arrangers are providing seller financing to the private equity funds. The amount of seller financing varies from deal to deal, but banks are frequently providing up to 75% of the funds necessary to purchase the loans, with equity contributed by the private equity fund making up the balance.

These deals are in essence a leveraged warehouse facility within a leveraged buyout. Primarily because of failures in the securitisation market for CDOs (whether syndicated loans or mortgage-backed securities), lead arrangers have been forced to step in to provide the necessary credit support to finance the purchase of the loans. Given that the private equity funds have taken the last-out equity position on the purchase of loans, there is a transfer of risk from the balance sheet of the bank to the new buyer.

This deal structure is attractive to both sides. Private equity has the prospect of attractive internal rates of return (IRRs) at a time when equity sponsors are struggling to raise enough debt at attractive rates to fund new acquisitions or sell existing portfolio companies. Banks, of course, can use these deals to reduce their balance sheet exposure, although incrementally, at a time when they face pressures to maximise capital.

The balance sheets of banks have faced, and will continue to face, a variety of pressures from the loan market. First, there has been an increase in the number of borrowers that have drawn down pre-emptively on their standby revolving credit facilities, apparently driven by declining free cashflow and concerns over possible deteriorations in the bank's balance sheet, which would limit its ability to fund future draws. Second, hundreds of billions of credit facilities are reaching maturity and will need to be refinanced or renewed. Third, banks need to get back to a position where they can make loans to new clients to develop their leveraged finance groups, which, before the recent market turmoil, were key drivers of profit.

Another reason these deals are attractive is that some banks have bargained for the inclusion of contingent interest provisions in their deals. Under these provisions, if the private equity fund achieves an IRR over a period of time above a certain negotiated threshold, the bank will share in the upside above that threshold.

"These clauses provide another option for banks to sell down their positions, at little if any incremental risk of allowing the proverbial fox into the henhouse"

Share the pain

In executing these equity fund sell-down transactions, the underlying credit documentation must be carefully reviewed. In some cases, the borrower has approval rights over the identity of assignees. In our experience, obtaining these consents has not been problematic, particularly in deals where the lead arrangers have not fully exercised their market flex. In deals where the borrower has approval rights and declines to approve the proposed assignment, it may be possible to structure around this by styling the seller financing as a participation in, rather than an assignment of, the seller's loans.

This is because many credit agreements do not give the borrower approval rights over the identity of participants. In an assignment, the assignee becomes a lender with all the rights and obligations of a lender. In a participation, by contrast, the participating bank remains a lender, and retains a lender's rights and obligations.

Buying a participation is a less attractive option for private equity for several reasons. A participant tends to have limited voting rights that are tied to a handful of fundamental economic provisions in the credit agreement, whereas an assignee gets the benefit of all of the voting provisions in the credit agreement. A participant does not have a right to attend lenders' meetings, and is forced to rely on the participating bank reporting back to the participant, which may leave the participant in a more passive and reactive position. If a participant incurs increased costs, Libor-breakage costs or tax liabilities, it can only recover those amounts from the borrower to the extent that the participating bank would be entitled to those amounts. Another variant is to structure the transaction through credit derivatives, although such structures often suffer from the same negative considerations as the participation structure above. In each of these variations, accounting and tax considerations will also need to be factored into the deal.

If a deal has multiple joint arrangers in a number of transactions, it is common practice shortly before closing for these arrangers to enter into an agreement that requires any sell-down or syndication of the debt to be done on a pro rata basis among the arrangers, based on the principal amount of their outstanding loans and unfunded commitments. These arrangements are intended to cause the arrangers to reduce their exposure in an order-

ly manner and, in effect, to share the pain equitably. If this type of agreement exists, either (i) the arranger seeking to sell its position in a credit will need to obtain a waiver from the other arrangers or (ii) the other lead arrangers will need to sign on to the deal struck with the selling arranger or negotiate that deal.

Protecting the henhouse

Lenders are also tapping another source of capital in sponsor acquisition financings, subject to certain restrictions: the sponsor and its affiliates.

In recent years, top-tier private equity sponsors have been able, in many (but not all) acquisition financing credit facilities, to include provisions that allow them and/or an affiliate to purchase a portion of the loans made or to be made under those facilities. From a lender's perspective, these provisions conflict with traditional expectations that loan parties and owners of the equity in loan parties (or their affiliates) will not acquire interests in senior loans and that such purchases should not be permitted as they violate expectations of pro rata pay-downs among lenders before any recovery by equity holders.

Almost inevitably, over time these clauses have crept into a number of middle market deals. The clauses should be distinguished from the deal structure described in the preceding paragraphs in which the investing private equity fund tends to be unaffiliated with the sponsor, having no equity stake in the underlying transaction, rather than the deal sponsor. This is an important distinction: in the structure described above, the interests of the unaffiliated equity fund purchasing the debt tend to be closely aligned with the interests of other lenders (unless the fund holds a direct or indirect equity position in the borrower, other members of the credit group or any of their parent entities, in which case the arranger should consider whether to include the provisions described below).

If written correctly (from the perspective of the senior lenders), these clauses provide another option for banks to sell down their positions, at little if any incremental risk of allowing the proverbial fox (the affiliated private equity sponsor) into the henhouse (the senior lender group). There is surprisingly little uniformity in the way that banks draft these provisions. The key issues relate to the ability of the affiliated private equity sponsor to vote the debt it acquires, and the scope (if any) of the limitations placed on the rights enjoyed by other lenders.

Votes

A number of different drafting permutations tend to be included in loan documents. Restrictions are placed on which sponsor-related entity or entities can purchase the debt – often it will be limited to debt funds managed by the sponsor, which will be walled off from the sponsor entity that oversees and administers the credit and, potentially, is in possession of material non-public information about the credit not known to other lenders.

A cap may be placed on the amount of debt that the sponsor entity and its affiliates can purchase.

There may be a requirement that the sponsor entity purchase the debt either within a specified period or before the commencement of the syndication process, particularly in the rare instance where the fee letter provides that the sponsor will not pay a commitment fee (or will pay a reduced fee) on any debt purchased by the permitted sponsor entity. Without this provision, the lead arranger's syndications desk has to assume that the sponsor entity will not buy the debt; the desk will be forced to engage in a full-scale syndications effort, for which it will not be compensated (or fully compensated) by the borrower.

An outright prohibition or cap on the amount of debt that the sponsor entity can vote may be introduced. If the sponsor entity is allowed to vote, from the syndicate's perspective, the sponsor entity should not be able to acquire a sufficient stake in the debt to hold a blocking position on lender votes. Although credit agreements generally contain yank-a-bank provisions that permit a holdout lender to be removed from the syndicate, it is only the borrower (and not the lenders) that can exercise that provision.

A provision in the credit agreement may also be included, coupled with a requirement that the sponsor entity sign a waiver addressed to the other lenders. It may unconditionally waive any present or future right to require any agent appointed under the credit facility or any lender to take any action (or refrain from taking any action) with respect to the credit facilities or any of the definitive loan documentation; attend any meeting, in its capacity as a lender, with any agent or lender or receive any documents or information, reports or notices from any such agent or lender; or make or bring any claim, in its capacity as a lender, under or in respect of the credit agreement or any of the other definitive loan documentation, against any agent or lender with respect to the duties and obligations of those agents and lenders under the definitive loan documentation.

The middle man

Many of these provisions are often excluded from the initial draft of a credit agreement allowing a sponsor entity to purchase bank debt. Banks that choose not to include these restrictions do so at their peril. The banks that do include this type of language are rarely willing to remove or substantively change these clauses, based on a recognition of their importance if the credit becomes troubled; the lenders need to decide how to proceed out of earshot of the sponsor and the loan parties.

Historically, lead arrangers have often pushed back strongly on a sponsor's request to purchase bank debt, because of (i) the sponsor's predictable request (which typically is met with strong and successful resistance from the bank) that it not be charged a commitment fee on capital that it, or one of its affiliates, provides; (ii) a concern that the sponsor and, probably, the borrower, will gain access to information about the other lenders' positions on, and strategies to resolve, problems with the credit; and (iii) until the last year or so, a belief that the lead arrangers, will be able to successfully syndicate the debt with relative ease, either with or without invoking market flex, and without the need for capital provided by the sponsor or its affiliates.

If the arranger includes the provisions discussed above in the loan documentation, it can adequately mitigate lenders' concerns relating to the sponsor's and the borrower's access to sensitive and possibly privileged information during credit workouts, credit-related litigation, and loan-party insolvency proceedings. Banks generally insist on being paid their full commitment fee, particularly in the current environment in which rich incentives are being offered to potential syndicate members (including the lending sponsor entity). Many of the costs of these incentives, such as original issue discount and upfront fees, are borne directly by the arranger, although provisions in some credit agreements now require the arranger to be made whole for these types of losses.

As the supply of syndicated debt continues to exceed demand among the traditional investor base, we may see more arrangers agreeing to allow sponsor entities to purchase debt, turning traditional convention in the banking markets on its head. Perhaps more interestingly, when the credit crunch ends, lead arrangers may face competition for the lead arranger role from the debt funds set up by private equity firms. In the past, many of those funds have been content to be syndicate members. However, the more sizeable funds have the resources and capital to originate deals. This is far more lucrative than being a mere syndicate member, because it cuts out the middle man, namely, the banks that have historically held the arranger role.

By contributing editor Neil Cummings of Proskauer Rose and Joshua W Thompson of Jefferies Finance

Will partnership law be worth it?

It is hard to see how a new structure for foreign-invested funds will work with existing law

An article (Opportunity for Domestic Funds) in the August 2008 issue of IFLR provided an overview of possible business forms for establishing onshore funds in China.

The two most prominent forms of renminbi-denominated funds (the partnership and the cooperative joint venture (CJV)) and the key legal and tax aspects of foreign investments into such funds are the subject of this article.

More than a year after China's revised Partnership Law took effect on June 1 2007, the outlook for foreign investment into renminbi, limited-partnership private-equity funds remains unclear. Legal and tax advisers are not immune from blame for this absence of progress. Designing a balanced regulatory and tax framework for the operation of foreign-invested partnerships (FIPs) conducting PE investments is a challenging task; government agencies are as in need of guidance as fund operators and potential investors. Both legal and tax professionals therefore need to engage in more effective advocacy, if onshore investment partnerships are to become more than just a topic of conversation.

Below are a few (by no means all) of the key regulatory and tax issues for forming onshore funds, as well as some solutions or at least strategies for tackling them. For reasons that will become clear, it starts with partnerships, then detours through the older, CJV form of fund operation in China and its tax treatment, and comes back to partnerships and their tax treatment towards the end.

What is the single biggest legal obstacle to the FIPs in China?

The Partnership Law provides that the State Council will issue regulations for the establishment of FIPs in China. Without such regulations, there is no organisational basis for FIPs. By the scope of its mandate, such regulations need to address FIPs generally, not just those in the investment business. (The August IFLR report appears to have neglected the general scope of the Partnership Law when it compared the "little regulatory burden" imposed by the Chinese Partnership Law with US securities regulation.)

In designing such generally applicable regulations, however, the government faces a fundamental dilemma. On one hand, assuming that FIPs may engage in all activities that are permitted for foreign-invested enterprises (FIEs), the regulation of FIPs need to be generally in parity with regulations governing other FIEs. If the regulation of FIPs is more relaxed than traditional FIE regulation, then a major transformation of the FIE landscape seems inevitable: foreign businesses, whatever line of business they operate in, will abandon the traditional FIE forms in favor of the partnership. For example, traditional FIE law (and Chinese Company Law itself) is notoriously rigid with respect to the permitted capital structure of a business: injections of and reductions in equity are difficult, debt-to-equity ratios stringently regulated, and the creation of different types or classes of ownership interests next to impossible. The Partnership Law by itself does not contain any of such restrictions.

The partnership in its simple statutory form is also characterised by flexibility in management structure and in the making of organisational changes, whereas traditional FIEs are not. Making such a form of doing business available to foreigners is therefore equivalent to punching a big hole in China's FIE regime.

On the other hand, keeping FIPs in parity with traditional FIEs would largely deprive FIPs of the attractions of the partnership form, and essentially defeat the purpose of forming partnerships.

Two draft regulations on FIPs circulated in 2007 illustrate the dilemma. A long draft published by the Ministry of Commerce in January required that all increases and decreases of capital in an FIP and other changes in capital structure be subject to government approval and that all capital contributions be made upfront. Moreover, all amendments of partnership agreements required approval, as did changes of business scope, of ownership and of a partner's status as general or limited partner.

It was as though the government itself is an indispensable partner in any FIP; it must have a say in any major partnership decision, and its power to do so, unlike the powers of other partners, cannot be contracted away ahead of time. Chinese lawyers read this draft with a sense of familiarity: the same measures applied to traditional FIEs. But the essence of the partnership form was thrown out the window.

By contrast, the State Council Legislative Affairs Office circulated a draft in September that was much shorter and required government approval only when an FIP is established and when it changes business scope. No limitations on capital structure were mentioned. The foreign business community failed to act to endorse this draft, which appeared almost revolutionary in the minimal role it gave to the government. It's not clear whether an opportunity to do so would ever reappear: to many government agencies the draft must have looked totally inadequate – it would have led to an opening in the FIE control regime, with unknown consequences.

It is not only unclear when the FIP regulations will appear, but whether they will be worth the wait. This rather large glitch in the idea of FIPs, unfortunately, also has nothing to do with private equity or the government's attitude towards it.

"Legal professionals need to engage in more effective advocacy if onshore investment partnerships are to become more than just a topic of conversation"

Will the NLPCJV form remain relevant for onshore funds?

Since at least 2003, the small number of foreign-invested VC and PE funds formed under to the Foreign-Invested Venture Capital Enterprise (FIVCE) regulations have used the non-legal person, cooperative joint venture (NLPCJV) form. Such funds enjoy important flexibility in adjusting capital structure; favourable tax rules (discussed below) were even published for them.

In a draft revision of the FIVCE rules in 2007, however, all previous references to NLPCJVs were substituted by references to limited partnerships, suggesting that the authors thought that the NLPCJV form would become obsolete and replaced by limited partnerships. They may not have been alone in this judgment, given the obscurity of NLPCJVs and the publicity received by the Partnership Law.

But the judgment seems rash in light of the inherent tension in the FIP concept discussed above. That tension may indefinitely delay the issuance of regulations on the organisation of FIPs, making NLPCJVs valuable in the interim. The tension may also be resolved by conforming the treatment of FIPs to traditional FIEs, in which case it will no longer be clear *why* people would switch to using FIPs (both NLPCJVs and partnerships are largely contractual creatures and what is adopted by one could normally be adopted in the other). And if, to the contrary, FIPs are truly allowed to operate like partnerships, it won't just be the NLPCJV form, but most traditional FIEs, that will be obsolete.

Some onshore funds have been formed recently using the partnership form, where foreigner investors indirectly participated through wholly owned domestic entities (the partnerships are thus not "foreign-invested" because all partners are domestic). This raises the old regulatory question of whether domestic businesses that FIEs invest in should be subject to similar rules, such as sectoral restrictions and approval requirements, imposed on FIEs themselves. The answer has been yes for corporate targets of FIEs, and if the answer is different for partnerships, regulatory loopholes analogous to those averred earlier would emerge.

From the perspectives of tax and corporate finance, investing in a Chinese partnership through domestic corporate entities eliminates most of the theoretical advantages of partnerships: single-level taxation and flexibility in adjusting capital structure. So without truly generous dispensations by local governments, it's unclear that the new fund structure presents any true advantage over the traditional NLPCJV.

"Making such a form of doing business available to foreigners punches a big hole in China's FIE regime"

The answer to the question is "probably yes", which leads us on to questions regarding the status of certain tax rules applicable to NLPCJVs.

Will NLPCJVs continue to be treated as transparent entities under the new Enterprise Income Tax (EIT) Law?

Before the EIT Law took effect this year, China's tax law explicitly provided that NLPCJVs are to be taxed at the entity or at the owner level, but not both. They were thus transparent in the sense of not being subject to two layers of tax, as companies are. The EIT Law omitted such explicit provisions, which has led some to suggest that NLPCJVs may no longer be deemed transparent.

However, there is no legal or policy rationale that would justify so big a change, which would also be inconsistent with the government's previous acknowledgement, in connection with tax rules issued for partnerships in 2001, that a range of similar business forms should all be treated as transparent. Of course, to the extent that the EIT Law's omission creates unnecessary uncertainty, tax practitioners should urge the government to eliminate that uncertainty, instead of speculate about the demise of a reasonable rule.

Will previous tax treatments favourable to foreign investors in VC funds taking the NLPCJV form continue to be available?

In 2003, Chinese tax authorities issued a circular describing conditions under which foreign investors in a FIVCE taking the NLPCJV form might obtain favourable tax treatment. If the fund does not have a management office in China, and if it delegates all management activities to an external entity, then foreign investors in the fund, regardless of whether they bear limited or unlimited liability, would not be deemed to have "establishments" in China. This means that income received by investors through the fund would only be subject to withholding tax, instead of net-income taxation at a generally higher rate. As a result, many foreign-invested VC funds adopted the external manager structure. Whether such a structure remains sufficient, under the EIT Law, to insulate foreign investors from net-income taxation is open to question.

Uncertainty arises not just because authorities have not confirmed the continued validity of the 2003 circular. If one thinks of the favourable rule it contains not in isolation but as derived from general principles, then the following must be considered. In general, a foreigner's "establishment" in China can take the form either of a physical presence (a business office) or a business agent. Under corporate (non-tax) law, the investors in a NLPCJV own the assets and rights of the business and are principals of its agents. Therefore any business office or agent of the fund itself would be deemed, for non-tax purposes, to be the office or agent of the fund's investors.

Under the 2003 circular, tax authorities seemed to assume, in the scenario where favourable tax treatment was made available, that the fund does not have its own business office in China (whether the office of the external manager should be attributed to the fund was not considered). And even if the external manager is an agent of the fund and its investors, under prior law, only business agents engaged in the trading of goods were deemed to give rise to "establishments" for tax purposes. Interpreted in this way, the 2003 circular offered a technically interesting approach that both provided foreign investors with favourable results and stayed consistent with general tax and corporate legal principles.

Under the EIT Law, however, the business agent category of establishment has been broadened to include all agents carrying out business activities. Questions can now be raised: why isn't the external manager a business agent of the fund and its investors? If it is, why don't the foreign investors have a business agent establishment through the manager? As troublesome as these questions seem, they are also inevitable. The continued validity of the 2003 circular should probably not be

taken for granted.

Besides technical consistency, what other reasons might tax authorities have for reconsidering the previous tax treatment of VC funds?

The above analysis of the 2003 circular interprets it as delivering a favourable tax result that taxpayers could perhaps have discovered themselves. By contrast, some might see the circular as a concession made by the tax authorities to the policy need of encouraging onshore venture capital. In this latter view, a favourable rule for foreign investors in onshore VC funds need not be derivable from general tax principles. As a piece of preferential policy, it can be an exception to the general principles. But why should the government have chosen the external manager structure as the right way of making an exception?

Even though, under the fund structure spawned by the 2003 circular, business tax is imposed on management fees received by the external manager, and the latter is itself subject to income tax, the government is probably not deriving much revenue from either tax. In the Chinese context, it's still rare for the same management entity to provide service to multiple funds. More often, as is the case elsewhere, the bifurcation of manager and GP (in the FIVCE context, the equivalent of a GP is called the "mandatory investor") is made for tax purposes. If use of an external manager does not serve genuine business purposes and is adopted merely so that fund investors can qualify for the benefit of the 2003 circular, then the fee paid to the manager is likely to be much lower than the typical rate of 1% or more of the committed capital of the fund. If the promoters and investors of the fund are all offshore, the bulk of the management fee could be arranged to be paid offshore to another entity.

Arguably, therefore, the fund structure encouraged by the 2003 circular is distortive without raising revenue for the government. Yet another reason to reconsider the circular is the following: suppose that, somehow, the impediments for onshore funds to adopt the partnership form are removed. Then, in order to offer foreign investors similarly favourable tax treatment as VC funds previously received, rules must be designed so that the foreign partners of a fund partnership can be treated as having no establishment in China. In this completely new context, to import the requirement that the partnership must not have its own business office and must delegate all its management tasks to an external manager will seem bizarre and lacking any connection with the logic of partnerships.

"It is not only unclear when the FIP regulations will appear, but also whether they will turn out to be worth the wait"

What alternative approaches might Chinese tax authorities take to provide foreign investors with similar benefits as under the 2003 circular?

Once it is assumed, as it sometimes has been, that FIP funds will be viable in the future, and when, on that basis, it is further discussed how foreign partners might avoid being treated as having an establishment in China, one intuitive approach is to differentiate between general and limited partners.

The intuition is that the limited partners are passive and removed from active management. Whatever the general partners and other agents of the partnership do, the limited partners have little say and cannot be understood as doing business through them. Therefore even if foreign general partners would be deemed to have establishments in China, foreign limited partners should not be.

This approach has the merit of dispensing with the artificial fund structure described in the 2003 circular. If applied, by analogy, to funds that adopt the NLPCJV form, it would deem those investors with limited liability for the fund to be establishment-free, while investors with unlimited liability would be subject to net-income basis taxation on income derived from the fund. While this is not as favourable as the 2003 circular, where all investors can be deemed establishment-free if the external manager fund structure is adopted, once investors are on notice, they can restructure the allocation to the unlimited liability investors so that there is little additional tax burden.

The intuition, however, may be unreliable. Under regulations governing funds taking the NLPCJV form, for example, there is little restriction on the ability of limited liability investors to control management. And in the partnership context, exactly how passive a limited partner must behave to remain a limited partner is a fundamental issue yet to be explored in practice.

Does Chinese partnership law treat limited partners differently when it comes to attribution of assets and activities?

Besides the intuition that limited partners are necessarily passive, certain legal doctrines may support a distinction between general and limited partners for determining whether an establishment should be found. For example, it is well known in US partnership law that limited partners do not have ownership interest in specific partnership assets, and that general partners are not agents of limited partners and cannot bind them as principals. Some taxpayers have invoked these doctrines to argue in the US (although unsuccessfully) against the attribution of permanent establishments of partnerships to their foreign limited partners.

However, such doctrines are absent in Chinese partnership law. While the statute is silent, scholars believe that in a Chinese general partnership, the partners jointly own the specific assets of the partnership. There is no indication in either the Partnership Law itself or in its scholarly exegesis that general partners have property rights that limited partners do not. By inference, then, even limited partners might be deemed to own specific partnership assets. Likewise, the Chinese law of agency (as contained in the Civil Law) is quite primitive, but given what it does say, one cannot conclude that a limited partner cannot be a principal with respect to a general partner's actions.

Nonetheless, there is no fundamental reason why tax law should hew to partnership or other commercial law. It has its own set of considerations (administrability, fairness, protection of government revenue, and minimisation of economic distortions) for designing rules. Arguably, the external manager fund structure contemplated by the 2003 circular *is* a distortion. Although, for purposes of determining whether foreign investors in Chinese VC or PE funds have establishments in China, differentiating between general and limited partners (or unlimited-liability and limited-liability investors) is not a perfect alternative, it might nonetheless prove to be less distortive, while remaining benign to the development of foreign-invested funds.

By Wei Cui, associate professor, China University of Political Science and Law

Beware specific performance

The aftermath of Clear Channel: longer form term sheets, interim facilities and specific performance clauses

Few cases have attracted as much attention in private equity and leveraged finance circles as the alleged refusal of banks to fund the $21 billion buyout of Clear Channel Communications by Bain Capital and THL Partners. The litigation, settled in mid-May, left some interesting legal questions unanswered, such as the general enforceability of financing commitment letters and availability of specific performance in that context. It is reported that the settlement entailed a lower price for Clear Channel stock under the revised merger arrangements and regarding debt facilities, a lower debt amount and increased pricing. The other financing terms were consistent with the commitment letter.

English and Australian courts have awarded specific performance to enforce merger and lending obligations. Bidders and banks that enthusiastically commit themselves in bid situations with limited outs should take care. They may well be forced to close the deal.

No financing out

In November 2006, Clear Channel entered into a merger agreement with entities owned by Bain/THL. The firms had signed a financing commitment letter with their banks to fund the acquisition. The commitment letter attached a medium-form term sheet and included the preparation of fully-negotiated facility documentation as a condition precedent to funding. There was no market material adverse change (market Mac) condition precedent in the term sheet.

During negotiations to finalise the facility documentation, an email between the banks discussing their intention to renege on the financing commitment was reportedly leaked to Bain/THL. The banks had also allegedly admitted that funding the deal would result in immediate mark-to-market losses on day one, and that they were trying to recut the deal.

Part of this included a reopening of some fundamental points – reducing the six-year facilities to three years, preventing the revolving credit facility from being used to repay existing debt, and prescribing unrealistic baskets for various negative covenants. On March 26 2008, Bain/THL launched proceedings in the Supreme Court of New York against the banks, alleging breach of contract, fraud, deceptive trade practices and civil conspiracy.

The purchasers did not have the right to terminate the merger agreement if their financing fell through (there was no financing out provision). It was imperative for them that the banks would supply financing, regardless of whether market conditions changed between the signing of the deal and the time when the banks were obliged to fund.

The merger agreement had a clause giving the buyer recourse to the remedy of specific performance but expressly excluding it as a remedy for sellers. The exclusive remedy for the sellers was the reverse termination fee. There was no corresponding specific performance clause in the commitment letter.

> **"Bidders and banks that enthusiastically commit themselves in bid situations with limited outs should take care"**

Allegations

The plaintiffs sought to specifically enforce the binding commitment made by the banks to fund the merger. Their case included the following claims:

- There was no uncertainty about the commercial terms of the commitment letter: they were agreed in the term sheet. As for the remaining terms, the agreement was that they would be no less advantageous than provisions that appeared in Bain/THL sponsor precedent transactions.
- There was no market Mac condition precedent. Still, the banks wanted to exit the deal because of the worsening credit market conditions in 2007. They demanded terms in the final documents that were materially different from those in the commitment letter. The plaintiffs argued that if such conduct went unchecked, the banks would have succeeded in reallocating the market risk they had agreed to assume in the commitment letter to the purchasers.
- The unique aspects of the Clear Channel business meant that the appropriate remedy was specific performance of the banks' obligation to fund.

The banks' defence included the following points:

- The negotiation of a final set of transaction documents was a condition precedent to funding of the transaction.
- The central premise of the plaintiffs' request for specific performance of the commitment letter called for the banks to lend money pursuant to documents that still had to be negotiated. This involved judicial intervention in complex commercial negotiations, which is unworkable and unprecedented.
- Specific performance of a contract to lend money is contrary to New York law.

UK and Australian law

Specific performance is a discretionary equitable remedy, by which the court compels a party to perform its contractual obligations according to the agreed terms.

For specific performance to be awarded, there must be at a minimum:

- An enforceable contract. In the context of financing commitment documents, although the agreement is usually subject to negotiation of full documents, the essential terms of the agreement should be settled at the commitment stage.
- Valuable consideration provided by the plaintiff.
- A breach of contract constituted by a failure to perform obligations, or an anticipatory breach by the defendant.

Equity will not grant specific performance if an award of damages at common

law will provide enough compensation. But the adequacy of damages is not the sole point to be considered. The court's discretionary considerations include the type of contract and the circumstances under which the contract is made. Readiness and willingness of plaintiffs to complete their own obligations under the contract, whether any impossibility, futility, illegality, delay, hardship or unfairness, or uncertainty surrounding the performance of the contract would result, and whether the order of specific performance would require the prolonged supervision of the court, are all discretionary considerations the court weighs up in determining whether to grant specific performance.

For our purposes, performance of a contract could be impossible or futile because a condition precedent (such as a market Mac clause) has not been satisfied in the financing documents or the merger agreement. However, the order for specific performance could also be made conditional on the satisfaction of the conditions precedent.

"If such conduct went unchecked, the banks would have reallocated the market risk they assumed to the purchasers"

Damages not always enough

A contract for the purchase of shares is a particular type of circumstance where an award of damages may well be an inadequate remedy. A contract for the sale of shares will be enforceable if the shares are not readily available in the market. It will be enough if plaintiffs can show that they would have difficulty in obtaining them by other means.

Specific performance of a takeover agreement was awarded by the New South Wales Supreme Court in *Lionsgate Australia Pty v Macquarie Private Portfolio Management*. In that case the takeover agreement included a specific performance clause, to which the court expressly referred. In the UK, specific performance has been awarded in the context of purchasing and selling shares, in *Eid v Al-Kazemi* and *Baker v Potter* for instance – neither of these cases involved an agreement with an explicit specific performance clause.

Orders for specific performance of loan contracts have not readily been granted. The general view has been that damages should be an adequate remedy because the subject matter of the contract is pecuniary and should be easily obtainable by other means. As always, there are exceptions to the rule – when the plaintiff's enterprise would be lost if the defendant were not to fulfil its promise, for example.

Other instances are when the loan agreement is more than a mere contract for the loan of money because the loan is part of a wider arrangement with sequential responsibilities. In *Wight v Haberdan Pty* a mortgagee was ordered to fund the plaintiff's purchase of real estate. The loan contract was held to have been part of a larger transaction including contractual obligations normally amendable to an order for specific performance. A contract to lend money was specifically enforced in the UK in *Starkey v Barton* in similar circumstances.

From this, it could be argued that the place of the financing commitment in an overall buyout transaction, along with the tight state of credit markets, take the matter out of the ordinary category of loan agreement and make a decree of specific performance more readily attainable.

Jittery market

Specific performance is by definition a discretionary remedy. The inclusion of a specific performance clause means that the parties have given express contractual acknowledgment of the inadequacy of damages as a remedy. That is something to which a court will have regard. To date, we have not seen the use of specific performance clauses in financing documents. It will be interesting to see whether they will become more common in this unstable deal environment. The interaction of a specific performance clause with any reverse termination fee provision, Mac clause, financing out provision, and other conditions precedent in the agreements should be carefully considered to ensure that they achieve the desired effect.

A more concrete way for borrowers to mitigate the risk of losing their financing between the signing of binding financing commitments and funding is to have commitment letters with long-form detailed term sheets (as opposed to short-form or medium-form term sheets) or interim facility agreements. Interim facility agreements developed in the UK and Europe to bridge this gap; they are essentially short-term bullet facilities (lasting between 30 and 90 days) to ensure funding availability.

The bullet maturity provides the necessary incentive for private equity sponsors to refinance it promptly with the permanent facilities. Interim facility agreements made their appearance in Australia with KKR's purchase of BIS Cleanaway from Brambles Australia in 2006. The transaction was funded by the interim facility. Although interim facility agreements are not yet a regular feature in this market, the jittery lending climate may well see an increase in their use.

By Yuen-Yee Cho and Victoria Todd of Mallesons Stephen Jaques

"An email between the banks discussing their intention to renege on the financing was reportedly leaked to Bain/THL"

The letter and the law

Most private equity funds will include a Cayman Islands exempted limited partnership as part of the structure. Iain McMurdo & Tom Katsaros of Maples and Calder explore the issues surrounding the use of side letters

A general partner may sometimes be asked to provide a side letter to potential investors in order to persuade them to invest in a private equity fund. Broadly speaking, the term side letter refers to an agreement between a general partner (either on its own behalf or on behalf of the exempted limited partnership) and a prospective limited partner. The investor will basically be seeking to obtain special terms from the partnership that apply specifically to that investor.

Side letters often give rise to complex issues that require a careful analysis of the relevant documents and surrounding circumstances in any given case. In principle, there is no objection to a separate side letter being entered into between a general partner and an investor regarding how issues in the partnership agreement will be addressed. In most cases, it would appear that the usual terms covered in side letters simply seek to clarify how the general partner will exercise its powers under the partnership agreement. However, issues may arise as to whether the general partner has properly exercised its powers to enter into any given term of a side letter, as well as whether the side letter actually amends or conflicts with the terms of the partnership agreement and hence affects the rights of other limited partners.

Powers of a general partner

For a side letter to be valid and binding, the general partner must have the power to enter into such side letters in the partnership agreement. That power should be clearly disclosed in the relevant offering materials. If no disclosure is made in the offering documents or the partnership agreement to other investors that side letters may be entered into with certain investors, issues of misrepresentation or non-disclosure could also arise.

In addition: (i) the side letter must not contravene any of the terms of the partnership agreement and Cayman Islands law generally; and (ii) the general partner must act at all times in compliance with its statutory and common law duties (including fiduciary duties), owed to the partnership and the limited partners in deciding whether or not to enter into a side letter with a specific investor. If these conditions are not met, the general partner could be held to be in breach of the provisions of the partnership agreement or in breach of its duties to the partnership.

Any breach of these basic propositions may result in the side letter being unenforceable or may put the general partner or the fund in a position where it will breach the terms of the partnership agreement. In extreme cases, the general partner could be liable to the fund if the fund can show that the loss resulted from the actions of the general partner being in breach of its duties and/or the partnership agreement.

It should be noted that where the partnership agreement expressly grants the general partner a broad power to enter into side letters, the general partner is still bound by its statutory duty under Section 4(3) of the Exempted Limited Partnership Law (2007 Revision) (the Law) to act in good faith in the interests of the partnership in deciding whether or not to agree to the terms of a side letter.

Contentious issues

Where the side letter seeks to introduce terms that may alter a material term of the partnership agreement, it can sometimes be difficult to ascertain the extent to which a general partner may exercise its power and discretion to agree to such terms in a side letter without seeking a formal amendment to the partnership agreement or the consent of the limited partners affected. In many cases, the partnership agreement will expressly provide that the general partner may amend the partnership agreement without the consent of the limited partners, provided the amendment is not material and does not alter the economic rights of the other limited partners. A careful analysis of what constitutes a material amendment will be required in these circumstances – often, this is not something that is easily apparent from the terms of the side letter.

The following are examples of terms issues that may appear in side letters.

- Statements in side letters affirming representations in a fund's offering documents or partnership agreement. Generally speaking, these are unlikely to cause significant difficulties.
- Agreements to provide additional information to investors may or may not cause issues depending on the circumstances. Certain institutional investors may be required by their own internal investment guidelines or onshore regulations to ascertain, monitor and disclose the constituent portfolios of underlying funds in which it invests. The provision of information for portfolio monitoring purposes that in itself will not lead to any investment decisions or a negative impact on the portfolio is usually unobjectionable in the context of closed-ended private equity funds.
- Undertakings or agreements in side letters that seek to outline the exercise of any discretionary powers by the general partner can, in so far as they can affect other investors, give rise to some difficult issues. On the other hand, statements in a side letter that seek to clarify how the directors or a general partner are likely to exercise their specific powers may be acceptable.
- Any terms that have a material affect on the economic rights of other partners (such as how costs are shared or indemnities borne) are likely to be problematic.
- Some side letters might contain most favoured nation clauses, which provide that an investor should have the opportunity to receive the benefit of any other favourable side letter terms granted to other investors. While these clauses may not of themselves be objectionable, they can give rise to practical difficulties in interpreting with certainty the exact terms that are by implication included in the side letter arrangements.

Careful thought and consideration must be given to all transactions where side letters are contemplated, particularly in the context of Cayman exempted limited partnerships. The parties should be aware of the potential issues created by side letters, particularly when advising a general partner who is not only bound by the terms of the partnership agreement but also owes statutory and common law duties to act in good faith in the interests of the partnership.

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Economics or foreign policy?

Changes to German law are soon to create new obstacles for investors. Frank Thiäner and Jens Hörmann of P+P Pöllath + Partners explain why

On January 1 2009 some changes to the German Foreign Trade and Payments Act (*Außenwirtschaftsgesetz,* AWG*)* will come into effect that are likely to have a significant impact on foreign investors wishing to invest in German target companies. Under the new regime, any such acquisition by foreign investors may trigger the right of the German Federal Ministry of Economics to investigate and even prohibit the transaction.

The reform

Who is affected?

Under the Foreign Trade and Payments Act, investors from non-EC countries that do not belong to the European Free Trade Association (EC plus Switzerland, Norway, Iceland and Liechtenstein) and that acquire shares representing 25% or more of the voting stock of a German company may have their acquisition investigated by the Federal Ministry of Economics. Shares held by companies controlled by the acquirer (by holding at least 25% of the voting stock) are treated as if they were held by the acquirer itself. Shares that are subject to voting agreements are also assigned to the acquirer.

If the Ministry comes to the conclusion that Germany's public order or national security are threatened by a transaction, it may prohibit the acquisition. Unfortunately, the Act does not contain any definition of public order or national security, so the Act brings a certain degree of uncertainty about which transactions fall within its scope. If the Ministry decides that a transaction falls within the scope of the Act, it may order that the acquisition (which may already be consummated) be reversed. The Ministry may also choose only to prohibit the exertion of voting rights of shares held by the foreign investor, thus restricting the investor's influence on the German target.

How long does it take to reach a decision?

Foreign investors are under no obligation to file their transaction with the Federal Ministry of Economics. However, they may do so after signing and will, in that case, receive a final decision on whether the transaction will be prohibited within one month. If the transaction is not filed with the Ministry, it may start an investigation on its own account within three months after the consummation of the transaction, with the effect that the transaction is put under the condition precedent of the Ministry's approval. The Ministry will immediately inform the investor of its decision to investigate the acquisition, which triggers the acquirer's obligation to provide the Ministry with data. The acquirer will be informed about the specific data required by the Ministry through an announcement in the Federal Gazette (*Bundesanzeiger*). The investigation must be completed within two months of receipt of the transaction data.

Aims and criticism

The reform seeks to protect sensitive branches of German industry such as the energy, telecom and military sectors. Potential threats are perceived to come from state-controlled funds (in particular from China, the Emirates and Russia) that may be used to influence German politics via investments in German key enterprises. State-controlled foreign corporations have also been classified as potentially dangerous.

The reforms have attracted much criticism. For example, the new powers granted to the Ministry of Economics are suspected of infringing the freedom of capital movement as guaranteed by Article 56 of the EC Treaty. The European Commission is planning to examine the Act for its reconcilability with Article 56 and the freedom of establishment (Article 49). Also, the scope of the Act is considered to be unreasonable because it not only restricts investment from foreign countries, state-owned funds or state-controlled corporations but foreign investors in general. Any private equity investor wishing to invest in Germany may find his transaction being investigated by the Federal Ministry of Economics.

The problem for foreign investors

The main problem is the legal uncertainty for foreign investors. If an investor has successfully completed a transaction, it may still be subject to investigation for a period of three months after the closing date. A further two months may pass until the Ministry has completed its investigation. The result may be that the transaction is prohibited and the acquisition must be reversed. This uncertainty is unacceptable for the seller, buyer, target, financing banks and employees of the target company.

Recommended course of action

Foreign investors wishing to acquire 25% or more of the voting stock of a German company should therefore adhere to the following guidelines.

Informal enquiry before signing

A foreign investor can contact the Federal Ministry of Economics before he signs a share purchase agreement on a confidential and informal basis in order to find out if the Ministry will investigate the transaction. A similar approach is generally taken if a bidder wishes to know the position of the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) on a takeover process. There are no guidelines on how such an informal approach should be made, though any informal contact bears the risk that information may be leaked. A seller is therefore unlikely to agree to such contact.

Filing for investigation after signing

Therefore, a foreign investor should voluntarily file the transaction with the Federal Ministry of Economics immediately after signing a share purchase agreement. He should refrain from filing only if he and the seller are in no doubt that the transaction does not qualify for an investigation by the Ministry. If the investor intends to file the transaction, the share purchase agreement should contain a clause that makes the clearance of the acquisition by the Ministry a condition precedent for the obligation of the parties to consummate the transaction. After the Ministry has received all relevant data, it has one month to decide whether it will prohibit the consummation. In order to speed up the process, the investor should agree with the Ministry on which information it needs in order to come to a decision as quickly as possible. It appears likely that an investor will, in most cases, be able to get a decision before the German Federal Cartel Authority (*Bundeskartellamt*) has cleared the transaction. Therefore, the filing of the acquisition should not lead to delay in most cases.

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Investing into India

Sidharth Bhasin of Shearman & Sterling in Hong Kong explains how private equity deals are structured

India has experienced a rapid growth in private equity deals in recent years. According to Grant Thornton, private equity deals in India increased by 142% from 2006 to 2007. Interestingly, not only has the aggregate volume of private equity investments in India increased, but the average deal size has also grown significantly. As per Grant Thornton, 56 private equity deals were done in India during the first four months of 2008, with an aggregate announced value of $4.94 billion, as opposed to 136 deals aggregating to $3.42 billion during the same period in 2007.

However, global market conditions have changed significantly recently and, although many expect private equity investments in India to continue to grow, it is likely that there may be a slowdown in the short-term. In these times it is even more important for private equity investors to structure their deals in a manner that provides effective protection to their investments and maximizes their returns.

Tax structuring

Virtually all investments into India are made from an investment vehicle domiciled in a country with which India has a double tax avoidance agreement. Mauritius, Cyprus and Singapore are the most frequently used jurisdictions for Indian investments. India recently signed a double tax avoidance agreement with Luxembourg, although the text of the agreement has yet to be made public.

Of the above, Mauritius has proved to be the most favored jurisdiction, especially for equity based investments. This is mainly due to the favourable India-Mauritius tax treaty and well-established precedents relating to establishment of Mauritius tax residency for availing treaty benefits. Under the treaty, no capital gains tax is payable in India on sales of shares of an Indian company if the seller is a Mauritius tax resident and does not otherwise maintain a "permanent establishment" in India.

However, it should be noted that there is no capital gains tax in India on sales of shares of an Indian company held for more than one year and sold though a recognised stock exchange. Thus, the Mauritius approach is advantageous if the Indian company is the primary exit vehicle for the investor and such exit is by way of a sale of shares of the Indian company that are not listed on a recognised stock exchange.

For debt investments, Cyprus is generally favored over Mauritius since the withholding tax on interest payments received in Cyprus is much lower (10%) than Mauritius (effective rate of approximately 21% for foreign currency instruments and approximately 42% for Indian rupee instruments). There has been a lot of focus on India-Mauritius and India-Cyprus tax treaties recently and speculation that both treaties might be renegotiated to remove some of the benefits (or at least make the requirements to avail the benefits more stringent).

Given the importance of these treaties and the volume of investments made through these jurisdictions, it would be interesting to see if these treaties are actually renegotiated and if so, the nature and scope of any resulting amendment.

Investment structuring

The type of investment vehicle used for making the investment (such as FVCI, NBFC) is important, not only from an entry point of view, but also for exit and downside protection. Each has its own advantages and restrictions and investors should carefully examine alternatives before selecting the investment vehicle. This choice could also affect certain deal terms and the deal structure in order to work around some of the regulatory restrictions. Some of these alternatives involve obtaining registrations in India and presently the timing for obtaining such registrations is uncertain.

It is also important for investors to know the restrictions and limitations of the particular investment instrument they opt for. Although the choice of the investment instrument would largely depend upon the terms of the investment and the type and extent of protections that the investor desires, there are a few India-specific issues that investors should be aware of.

For instance, in order to be treated as an equity investment, all preference shares, convertible debentures and other convertible instruments must be fully and compulsorily convertible into ordinary equity shares (without any redemption feature). If any such instrument has a redemption feature built into it, then it would be treated as debt and would need to comply with the external commercial borrowing (ECB) guidelines. These guidelines contain all-in-cost ceilings, end use restrictions, limits on maturity and certain other restrictions and limitations, including a requirement to obtain the prior approval from the Reserve Bank of India for any debt intended to be used for Indian rupee expenditure.

Certain structures have evolved to work around this limitation and still provide investors with customary downside protections (although some of these structures are being scrutinised by the regulators). Even if the investment is considered to be equity, there are also caps on the amount of divident and interest payable on such fully convertible preference shares and debentures.

Another important point is that preference shareholders can only vote on resolutions that directly affect the rights attached to such preference shares. Therefore, investors desiring management participation and decision-making rights should keep this important limitation in mind while structuring their investments.

Dynamic environment

The regulatory framework in India is constantly changing and with it so are the investment structures used to provide investors with the desired level of protection and control. The Indian tax authorities recently tried to tax gains made by investors using the Mauritius investment route. Although the outcome of these claims has not yet been decided, certain structures have developed to insulate the investors from such claims (for example, using a double-Mauritius structure).

This further highlights the need for proper and effective structuring up front to enable investors to continue to realise the returns that they have come to expect in India. A well planned and properly implemented structure can provide the desired level of protection and control and could result in returns that are proportionate to the risks involved in doing private equity deals in India.

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Updating the SICAR

Luxembourg limited partnerships will be more attractive for risk capital structuring says Marc Meyers, partner at Loyens & Loeff, Luxembourg

After more than four successful years following its enactment, the law of June 15, 2004 relating to investment company in risk capital (SICAR) is being modernised to fit industry needs and thereby further benefiting its operational flexibility. The proposed modernisation aims to, among other things, increase the attractiveness of the Luxembourg limited partnership (*société en commandite simple* or SCS) for risk capital structuring purposes.

The Luxembourg legislature is following a two-fold approach for SCSs, largely based on comments from practitioners and inspired by the needs of the private equity industry. It aims to allow an SCS to also opt for a variable share capital structure, as well as to replicate Anglo-Saxon financing techniques for partnerships.

A flexible tool

The proposed amendments will align the SCS with the other available corporate structures, so as to allow a SCS organised as a SICAR to have a variable share capital (to provide in its articles of incorporation that the amount of its share capital shall at all times be equal to its net asset value). As a consequence, variations in the share capital of the SCS shall be effected by law. They will not have to comply with any measures regarding publication in the Official Gazette of the Grand Duchy of Luxembourg (Mémorial) and registration with the register of commerce and companies (Company Register).

The Luxembourg Council of State (*Conseil d'Etat*) welcomed this proposed amendment by confirming that the variable share capital structure represents a significant innovation for an SCS organised as a SICAR. It also recommended that a SCS organised as a SICAR with a variable share capital should be allowed to derogate from articles 6 and 17 of the commercial companies law of 1915 (1915 Law), as well as from article 6 of the law of December 19, 2002 on, among other things, the Company Register (2002 Law). This will ensure a consistent application of the variable capital concept.

Non-disclosure of limited partners' identity and commitments

The derogations from article 6 of the 1915 Law and article 6 of the 2002 Law would allow a SCS organised as a SICAR with variable share capital not to disclose their limited partners' identity and the amounts of their commitments to the SCS in the Mémorial and to avoid any registration thereof with the Company Register.

Efficient repatriation of available cash

The derogation from article 17 of the 1915 Law would allow the managing general partner of a SCS organised as a SICAR with variable share capital not only to make profit distributions, but also any other payments whether they represent interests, gains, dividends or capital. This would not trigger the obligation to protect creditors' rights in respect of a fixed capital structure, which could lead a limited partner to be forced to repay any interest and dividends received, if they have not been paid out of real profits. Such a structure consequently allows the managing general partner not only to return any profits on investments to investors, but also the acquisition cost of any realised investments. This enables a flexible and efficient repatriation of excess cash to investors.

Anglo-Saxon financing techniques

The Luxembourg Chamber of Commerce, while commenting on the draft bill amending the SICAR legislation, has confirmed that recent Luxembourg practice has replicated a recurrent financing practice used by Anglo-Saxon limited partnerships. This consists of the capitalisation of the partnership with a minimum share capital amount (remaining fixed), the balance of any financing needs being satisfied on the basis of (interest free) loan commitments from limited partners pro rata to their "equity" participation.

Maximum financing and refinancing flexibility

The replication of this mixed financing of capital and loan commitments permits maximum financing and refinancing flexibility for a SCS organised as a SICAR. Additionally, combined with a Luxembourg special purpose acquisition or financing vehicle (Soparfi), it provides for a tax efficient private equity investment structure.

Legal certainty

The Chamber of Commerce has, in its aforementioned comments, also confirmed that nothing should prevent the limited partners of a SCS to simultaneously be creditors. Consequently, it has suggested that the legislature confirm that for a SCS organised as a SICAR, loan commitments would not incur any risk to be requalified into share capital or capital commitments. This provides legal certainty to practitioners and the industry regarding such structuring.

Positive conclusion

The revisions, which are largely based on the needs of the private equity industry, will surely have a positive impact on the SICAR regime and ensure its continuing success with promoters and assets managers, as well as within the investor community. Furthermore, the increased attractiveness of the Luxembourg limited partnership under the SICAR regime should resonate within the international private equity community and stimulate the use of the SCS organised as a SICAR.

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Ways to stay out of court

Kuri Breña Sánchez Ugarte y Aznar outline indemnification mechanisms in Mexican M&A transactions

In negotiating stock or asset purchase agreements relating to Mexican companies, parties have sought alternatives in an effort to minimise the role of the courts if the purchaser makes an indemnification claim against the seller for breach of representations and warranties.

Independent determination

Parties often agree that indemnification claims submitted by purchasers be resolved by an independent firm with the required technical capabilities. In many cases the central issue in such claims is that the financial statements of the target company or the representations and warranties contained in the purchase agreement with respect to such financial statements did not accurately reflect the target company's situation. Therefore, accounting firms are chosen as the independent professionals to issue an opinion on whether the indemnification claim has merit or not, based on the information provided by the seller to the purchaser, and the seller's assertions. The parties agree to be bound by the decision of the independent firm.

The parties also agree on a mechanism to segregate certain funds to be used to indemnify the purchaser, if the decision of the independent firm finds that the claims of the purchaser have merit.

Administration trust

The escrow agreement is a legal mechanism that is not contemplated by Mexican law. Although there are contractual arrangements that can achieve the same goals under Mexican law, such as a conditional deposit, Mexican attorneys often prefer not to use cross-border hybrids and rather resort to a legal mechanism that has statutory recognition and is widely accepted in Mexico, such as the trust (*fideicomiso*). Therefore, trusts are used as the mechanism in lieu of an escrow. Trusts are used in Mexico for several purposes, one of which is the administration of funds and the release of such funds upon instruction from the parties as provided in the trust agreement. In Mexico, only financial institutions can act as trustees. In the case described above, a bank would typically be chosen as trustee.

The trust agreement must contain provisions specifying which parties (and in which circumstances) can instruct the trustee to release amounts that are part of the indemnification fund, as well as rules specifying the cases in which such amounts can be delivered to the sellers after the period for the purchaser to submit any indemnification claims under the purchase agreement has lapsed.

"Parties often agree that indemnification claims submitted by purchasers be resolved by an independent firm with the required technical capabilities"

Dispute resolution

Although the mechanism described above would not preclude the parties from resorting to the dispute resolution method agreed upon in the purchase agreement, the purpose of implementing the indemnification procedure is to establish a mechanism that is a binding agreement and that is based on the assumption that both parties wish to settle any indemnification disputes in a more efficient manner than through lengthy litigation.

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Let's work together

Sale to a Spac has tended to be considered a last resort exit route for a private equity fund. Graham Defries and David Willbe of Dechert explain why the time has come to reconsider

Special purpose acquisition corporations (Spacs) are an established feature of the corporate landscape on both sides of the Atlantic. The investor protections key to the structure of Spacs makes them more attractive to investors weathering financial turbulence: Spac IPO activity tends to increase as standard IPO activity declines. This year the volume of Spac listings has increased in both the US and Europe.

The response to Spacs from private equity professionals has been either concern that they might compete for potential investments or to embrace the concept and launch a Spac, as Mark Ein, Nicolas Berggruen and Tom Hicks (among others) have done. With around $12 billion raised by Spacs last year, however, the time may have come for private equity houses to consider whether or not they could have other uses as potential exit routes or co-investment partners.

The anatomy of a Spac

A Spac is a corporate vehicle with a sponsor/management team and various investor protection mechanisms. It raises capital through a listing, typically by an institutional placing of units comprising one share and one warrant. A proportion of the funds raised is placed into a trust, and will remain unavailable to the Spac until it has identified a target acquisition and shareholders have voted in favour of the deal. From 86% on average in 2004, the emerging market standard is that 100% of the funds raised are placed in trust – the Spac's working capital and up-front fees being provided by the sponsor's risk capital of around 3% of the deal size and a proportion of the interest generated on the trust monies.

A 20% promote (on an pre-warrant dilution basis) is typically taken by the sponsor, on terms that it remains worthless (because the shares are escrowed and not entitled to a share of the trust monies) until a deal has been completed. The sponsor's return, both on its promote and its risk capital, is therefore inherently bound up with the completion of an acquisition. A Spac has a defined period of time during which to identify and complete an acquisition, which is usually 18 months to two years, after which the capital in the trust is returned to investors.

Although not a requirement of the Spac structure, the market standard is that the acquisition will be at least three and ideally four to five times the size of the trust fund in order to minimise the dilutive effect of the sponsors' promote and so drive the investors' returns. Following the acquisition, all of the Spac-specific structuring falls away so that the Spac becomes an ordinary listed company.

A willing buyer?

For a private equity fund seeking an exit from an investment, a sale to a Spac may be an attractive prospect. The sponsors are incentivised to find a good deal to present to their shareholders as quickly as possible, as the value of their promote depends upon completing an acquisition during the allotted time. The window of opportunity is further limited for US Spacs, which are subject to far greater regulation in this area than their European counterparts, with a four or more month time period required to prepare and circulate the necessary materials and hold the shareholder vote.

In order to fund the acquisition, Spacs use a mixture of cash from the trust fund, debt finance and a limited amount of newly-issued equity in the Spac. As the availability of affordable debt has fallen, so the proportion of equity used to complete acquisitions has risen. Even in high value deals, significant proportions of the purchase price have been funded through equity. In November 2007 Freedom Acquisition Holdings Inc closed the $3.4 billion acquisition of GLG Partners using $1 billion of cash (funded from its approximately $512 million IPO and a $570 million debt facility), with the $2.4 billion balance made up of new equity issued by Freedom.

The Freedom/GLG deal is near the upper end of the Spac range in terms of transaction size (both in terms of the price paid and price as a multiple of the trust monies) and therefore the number of new shares issued is far larger than normal, but in the current climate it is usual that some proportion of the consideration in any sale to a Spac will be paid in new equity. This is a principal reason why Spacs can continue to do deals in a market with limited access to affordable debt. In a more typical transaction, an acquisition four times the size of the Spac's trust fund might be funded by equity worth one and a half to two times the value of the trust monies. With share-based consideration issued at a suitable discount to the trading price of the Spac's shares to counteract dilution from the man-

"With around $12 billion raised by Spacs last year, the time may have come for private equity houses to consider whether or not they could have other uses as potential exit routes or co-investment partners"

agement promote, the seller might expect to end up with a stake of around 45%-55% of the Spac following the dilution effect of conversion of the Spac's outstanding warrants.

In a market where exiting investments via an IPO can be less attractive in terms of valuation and deal certainty, a sale to a Spac offers an alternative that achieves the desired result and provides much greater certainty as to valuation. The Spac's shareholders must vote to approve the deal, but there is a vested interest for the sponsors in persuading shareholders to approve the deal, and around 80% of Spac deals that have gone to a vote have been approved.

An investment partner?

Around 57% of Spacs are confined to looking for targets in specified industry sectors, and these Spacs are generally sold to investors on the basis of the experience and expertise of their management team to source and run a target company. A private equity fund seeking further exposure in a sector may find it an attractive prospect to co-invest alongside such a Spac, backing the Spac's sponsors on the strength of their track record to deliver value following the acquisition. Co-investment capital provided by a fund to assist in financing an acquisition will be attractive to the Spac's sponsors, who will wish to complete an attractive acquisition with as little new equity issuance (which will dilute their promote) as possible.

An interested investor could also procure more favourable terms for co-investment by assisting the Spac's sponsors in overcoming two aspects of the popular structure that have shown themselves to be potential issues for the Spac and its sponsors. Although it is unlikely that the provision of such capital would provide a substantial enough return for any private equity fund in and of itself, that provision could be offered as part of a deal that also contained favourable terms for a fund's co-investment in the Spac's target and/or a substantial stake in the Spac.

As the value of the sponsors' promote is inextricably linked to a deal being accepted by the Spac's shareholders, it is not uncommon for the sponsors to be 'greenmailed' by shareholders with large stakes threatening to vote against the deal unless a financial incentive is provided. An investor with the available capital to do so might make an offer to buy shares from presumed "no" voters and vote them in favour of the deal in order to circumvent this potential problem. Likewise, an investor might agree to the provision of capital to fund a warrant repurchase programme, which would alleviate the dilution of the sponsors' promote and the investor's stake.

The next step

Historically, some have suggested that a sale to a Spac would be the exit route of last resort for a private equity fund. With access to financing for traditional investment routes and exits via secondary buyouts more limited now, and with the IPO market often uncertain and offering weaker valuations, non-traditional routes may be worth exploring.

Spacs have called capital, a public listing to provide an attractive exit route from any investment, limited time in which to complete a suitable acquisition and sponsors who are heavily incentivised to complete an acquisition in time. With the Spac market trending towards bigger deals and higher quality in management teams and their advisers, the time to re-evaluate the Spac's usefulness may have arrived.

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