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Country Q&A—United States

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Market and Incentives

1. Please describe briefly the private equity market in your jurisdiction, in particular:

- **The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.**
- **Market trends (for example, the role of hedge funds in private equity).**

Sources of Funding

Sources of private equity funds include:

- Public, corporate and union pension funds
- Banks and other financial institutions
- Insurance companies, endowments and foundations
- Family offices
- High net-worth individuals
- Fund of funds

According to a survey of 110 funds, public, corporate and union pension funds accounted for approximately 40.3 percent of capital commitments in 2006 with banks and other financial institutions, insurance companies and endowments and foundations contributing approximately 25 percent to the same funds (*Private Equity Analyst*, April 2007).

Market Trends

2007 has been a watershed year for US private equity sponsors. During the first half of the year, the frenzied pace of private equity deal-making was on target to far surpass 2006's outstanding results.

Large private equity deals dominated the US mergers and acquisitions press for both:

- The size of deals, including:
 - TXU Corp: US\$44.161 billion (about €30.569 billion)
 - First Data Corp: US\$26.964 billion (about €18.665 billion)
 - Sallie Mae: US\$24.662 billion (about €17.072 billion)

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- The pace of deal signings, for example:
 - Harman International, Cablevision and US Foodservice, with a total value of US\$37.4 billion (about €25.9 billion), were announced six days apart
 - Cablevision and US Foodservice were announced on the same day

Then, towards the end of June, unrest started to creep into the high yield debt market as the aggregate size of the offerings coming to market started to significantly outpace the demand for such investments. The excess supply of offerings led to several offerings being restructured (Thompson Learning, TXU and First Data) or, in a few instances, being pulled entirely from the market (Service-Master and Allison Transmissions) therefore requiring the sponsors to close those acquisitions by drawing down on bridge facilities.

At about the same time, the press started to report stories of concerns about the health of the US sub-prime mortgage market (including the mortgage-backed securities markets). Unrest in those markets filtered into the leveraged finance market, which led to an unprecedented shutdown of the leveraged finance market in early to mid-July 2007. These events culminated in an almost overnight halt to large private equity deal-making. Large leveraged finance lenders stopped writing new commitments and many lenders who wrote commitments before July found themselves in a position of not being able to syndicate those underwritings. The lack of a syndication market further compounded the credit crunch through the summer. In the few instances, where lenders were able to syndicate loans post-closing, they did so at a loss even though there was no indication that the portfolio company was experiencing any financial difficulty.

The tightening of the credit markets has also led to a number of terminated or restructured signed, but not closed, deals. In several instances, sponsors have claimed the target experienced a material adverse effect resulting in a renegotiation of the

deal (Home Depot) or termination of the deal in its entirety (Harman International). More recently, Cerberus walked away from its US\$4 billion (about €2.77 billion) acquisition of United Rentals without claiming that United Rentals suffered a material adverse effect or that its lenders had pulled out of the deal. Rather, Cerberus stated it was entitled to terminate the acquisition agreement and pay a reverse break-up fee.

While the outlook for large deal-making over the near term is still unclear at this point, small and middle-market deals are still being pursued and consummated. Likewise, large US private equity sponsors continue to look abroad for acquisition candidates and the anticipated restructurings of pre-July 2007 transactions may provide a further supply of acquisition candidates.

In addition to the credit crunch, the US private equity industry is also faced with a potential law change in how private equity carried interests are taxed. Under existing US tax law, carried interests (that is, the share of profits paid to the sponsor by limited partners of a private equity fund) are generally taxed at capital gains rates of 15 percent as opposed to ordinary income tax rates which can reach 35 percent. At the time of writing, the US House of Representatives passed a tax bill that would raise the rate of tax on carried interests to 35 percent. Early indications suggest this bill will not be passed into law. While it is too early to determine what, if any, changes to the current tax law may ultimately pass both houses of Congress and be submitted to President Bush for passage, it is clear this is an issue that will be closely followed by the private equity community and its advisers in the coming months.

2. Please summarize the level of activity in recent years in relation to:

- **Fundraising by private equity funds and hedge funds**
- **Private equity investment in established, early-stage and start-up businesses**

- **Private equity-financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs) and public-to-private transactions)**
- **Exits from private equity funds (that is, the realizations of the investments)**

Fundraising

In 2006, US-based private equity funds raised a total of 290 funds with aggregate funds raised through year-end totaling US\$181.273 billion (about €125.482 billion) (*Buyouts*, January 8, 2007). Through Q3 2007, 262 US-based private equity funds raised an aggregate of US\$214.835 billion (about €148.714 billion) (*Buyouts*, October 8, 2007).

In contrast, fundraising by hedge funds has slowed in recent years. According to a study of hedge funds that have raised at least US\$50 million (about €35 million), in 2006, 86 US-based hedge funds and one Canada-based hedge fund raised US\$31 billion (about €21 billion), compared to the 82 hedge funds that raised US\$34 billion (about €24 billion) in 2005 and the 81 hedge funds that raised US\$40 billion (about €28 billion) in 2004 (*Absolute Return*, February 2007).

Investment

Investments in start-ups, early-stage, expansion and later-stage companies for 2006 and through Q3 of 2007 are as follows (*Price waterhouseCoopers MoneyTree Report*):

- Start-ups for 2006: 342 transactions; aggregate value of US\$1.13 billion (about €782 million)
- Start-ups through Q3 2007: 278 transactions; aggregate value US\$659 million (about €456 billion)
- Early stage for 2006: 918 transactions; aggregate value of US\$4.039 billion (about €2.796 billion)

- Early stage through Q3 2007: 713 transactions; aggregate value of US\$3.715 billion (about €2.572 billion)
- Expansion for 2006: 1,276 transactions; aggregate value of US\$11.475 billion (about €7.943 billion)
- Expansion through Q3 2007: 886 transactions; aggregate value of US\$8.013 billion (about €5.547 billion)
- Later stage for 2006: 1,002 transactions; aggregate value of US\$9.841 billion (about €6.812 billion)
- Later stage through Q3 2007: 860 transactions; aggregate value of US\$9.376 billion (about €6.490 billion)

While these figures do not come close to the investment activity in 1999 and 2000, they do indicate private equity has a steady appetite for venture capital investments across all stages.

Transactions

In 2006, US-based private equity firms consummated 1,007 control-stake leveraged buyouts with an aggregate reported transaction value of US\$314.780 billion (about €217.899 billion) (*Buyouts*, January 8, 2007). Through Q3 2007, US-based private equity firms consummated leveraged buyouts with an aggregate reported transaction value of US\$359.0 billion (about €248.510 billion) (*Buyouts*, October 22, 2007).

Exits

US private equity sponsors exited from (*Mergermarket* database):

- 375 US-based portfolio companies in 2005 (US\$102.554 billion (about €70.991 billion) of aggregate reported transaction value)

- 474 US-based portfolio companies in 2006 (US\$84.161 billion (about €58.259 billion) of aggregate reported transaction value)
- 344 US-based portfolio companies through Q3 2007 (US\$67.139 billion (about €46.476 billion) of aggregate reported transaction value)

3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

There is no particular, generally available tax regime that encourages investment in unlisted companies.

Fund Formation

4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

The legal structure private equity funds most commonly use is the Delaware limited partnership. The limited partnership affords investors limited liability for the fund's obligations while the fund sponsor, or an affiliate, acts as the general partner and has unlimited liability for the fund's obligations.

An alternative to the limited partnership is the Delaware limited liability company (LLC). However, an LLC is not generally appropriate for funds that either have non-US investors or that invest outside the US, due to some jurisdictions' adverse tax treatment of LLCs; in particular, because LLCs are not residents of the US for tax treaty purposes, or, in some cases, LLCs are not recognized as a pass-through entity under the tax rules of some jurisdictions. Both limited partnerships and LLCs are generally treated as pass-through vehicles for US tax purposes, allowing investors flow-through tax treatment.

Some private equity funds, due to their investor mix or investor focus, are organized offshore, typically

in the Cayman Islands or the British Virgin Islands. These structures generally provide a similar level of limited liability to investors as that provided by a Delaware vehicle.

5. For each structure identified in Question 4, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- **So far as domestic investors are concerned**

- **So far as foreign investors are concerned**

Regardless of the legal structure, nearly all private equity funds with a US connection are tax transparent, as they are taxed as partnerships for US tax purposes. As a result, the fund itself is not subject to US tax; instead the income of the fund flows through to each investor and is taxable in each investor's hands.

The character of the income also passes through so that capital gains realized by the fund maintain their character when taxed to the investors. The same result applies to US and non-US investors, although other jurisdictions may impose tax on the fund or on the income of an investor domiciled in those jurisdictions.

6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

US tax laws provide for an election under which most non-US entities may elect to be tax transparent for US tax purposes. Consequently, tax transparency is rarely an issue for private equity funds using a non-US structure. In some cases, a private equity fund may actually desire to use a vehicle that is not tax transparent (for example, to avoid investors

having certain US tax filing and tax-paying obligations), and in those cases, fund sponsors may similarly elect to ensure that their fund vehicles are not tax transparent for US tax purposes.

7. Are a private equity fund's promoter, principals and manager required to be licensed?

The US Investment Advisers Act of 1940 (Advisers Act) requires certain investment advisers, including private fund managers, to register with the Securities and Exchange Commission (SEC). An investment adviser essentially is any person who is paid to advise others regarding securities investments.

The Advisers Act provides a number of exemptions from its registration requirements, including the private investment adviser exemption. This exemption applies to any adviser who:

- Does not hold itself out to the public as an investment adviser
- Does not act as an investment adviser for any registered investment company
- Has had fewer than 15 clients in the most recent 12-month period

8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a private equity fund can be marketed or advertised (for example, under private placement or prospectus rules).

Any issuer that is engaged in the business of investing or trading in securities is required to be registered as an investment company under the US Investment Company Act of 1940 (Investment Company Act). However, most private equity funds meet one of the following exemptions from the definition of an investment company and are therefore not required to register:

- Section 3(c)(1) of the Investment Company Act exempts any issuer whose outstanding securities are beneficially owned by not more than 100 persons
- Section 3(c)(7) of the Investment Company Act exempts any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers (that is, natural persons, family-owned companies and trusts who own at least US\$5 million (about €3.46 million) in investments and any company that owns and invests at least US\$25 million (about €17.31 million))
- In each case, if the issuer does not make a public offering of those securities

The Securities Act of 1933 provides that securities need not be registered with the SEC if the securities are offered and sold by an issuer in a transaction not involving any public offering. The offering must be private and not involve a general solicitation. In addition:

- Issuers must have a substantive relationship with a prospective investor before the offering of interests (commonly referred to as a pre-existing relationship) and must have knowledge of an investor's suitability to purchase interests in a private offering
- The SEC prohibits any advertisement, article or notice, or any communication in any newspaper, magazine or similar media as well as radio and television broadcast, that has the purpose or effect of offering or selling the fund
- Issuers must take precautions when determining the content for their websites—the SEC is particularly concerned about a general solicitation via the Internet. Issuers should restrict Internet pages that provide access to private offerings of securities to prospective investors through password protection after the issuer or affiliate has determined that the investor is suitable

9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

One of the common exemptions from SEC registration of a fund as an investment company is to limit the number of investors to 100 (see Question 8), even after applying certain look-through rules. The other common exemption, requiring that all investors be qualified purchasers, does not include an express limit on the number of investors, but the application of other securities laws generally result in funds not admitting more than 499 investors.

10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

A fund is generally governed by a limited partnership agreement, a limited liability company agreement or a shareholders' agreement, depending on the nature of the fund. Typical terms that provide investor protection include the following:

- A capital commitment of the sponsor that represents some percentage of total committed capital
- Investment restrictions imposed on the manager
- Limits on borrowing on behalf of the fund
- Forced distributions under certain circumstances
- Clawback of the profits interest of the sponsor in the case of excess carry distributions
- Restrictions on the sponsor's ability to create a competing fund
- Removal of the sponsor by a specified percentage of the investors
- Advisory committees made up of investors that have some approval or oversight role regarding conflicts of interest and valuation issues

11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory limits on investment periods. Private equity funds typically have investment periods of three to six years.

While there are no statutory limits on amounts or transfers of investments, sponsors must ensure that fund interests are not transferred to investors who would cause the fund to lose its applicable exemptions or tax status. For example, interests cannot be transferred to an investor who is not an accredited investor or qualified purchaser. In addition, fund sponsors must comply with anti-money-laundering regulations and accordingly, must perform due diligence on each new investor in a fund. Sponsors may also need to limit the number of pension plan and other similar investors to avoid legislation under the Employee Retirement Income Security Act of 1974.

12. What are the most common investment objectives of private equity funds (for example, what is the average life of a fund and what are the typical average rates of return sought)?

Private equity funds typically seek to achieve long-term capital gains by investing in, and taking an active role in the management of, a number of private investments.

The average term of a private equity fund is ten years (often with a right granted to the sponsor to extend for up to two years). Capital is drawn down from investors during an investment period which is generally three to six years. The manager uses the remainder of the term to increase the value of the portfolio investments and seek profitable exit opportunities.

Investors can expect an internal rate of return of 20 percent to 25 percent overall in a successful fund.

13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

A private equity sponsor typically forms a new entity (either a corporation, limited liability company or limited partnership) to effectuate the acquisition. Tax and other considerations are taken into account when choosing which form of acquisition entity to use. A sponsor's equity contribution to the acquisition entity is either in the form of common stock or a combination of common stock and preferred stock. On rare occasions, a sponsor funds an acquisition entity with debt.

If a combination of common and redeemable preferred stock is issued, at the closing, a substantial amount of the initial equity value of the portfolio company will be in redeemable preferred stock, which will earn a modest return (6 percent to 8 percent) per year. Any equity appreciation in the business in excess of the fixed return on the redeemable preferred stock accrues to the holders of the common stock. Valuations may be scrutinized closely by US taxing authorities, particularly where there are substantial upward revaluations shortly after formation.

Convertible preferred stock is more typically used in early-stage investments, like venture capital transactions and in minority investment transactions because it provides the investor a preferred return ahead of the common stockholders (and also permits the seed or minority investor to share in equity appreciation on conversion to common stock). Certain aggressive structures, or aggressive valuations, could cause US taxing authorities to challenge the intended tax analysis or valuations.

Buyouts

14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

It is common for buyouts of private companies to take place by auction.

A seller usually engages a financial adviser to manage the auction process. The financial adviser establishes the procedures for the auction with a goal of reducing the field of potential bidders to a limited number of viable purchasers of the business who are asked to submit final bids and with whom the seller may enter into negotiations with. If the seller is a public company selling a significant division or subsidiary, the financial adviser may be asked to provide the seller with a fairness opinion in relation to the winning bid.

There is generally no legislation that governs sales of private companies other than certain securities laws (that is, anti-fraud) and antitrust rules.

15. Are buyouts of listed companies common (public-to-private transactions)? If so, which legislation and rules apply?

As the size of US private equity funds have grown over the last few years, there has been a steady rise in the number of private equity sponsors (or consortiums of private equity sponsors) acquiring public companies. For example, according to the *Mergermarket* database:

- In 2005, there were 45 announced take-private acquisitions of US public companies by US private equity sponsors
- In 2006, there were 65 announced transactions
- Through Q3 of 2007, there were 61 announced transactions

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This rise in the number of public companies being acquired by private equity sponsors can be attributed to both the:

- Availability of relatively cheap debt financing through mid-2007
- Increase in the number of public companies that were forced to put themselves into play due to shareholder activism led by hedge funds and investors like Carl Ichan

In addition, the time and expense of complying with enhanced recordkeeping and disclosure requirements under recent securities laws changes, including Sarbanes-Oxley, have created new incentives for smaller public companies to go private.

Directors are fiduciaries of the company and its stockholders. Under Delaware common law (which many states follow), once directors have decided to sell control of a company, they are no longer charged with protecting the corporate enterprise, but rather become auctioneers charged with seeking the best price for the enterprise. This fundamental tenet of takeover law is reflected in the terms of almost every public company acquisition agreement, which, generally speaking, allows the target company to terminate a definitive acquisition agreement if it receives a superior offer. A break-up fee will be payable by the target if it exercises its fiduciary out and accepts the superior offer.

Acquisitions of US public companies take the form of either:

- A one-step transaction involving a merger after a proxy solicitation and vote of the target's stockholders to approve the merger
- A two-step transaction involving a tender offer by the buyer followed by a back-end merger after the buyer acquires voting control of the target's stock directly from its stockholders in the tender offer

Although a one-step transaction can take twice as long (or longer) as a two-step transaction to

complete (a two-step transaction can be completed in as little as 20 business days), the one-step transaction has traditionally been the favored form by private equity sponsors because:

- Margin rules may limit the amount of debt that can be used to acquire public company stock
- The best-price rule requires that each stockholder be paid the highest price offered to any stockholder in the tender offer. Until very recently, there was concern in the private equity community that offers of employment agreements, equity participation and the like to the incumbent management team may be consideration in respect of their target company stock which, under the best-price rule, would have to be offered to all stockholders in the tender offer

The SEC recently adopted changes to the tender offer rules, which clarified that offers of employment agreements, equity participation and the like to the incumbent management team, are not subject to the best-price rule if certain conditions are satisfied.

There are a number of detailed SEC disclosure and other requirements in a going-private transaction, in which the target's incumbent management team participates, that need to be taken into account by private equity sponsors. Going-private transactions may also be subject to enhanced judicial scrutiny if challenged by a stockholder.

16. What are the principal documents produced in a buyout?

In a public-to-private acquisition, the principal agreement is a merger agreement between the target company and acquisition entities formed by the private equity sponsor.

In a private acquisition, the principal agreement is either a merger agreement, a stock or equity purchase agreement, or an asset purchase agreement. The transaction structure is often dependent on numerous issues.

In addition, in a private acquisition, there may be additional agreements between the seller(s) and the private equity sponsor, such as:

- Escrow agreements
- Transition services agreements (usually where the seller is a trade seller who is selling a division or carve-out business)
- Non-compete agreements
- Real estate leases

In connection with the funding of the acquisition entity, the acquisition entity, the private equity sponsor's fund and/or the incumbent management team may enter into a(n):

- Subscription agreement
- Equity contribution agreement
- Stockholders' agreement
- Employment agreement
- Non-competition agreement

Private equity sponsors are usually required to provide the seller with an equity commitment letter from its fund. The equity commitment letter represents the fund's binding commitment to provide the equity capital to the acquisition entity. In most instances, the conditions to funding under the equity commitment letter is the satisfaction or waiver of the acquisition entity's closing conditions under the acquisition agreement. Sellers typically insist on third-party beneficiary status under the equity commitment letter, granting the seller the right to enforce directly against the private equity fund the obligation to provide the equity capital at the closing.

Alternatively, a seller may insist on a direct guarantee from the private equity fund. In situations where the sponsor has agreed to a no-financing condition transaction (see Question 17), the guarantee also ensures that the seller can collect the reverse break-up fee in the event of a triggering termination event.

17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

The most common forms of buyer protections in a private acquisition are interim operating covenants, closing conditions and post-closing indemnification provisions.

Buyers typically insist on interim operating covenants requiring the seller to operate the business in the ordinary course and not enter into enumerated transactions without the consent of the buyer between signing and closing.

Buyers usually require certain conditions to closing, including:

- Receipt of required governmental and third-party consents by the seller
- No material adverse change in the target entity
- Receipt of buyer's debt financing
- Compliance with covenants by seller
- A bring-down of seller's representations and warranties

The seller's post-closing indemnification covenant usually requires the seller to indemnify the buyer for breaches of the seller's representations and warranties and covenants and may also include specific indemnities for pre-closing taxes, known environmental matters and other matters. Sellers typically require buyers to agree to a cap on the potential losses they can claim through the indemnity and a reasonable survival period during which the buyer can bring an indemnification claim post-closing. Indemnification caps and the corresponding survival periods are usually highly negotiated.

Typically, a private equity sponsor does not seek any special or incremental protections from the management team of the target. If the target's management team is selling equity in the transaction, they would typically share pro rata in any post-closing indemnification obligation and escrow holdback.

In recent (that is, post-2004) multibillion-dollar acquisitions, private equity sponsors have agreed to transactions where their obligation to close was not subject to their receipt of debt financing. In exchange, sponsors have insisted on a cap on the aggregate damages that may be payable if they fail to close due to a failure to receive their debt financing or for any other reason. The cap typically takes the form of a reverse break-up fee payable by the sponsor. Such reverse break-up fees are typically a small percentage (two percent to three percent) of the aggregate transaction value for a termination due to a financing failure, and in certain transactions, the fee may be slightly more if the sponsor fails to close for any other reason.

In a public-to-private transaction, there is typically no post-closing indemnification or other post-closing protections, so buyers rely on interim operating covenants and the "no material adverse change" closing condition as their key protections.

18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

While there generally is no legislation governing private company managers' duties with respect to the company, almost every state imposes a common law duty of loyalty to the company. Generally, the manager must act in good faith and in a manner that avoids conflicts of interest. The duty of loyalty generally expires on the termination of employment.

19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Typical terms of employment include:

- Title and a description of responsibilities
- Term including renewal options/periods
- Salary and annual incentive bonus opportunity
- Vacation and participation in medical and other health and welfare programs
- Car allowances and other benefits
- Non-competition, non-solicitation (relating to employees, customers and vendors) and confidentiality covenants
- Termination and related severance provisions

In relation to non-competition covenants in connection with employment arrangements, certain states, like California, generally view such covenants as against public policy and are thus unenforceable.

Recently enacted comprehensive rules governing the federal income taxation of non-qualified deferred compensation could have an impact on the structure and terms-of-employment contracts and related compensation arrangements.

20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company by-laws?

In a typical, single-sponsor transaction, the private equity sponsor controls roughly 80 percent to 90 percent of the fully diluted equity of the company, with management owning the balance through direct share ownership and/or stock options or other incentive securities. Therefore, sponsors typically enjoy voting control as well as economic control over the business. It is common for the private equity sponsor and the other equity holders to enter into a stockholders' agreement which provides the sponsor with the right to nominate a majority of the directors of the company and include a voting provision whereby all parties to the agreement agree to vote their stock in favor of the sponsor's board nominees. Stockholders' agreements also contain provisions, such as drag-along rights, that provide the sponsor with control over exit transactions.

In consortium transactions or in a transaction where the lead sponsor invites a significant minority investor to participate in the transaction, the stockholders' agreement may include supermajority voting provisions that give the minority a veto over certain fundamental transactions, such as financings, add-on acquisitions and exit transactions.

21. What percentage of the financing will typically be provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

The percentage of debt financing used to effect a typical private equity leveraged buyout transaction ranges anywhere from 55 percent to 85 percent of the total funds necessary to effect the buyout, refinance existing debt and pay related transaction fees and expenses.

There are many different types of debt financing that may be provided in buyout transactions, for instance:

- Senior secured first and/or second-lien financings
- Subordinated mezzanine financings
- Senior or subordinated bonds
- Convertible and other hybrid debt financings

Senior secured financings are typically senior or pari passu in right of payment to all of the borrower's other debt, secured by all or a significant portion of the borrower's assets and comprised of one or more facilities of term loans which provide financing for the buyout and a revolving credit facility which provides liquidity for the borrower's working capital and other general corporate needs. The mix of these various forms of debt in any particular transaction depends on the aggregate size of the debt financing and the relevant private equity fund's goals as to the aggregate costs of funds for the financing and its preferences as to the various forms of debt available.

22. What forms of protection do debt providers typically use to protect their investments, in particular, through what types of:

- **Security?**
- **Contractual and structural mechanisms, such as subordination?**

Security

Security and guarantees are the primary sources of protection that debt providers use. Senior secured financings customarily are secured by the assets owned by the borrower and are guaranteed by all or certain designated subsidiaries. The obligations of these guaranteeing subsidiaries are, in turn, secured by the subsidiaries' assets.

Contractual and Structural Mechanisms

Contractual subordination. Two separate classes of creditors contractually agree that the subordinated class of creditors will not have any right to any payment with respect to any extensions of credit they make to the relevant borrower until all extensions of credit made to that borrower by the senior class of creditors have been satisfied in full.

Structural seniority. This can be accomplished by a class of creditors extending debt to an operating company subsidiary of a holding company, instead of extending the credit to the holding company. By structuring the debt in this fashion, the creditors are repaid before creditors, with a debt claim only at the parent company, since in an insolvency proceeding, the operating company subsidiary must satisfy all of its debt claims before the parent company receives any residual value through its equity claim in such subsidiary.

Other Mechanisms

Debt providers also protect their investments through financial maintenance covenants as well as other negative and affirmative covenants.

23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this impact on the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Though there are a number of laws and regulations that can have the effect of restricting loans made to finance acquisitions, US laws do not prohibit financial assistance. However, fraudulent conveyance laws in the US can have the effect of voiding guarantees and security where the courts find that a fraudulent transfer has occurred and, therefore, impact the ability of a target company and its subsidiaries to give security and in the case of its subsidiaries, provide guarantees in support of a target company's repayment obligations to lenders. The primary exception that lenders rely on in leveraged buyout transactions in the US is solvency (that is, after giving effect to the buyout transaction, including the incurrence of all debt and the provision of any guarantees and security that the borrower and its subsidiaries are solvent).

24. What is the order of priority on insolvent liquidation? Are debt providers given priority over equity holders by law or is priority purely a matter of contract and company constitution?

Although Chapter 7 of the United States Bankruptcy Code is generally recognized as applying to liquidations and Chapter 11 of the Bankruptcy Code is generally recognized as applying to reorganizations, most businesses in need of bankruptcy relief use the provisions of Chapter 11. This is regardless of whether the initial goal or ultimate outcome of the proceedings is the liquidation of the business or the reorganization of the business as a going concern. Under either a liquidating or stand-alone plan of reorganization, the statutory priorities, with respect to repayment of amounts owing, are as follows, in descending order:

- Secured claims to the extent of the value of the underlying collateral
- Administrative claims (generally, claims that arise after a bankruptcy is commenced and before the effective date of the plan of reorganization)
- Priority claims (for example, certain claims for unpaid wages and taxes)

- General unsecured claims
- Equity

Nevertheless, because section 1129 of the Bankruptcy Code requires administrative claims and certain priority claims to be paid in cash, in full, as a condition of confirmation of a plan of reorganization, a senior secured creditor with liens on a material portion of a debtor's assets is often effectively subordinated to the payment of administrative and priority claims as the price of liquidating through Chapter 11, which can be advantageous for the senior secured creditor.

In addition, the rights of any single holder, including rights relating to priorities of distribution, may be compromised by an affirmative vote of a majority of holders (that is, two-thirds in amount and one-half in number) classified within the same class as such holder. Inter-creditor and subordination agreements are enforceable in a Chapter 11 to the same extent enforceable outside of bankruptcy. Although distribution schemes in plans of reorganization often take into account the enforcement of contractual subordination agreements, there is no requirement that these agreements, in fact, be enforced through a plan of reorganization.

25. Is it possible for a debt holder to achieve equity appreciation through conversion features, such as rights, warrants or options?

It is possible, although not typical, for debt holders to participate in the equity upside of a sponsored transaction. In small and middle-market transactions that are financed with mezzanine financing, the lenders in those transactions may require nominally priced stock purchase warrants (approximately five percent of the fully diluted equity of the company) as a part of their financing package.

Warrants are not customary in larger transactions that are financed in part with publicly issued high yield bonds.

Private Equity/Venture Capital Associations

There are generally no governmental organizations that publish information about private equity. There are a multitude of publications, such as *The Daily Deal*, *Mergermarket*, *Deal Lawyers*, *Mergers & Acquisitions Law Report*, *The M&A Journal*, *Buyouts*, *Mergers and Acquisitions—Deal Makers Journal*, and *Dealmaker Morning Call*, that provide statistical and substantive information concerning private equity deals, trends, techniques, legal developments that impact mergers and acquisitions, and fund raising activity by sponsors, hedge funds and other alternative investment vehicles. Many of these publications are available through electronic subscription.

Portfolio Company Management

26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Incentive plans may account for 10 percent to 15 percent of the fully diluted equity in small and middle-market transactions and five percent to 10 percent in larger transactions. Sponsors may offer stock options, restricted stock, incentive stock options or a combination of these.

Incentive securities are usually subject in part to:

- Time-based vesting (upwards of 50 percent of the aggregate pool)
- Performance-based vesting (performance metrics may be based on earnings, the internal rate of return realized by the sponsor at the exit and so on), with, in some instances, a sub-portion of the performance-based pool subject to the attainment of stretch performance goals.

Restricted stock may be used where the acquisition entity is funded by the sponsor with both common and redeemable preferred stock (*see Question 13*) due to potential favorable tax treatment afforded to low-value restricted stock in cases where the recipient makes an appropriate tax election to take the fair market value of the common stock grant into taxable income at the time of the grant and pay income taxes at ordinary income rates, with the corresponding appreciation generally taxed at capital gains rates on a realization event.

Private equity sponsors may also require senior managers to invest in the transaction, either through a direct cash investment or through the use of their current equity holdings in the target company. The use of current equity could involve as much as 50 percent of a manager's pre- or post-tax current holdings in the target company. Sponsors typically work with managers to design equity rollovers in a tax-efficient manner.

It is important to note that, when a private equity sponsor exits a portfolio investment through a private sale, it should ensure in the definitive transaction agreement that:

- Any tax deductions relating to incentive securities should be for the account of the selling sponsor
- Any attending tax benefits, including potential refund claims for taxes paid in previous years and potential post-sale tax deductions in respect of such incentive securities, should pass to the selling sponsor

27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

Corporations can offer incentive stock options (ISO). ISOs are taxed at capital gains rates when the shares are sold. There is no tax on ISOs when they are exercised. Accordingly, the issuer is not entitled to a tax deduction for ISOs.

ISOs are not widely used because the shares must be held for at least one year after an ISO is exercised by the manager to achieve capital gains treatment. In addition, companies are limited on the amount of ISOs they can grant.

Another tax-efficient structure is unique to portfolio companies operated in pass-through form (that is, those taxed as partnerships). These companies may grant managers profits interests in exchange for performing services for the company or an affiliate. These profits interests generally represent the right to a share of the future profits of the venture. These interests may be structured with performance and vesting hurdles similar to stock options or restricted stock, but generally result in capital gains to the manager to the extent that the underlying income is in the nature of capital gains, rather than ordinary income that generally results from the exercise of non-qualified stock options. In addition, when the portfolio company is ultimately sold, the manager typically recognizes gain and receives cash equal to the value of the profits interest at the time of sale and is taxed at capital gains, rather than ordinary income, rates on the gain. Note that the tax laws and rules concerning profits interests, as well as many other forms of private equity compensation, are currently the subject of (sometimes controversial) review by Congress and the Internal Revenue Service and are particularly subject to potential change.

Exit

28. What forms of exit are typically used to realize a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buyout)? What are the relative advantages and disadvantages of each?

Trade sales, IPOs and secondary buyouts are all typical forms of exit. In addition, up until mid-2007 when there was a robust debt financing market, many sponsors bolstered their overall returns by executing dividend recapitalizations of recently acquired portfolio companies. For Q1 of 2007, portfolio companies of private equity sponsors borrowed US\$10.3 billion (about €7.1 billion) to finance dividends, while in Q1 2006, they borrowed US\$3.7 billion (about €2.6 billion) to finance dividends (*Standard and Poors Leveraged Commentary and Data*, March 28, 2007).

Financial sponsors brought 41 percent of all new companies to market during Q1 of 2007 and raised 55 percent of all proceeds during this period, up from 20 percent and 10 percent, respectively, during Q1 2006 (*PricewaterhouseCoopers US IPO Watch*, October 3, 2007). IPOs are attractive because the sponsor is often required to hold a portion of its original investment post-offering, therefore providing an opportunity to realize a greater return on its total investment if the offering is a success. IPOs, however, are expensive, very time consuming and cause the portfolio company to become subject to burdensome securities regulations including Sarbanes-Oxley.

Private sales are more common exit scenarios. These have the benefit of providing for a complete exit from the portfolio company and they typically take less time than an IPO (although private sale can also be time consuming). In addition, the natural buyer of the portfolio company may be a competitor, so there are sensitivities from a business and antitrust perspective that need to be considered carefully. In the near term, it is anticipated that secondary buyouts will be harder to consummate given the tightening of the debt markets that occurred in mid-2007.

29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Circumstances normally dictate how and when a sponsor exits from an unsuccessful portfolio company. In most cases, this means that the unsuccessful portfolio company is in financial trouble and is forced to seek bankruptcy protection.

With court approval, a debtor can sell all or substantially all of its assets (*Section 363, Chapter 11, Bankruptcy Code*). Section 363 sales usually take place by auction under the control of the bankruptcy court. A debtor typically enters into a purchase agreement with a stalking horse, which agreement is binding on the stalking horse but is only binding on the debtor once it is approved by the bankruptcy court. Other bidders are invited to bid against the stalking horse with the highest bidder usually being declared the winner in the auction. These sales do not typically result in any proceeds being paid to the equityholders and often certain classes of creditors, such as unsecured creditors, may only receive a few pennies on the dollar for their claims.

Section 363 sales are beneficial to buyers because they generally cleanse the debtor's assets of all pre-bankruptcy claims, including liens of secured creditors, which enables a buyer to perform less due diligence than in a normal acquisition transaction. Secured lenders favor such transactions because they often lead to a much quicker recovery than under a normal reorganization process.

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