

# 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).
- Any proposed or pending regulatory changes.

### Sources of funding

Sources of private equity funds include:

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

Although fundraising decreased significantly in 2008 compared to 2007, according to a survey of more than 100 funds, the relative capital commitments from these sources remained fairly consistent (*Dow Jones, Private Equity Analyst, Special Section, 2009*):

- Public pension funds, funds of funds and corporate pension funds accounted for approximately 54% of total capital commitments, with public pension funds being the largest single contributor with approximately 26.6%.
- Endowments, foundations, insurance companies, banks and other financial institutions accounted for approximately 26.3% of total capital commitments.
- Insurance companies accounted for approximately 5.7% of total capital commitments (a decrease from 10.2% of total capital commitments in 2007).
- Sovereign wealth funds accounted for approximately 5.4% of total capital commitments.

### Market trends

**Deal making.** US private equity deal making declined significantly in both deal volume and transaction size in 2008, and this trend has continued in the first half of 2009. There were 1,072 private equity deals in the US in 2008 with disclosed values totalling approximately US\$77.4 billion (about EUR53 billion), representing declines of approximately 30% and 82% respectively in comparison to the 2007 figures (*Ernst & Young, 2009 US private equity watch, July 2009*).

The first half of 2009 saw 314 private equity deals with disclosed values totalling US\$14.5 billion (about EUR10 billion), compared to 503 deals with disclosed values totalling US\$41.9 billion (about EUR28.7 billion) in the first half of 2008 (*Ernst & Young, Announced US PE Activity*). However, the second quarter of 2009 saw an upturn in disclosed deal value (130 deals with disclosed values totalling approximately US\$9 billion (about EUR6 billion)) from the first quarter of 2009 (184 deals with disclosed values totalling US\$5.5 billion (about EUR3.8 billion)) (*Ernst & Young, 2009 US private equity watch, July 2009; Ernst & Young, Announced US PE Activity*).

The number of private equity deals (acquisitions and exits) with disclosed values over US\$1 billion (about EUR0.7 billion) decreased from 20 (with disclosed values totalling US\$73.9 billion (about EUR50 billion)), in the first half of 2008 to two such deals (with a total disclosed value of US\$17.2 billion (about EUR11.8 billion)) in the first half of 2009. This included the US\$13.9 billion (about EUR9.5 billion) acquisition of IndyMac by a consortium of private equity investors (*MergerMarket database*). This is considerably less than the 91 such deals (with a total disclosed value of US\$385.6 billion (about EUR245 billion)) in 2007 (*MergerMarket database*). Average disclosed deal size has also decreased, from US\$621 million (about EUR425 million) in 2007 to US\$301 million (about EUR206 million) in 2008. Although the average stands at US\$231 million (about EUR158 million) for the first half of 2009, this drops to US\$123 million (about EUR84 million) if the IndyMac acquisition is excluded (*MergerMarket database*).

**Credit crunch.** The inability to refinance portfolio companies' existing debt and a lack of exit opportunities have resulted in a significant increase in restructurings, recapitalisations and workouts with creditors, as well as bankruptcies. Almost US\$30 billion (about EUR20.5 billion) in debt was exchanged for equity in 2008, more than three times the total amount during the previous 23 years (*Ernst & Young, 2009 US private equity watch, July 2009*). Private equity-owned companies comprise over half of the 293 companies on Standard & Poor's recent "weakest links"

list of corporations facing credit downgrades, and private equity funds were involved in 78 of the last 140 corporate defaults as of 4 June 2009 (*The IUF's Private Equity Buyout Watch, Debt matters: what is at stake in the struggle to refinance portfolio companies, 4 June 2009*). A number of notable private-equity-backed companies have engaged in debt exchanges and purchases since 2008, such as (*Ernst & Young, Summary of PE Portfolio Company Debt Exchanges and Repurchases: 2008-April 2009*):

- Dollar General (Goldman and KKR).
- GMAC (Cerberus).
- Harrah's Operating Company (Apollo and TPG Capital).
- OSI Restaurant Partners (the holding company for Outback Steakhouse) (Bain Capital).

Debt exchanges also now benefit from recent tax legislation that allows tax on the buying back of debt to be deferred (*see Question 27*) (*Bloomberg, Private Equity Indigestion Comes With Bain Bloomin' Onion Debts, March 11, 2009*).

Private equity-controlled companies made up 22 of the 86 Standard and Poor-rated US companies that filed for bankruptcy in 2008 (*Bloomberg, Private Equity Indigestion Comes With Bain Bloomin' Onion Debts, 11 March 2009*). Notable private equity-backed companies that have filed for bankruptcy include (*The Economist, The Barbarians Are Coming, Again, 28 July 2009*):

- Sharper Image (Sun Capital Partners).
- Linens 'N Things (Apollo).
- Chrysler (Cerberus).
- Washington Mutual (Texas Pacific Group).

**Limited partner leverage.** Limited partners have used private equity firms' recent poor performance and lack of deal activity to increase pressure to reduce management fee rates, which have been stable for several years at about 2% of committed capital. A number of private equity firms have made concessions to limited partners in 2009:

- Bain Capital offered to temporarily waive its management fees for some of its older funds (*Reuters, Private equity firms try harder to please investors, 17 March 2009*).
- Texas Pacific Group offered to release its limited partners from up to 10% of their capital commitments and reduce its management fee by 10% (*Mondaq Business Briefing, Private Equity Fund Formation 2009 'At Market' Deal Terms, 10 March 2009*).
- New Mountain Capital's new US\$5.1 billion (about EUR3.5 billion) fund has a 1.75% annual management fee (*The Deal Pipeline, New Mountain raises \$5.1B fund, 4 March 2009*).
- Blackstone Group plans to charge a 1.5% management fee for a US\$15 billion (about EUR10 billion) fund it is currently raising (*Bloomberg, Reduced LBO Fees Mean 2% Disappears as Pensions Lament Losses, 6 July 2009*).
- Firms starting new leveraged buyout (LBO) funds in 2009 appear to be seeking an average management fee of 1.8% (and closer to 1.65% for funds of more than US\$1 billion (about EURO.7 billion)).

It is unclear whether this reduction in management fee rates indicates a long-term shift to non-performance-based fees or is another effect of the current economic downturn.

**Investment opportunities.** While deal making has tailed off significantly since 2007, private equity sponsors are still finding ways to deploy capital. They have become increasingly interested in acquiring troubled banks (such as the acquisitions of IndyMac (*see above, Market trends*) and BankUnited) although their participation in such deals has long been limited by federal regulators.

The newly adopted FDIC policy, although less stringent than the original proposal, may deter private equity firms from participating in bank acquisitions (*see below, Regulatory changes*).

In addition, private equity firms have increasingly invested in minority-stake and PIPE (private investment in public equity) transactions. The number of minority stake transactions by private equity firms in the US increased from 212 in 2007 to 273 in 2008, with 153 such transactions by the end of May 2009. Investment by private equity firms in PIPE deals increased from US\$3.4 billion (about EUR2.3 billion) in 2007 to US\$19.1 billion (about EUR13 billion) in 2008, with private equity's share of the US PIPE market rising from 4% in 2007 to 11% in 2008 (*Ernst & Young, Private Equity Deal Activity Remains Slow as Pricing Equilibrium Between Buyer and Seller Has Yet to be Achieved, 23 July 2009*).

By July 2009, private equity and venture capital firms had increased their participation in PIPE deals to 18% (*Private Equity Analyst, Private Equity Firms Find Opportunities with PIPEs, 20 August 2009*). However, limited partners do not appear to be pleased with this shift in strategy. The limited partners of Leonard Green & Partners' US\$5.3 billion (about EUR3.6 billion) fund agreed to increase the amount allowed to be invested in PIPE deals from 12.5% to 25% in exchange for lowering the management fees on PIPE deals over the 12.5% threshold from 1.5% to 1% (*Private Equity Analyst, Private Equity Firms Find Opportunities with PIPEs, 20 August 2009*).

### Regulatory changes

A number of legislative proposals that have the potential to affect private equity firms and their advisers are at various stages before Congress. These include:

- Requiring almost all US-based investment advisers with more than US\$30 million (about EUR20.5 million) in assets under management to register with the Securities and Exchange Commission (SEC) by eliminating various exemptions such as the 15 client *de minimis* threshold (*see Question 7*).
- Creating an exemption to registration for foreign private advisers that meet requirements relating to the number of US clients and the total amount of such clients' assets that are under management.
- Permitting the SEC to adjust the meaning of the term "client" (for example, to expand the definition of "client" to include a fund's investors).

- Requiring registered advisers to submit reports to the SEC on the private funds they advise, detailing the:
  - assets under management;
  - use of leverage;
  - counterparty credit risk exposures;
  - trading and investment positions; and
  - other matters deemed relevant to the public interest, the protection of investors or the assessment of systemic risk.

Although such reports would be confidential and not subject to the Freedom of Information Act, the SEC would be authorised to make such reports available to the Federal Reserve and the contemplated Financial Services Oversight Council (see below).
- Establishing a Financial Services Oversight Council, a council of federal regulators to assess systemic risk and advise the Federal Reserve on designating private funds as Tier 1 Financial Holding Companies. These funds would then be subject to numerous requirements, including:
  - strict capital and liquidity requirements;
  - a prompt corrective-action regime on declining capital levels;
  - risk management practices; and
  - public disclosure requirements.
- Giving the SEC powers to require registered advisers to:
  - submit to periodic and special examinations to monitor compliance with record-keeping requirements; and
  - provide investors, prospective investors, counterparties and creditors of any private fund it advises with certain reports, records and other documents.
- Subjecting broker-dealers to a fiduciary duty when providing investment advice.
- Authorising the SEC to promulgate rules prohibiting sales practices, conflicts of interest and compensation schemes for broker-dealers and investment advisers that it deems contrary to the public interest or investors' interests.
- Increasing the ability of the SEC to pursue those involved in securities laws violations by expanding their jurisdiction, and extending aider and abettor liability to the controlling person or entity of a person or entity violating certain securities laws under certain circumstances.
- Prohibiting mandatory arbitration clauses in broker-dealer, municipal securities dealer and investment advisory agreements.
- Requiring private funds of more than US\$50 million (about EUR34 million) to:
  - register as investment companies under the Investment Company Act;
  - provide significant annual public disclosures to the SEC;

- maintain books and records in accordance with SEC rules; and
- co-operate with the SEC on requests for information (see Question 8).

The SEC has proposed amendments to the Investment Advisers Act that would make investment advisers (or their affiliates) who directly hold client assets subject to both:

- A yearly surprise exam by an independent public accountant to verify the integrity of their client assets.
- A custody control review conducted by an accountant registered and inspected by the Public Company Accounting Oversight Board.

The proposed rule also includes a requirement for custodians to deliver periodic account statements to their clients (or to the underlying investors where advisers to pooled investment vehicles, such as private equity funds and hedge funds, do not distribute annual audited financial statements to investors).

The SEC intends to curtail pay-to-play practices, by proposing a rule that would prohibit investment advisers from making payments to influence government officials, who select advisers to manage public pension funds. The proposed rule would bar an investment adviser from providing advisory services for compensation to a government entity (including a public pension plan) for two years if the adviser (or certain of its executives and employees) makes a political contribution to an elected official of (or candidate for) a governmental entity in a position to influence the selection of the adviser for such services. There is a *de minimis* exception for contributions by certain employees of up to US\$250 (about EUR171) per election per candidate, if the contributor is entitled to vote for the candidate. The proposed rule would also prohibit an investment adviser and certain of its executives and employees from, among other things:

- Making a payment to a political party where the adviser is seeking to provide advisory services to the government; and
- Paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the investment adviser.

The FDIC has adopted a policy statement establishing new bidder eligibility standards for private equity and similar non-bank investors seeking to acquire or invest in failed banks. The policy requires investors to commit to ensuring that the depository institution acquiring the banking operations of a failed bank both:

- Is initially capitalised for three years at a minimum ratio of 10% Tier 1 common equity to total assets (subject to possible FDIC extension).
- Remains well capitalised level throughout their ownership.

The proposed legislation would significantly affect the answers in Questions 7, 8 and 9, which are based on the current status of the law.

There are also certain tax-law changes affecting management compensation arrangements (see Question 3) and to legislation that allows the tax on buying back debt to be deferred (see Question 27).

## 2. Please summarise any changes in 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), leveraged buyouts and public to private transactions).
- Exits from private equity funds (that is, the realisations of the investments).

### Fundraising

In the first half of 2009, 173 US private equity funds raised US\$54.9 billion (about EUR37.5 billion) 64% less than the US\$152.7 billion (about EUR104 billion) raised by 261 funds in the first half of 2008 and the lowest mid-year total since 2005 (*Dow Jones Private Equity Analyst, US Private Equity Fund-Raising Down 64% at Half-Year Point but May Regain Momentum as Stock Stabilize, 8 July 2009*).

Fundraising for venture capital underwent a significant contraction in the first half of 2009, with 74 venture capital funds raising US\$6.3 billion (about EUR4.3 billion), representing a (*NVCA, News Release, 13 July 2009*):

- 52% decline in the number of funds and a 62% decline in capital raised compared to the first half of 2008.
- 33% decline in the number of funds and a 47% decline in capital raised compared to the second half of 2008.

The US\$1.7 billion (about EUR1.2 billion) raised by venture capital funds in the second quarter of 2009 is the lowest quarterly total since 2003 (*Fund Evaluation Group, Research Review – Private Capital Quarterly, Second Quarter 2009*).

### Investment

Investments by venture capital funds in the second quarter of 2009 increased slightly (with 612 transactions and totalling an investment of US\$3.67 billion (about EUR2.5 billion)) compared to the first quarter of 2009 (with 603 transactions and a total investment of US\$3.19 billion (about EUR2.2 billion)) (*PricewaterhouseCoopers MoneyTree Report, National Aggregate Data*).

Although this is the first such quarterly increase since the third to fourth quarters of 2007, investment activity for the first half of 2009 is lower than any two consecutive quarters since the first half of 1997, representing a (*PricewaterhouseCoopers MoneyTree Report, National Aggregate Data*):

- 41% decline in the number of deals and a 55% decline in investment compared the first half of 2008.
- 35% decline in the number of deals and a 47% decline in investment compared to the second half of 2008.

Investments in start-ups, early stage, expansion and later stage companies in the first half of 2009 have all decreased significantly compared to 2008 (*PricewaterhouseCoopers MoneyTree Report, online database*).

### Transactions

In the first quarter of 2009, US private equity firms completed 120 control-stake transactions with a disclosed total value of US\$5 billion (about EUR3.4 billion). This represented a (*Buyouts, Add-Ons & Distressed Deals Punctuate A Slow Q1, 13 April 2009*):

- 52.3% reduction in deal volume and 92.1% reduction in disclosed deal value from the first quarter of 2008.
- 15% reduction in deal volume and 29.6% reduction in disclosed deal value from the fourth quarter of 2008.

Approximately 51% of these deals in the first quarter of 2009 were add-on acquisitions for existing portfolio companies, the first time add-ons have outnumbered traditional platform acquisitions since *Buyouts* began tracking such data in 2003, and a significant increase over the 33.8% in the fourth quarter of 2008 (*Buyouts, Add-Ons & Distressed Deals Punctuate A Slow Q1, April 13, 2009*).

### Exits

The number of exits (not including secondary buyouts) from US portfolio companies has decreased significantly in 2009. The first half of 2009 saw 115 such exits (45 exits disclosing values totalling US\$7.81 billion (about EUR5.34 billion)), compared to 243 such exits (151 exits disclosing values totalling US\$76.79 billion (about EUR52 billion)) in the first half of 2008. This is considerably less than 2007, which saw 642 such exits (392 exits disclosing values totalling US\$132.2 billion (about EUR90 billion)) (*MergerMarket database*).

Secondary buyouts of US portfolio companies decreased even more significantly than other exits. There were 21 secondary buyouts (with seven buyouts disclosing values totalling US\$587 million (about EUR401 million)) in the first half of 2009, compared to 61 secondary buyouts (23 secondary buyouts disclosing a total value of US\$4.63 billion (about EUR3.2 billion)) in the first half of 2008 (*MergerMarket database*).

The largest M&A exit in the second quarter of 2009 was the merger of Apollo Management's Hughes Telematics with Polaris Acquisition, valued at US\$726.8 million (about EUR497 million) (*Reuters Buyouts, M&A Exits Continue to Dwindle; Education IPOs Shine, July 6, 2009*). There has been an upturn in IPOs by financial sponsor-backed companies, with two IPOs in August 2009:

- Avago Technologies (KKR and Silver Lake).
- Emedeon (General Atlantic Partners and Hellman & Friedman).

Both KKR and Apollo have indicated that they intend to take several of their respective portfolio companies public in 2010 (*Buyouts, Buyout Firms Rush for the Public Exit, 17 August 2009*).

There were five venture-backed IPOs valued at a total of US\$720.7 million (about EUR493 million) in the second quarter of 2009, the most since the first quarter of 2008, and the first IPO since the third quarter of 2008 (*NVCA, News Release, July 1, 2009*). Although this is a significant upturn in the venture capital exit market compared to recent activity levels, current activity is far below recent historical norms, as each year from 2004 through

2007 saw at least 50 venture-backed IPOs. In addition, the first half of 2009 has seen 121 venture-backed companies acquired with a total disclosed value of US\$3.23 billion (about EUR2.2 billion), a 37% decrease in the number of deals and a 60.5% decrease in disclosed value from the first half of 2008 (*National Venture Capital Association, Venture-Backed Exit Market Shows Signs of Life in Second Quarter, 1 July 2009*).

### 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 generally available tax regime that encourages investment in unlisted companies.

However, Congress has enacted tax legislation that may encourage private equity fund sponsors to repurchase their portfolio companies' debt where it can be repurchased at a discount. Typically, when a person related to a borrower (such as a private equity fund sponsoring a portfolio company) buys back debt at a discount from a creditor, the discount is income to the borrower, subject to tax. The new legislation defers such income for four or five years from the date of repurchase (depending on whether the repurchase takes place in 2009 or 2010) and then realises the income over the following five-year period. For example, debt repurchased in 2009, income can be deferred until 2014 and then included ratably from 2014 through to 2018.

## FUND FORMATION

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

Private equity funds most commonly use the Delaware limited partnership legal structure. 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 may not be 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 investors in LLCs may have difficulty accessing the benefits of tax treaties.
- LLCs not being recognised as a pass-through entity in 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 organised 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.

Nearly all private equity funds with a US connection are taxed as partnerships for US tax purposes, regardless of their legal structure, and are therefore tax transparent. 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 realised 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 allow most non-US entities to 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 wish to use a vehicle that is not tax transparent (for example, to avoid investors having certain US tax filing and tax paying obligations).

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

A promoter or sponsor of a private fund is not required to register with the SEC, or otherwise be licensed merely to conduct its activities. However, the promoter or an affiliate is likely to be acting as an investment adviser to the fund, and the US Investment Advisers Act of 1940 (Advisers Act) then applies. An investment adviser is any person who is paid to advise others regarding securities investments and the Advisers Act requires certain investment advisers, including private fund managers, to register with the SEC.

The Advisers Act provides a number of exemptions from its registration requirements, including the private investment adviser exemption, which 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?

Any issuer, such as a private equity fund, that is engaged in investing or trading in securities must be registered as an investment company under the US Investment Company Act 1940 (Investment Company Act). However, most private equity funds do not count as investment companies and are not required to register as they meet one of the following criteria:

- Having outstanding securities that are beneficially owned by fewer than 100 persons (*section 3(c)(1), Investment Company Act*).
- Having outstanding securities owned exclusively by persons who are qualified purchasers at the time of acquisition, that is (*section 3(c)(7), Investment Company Act*):
  - natural persons, family-owned companies and trusts who own at least US\$5 million (about EUR3.4 million) in investments;
  - companies that own and invest at least US\$25 million (about EUR17 million)

In addition, the issuer need not be registered with the SEC if the securities are offered by an issuer in a transaction that does not involve any public offering. To qualify (*Securities Act, 1933*):

- The offering must be private and not involve a general solicitation.
- Issuers must have a substantive relationship with a prospective investor before the offering (commonly referred to as a pre-existing relationship), and must have knowledge of an investor's suitability to purchase interests in a private offering.
- There cannot be 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 content for their websites, and the SEC is particularly concerned about a general solicitation through the internet. Issuers should restrict internet pages that provide access to private offerings of securities to prospective investors by password protection, until 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 ways to avoid SEC fund registration for 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 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:

- A sponsor's capital commitment representing some percentage of the 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 event 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.
- Modifications to statutory fiduciary duties.

## 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. However, in light of the recent state of the economy and investor liquidity concerns, limited partners may be more interested in funds with shorter investment periods.

While there are no statutory limits on investment transfer amounts, 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, an investor who is not an accredited investor or qualified purchaser). In addition, fund sponsors must comply with anti-money laundering regulations and therefore 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 regulation under the Employee Retirement Income Security Act 1974.

## INVESTMENTS

### 12. What are the most common investment objectives of private equity funds?

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 of 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.

Before the recent market downturn, investors could expect an internal rate of return of 20% to 25% overall in a successful fund. Over approximately the past 12 to 18 months, internal rates of return have dropped significantly even for the more successful funds.

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

If a combination of common and redeemable preferred stock is issued at closing, a substantial amount of the portfolio company's initial equity value will be in redeemable preferred stock, which earns a modest return (6% to 8%) 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 scrutinised closely by US taxing authorities, particularly where there are substantial upward revaluations shortly after formation.

Convertible preferred stock is more common in early stage investments (such as venture capital transactions) and minority investment transactions because it:

- Gives the investor a preferred return ahead of the common stockholders.
- Allows the seed or minority investor to share in equity appreciation on conversion to common stock.

Certain aggressive structures or valuations can cause the US taxing authorities to challenge the intended tax analysis or valuation.

## 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 who are asked to submit final bids, and with whom the seller may enter into negotiations. If the seller is a public company selling a significant division or subsidiary, the financial adviser may be asked for a fairness opinion on the winning bid.

There is no legislation that generally governs sales of private companies other than certain anti-fraud and anti-trust rules.

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

The time and expense of complying with enhanced recordkeeping and disclosure requirements due to securities laws changes over the last few years, including the Sarbanes-Oxley requirements, create new incentives for smaller public companies to go private. As the size of US private equity funds grew over the same period, the number of private equity sponsors (or consortiums of private equity sponsors) acquiring public companies steadily rose. However, this trend has stopped and the first half of 2009 saw only eight take-private transactions with a total disclosed deal value of US\$890 million (about EUR607 million). In comparison, the first half of 2008 saw 15 take-private transactions with a total disclosed value of US\$8.82 billion (about EUR6 billion) and 2007 saw 67 take-private transactions with a total disclosed value of US\$257 billion (about EUR176 billion) (*MergerMarket database*).

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 instead 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 allow the target to terminate a definitive acquisition agreement if it receives a superior offer. A break-up fee is normally 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 form favoured by private equity sponsors because:

- Margin rules may limit the amount of debt that can be used to acquire public company stock.
- Until recently, private equity sponsors were concerned that offers of employment agreements and equity participation to incumbent management could be seen as additional consideration for the management's stock, which could trigger the best price rule requirement to pay such additional consideration to all stockholders in the tender offer. In late 2006, the SEC amended the best price rule to clarify that such arrangements are not subject to the rule as long as 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 must be taken into account by

private equity sponsors. Such 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.
- An asset purchase agreement.

The transaction structure is often dependent on numerous factors and 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.

The acquisition entity, the private equity sponsor's fund and/or the incumbent management team may, in connection with the funding of the acquisition entity, enter into:

- Subscription agreements.
- Equity contribution agreements.
- Stockholders agreements.
- Employment agreements.
- Non-competition agreements.

Private equity sponsors must usually 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 funding conditions under the equity commitment letter consist of 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 the obligation to provide the equity capital at closing directly against the private equity fund. 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.** Buyers typically require covenants from the seller that they will, between signing and closing:
  - operate the business as usual;
  - not enter into certain transactions without the buyer's consent.
- **Closing conditions.** Buyers typically insist on closing conditions, 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.
- **Post-closing indemnification provisions.** The seller must usually indemnify the buyer for breaches of the seller's representations, warranties and covenants, and may also include specific indemnities for pre-closing taxes, known environmental issues 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 target's management team. If the target's management team is selling equity in the transaction, they normally share pro rata in any post-closing indemnification obligation and escrow hold-back.

In the multi-billion dollar acquisitions that have occurred since 2004, private equity sponsors' obligations to close were not typically subject to their receipt of debt financing. In exchange, sponsors have insisted on a cap on the total damages 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. Reverse break-up fees for a termination due to a financing failure are typically a small percentage (2% to 3.5%) of the total transaction value or may be slightly more if the sponsor fails to close for any other reason. In such deals, provisions barring sellers from being able to seek specific performance to force the closing, even if all conditions to buyer's obligations to close the deal have been satisfied, are common.

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 is no legislation generally governing private company managers' duties 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 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 or periods.
- Salary and annual and long-term incentive bonus opportunities.
- Vacation and participation in medical and other health and welfare programmes.
- Car allowances and other benefits.
- Non-competition, non-solicitation (for employees, customers and vendors) and confidentiality covenants.
- Termination and related severance provisions.

Certain states, including California, view non-competition covenants in employment contracts as against public policy and therefore unenforceable.

Recently enacted rules governing federal income taxation of non-qualified deferred compensation could have an impact on the structure and terms of employment contracts and related compensation arrangements (see *Question 27*).

### 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 bye-laws?

In a typical, single sponsor transaction, the private equity sponsor controls roughly 80% to 90% 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 both voting and economic control over the business. It is common for the private equity sponsor and the other equity holders to enter into a stockholders agreement that gives the sponsor the right to nominate a majority of the company's directors and include a voting provision whereby all parties to the agreement agree to vote their stock in favour of the sponsor's board nominees. Stockholders' agreements also contain provisions, such as drag-along rights, that give the sponsor 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 finance is typically provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

The level of debt financing used in a typical private equity LBO continues to be dramatically lower than the levels used before the onset of the credit crisis in the summer of 2007, showing a decline from US\$209.9 billion (about EUR144 billion) in 2007 to US\$41.3 billion (about EUR28.2 billion) in 2008. Issuances of loans in the first quarter of 2009 decreased by approximately 98% to US\$0.2 billion (about EURO.14 billion). The average equity contribution for LBOs increased from 32.9% in 2007 to 42.6% in 2008 (*Ernst & Young, 2009 US private equity watch, July 2009*).

There are many different types of debt financing used in buyout transactions, including:

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

Senior secured financings typically have senior or *pari passu* payment rights to the borrower's other debt, secured by all or a significant portion of the borrower's assets. They normally consist of one or more term loan facilities that finance 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 total size of the debt financing, and the relevant private equity fund's goals as to the total costs of funds for the financing, and its preferences as to the various forms of debt available.

2009 has seen a number of senior secured bonds issued, as issuers have taken advantage of episodic periods of investor demand in the high yield market. These issuances have often been used for refinancings, but have also been used in LBO transactions.

### 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 (for example, covenants or subordination)?

#### Security

Security and guarantees are the primary sources of protection that debt providers use. Senior secured financings are customarily secured by the assets owned by the borrower and are guaranteed by subsidiaries. The guarantor subsidiaries' obligations are in turn, secured by their assets.

#### Contractual and structural mechanisms

**Contractual subordination.** Two classes of creditors can contractually agree that one class of creditors is subordinated, and will not have any rights in an insolvency proceeding until the senior class of creditors has been repaid 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 holding company, since in an insolvency proceeding the operating company subsidiary must satisfy all of its debt claims before the holding 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. Private equity sponsors may agree to infuse capital into their portfolio company borrowers on certain trigger events negotiated with their debt providers.

### 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 affect 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?

Financial assistance is not prohibited, although there are a number of laws and regulations that can restrict loans made to finance acquisitions, and the courts can void guarantees and security given by a target company and its subsidiaries if a fraudulent transfer has occurred.

The primary exception relied on by creditors in LBO transactions is the guarantee that the borrower and its subsidiaries will be solvent after the buyout transaction, including any debt resulting from the transaction and the provision of any guarantees and security.

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

Although chapter 7 of the United States Bankruptcy Code is generally recognised as applying to liquidations, and chapter 11 of the Bankruptcy Code is generally recognised as applying to reorganisations, 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 reorganisation of the business as a going concern. Under either a liquidating or stand-alone plan of reorganisation, the statutory priorities for 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 reorganisation).
- Priority claims (for example, certain claims for unpaid wages and taxes).
- General unsecured claims.
- Equity.

Although 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 reorganisation, a senior secured creditor with liens on a material portion of a debtor's assets may agree to be effectively subordinated to the payment of a predetermined portion of administrative and priority claims as the price of liquidating through chapter 11, because a chapter 11 liquidation can be more advantageous for the senior secured creditor than simply foreclosing on its collateral.

In addition, the rights of any single holder, including rights relating to priorities of distribution, can be waived 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 as outside of bankruptcy. Although distribution schemes in plans of reorganisation often take into account the enforcement of contractual subordination agreements, there is no requirement that these agreements be enforced through a plan of reorganisation.

A court can also subordinate one creditor's claim to another creditor's claim (or the claims of all other creditors) if it is shown that the creditor has engaged in inequitable conduct (for example, fraud, illegality, breach of fiduciary duties or where the debtor is fraudulently employed as a dummy or shell company) that resulted in an injury or disadvantage to the other creditor(s). In that case, the subordinated claim will be treated lower in priority than the claim to which it is subordinated, but the subordination will not affect its treatment in relation to any other claim or to equity.

Additionally, a court will look past the form of debt to determine its substance and may recharacterise the debt as equity (and treated as lower in priority than all claims) if this is determined to be the economic substance of the transaction. Factors examined by the courts include:

- Names given to the instruments, if any, evidencing the indebtedness.
- Presence or absence of a fixed maturity date and schedule of payments.
- Presence or absence of a fixed rate of interest and interest payments.
- Source of repayments and interest payments.
- Right to enforce payment of principal and interest.
- Ratio of shareholder loans to capital.
- Amount or degree of shareholder control.
- Security, if any, for the advances.
- Extent to which the advances were subordinated to the claims of outside creditors.

- Extent to which the advances were used to acquire capital assets.
- Presence or absence of a sinking fund to provide repayments.
- Status of the contribution in relation to regular corporate creditors.
- Thin or inadequate capitalisation.
- Whether the ultimate financial failure was caused by undercapitalisation.
- Ability of the corporation to obtain loans from outside lending institutions.
- Failure of the debtor to repay on the due date or to seek postponement.
- Whether a note or other debt document was executed.
- How the debt was treated in the business records.
- Intent of the parties.

Creditors may seek recharacterisation of debt as equity, particularly where a loan is provided by a shareholder (in particular, a shareholder with a significant or controlling interest in the company), or where an equity infusion or investment is structured as a loan to protect an investor's risk. In these cases, steps should be taken to lessen the risk of recharacterisation.

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

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It is possible, although not typical, for debt holders to participate in the equity appreciation of a sponsored transaction. In small- and middle-market transactions that are financed with mezzanine financing, the creditors in those transactions may require nominally priced stock purchase warrants (up to 5% of the fully diluted equity of the company) as a part of their financing package.

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

### **PORTFOLIO COMPANY MANAGEMENT**

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#### **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?**

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Incentive plans typically account for 10% to 15% of the fully diluted equity in small- and middle-market transactions and 5% to 10% in larger transactions. Sponsors may offer stock options, restricted stock, other stock-based awards, or a combination of these.

Incentive awards are usually subject in part to both:

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

Restricted stock may be used where the acquisition entity is funded by the sponsor with both common and redeemable preferred stock (see *Question 13*). This allows the recipient to gain a favourable tax-treatment by electing 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 gain rates on realisation.

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 can involve as much as 50% 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.

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

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

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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 and accordingly the issuer is not entitled to a tax deduction. ISOs are not widely used because, to achieve capital gains treatment, the shares must be held for both:

- One year following the grant date of the ISO.
- One year after the ISO is exercised by the manager.

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 can 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 resulting from the exercise of non-qualified stock options or vesting of restricted stock). In addition, when the portfolio company is ultimately sold, the manager typically recognises gain and receives cash equal to the value of the profits interest at the time of sale and is taxed on the gain at capital gains rates, rather than as ordinary income.

Section 409A of the Internal Revenue Code for the first time comprehensively codifies the federal income taxation of non-qualified deferred compensation, and can affect the structuring of many private equity compensation arrangements. There continues to be significant legislative activity potentially affecting private equity compensation and Congress is considering legislation that would limit the favourable tax treatment of profits interests.

In late 2008, Congress enacted Section 457A of the Internal Revenue Code which eliminates the ability of hedge fund (and some private equity fund) managers to defer management fees and some incentive compensation paid to them by their offshore hedge fund vehicles. This virtually eliminates the tax benefits of non-qualified deferred compensation arrangements maintained by tax-indifferent parties.

A bill was introduced to Congress on 2 April 2009 that proposes a tax on carried interest earned by managers of private equity and hedge funds at ordinary income rates (as opposed to the more favourable capital gains treatment that carried interest generally receives). President Obama, in his budget proposal, assumes that this legislation will be enacted by 2011. However, no action has yet been taken on this bill, which was introduced twice before in 2007.

## EXIT

**28. What forms of exit are typically used to realise 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. However, given the current state of the market and lack of financing, exits have decreased significantly since the summer of 2007. Dividend recapitalisations, which were commonly used by financial sponsors to achieve quicker returns, reached a global peak of US\$73.2 billion (about EUR50 billion) in 2007. However, the current lack of financing has reduced this to US\$1.9 billion (about EUR1.3 billion) in 2008 and only US\$365 million (about EUR250 million) as of the end of July in 2009 (*The Wall Street Journal, The Ghost of Dividend Recaps Past, August 21, 2009*).

The number of IPOs decreased dramatically in 2008, and 105 IPOs were either postponed or withdrawn, compared to 28 postponed or withdrawn in 2007. 14 financial sponsor-backed IPOs raised US\$2.3 billion (about EUR1.6 billion) in 2008, compared to a record 163 such IPOs that raised US\$30 billion (about EUR20.5 billion) in 2007. Financial sponsor-backed IPOs only constituted about 24.6% of the IPO volume and 7.9% of the total proceeds in 2008, compared to 55.1% of the IPO volume and

## PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATION

### The National Venture Capital Association (NVCA)

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**Status.** The NVCA is a trade association that represents the US venture capital industry.

**Membership.** The NVCA is comprised of more than 450 member firms.

**Principal activities.** The NVCA aims to foster a greater understanding of the importance of venture capital to the US economy and support entrepreneurial activity and innovation. It represents the venture capital community's public policy interests, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members.

**Information sources.** See website above.

46.1% of the total proceeds in 2007 (*PricewaterhouseCoopers, 2008 US IPO Watch, Analysis and Trends*).

The first half of 2009 saw 14 IPOs with proceeds totalling US\$2.3 billion (about EUR1.6 billion), of which eight were financial sponsor-backed IPOs with proceeds totalling of US\$1 billion (about EUR0.7 billion). This is a significant increase over the first half of 2008, when financial sponsor-backed IPOs constituted 26% of the total volume and 6% of the total proceeds (*PricewaterhouseCoopers, Second quarter IPO market records first increase in activity since 2007, 15 July 2009*).

IPOs are attractive because the sponsor is often required to hold a portion of its original investment post-offering, therefore providing an opportunity to realise 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 the Sarbanes-Oxley regime.

Private sales are more common exit scenarios. These have the benefit of a complete exit from the portfolio company and typically take less time than an IPO (although a private sale can also be time consuming). In addition, the natural buyer of the portfolio company may be a competitor, so there may be business and anti-trust aspects to consider.

There were 21 secondary buyouts in the first half of 2009, compared to 61 secondary buyouts in the first half of 2008 and 210 secondary buyouts in 2007 (*MergerMarket database*).

**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 then invited to bid against the stalking horse in an auction. These sales do not typically result in any proceeds being paid to the equity holders 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, includ-

ing secured creditors' liens, which enables a buyer to perform less due diligence than in a normal acquisition transaction. Secured creditors favour the procedure because it often leads to a quicker recovery than under a normal reorganisation process.

*\*The authors of this chapter include the following members of the White & Case LLP Private Equity Group: John M. Reiss, Daniel M Latham, John S Kim, Emily Chu (M&A); David A Goldstein, Jason Gregory (Fund Formation); Kenneth Raskin, Laura Westfall (Employee Benefits); Jeremy Naylor (Tax); Gerard H Uzzi, Avi Goldenberg (Financial Restructuring and Insolvency); Joseph H Brazil (Financing).*

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