Private equity

The new world

John M Reiss, Daniel M Latham and **David A Goldstein** of **White & Case LLP** survey the private equity landscape.

While fundraising in the first half of 2008 by private equity funds remained robust and fairly consistent with the first half of 2007 levels, deal making dropped off significantly both in terms of deal volume and transaction size following the onset of the credit crisis in the summer of 2007.

This has triggered a number of changes in market practice. While some of these changes represent no more than short-term adjustments, it is now clear that the days of the mega-buyout are a thing of the past and the credit crisis of 2007 has had a lasting impact on the US private equity landscape.

Against that background, this article looks at:

- The market.
- Fund formation.
- Buyouts.
- Portfolio company management.
- Strategies and issues.

THE MARKET

The slow down in private equity deals in the second half of 2007 continued through the first half of 2008. For in-

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stance, in Q2 of 2008, US buyout volume dropped 89% from the same period last year (*The Wall Street Journal, "M&A World Continues to Spin but at a Slower Pace", 1 July 2008).*

All of the biggest deals fell outside of the top 20 range from 2007 and the two largest deals of 2008 came in at less than $6 billion (Lone Star's acquisition of the home lending business of CIT and the Nordic Capital/Avista Capital acquisition of the ConvaTec business unit of Bristol-Myers Squibb).

Deals change shape

One change directly attributable to the pace of deal making and the mega-size of US private equity deals in 2006 through the summer of 2007 is the unprecedented number of renegotiated and terminated deals, several of which wound up in court before they were resolved.

In several instances, sponsors claimed a material adverse change had occurred in the target company (the Bain Capital, Carlyle, CD&R acquisition of Home Depot Supply; Lone Star Fund's acquisition of Accredited Home Lenders; the KKR/Goldman Sachs acquisition of Harman International), which lead to a renegotiation of the purchase price (Home Depot, Accredited Home) or a restructuring of the deal (Harman).

There were also instances where lenders attempted to back out of binding financing commitments (Providence Capital's acquisition of Clear Channel Communications and Centerbridge Partners and Fortress Investment Group's purchase of Penn National Gaming) and instances where sponsors terminated signed deals based solely on the terms of the acquisition agreement (Cerberus's proposed acquisition of United Rentals; Goldman Sachs proposed acquisition of Myers Industries).

In all of these cases, the sponsors took unprecedented steps to reshape or walk away from signed deals because it became apparent the purchase price they were paying was too much or they simply lost interest in the deal.

While it is not expected that this trend will continue far into the future (primarily because most mega-deals have closed or been terminated), in future deal making there will be robust negotiations around deal protections in acquisition agreements for both sellers and sponsors.

Unsyndicated financings. One side effect of the onset of the credit crunch that hampered deal making in the last half of 2007 and continued to hamper deal making in 2008 is the build up of unsyndicated financings on the balance sheets of the large financial institutions that have been traditional sources of debt financing for US private equity.

For example, in July 2007 there were $245 billion of unsold loans on the balance sheets of the major private equity financing institutions, while by the end of March 2008, the backlog amounted to $95 billion (*Bloomberg, "Carlyle, Deutsche Bank Seek to Raise $500 Million CLO (Update3)", 21 April 2008).*

In many instances, such financings were syndicated at a discount notwithstanding that the underlying portfolio companies were performing reasonably well. While it is not expected that this trend will continue, as most pre-credit crisis financings have been syndicated, the current reluctance for private equity lending by those institutions is attributable in part to the gridlock that occurred in the syndication markets and the write-downs lenders took to as they sold loans at unprecedented discounts.

Smaller deals. Two recent trends that are expected to continue into the future is that the size of private equity deals will tend to be relatively modest (that is, less than $5 billion) and the size of equity cheques sponsors will be asked to write will continue to increase.

In the first half of 2008, there were a fair number of deals in the $1-3 billion range (Carlyle's majority stake in Booz Allen Hamilton; the Blackstone/Wellspring acquisition of Performance Food Group; Blackstone's acquisition of Apria Healthcare) and the largest US private equity deal through the first half of 2008 was less than $6 billion.

Given the recent history in the lending markets, it is not uncommon to see equity cheques in the range of 50% of the total acquisition price. This trend is also likely to continue until the lending markets warm up to private equity again.

Fundraising

In 2007 US-based private equity funds raised a total of 415 funds with aggregate funds raised through year-end totalling a record $313 billion (*Private Equity Wire, 8 July 2008 and Deal Journal, 8 January 2008*).

On the whole, US private equity fundraising through Q2 of 2008 has remained strong, totalling an aggregate of $132.7 billion by 185 funds, only 3% short of the $137.2 billion raised by 199 funds during first half of 2007 (*Private Equity Wire, 8 July 2008*), even though leveraged buyout fundraising suffered a 20% decline through Q2 of 2008 with a total of 75 funds raising $85.5 billion, down from $107.6 billion raised by 91 funds during the same period in 2007.

The slow down in buyout fundraising has been offset by steady fundraising by mezzanine and venture capital funds. During the first half of 2008, seven mezzanine funds raised a new first half record of $24 billion. In Q2 of 2008, 71 venture capital funds raised $9.1 billion, a 3% increase in dollar value but a 14% decrease in number of funds from Q2 of 2007.

FUND FORMATION

The legal structure private equity funds most commonly use as a vehicle is the Delaware limited partnership. The limited partnership affords investors limited

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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, as the tax treatment of LLCs in some jurisdictions is not favourable (LLCs are not residents of the US for tax treaty purposes and, in some cases, LLCs are not recognised as a flow-through entity under the tax rules of some jurisdictions).

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.

Tax transparency

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.

This means that the fund itself is not subject to US tax; instead, the income of the fund flows through to each investor and is taxable in the investor's hands. The character of the income also flows 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.

US tax laws provide for an election under which most non-US entities may elect to be tax transparent for US tax purposes (*see Article, "US corporate taxation: an introduction", page 225*). This means that tax transparency is rarely an issue for private equity funds using a non-US structure.

In some instances, 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). In those cases, fund sponsors may similarly elect to ensure that their fund vehicles are not tax transparent for US tax purposes.

SEC registration

A promoter or sponsor of a private fund is not required to register with the Securities and Exchange Commission (SEC) or otherwise be licensed merely to conduct its activities. However, the promoter or an affiliate is likely acting as an "investment adviser" to the fund and implications of the US Investment Advisers Act of 1940 (Advisers Act) must be considered.

The Advisers Act requires certain investment advisers, including private fund managers, to register with the 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.

Registration as an investment company

Any issuer, such as a private equity fund, which is engaged in the business of investing or trading in securities must 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 $5 million in investments and any company that owns and invests at least $25 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 pri-

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vate offerings of securities to prospective investors through password protection after the issuer or affiliate has determined that the investor is suitable.

Fund governance

A fund is generally governed by a limited partnership agreement, an LLC or a shareholders' agreement, depending on the nature of the fund.

Investor protection. 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.
- Modifications to fiduciary duties that exist under law.

Transfers. 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.

Investment term. 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% to 25% overall in a successful fund.

Typical investment structure

A private equity sponsor typically forms a new entity (either a corporation, LLC or limited partnership) to effect the acquisition of a portfolio company.

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% 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 typically used in early-stage investments, such as 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 tax authorities to challenge the intended tax analysis or valuations.

BUYOUTS

Buyouts of private companies usually 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 anti-trust rules.

Listed company buyouts

As the size of US private equity funds has 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. However, consistent with the overall slowdown in US private equity ac-

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tivity, the last half of 2007 and the first half of 2008 saw a dramatic decrease in take-private transactions. According to *mergermarket*:

- In 2006, there were 65 announced transactions.
- In Q1 and Q2 2007, there were 84 announced transactions.
- In Q3 and Q4 2007, there were 27 announced transactions.
- Through Q2 of 2008, there were 19 announced transactions.

The time and expense of complying with enhanced record-keeping and disclosure requirements due to securities laws changes over the last few years (including the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)) also 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 favoured form 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 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 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.

Principal buyout documents

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 will depend on how the transaction is structured (itself dependant on numerous factors) but is one of the following:

- A merger agreement.
- A stock or equity purchase agreement.
- An asset purchase agreement.

In addition, in a private acquisition, there may be additional agreements between the sellers 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.

Equity funding agreements. 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 the following:

- A subscription agreement.
- An equity contribution agreement.
- A stockholders' agreement.
- An employment agreement.
- A non-competition agreement.

Equity commitment letters. Private equity sponsors are usually required to provide the seller with an equity commitment letter from its fund. This represents the fund's binding commitment to provide the equity capital to the acquisition entity.

In most instances, the condition to funding under the equity commitment letter is

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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, which gives the seller the right to enforce the private equity fund's obligation to provide the equity capital at the 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 (that is, where the sponsor has agreed that its obligation to proceed with the transaction will not be subject to the receipt of its debt financing), the guarantee also ensures that the seller can collect the reverse break-up fee in the event of a triggering termination event.

Buyer protections

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 hold-back.

Reverse break fees. In recent (that is, post-2004) multi-billion 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 (2% to 3.5%) 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 many recent deals, it is common to see 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.

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.

Management control

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. Thus, 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 favour 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.

Debt financing

The level of debt financing used to effect a typical private equity leveraged buyout transaction has fallen dramatically since the summer of 2007 and there has been a corresponding increase in the size of equity contributions.

New issuances of loans for Q2 of 2008 decreased 86% to $7.9 billion, compared with $57.7 billion for Q2 of 2007 (*Invest-*

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ment Dealers Digest, 7 July 2008). Through April of 2008, the average equity contribution for leveraged buyouts was up to over 45% compared to 30% in 2007 (*Mergers and Acquisitions Journal, 1 May 2008*).

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.

Debt providers protect their investments by taking security and guarantees, using contractual subordination, structural seniority and through financial maintenance covenants as well as other negative and affirmative covenants.

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 all or certain designated subsidiaries whose obligations are, in turn, secured by the subsidiaries' assets.

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.

Financial assistance. 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 a target from giving financial assistance for the purchase of its own shares.

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. This has an impact on 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, the borrower and its subsidiaries are solvent).

Priority. Although chapter 7 of the US Bankruptcy Code is generally recognised as applying to liquidations and chapter 11 of the Bankruptcy Code (chapter 11) 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 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 reorganisation).
- 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 reorganisation, 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 major-

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ity 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 reorganisation 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 reorganisation.

PORTFOLIO COMPANY MANAGEMENT

Incentive plans may 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, incentive stock options, or a combination of these.

Incentive securities are usually subject in part to:

- Time-based vesting (upwards of 50% of the aggregate 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 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 due to potential favourable tax treatment afforded 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 gain rates on a realisation event.

Management investment. 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% 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.

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 manager must hold shares for at least one year after an ISO is exercised 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 flow-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. They 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 recognises 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.

Section 409A of the Internal Revenue Code codifies the federal income taxation of nonqualified deferred compensation, and can affect the structuring of many private equity compensation arrangements. There continues to be a good deal of significant legislative activity potentially affecting private equity compensation.

For example, Congress is considering legislation that would tax certain carried interest at ordinary-income rates, add tax penalties on deferred compensation in excess of $1 million, and accelerate the taxation of deferred compensation from certain off-shore entities.

STRATEGIES AND ISSUES

Trade sales, IPOs and secondary buyouts are all typical forms of exits. In addition, up until mid-2007 when there was a robust debt financing market, many sponsors bolstered their overall returns by executing dividend recapitalisations of recently acquired portfolio companies.

Through July 2007 portfolio companies of sponsors completed 129 dividend recapitalisations for a total value of $47 billion. The second half of 2007 showed a marked decrease with only seven recaps completed for a total of $2 billion.

Financial sponsors brought approximately 47% of all new companies to mar-

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ket through Q2 of 2007 and raised 58% of all proceeds during this period, up from about 29% and 15%, respectively, through Q2 of 2006 (*PricewaterhouseCoopers US IPO Watch, 7 August and 3 October 2007*).

Financial sponsor-backed IPOs for Q3 of 2007 were as high as the rest of the year, reaching 52% of all transactions and raising 38% of all proceeds. In Q4 of 2007, following the trend, financial sponsors were responsible for 68.3% of the total IPOs and 31.86% of all proceeds (*PricewaterhouseCoopers US IPO Watch, 2007 Analysis and Trends*).

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 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 a 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 anti-trust perspective that need to be considered carefully. Through May 2008, there had been 88 secondary buyouts worth $13.1 billion, less than one fifth of what it was for the same period in 2007.

Unsuccessful investments. 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 (*§ 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 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 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, including liens of secured creditors, which enable a buyer to perform less due diligence than in a normal acquisition transaction. Secured lenders favour such transactions because they often lead to a much quicker recovery than under a normal reorganisation process.

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The authors would like to thank Joseph H Brazil, Andrew Oringer and Gerard H Uzzi, partners at White & Case LLP, and Nicholas V Marchica, Eduardo Lasmar, Nicola Rosenstock and Jeremy Naylor, associates at White & Case LLP, for their assistance with this article.

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