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Olympic Update: The U.S. and the UK Battle for the Gold on Choice of Law

It is hard to believe that private equity professionals and not just comparative law professors and lawyers are intensely focused on the differences between English law and U.S. law acquisition agreements. That attention is warranted because those differences are now becoming of increasing commercial and strategic importance in sale processes. As developing economies host more private equity transactions, U.S. private equity professionals are learning that it is increasingly common for acquistion agreements for targets outside of the UK to be governed by UK law. This is true not only for deals where the seller is based in the UK, but also even where neither of the parties nor the target has any real connection with the UK. For instance, a Dutch seller of Asian assets is likely to use a UK agreement.

The choice of law is driven by a number of factors, including familiarity and confidence with English law in international transactions and concerns over U.S. litigation and costs (where a U.S. choice of law might otherwise be logical), but, more importantly, by the perceived advantages of the UK approach for sellers. In auction processes, the choice of law will usually be determined by the seller, which prepares the first draft of the acquisition agreement.

Private equity buyers and sellers should remember that the practice and philosophy

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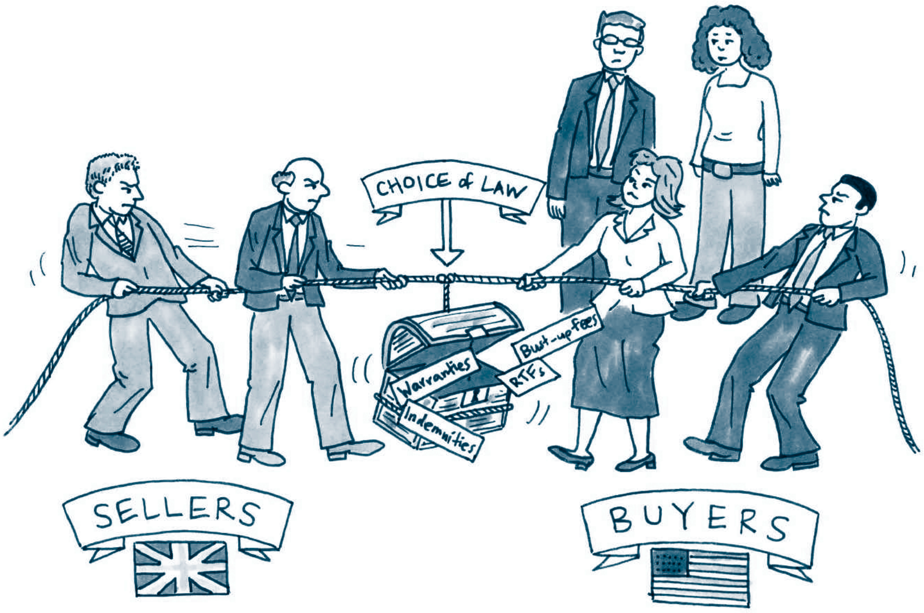

"As choice of law goes, so go the negotiations."

WHAT'S INSIDE

Letter from the Editor

The geographic diversification of the private equity landscape continues, notwithstanding the Euro zone crisis and the political turmoil in some parts of the globe. In 2011, U.S. deals accounted for less than half of global private equity activity, and the emerging markets are clearly playing an increasing role in the private equity scene.

On our cover, we explore the increasingly common usage of English law-style agreements in cross border transactions involving even non-UK sellers and assets. We explain why sellers of all nationalities may favor such an approach, while buyers (especially those from the U.S.) may prefer U.S.-style agreements in cross border deals. The primary differences relate to key deal drivers: certainty, pricing, financability and liability.

Earlier this year, when the European banks lacked the capacity to participate in the leveraged lending market, the notoriously episodic high yield window opened, and the European high yield market stepped up to provide all or a majority of the debt financing required for a number of transactions. With high yield debt playing an enhanced role in the capital structure came increasingly complex intercreditor arrangements as well as enhanced disclosure demands from a more vocal investor base. We trace the evolution of the European high yield market and explain the benefits and limitations of these market developments for lenders and private equity sponsors.

We may all have expected "covenant-lite" financings to be a historical remnant of an age gone by, but this spring their progeny have appeared. In this issue, we report on key provisions in the 2012 version of "covenant-lite" deals, particularly the impact of "springing covenants."

Elsewhere in this issue, we report on developments in the Delaware courts that impact private equity buyers and sellers in unexpected and potentially challenging ways. Two recent Delaware court cases suggest that the fact that a controlling stockholder is facing a liquidity crunch may be an important factor in determining how best to manage a sales process. In addition, we highlight a significant line of cases in New York and Delaware that appear to change the historical assumption often mistakenly made by buyers and sellers that the principle that "fraud vitiates everything" trumps the principle of caveat emptor. As we report, these cases seem to suggest that the courts are likely to enforce a waiver for fraud under appropriate circumstances, and, therefore, the inclusion of fraud claims in a waiver or a limitation of remedies provision should be carefully considered.

Finally, we share some private equity-focused exit opportunities made possible by the "JOBS" Act's wholesale revision of "gun jumping" and update you on the "pay to play" scene.

All of us in the Private Equity Group wish you a terrific summer. As you begin to think about the fall, please let us know if there are any questions or concerns you would like to see addressed in future issues of *The Private Equity Report*.

Franci J. Blassberg
Editor-in-Chief

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The Liquidity Crunch (This Year's Model):

Recent Delaware Cases Involving Controlling Stockholders

Private equity investors that control the boards of their portfolio companies have long assumed that they will also be able to control any arms-length sale of the public portfolio company to a third party, provided only that each stockholder of the company is treated the same way in such sale. However, recent decisions of the Delaware Court of Chancery call that assumption into question. These decisions suggest that the liquidity afforded a large stockholder in such a sale transaction may, in certain circumstances, constitute additional consideration not shared with the public stockholders and therefore, creates a conflict of interests that limits the ability of the private equity sponsor and its director appointees to control the sales process.

Under Delaware law, a transaction in which a controlling stockholder is treated differently from other stockholders is subject to the exacting test of "entire fairness." Entire fairness requires the conflicted stockholder to prove that the deal was procedurally and substantively fair to the company's minority stockholders. Such claims are almost impossible to get dismissed at an early stage of the litigation process and can be expensive to settle. The only potential escape from the entire fairness box is to give a fully empowered special committee of non-conflicted directors control over the sale process and to condition the transaction on the approval of a majority of the shares held by non-conflicted stockholders.

The conflict between a controlling stockholder and the minority public stockholders is obvious where the controlling stockholder proposes to take the company private or seeks to obtain a higher price for its shares than that paid to the public. In the first case, the controlling stockholder stands on both sides of the transaction; in the second case, it is competing with the public stockholders over the allocation of the overall purchase price. But a conflict has not generally been thought to exist in a transaction involving a sale to a third party buyer in which all stockholders are treated in the same way. However, in two recent decisions, the Delaware Court of Chancery has held that a large stockholder may also be conflicted if it has an urgent liquidity need or if the market for the company's stock is not sufficiently robust to allow that stockholder to sell its entire stake into that market over a reasonable period of time.

In *N.J. Carpenters Pension Fund v. infoGROUP* (Del. Ch., Sept. 30, 2011) the Court of Chancery considered breach of fiduciary duty claims in connection with the all-cash sale of infoGROUP to CCMP Capital Advisors. Plaintiffs alleged that infoGROUP's 37% stockholder, who was also a member of the company's board, instigated the sale in order to satisfy his "desperate need for liquidity" and that the sale took place at a particularly inopportune time in light of a weak M&A market and the company's improving prospects. The court refused to dismiss these claims, finding that the 37% stockholder's need for liquidity was both material and not shared with the company's other stockholders. The court held that in certain circumstances "liquidity is a benefit that may lead directors to breach their fiduciary duties."

Similarly, I*n re Answers Corporation Shareholders Litigation* (Del. Ch., April 11, 2012) involved the all-cash, third-party sale of Answers Corporation, a thinly traded Delaware public company, 30% of the stock of which was held by a financial sponsor. Following closing, former Answers stockholders brought suit against the company's directors for breach of fiduciary duty and against the buyer for aiding and abetting such breach. Because the company's charter exculpated directors from liability for duty of care claims, plaintiffs could recover damages only if they were able to prove that the directors breached their duty of loyalty. On a motion to dismiss, the court held allegations that a sale transaction provided the only way for the 30% stockholder to get liquidity and that such liquidity constituted a benefit not shared with the other stockholders (who had the practical ability to sell their shares on the limited public market) to be sufficient to state a claim for breach of loyalty against the directors appointed by the 30% stockholder. Citing the infoGROUP

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The Liquidity Crunch (This Year's Model) (cont. from page 3)

decision, the court held that the stockholder's desire for liquidity could put those directors in a position where their interests conflicted with those of the public stockholders.

These two decisions should be contrasted with the outcome in *In re CompuCom Systems, Inc Stockholders Litigation* (Del. Ch. 2005). As with infoGROUP and Answers, CompuCom Systems was alleged to have been sold at a "fire sale price" so that its controlling stockholder could satisfy a "pressing need for cash" that resulted from the failure of the stockholder's other investments. In the case of CompuCom, however, the court dismissed fiduciary duty claims on the grounds that the sales process had been managed by a special committee of outside directors, which had hired independent counsel and financial advisors and that had agreed to the sale transaction only at the end of a multi-year exploration of strategic alternatives. Thus, while the CompuCom controlling stockholder avoided liability, it did so only by surrendering control over the sales process.

…[A] conflict has not generally been thought to exist in a transaction involving a sale to a third party buyer in which all stockholders are treated in the same way. However, [following] two recent decisions...in the case of a private equity stockholder that is near or past the end of the fund's life, or a sponsor that needs an exit to support its pending fund-raising initiatives, or where the public market does not provide a realistic exit route for the sponsors in the ordinary course (but does for other stockholders), the stockholder and the company's board need to take the potential conflict into account.

It's worth noting that the infoGROUP and Answers decisions involved motions to dismiss, and it is by no means clear that if matters were to be litigated to completion the defendants would be found liable for damages. However, these cases demonstrate that the Delaware courts are willing, as a legal matter, in the right circumstances, to view the mere size of the holdings of a controlling stockholder as putting that stockholder – and its representatives on the subject company's board – in a conflict situation. At a minimum, the inability to get rid of such a claim at the motion to dismiss stage means that the litigation will be substantially more time-consuming to defend and more expensive to settle.

These decisions do not mean that all sale transactions involving a public portfolio company will be subject to an entire fairness review, or that a special committee must always be used in such cases to limit liability risks. Where the large stockholder has no immediate need to sell and the public market is sufficiently liquid to provide a viable exit mechanism in the ordinary course, the courts would have to go well beyond their recent holdings to impose liability based merely on the size of the controlling stockholder's interest. On the other hand, in the case of a private equity stockholder that is near or past the end of the fund's life, or a sponsor that needs an exit to support its pending fund-raising initiatives, or where the public market does not provide a realistic exit route for the sponsors in the ordinary course (but does for other stockholders), the stockholder and the company's board need to take the potential conflict into account. In these circumstances, private equity firms may well wish to consider using the types of procedural protections—such as a special committee and potentially minority stockholder approval—that have been developed in the context of going private transactions to limit litigation risk. Even if the controlling stockholder is confident of being able to satisfy the strict standard of entire fairness—which may well be the case assuming the company is adequately shopped, all stockholders receive the same consideration, and there is no reason to believe the time of sale to be particularly inopportune—the benefit of limiting the litigation risk inherent in a duty of loyalty challenge may well outweigh the cost of giving up control over the sales process. ■

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Springtime: The Return of "Covenant-Lite" Financings

In one encouraging sign of life in the private equity financing markets earlier in the spring, so called "covenant-lite" Credit Agreements, which had practically disappeared between 2008 and 2010, became fashionable again. Indeed, according to the *Financial Times*, in April 2012, 40% of all institutional loans in the U.S. were "covenant-lite," which is the highest monthly proportion since May 2007. Whether this trend will continue remains to be seen given the recent cooling in the financing markets.

"Covenant-lite" describes a Credit Agreement for non-investment grade Borrowers which does not contain one of the protective covenants for the benefit of the lenders that used to be customary in Credit Agreements. A "covenant-lite" Credit Agreement typically has no financial maintenance covenants on any Term Loans. A "covenant-lite" Credit Agreement sometimes also has bond style negative covenants for all lenders. However, in cases where a Credit Agreement includes a revolving facility, the Revolving Lenders virtually always require some financial covenant protection. Such protection kicks in only under certain circumstances, however, giving rise to the industry term "springing covenants" to describe these type of "covenant-lite" deals.

This article focuses on current market practice with respect to key provisions in "covenant-lite" deals with a revolving credit facility and the sometimes tricky interplay between the rights of the Revolving Lenders in these deals, who enjoy the direct benefit of the financial maintenance covenant protection, and the Term Lenders, who do not.

Bond Style Covenants

Bond style negative covenants are desirable for private equity sponsors because they give a Borrower more flexibility than the negative covenants typically found in Credit Agreements. Such relative flexibility can be used, for instance, to incur additional debt, make investments, pay dividends and take other actions that could arguably increase operational risk and that would sometimes not be permitted under a traditional Credit Agreement. While such flexibility can prove very valuable to Borrowers, especially Borrowers controlled by private equity sponsors, the primary focus of "covenant-lite" loans is often on the absence of financial maintenance covenants.

Financial Maintenance Covenants

Financial maintenance covenants differ from other negative covenants because, instead of precluding the Borrower from taking certain actions, they require a Borrower to maintain certain ratios, such as a leverage ratio or an interest coverage ratio. As a result, events outside a Borrower's control can lead to a breach of a financial maintenance covenant. These ratios are set at levels designed to "stress test" a Borrower and to trigger an event of default under the Credit Agreement if they are breached, thereby allowing Lenders to intervene if a Borrower's financial condition deteriorates even absent any affirmative action of the Borrower. The absence of these type of financial maintenance covenants for the benefit of the Term Lenders in "covenant-lite" deals is, therefore, a particularly significant part of the appeal of these facilities to sponsors.

Recent Market Activity

Activity

Earlier this year, in exchange for a premium that is often between 25 and 50 basis points relative to the margin applicable to a comparable Credit Agreement with traditional financial covenants, Term Loan Lenders were willing to go "covenant-lite," and to agree to the absence of financial maintenance covenants, for the right Borrowers and the right leverage profile. But Revolving Lenders typically continue to require some financial covenants on the Revolving Loans.

What Types of Financial Covenants Are Used?

"Covenant-lite" Credit Agreements with a revolving tranche typically include a maximum senior secured leverage ratio only. We would not expect to see a minimum interest coverage ratio.

Springing Feature

Even when a "covenant-lite" Credit

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Bond style negative covenants are desirable for PE sponsors because they give a Borrower more flexibility than the negative covenants typically found in Credit Agreements.... While such flexibility can prove very valuable to Borrowers,... controlled by private equity sponsors, the primary focus of "covenant-lite" loans is often on the absence of financial maintenance covenants.

Agreement includes a financial covenant for the benefit of its Revolving Lenders, the covenant becomes binding on the Borrower only if the revolving tranche of the Credit Agreement is drawn, whether because Revolving Loans are outstanding or Letters of Credit have been issued. This explains why these financial covenants are referred to as springing covenants in the nomenclature of the industry. A point for negotiation is whether Revolving Loans can be drawn and Letters of Credit can be requested to be issued up to a certain dollar amount before the covenant springs to life.

Because Letters of Credit are sometimes required for specific purposes, effectively giving a Borrower little control, if any, over the decision to request an issuance of a Letter of Credit, a negotiating cushion applicable to Letters of Credit before the financial covenant "springs" to life is very useful. A number of recent major sponsor Credit Agreements contemplate a cushion allowing Letters of Credit to be issued up to 10% or 15% of the Commitments before the covenant is tested.

A cushion applicable to Revolving Loans may also be negotiated on a case-by-case basis although such a cushion is clearly not as common as a cushion applicable to Letters of Credit. On occasion, a cushion can be used both for Letters of Credit and Revolving Loans (in which case the covenant springs to life when the aggregate amount of issued Letters of Credit and outstanding Revolving Loans exceeds the cushion), enabling a Borrower to draw some Revolving Loans without triggering the applicability of the covenant if the amount of outstanding Letters of Credit is below the cushion.

When Is the Springing Covenant Tested?

In a typical "covenant-lite" Credit Agreement with a revolver, the financial covenant is tested only on a maintenance basis at the end of a fiscal quarter if at such time Revolving Loans are outstanding or Letters of Credit have been issued, in each case in excess of any applicable cushion. A key point of contention, that is not quite settled in the market, is whether the covenant should also be tested on an incurrence basis when Revolving Loans or Letters of Credit are requested. Testing the covenant on an incurrence basis would enable the Lenders to refuse to make Revolving Loans or issue Letters of Credit if the Borrower is not in compliance on a *pro forma* basis with the financial covenant at the time a drawdown or a Letter of Credit is requested. Revolving Lenders argue that unless the covenant is tested on an incurrence basis, a Borrower would be able to draw on its revolver during a quarter and repay the Revolving Loans before the end of the quarter without the covenant ever been tested. A Borrower would argue that the fact that it is able to repay outstanding Revolving Loans periodically is evidence of its financial health and eliminates the need to test the financial covenant.

Beneficiaries of the Springing Covenant

Given that the demand for the springing financial covenant comes from the Revolving Lenders, it is important in a "covenant-lite" Credit Agreement that includes a revolving tranche that the springing financial covenant should be given only for the benefit of the Revolving Lenders. To this end, these Credit Agreements should provide that the covenant default that is triggered by a breach of the springing financial covenant is an event of default only with respect to the Revolving Loans. In addition, Revolving Lenders should control the springing financial covenant and the requisite percentage (typically a majority) of the Revolving Lenders should be able to amend or waive the financial covenant without the need to seek approval from the Term Lenders. If such an event of default is triggered, the Required Revolving Lenders should have the right to terminate the revolving commitments and accelerate outstanding Revolving Loans. Term Lenders should have no rights growing out of the default, subject to the cross default provision discussed below.

Can the Term Lenders Indirectly Get the Benefit of the Springing Covenant?

Even assuming a Credit Agreement contains all of the provisions above, the Term Loan Lenders under the "covenant-lite" Credit Agreement can potentially get the benefit of a Borrower's breach of a financial covenant given for the benefit of the Revolving Lenders indirectly in a number of ways.

Cross-Defaults Within the Credit Agreement

The parties will need to consider whether the Term Loans should cross default to the Revolving Loans when the Revolving Loans are in default due to a breach of the financial covenant. In a non-"covenant-lite" Credit Agreement context, a financial covenant breach usually triggers an immediate event of default subject to the grace period available to exercise equity cure rights, typically 10 Business Days following the due date of the relevant financial statements. While a financial covenant breach rarely catches a Borrower by surprise, Borrowers nonetheless do not have much time to negotiate a waiver or an amendment before the financial covenant breach matures into an event of default, and those discussions often take place after the event of default is triggered. Giving the Term Lenders an immediate cross default under a "covenant-lite" Credit Agreement would greatly complicate those discussions. While some Lenders in "covenant-lite" deals request a cross-default after a relatively generous grace

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Market Dislocation:

Developments in the European High Yield Market

Notwithstanding the economic turbulence in the Euro zone, the first quarter of 2012 saw a significant rise in high yield offerings in Europe (a reported increase of four times over the last quarter of 2011). With new regulatory constraints on banks limiting the availability of bank credit facilities in Europe, the European high yield market, despite its continuing volatility, has filled many of the gaps left by the weakness of the bank financing market.

The structures of many European leveraged financings have had to change to accommodate the increasing replacement of bank term debt with high yield notes in transactions. The high yield investor base has also become more vocal over the last year or two, with calls for more comprehensive disclosure and reporting to high yield investors, particularly of the complex intercreditor arrangements that have come with the new structures. Although the high yield windows may open and shut with inexplicable rapidity, it appears that the structural changes and the vocal investor base are here to stay. This article considers some of those structural changes, the current investor requests and their respective implications for private equity sponsors.

Evolving Market Practices: Until recent years, many European high yield notes were either issued on a senior subordinated basis (and so contractually subordinated) or on a senior basis by a holding company and with limited credit support from operating companies (and so structurally subordinated). High yield notes were often unsecured or only benefited from a limited security package often provided only by holding companies. More recently, however, many high yield notes transactions in Europe have benefited from enhanced structural protections and security. Indeed, in 2011 almost half of all European high yield issuances were secured. In many cases, security has comprised security from operating companies and not just holding company or "structural" security.

As the market continues to develop, three core structures appear to be taking centre stage in Europe along with the more traditional subordinated structures: *pari passu* bank/notes transactions, "super senior" structures and SPV notes structures. If properly executed, these alternative structures provide high yield noteholders with enhanced protections whilst preserving for private equity sponsors and issuers the operational and future financing flexibility that are so important to them.

The Pari Passu Bank/Notes Structure: In one recently emerged structure, traditional bank term and revolver debt is combined with high yield notes, with the high yield notes and bank debt ranking *pari passu* in right of payment and security and sharing a common security package. While the bank debt and notes rank *pari passu*, until recently, banks have retained control over enforcement and collateral decisions via intercreditor agreements, giving borrowers comfort that they will be able to continue to deal primarily with their "relationship" banks, particularly in stressed scenarios. However, increased rumblings from the high yield investor community in Europe about the differing treatment of their notes even in apparently "*pari passu*" structures, particularly with respect to enforcement, have resulted in noteholders gaining increased voting power over the last year. In several deals, noteholders were granted rights to enforcement control when the notes represented a particular threshold amount of the secured debt (typically 70% to 75%). In another model, both bank and bond creditors are able to vote from closing, but with the noteholder vote capped to a low percentage of the overall vote until the notes represent a significant proportion of the overall debt (*e.g.*, 66.6%).

More recently, in the February 2012 issuance by Schaeffler, noteholders in a *pari passu* bank/notes structure were granted rights to a proportionate vote with the bank creditors, on a €1 equals one vote basis. At the time, this was heralded as a breakthrough for European investors with some commentators going as far as to say that proportionate voting for senior secured noteholders would become the new paradigm. Reports from recent meetings between the Association for Financial Markets in Europe (AFME) and the Loan Market Association (LMA) suggest that, at least informally, the LMA and AFME have agreed that commensurate voting rights for senior secured noteholders is the best way to proceed (though these reports have not been confirmed by any formal announcement by the LMA or AFME). The market is still evolving on this front and, depending on the ratio of bank and bond debt, this trend has the potential to enhance significantly the negotiating power of noteholders when seeking changes to the security structure and during any restructuring discussions with a private equity sponsor.

The "Super Senior" Structure: A second structure, known as the "super senior" structure, has emerged where banks provide only senior secured revolving facilities, with the "term" debt financing comprised solely of high yield notes. In this structure, the notes effectively take the place of the term debt traditionally incurred to finance the acquisition and/or refinance existing debt. In these transactions, the revolving credit facilities usually make up a relatively small portion of the capital

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Developments in the European High Yield Market (cont. from page 7)

structure and are documented under a traditional credit agreement. However, the covenants are predominantly "incurrence" based, mirroring those applicable to the high yield notes (although sometimes with additional limited financial covenants such as a leverage covenant and/or an interest coverage covenant), and the defaults are similar to those seen in high yield financings. These more flexible covenants and defaults are much more advantageous from issuer and sponsor perspectives.

In the super senior structure, the revolving facilities obtain their super senior status by ranking ahead of the senior secured notes (and, in some cases, any term bank debt) in the enforcement waterfall—*i.e.*, they are paid first from the proceeds of security enforcement. Unlike in most *pari passu* bank/note deals, the notes generally control enforcement subject to increasingly familiar and formulaic security enforcement principles. These principles and the intercreditor arrangements generally can be expected to contain restrictions on the amount of time in which enforcement must be completed and assets realised (4 to 6 months is typical). In addition, they will likely provide for fair value protections for the revolving facilities, often in the form of fair sale opinions, and sometimes require that proceeds from a distressed sale be sufficient to repay any revolving facility outstandings in full (leaving borrowers to deal only with the noteholders on any restructuring). Noteholders often also require a purchase right, enabling them to purchase outstanding revolving facility debt at par, and, thus, providing them with another enforcement option.

The SPV Structure: A third structure has emerged in refinancings to address consent issues raised by European bank deals. In this structure, the proceeds of notes issued by a special purpose vehicle are used to finance a new tranche under a credit facility, which in turn is lent into the borrower group to refinance existing debt. This structure utilises the "facility change" mechanism common in European credit agreements and so is generally used to obviate the need to obtain the unanimous consent of existing credit facility lenders that would otherwise be required to raise the new debt.

Disclosure: The last twelve months have also seen an increasingly organised high yield investor base in Europe call for enhanced disclosure in offer documents, increased access to underlying transaction documents (including the making available in a public forum such as the issuer's website of material debt facilities, intercreditor agreements and amendments and waivers in respect of the same), enhanced financial disclosure and improvements to covenants in respect of ongoing disclosure (including conducting investor calls after publication of quarterly and annual accounts). With increasingly complex structures in which the notes often obtain senior guarantees and security from the operating group, there are also requests for improved disclosure in respect of group structures and ongoing reporting in respect of changes to the group. These requests have often been accommodated, and many recent European high yield transactions provide for enhanced initial and ongoing disclosure.

Observations

From a private equity sponsor perspective, although the incurrence based covenants of a high yield offering are very advantageous, the new structures have brought with them challenges. Among those challenges are: the absence of a core group of relationship banks to provide any necessary consents to required changes to financing terms, the need to obtain separate working capital and revolving facilities, and the maintenance of an acceptable level of reporting and confidentiality of sensitive business terms in the face of investor expectations for increased transparency. Private equity sponsors and issuers have also been focused on the need to maintain future financing flexibility to make operational business changes within the constraints of such complex and comprehensive secured high yield financing structures. Legal regimes in Europe can make it difficult to accommodate future secured debt within an existing secured financing structure without revisiting the initial security package and documentation. However, the increasing number of European high yield financings utilizing these new structures suggests that the challenges which they present can be managed to accommodate sponsor needs.

Although the European high yield market is likely to remain very volatile, the continuing weakness of the European bank market is likely to drive private equity sponsors and underwriters to continue to develop structures to facilitate leveraged acquisitions where all or a majority of the debt financing is provided by the high yield market. Some European companies, particularly seasoned issuers, have turned to the deeper (as of earlier this spring) U.S. high yield market during turbulent periods in Europe, and the new structures may facilitate the issuance of high yield notes in that market as well. ■

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Wading in the Waters:

Conducting IPO Pricing Discovery After the "JOBS" Act

The Jumpstart Our Business Startups Act (the "JOBS Act") has altered in certain fundamental ways the landscape of the federal securities laws. One such change permits portfolio companies of private equity sponsors that qualify as emerging growth companies ("EGCs") and their authorized representatives to "test the waters" with investors both before and after the filing of a registration statement to determine investors' level of interest in a securities offering contemplated by such portfolio company. This type of pricing discovery should prove especially useful to EGCs and their significant shareholders (including private equity funds) when assessing process, valuation and timing considerations in connection with the initial public offering ("IPO") process.

Background

The Securities Act of 1933 (the "Securities Act") generally makes it unlawful for any person to make any offer to sell a security unless a registration statement with respect to the security is on file with the SEC. Similarly, while oral offers are permitted following the filing of a registration statement, written offers are generally prohibited unless made by means of a compliant prospectus.

In a significant departure from long-standing U.S. federal securities law, rules and regulations designed to prevent "gun-jumping" (*i.e.*, making an offer before legally permitted to do so), the JOBS Act amends the Securities Act to permit—either before or following the filing of the registration statement with the SEC—an EGC (*i.e.*, a company with less than $1 billion in annual gross revenues during its most recently completed fiscal year that has not, during the previous three-year period, issued more than $1 billion in non-convertible debt[1]), and any persons authorized to act on behalf of the ECG, to make oral or written communications with certain institutional investors regarding those investors' interest in a securities offering that the ECG is contemplating.

Conducting Pricing Discovery

Freed from these gun-jumping restrictions, EGCs and their authorized representatives (which could include their primary shareholders, including private equity firms, and underwriters) may now conduct pricing discussions and better calibrate the timing of a potential securities offering (including an IPO) before investing a significant amount of time and money preparing for an offering process that may not result in a successful offering. Similarly, after the filing of the registration statement, EGCs and their authorized representatives may continue to meet with investors as frequently as desired to continue pricing discovery and further calibrate market timing. However, in order to comply with the Securities Act and other applicable restrictions, certain rules of the road should be observed.

Process Matters. Distribution participants may test the waters only with qualified institutional buyers ("QIBs"), as defined in Rule 144A under the Securities Act, and institutional accredited investors ("IAIs"), as defined in Rule 501 under the Securities Act. Consequently, pre-marketing outreach must be limited to these institutions only, and policies and procedures must be implemented to ensure that targeted investors fall within the permissible categories. Failure to limit the dissemination of pre-marketing communications to QIBs and IAIs could result in a gun-jumping violation if any such communications make their way into the hands of unqualified investors or the public at large. As such, EGCs and their representatives should take reasonable precautions to ensure that pre-marketing communications are not broadcast or otherwise transmitted in a way that makes them susceptible to being recorded, retransmitted or rebroadcast, and investor participants in meetings should not be permitted to retain written pre-marketing materials.

Potential Anti-Fraud Liability for Selective Disclosure. All pre-marketing communications will be subject to potential anti-fraud liability for material misstatements and omissions under Section 12(a)(2) of the Securities Act and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. In addition, even in the absence of a technical filing requirement, the SEC has begun to request that all written pre-marketing materials be submitted as supplemental information in connection with SEC review of the registration statement. If pre-marketing materials are inconsistent with disclosure included in the registration statement or include additional information not contained in the registration statement, the SEC may request that the registration statement be amended (thus exposing the issuer and other distribution participants, including significant shareholders as control persons, to potential anti-fraud liability with respect to the new information included in the registration statement under Section 11 of the Securities Act). In order to mitigate the potential for liability related to pre-marketing communications, such communications (both oral and written) should be materially consistent with: (1) disclosure that would be expected to be included in the registration statement, if the communication occurs pre-filing or (2) disclosure included in the registration statement, if the communication occurs post-filing.

Non-GAAP Measures. The requirements of Regulation G and Item 10 of Regulation S-K governing the use of non-GAAP measures (including the GAAP reconciliation

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1 *"Non-convertible debt" means any non-convertible security that constitutes indebtedness, whether issued in a registered offering or not. SEC registered debt securities issued in an A/B exchange offer do not count towards this debt limit.*

Conducting IPO Pricing Discovery After the "JOBS" Act (cont. from page 9)

requirements) do not apply to pre-marketing communications. However, for the reasons discussed above with respect to potential anti-fraud liability, EGCs and their advisors should think carefully about creating any material information asymmetry between pre-marketing communications and the registration statement, including by: (1) disclosing different non-GAAP measures from those included or to be included in the registration statement or (2) omitting the GAAP reconciliation and other related disclosure.

What About Confidentiality? With market practice in the gestational stage, it is difficult to know what processes will be adopted to address confidentiality concerns. EGCs are likely to want their pre-marketing communications with potential investors to remain confidential. In addition, to the extent that an EGC has previously issued any outstanding securities, a confidentiality agreement would address selective disclosure concerns. However, potential investors may be unwilling to restrict their trading activities by subjecting themselves to a confidentiality undertaking.

Final Thoughts

There is no doubt that the ability to test the waters will prove a useful tool for EGCs and their significant shareholders, including private equity sponsors. However, given the unchartered waters of the post-JOBS Act era, potential SEC regulatory action and guidance and the future development of market practice, it would be prudent to wade into the water carefully. ■

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The Return of "Covenant-Lite" Financings (cont. from page 6)

period, cross-acceleration appears to be market.

Cross-Default to Other Debt

A breach of the springing financial covenant may cross default other material indebtedness of a Borrower permitted under a "covenant-lite" Credit Agreement. This may indirectly cross default the Term Loans, unless the cross default to such other material indebtedness carves out a default in such other material indebtedness triggered by a cross default to the Revolving Loans when the Revolving Loans are in default due to a breach of the springing financial covenant.

Audit Opinion

Borrowers whose financial condition deteriorates may have difficulty receiving an unqualified audit opinion. The failure to timely deliver annual audited financial statements not subject to a "going concern" or similar qualification would typically be an event of default enabling the Term Lenders to take action. Some Credit Agreements, therefore, provide that the requirement to deliver unqualified annual audited financial statements will not be breached if the audit opinion includes a qualification based only on the potential inability to satisfy the financial maintenance covenant.

Cash Collateralization of Letters of Credit

As discussed, in "covenant-lite" Credit Agreements with a revolving tranche, the financial covenant springs to life only when Revolving Loans are outstanding or Letters of Credit are issued, sometimes in excess of a cushion. With that in mind, "covenant-lite" Credit Agreements typically contemplate that the financial covenant is not tested if Letters of Credit are cash collateralized. Indeed, cash collateralizing Letters of Credit eliminates the related credit risk and puts the Revolving Lenders in the same position as they would have been in had the Letters of Credit not been issued.

One needs to keep in mind that cash collateralizing Letters of Credit for the benefit of Revolving Lenders is an action that benefits one group of Lenders (*i.e.,* the Revolving Lenders) without the same benefit being extended to the Term Lenders. Indeed, the cash posted to collateralize Letters of Credit obligations is intended to be held for, and applied to, the satisfaction of the specific Letters of Credit obligations for which the cash collateral was provided prior to any other application of such cash to satisfy other obligations under the Credit Agreement. On a deal-by-deal basis, one needs to consider whether this arrangement is consistent with the requirement to treat all lenders *pro rata*, as that provision is drafted in the relevant Credit Agreement (formulations vary). If it is not, the ability to cash collateralize Letters of Credit on a voluntary basis without breaching the "treat all lenders *pro rata*" requirement should be specifically provided for in the Credit Agreement.

* * *

"Covenant-lite" Credit Agreements come in and out of fashion as quickly as the market moves from good to bad. What is settled one day may become too aggressive the next day, and Borrowers will no doubt find new ways to push the market when it is favorable. Given the crucial importance of the "covenant-lite" market to private equity sponsors and the fluidity of the market, we will continue to monitor market terms and update our readership accordingly. ■

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More European Distress:

Germany Increases Flexibility for Distressed Investing and Empowers Creditors

Investing in distressed assets across the Euro zone is widely perceived as a key opportunity on the private equity landscape. Significant amounts of money have been raised for distressed investments, and the number of potential investors has grown substantially.

Distressed investing in Europe has traditionally been perceived as riskier and more challenging than U.S. distressed investing due to a number of features of the Euro zone legal systems. For one thing, many insolvency regimes in Europe are predisposed toward liquidation of troubled companies rather than restructuring them and preserving going-concern values. Therefore, a distressed investment in a European troubled entity has traditionally posed significantly more risk of value loss than in a reorganization-focused regime such as the U.S. Whereas Chapter 11 reorganization in the U.S. and administration in the UK have become relatively well-tested and predictable methods of balance sheet restructuring, the relative dearth of successful, high-profile financial restructurings in continental Europe leads to greater uncertainty for investors in this zone. This in turn increases risk of investment loss should a formal insolvency proceeding be required, and raises the level of difficulty for achieving a consensual out-of-court workout.

In the last year or so, perhaps in anticipation of a greater need for balance-sheet restructurings, some Euro zone countries have updated or amended their insolvency regimes. The amendments to the German insolvency code, which went into effect on March 1, 2012, are among the most recent and interesting such changes.

The German statutory amendments streamline and add predictability to the treatment of distressed investments by, among other things, allowing debt-for-equity swaps in restructuring plans without requiring approval of existing shareholders and by giving a preliminary creditors' committee broader influence over the direction of insolvency proceedings and the insolvent company in a way that is protective of going-concern value. While the new rules are not a comprehensive overhaul of the German system, they do add new tools for distressed investing in German domestic companies and multinationals with a significant German presence.

Distressed Investment Background and Fundamentals

"Distressed investing" can refer to several different kinds of investment:

- **Debt trading**, in which an investor purchases debt at a discount with the intent to sell it at a more favorable price;
- **Debt restructuring**, in which an investor purchases some or all of a tranche of debt at a discount with the hope of realizing a profit by paying off the debt or restructuring it on favorable terms; and/or
- **Control investing**, in which an investor hopes to gain control of an entity either through purchasing its debt or making a new-money loan, with the expectation that the debt will later be converted into equity if and when the company becomes insolvent.

As described more fully below, the new German laws provide added control and participation for all three types of investors in the event of an insolvency, but have the most impact in the context of control investing.

Updates to the German Insolvency Laws

Facilitation of Debt-Equity-Swaps

The recent reforms significantly improve the mechanisms by which creditors can convert their debt claims into equity. This should increase flexibility for designing restructuring plans and provide greater predictability and a reduced timeframe for converting a distressed investment into a control position in a target company.

While in the past the German insolvency law provided no mechanism for any changes to shareholders' rights without their formal consent (leading to delay and unpredictability, as shareholders understandably would be reluctant to approve a significant dilution or, essentially, elimination of their position), such swaps can now be accomplished via an insolvency plan. While shareholders, along with other affected classes, would have the right to vote on such a plan under past practice, a new mechanism (akin to a U.S. "cram down" restructuring) would allow the plan to be implemented without consent in certain circumstances Similarly, an insolvency plan can now be used to implement a dilutive investment, whether from an existing or a new investor, without shareholder approval.

While the exact impact of the new law will depend on how it is implemented through the court process, the possibility of allowing debt-for-equity conversion or highly-dilutive new equity investments with a streamlined and predictable process that reduces the ability of existing equity to hold up the process will increase the attractiveness of control investing in German companies.

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Germany Increases Flexibility for Distressed Investing (cont. from page 11)

Court may appoint a Preliminary Creditors' Committee in the early stages of insolvency filing

Historically, creditors in a German insolvency proceeding have not had a meaningful mechanism to influence restructuring matters in the period between the insolvency filing and the initial creditors' meeting, which may be a few months later. The reform act addresses this problem by allowing creditors to establish a "Preliminary Creditors' Committee" (*vorläufiger Gläubigerausschuss*) at an early stage of the proceedings in major cases. (Under past law, insolvency administrators sometimes appointed a creditors' committee, but the committee had no formal say in the proceedings).

After an insolvency filing, the debtor, its preliminary administrator or a creditor may request that a Preliminary Creditors' Committee be established. Such requests will be granted where (1) there are eligible creditors willing to serve on the committee; and (2) where a debtor has ongoing business operations of a certain magnitude in terms of balance sheet total, revenue and employees.

The exception to the rule is that a court may refuse to appoint a committee if, in the court's view, such an appointment would negatively affect the debtor's financial situation. Although this provision is clear on paper, it remains to be seen how the courts will interpret the exception, and whether the exception will, in effect, swallow the rule.

When a Preliminary Creditor's Committee is appointed, the committee will have the power (described further below) to consult with the insolvency court in selecting the preliminary insolvency administrators (*(vorläufiger) Insolvenzverwalter*) and to opt for self-administration (*Eigenverwaltung*), both of which will let creditors have a substantial impact on restructuring proceedings. This power is analogous to a receivership in the U.K., in which creditors may select a receiver and influence other key aspects of the restructuring or administration process.

Strengthening of Self-administration (Eigenverwaltung)

The new laws should invert the existing presumption that favors the appointment of outside insolvency administrators over permitting self-administration (*Eigenverwaltung*) by the insolvent entity.

Historically, when an insolvency proceeding was initiated, the court would typically appoint a preliminary insolvency administrator to take control of all the company's business and would only permit the existing management team to remain in place where, in the court's opinion, it would not delay the insolvency process or otherwise adversely affect creditors. In practice, instances of self-administration - in which the company's management retained control of the business under the supervision of a court-appointed trustee - were relatively rare, even though in a crisis situation such as an insolvency filing, it is often critically important to have an experienced management team with industry knowledge and relationships with key players working to stabilize a debtor's business operations. Under the previous insolvency regime, where management was typically fully replaced by a less experienced administrator, business reorganizations became quite risky, with liquidation a typical result.

The new law, similar to U.S. Chapter 11, establishes a presumption in favor of self-administration: the court can only reject the application for self-administration if it concludes that creditors would be negatively affected. In reaching its conclusion the court will be required to hear submissions from the Preliminary Creditors' Committee, if one has been appointed, thus affording significant creditors a much greater ability to influence the restructuring outcome. If the Preliminary Creditors' Committee unanimously supports self-administration, the court will follow that recommendation.

The new law further adopts principles roughly comparable to U.S. Chapter 11 proceedings by permitting a debtor to seek a "protective shield" period of up to three months in which the debtor may negotiate with key constituents in an effort to prepare a pre-packaged insolvency plan. Such a procedure is only permitted where the debtor is not illiquid, the debtor has elected self-administration, and the intended restructuring does not appear to be obviously futile. During a protective shield period, the court may ensure that (1) enforcement measures (*Zwangsvollstreckungen*) of creditors are suspended and (2) obligations incurred after the filing constitute preferential debt in any subsequent insolvency proceedings. This procedure should benefit investors by allowing the debtor's business to operate free of enforcement proceedings and by providing trade creditors comfort in doing business with the debtor, thereby minimizing the negative impact of the restructuring on the business while the creditors and debtor negotiate the terms of a restructuring.

Creditors May Influence Appointment of Insolvency Administrators

In cases where self-administration is not chosen, the new law permits the

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ALERT

Compliance Date for Placement Agent Prohibition in Pay-to-Play Rule Delayed Again

As private equity professionals are well aware, Rule 206(4)-5 under the Investment Advisers Act of 1940, commonly known as the "Pay-to-Play Rule," is of great significance to the industry because it will apply to the use of placement agents and solicitors by registered and unregistered investment advisers including private equity and hedge fund advisers. On June 8, 2012, consistent with other delays in the implementation of many financial reforms to arise out of the financial crisis, the SEC extended the compliance until at least April 2013.

Political Contributions Restriction is Unaffected

The SEC adopted the Pay-to-Play Rule in order to eliminate the perceived role that political contributions might play in decisions by state and local pension plans and other government entities to invest in private funds or to give other business to investment advisers.[1] The Pay-to-Play Rule is perhaps best known for its "Two Year Timeout" provision, which prohibits an investment adviser from receiving compensation from a Government Client for two years if the adviser or certain of its employees make a political contribution to specified elected officials or candidates for office. The Two Year Timeout provision has been in effect since March 14, 2011 and was unaffected by the SEC's action on June 8.

Solicitor Restriction Is Delayed

The Pay-to-Play Rule also contains a "Solicitor Restriction." This restriction prohibits the ability of an investment adviser and certain of its affiliates (including private funds managed by the adviser) to compensate a third party (such as a placement agent) to solicit advisory business or an investment from a government entity unless two conditions are satisfied. First, the placement agent or other third party must be registered with the SEC as an investment adviser, broker-dealer or municipal advisor. (The registration requirement for "municipal advisors" was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act; the SEC has not yet adopted final rules implementing this provision). Second, the third party must be subject to equivalent "pay to play" restrictions.

The Solicitor Restriction compliance date had been delayed until June 13, 2012 in order to provide FINRA and the Municipal Securities Rulemaking Board sufficient time to adopt equivalent "pay to play" restrictions for broker-dealers and municipal advisors. Neither of these organizations has yet done so; the MSRB has indicated that they will not do so until the SEC issues its final municipal advisor registration rule.

In light of these delays, the SEC has extended the compliance date for the Solicitor Restriction until nine months after the compliance date of its final municipal advisor registration rule, which the SEC expects to issue in the second half of 2012. Thus, the compliance date for the Solicitor Restriction will not occur until April 2013 at the very earliest. ■

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[1] *Client Update: SEC Adopts New Pay-to-Play Rule (July 12, 2010), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8200106a-2f07-49b1-a3e6-99f1b0470e06.*

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Geoffrey Kittredge
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EM PE Fundraising Masterclass
EMPEA
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May 8–12, 2012
Paul R. Berger
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Sponsors Beware:

"Trades or Businesses" and Joint and Several Exposure for Unfunded Pension Liabilities Under ERISA

As savvy private equity professionals know, under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), a private equity fund's assets could be exposed to joint and several liability for unfunded pension benefit liabilities of any portfolio company of the fund if the fund is engaged in a "trade or business" and is under "common control" with the portfolio company. As these private equity professionals also know, however, private equity firms and their advisors have historically utilized a variety of structuring and other planning mechanics to reduce the risk that they would be viewed as engaged in a "trade or business" under ERISA.

Still, in recent years, the Pension Benefit Guaranty Corporation (the "PBGC") has begun to assert that an investment fund sponsored by a private equity firm may be a "trade or business" that can be treated as under "common control" with one or more portfolio company investments for purposes of ERISA. For instance, in September, 2007, the PBGC Appeals Board issued a denial of an appeal of a PBGC finding of an investment fund being a "trade or business" under "common control" with a defunct portfolio company. While there has been no material judicial review of the PBGC's views in the private equity investment funds area, several recent judicial decisions involving purportedly passive investment vehicles of individuals and families have held that such vehicles are engaged in a "trade or business" under ERISA. Although these cases can be distinguished from a typical private equity fund structure, they should be considered in fund raising, and in the worst case scenario, in defense against an assertion by the PBGC that a fund is engaged in a "trade or business."

Background: ERISA Controlled Group Liability

ERISA, which is the federal law governing pension plans and how they are operated and funded, imposes joint and several liability on each member of a "controlled group" of business entities for certain pension obligations. For instance, in the context of a so-called "single employer" plan (*i.e.*, one maintained by a company exclusively for its employees and those of its controlled subsidiaries), all "trades or businesses" that are part of the same controlled group can be jointly and severally liable for any deficiency in such plan's funding that exits at the time at which the plan is terminated. Such a termination ordinarily will occur in the context of a bankruptcy proceeding. Similarly, if an employer withdraws from a multiemployer pension plan (*i.e.*, a plan maintained pursuant to one or more collective bargaining agreements which is funded by contributions from more than one employer) that has unfunded benefits at the time of the withdrawal, such employer and each "trade or business" that is part of its ERISA "controlled group" are jointly and severally liable for its allocable share of the liabilities related to the multi-employer plan's unfunded vested benefits ("Withdrawal Liabilities").

Applicability to Private Equity Sponsors

In the context of the typical investment fund structure, an ERISA "controlled group" will exist if two or more corporations or partnerships are "trades or businesses" and are determined to be under common control, based essentially upon there being at least 80% common equity ownership. In the private equity context, this means that any two or more 80% or more common equity owned portfolio companies of a private equity investment fund face such potential joint and several liability.

But the private equity investment fund itself and its manager are often structured so that the fund is a passive investor in the portfolio companies, with all of the active management effected by the separately owned and operated manager. Many practitioners believe that, by isolating the fund from the normal operations of the manager and the portfolio companies, the fund would not be treated as a "trade or business" under ERISA. If the fund is not a "trade or business," it can not be part of the ERISA "controlled group" that includes any of the portfolio companies in which it is invested, which should insulate at least some of its assets from the pension liabilities of such companies.

The Hughes Decision

Although the Supreme Court has held that "investing is not a trade or business," in *Central States, Southeast and Southwest Areas Pension Fund v. Hughes*, decided April 30, 2012, the Northern District of Illinois determined that the purportedly passive investment activities of a family estate planning vehicle was a "trade or business" for purposes of applying ERISA's "controlled group" test. In *Hughes*, a multi-employer pension plan sought to impose Withdrawal Liability against three corporations, each of which was owned in significant part by members of one family and a related trust. The plan argued that the three corporations were jointly and

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Unfunded Pension Liabilities Under ERISA (cont. from page 15)

severally liable for the Withdrawal Liability by reason of being "commonly controlled" "trades or businesses" for purposes of the relevant provisions of ERISA. One of these corporations was operated for estate planning purposes and for decades had held only securities, notes and one parcel of real estate. This corporation had constructed a small office on that property and leased space to tenants under "net leases" where the cost of certain expenses was factored into the rent due. The corporation argued that these limited activities did not make it a "trade or business" for purposes of ERISA's "controlled group" test.

In similar contexts, several courts have used a two part test to determine whether an entity's activities constitute "a trade or business," asking whether such activities were intended for profit or income and continuous and regular in nature. The *Hughes* court stated that passive investing, including the holding of real estate, will generally satisfy the "for profit" prong, so long as income production is the primary purpose for holding the investment assets. In its "for profit" analysis, the court pointed to a variety of factors, including that the corporation made improvements to the land it owned, the property earned rental income and claimed business related income tax deductions, and the corporation possessed a federal employer identification number. The court found that the entity also engaged in "continuous and regular" activities because the corporation regularly paid an operating entity a fee to manage the property, contracted with third parties to clean and maintain the property, and paid costs in order to support and maintain the value of the property in the estate.

Hughes draws upon a Seventh Circuit decision that affirmed a district court's surprising factual determination that an estate planning vehicle was a "trade or business." That case, *McDougall v. Pioneer Ranch Ltd. P'ship, 494 F.3d 571 (2007)*, involved a sizable Withdrawal Liability claim between the sole proprietor of a defunct business and a "family owned vacation property," which was documented as a working farm for estate and tax planning purposes. The district court found that the partnership created to own the property was a trade or business, despite a long history of significant operating losses, because, among other factors, it: claimed business related tax losses on its federal income tax returns; sold some of the farm's products; employed one full-time worker and one-part time worker and had a federal taxpayer identification number.

Happily, the appellate decision reflects some skepticism from the panel as to whether they would have reached the same factual conclusions as the district court. Moreover, the holding in *McDougall* could readily be distinguished from a properly operated private equity investment fund on the basis, among other factors, that the farm had reported itself as a trade or business to avail itself of federal tax benefits and was therefore estopped from denying that character when confronted with a material Withdrawal Liability claim. *Hughes*, however, disregards that element of *McDougall* to enable it to find a mechanism to construct a "trade or business" from relatively modest activities.

Impact of the Decision on Private Equity Funds

There are several bases upon which to distinguish *Hughes* and its predecessors from the typical private equity investment fund situation, including that each of these cases involved the ownership and operation of real property, which almost always necessitates more ongoing activity than pure securities holding. Furthermore, each case presents circumstances where the entity or its advisors were not careful or consistent in honoring the entity's character as a passive investor.

Nonetheless, the *Hughes* decision is significant for private equity sponsors because of the low threshold it applied in determining a profit intent—a threshold an investment fund should assume it would readily transcend. But even more notable for sponsors are the factors *Hughes* cites in support of the conclusion that the entity's activities were sufficiently continuous and regular to constitute a "trade or business," including the retention and payment of a manager to act on the entity's behalf and other relatively modest steps to maintain the real property that the entity owned. In light of its reliance on these factors, the *Hughes* court may have staked out a very narrow view of what activities a passive investor may undertake before becoming a functional "trade or business" under ERISA. Private equity sponsors will no doubt continue to take the position that the passive nature of their relationships to their portfolio companies precludes a determination that they are engaged in a "trade or business," but *Hughes* is unlikely to make that argument easier to assert. ■

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Yes, Virginia, You Really Can Waive Fraud Claims

Many dealmakers, relying on the classic adage that "fraud vitiates everything," assume that remedy waivers, including non-reliance and exclusive remedy provisions, do not apply to claims alleging fraud. On the buy side, this assumption can sometimes lead private equity professionals and their advisors to accept broad waivers in acquisition agreements, without a carveout for fraud, because they believe such a carveout is unnecessary as a matter of law. On the sell side, the assumption can lead practitioners to decline to fight over a buyer's request for such a carveout, again on the belief that the presence or absence of the carveout is not legally relevant.

However, as a recent Delaware Supreme Court case illustrates, a significant line of case law in both New York and Delaware makes clear that broad remedy waivers of this kind are likely to be enforced, particularly if such waivers are between sophisticated parties and are not induced by a fraudulent misrepresentation expressly made by the parties in connection with the provision of the waiver. Indeed, waivers need not even specifically reference fraud in order to bar fraud claims. Accordingly, private equity professionals should assume that the inclusion or omission of a carveout for fraud in a waiver provision in acquisition agreements is significant and will affect the rights and remedies of the negotiating parties.

Notably, this recent case about unwitting fraud waivers arose in the context of a transaction in which the fraud was recognized during the due diligence process and before the deal was signed. *RAA Management, LLC v. Savage Sports Holdings, Inc.*, decided May 18, 2012, involved a claim by a prospective buyer (RAA) that a target (Savage) made fraudulent misrepresentations during the parties' preliminary negotiations, allegedly leading RAA to spend $1.2 million on due diligence and negotiation costs that it would not have otherwise incurred. The purported misrepresentations included providing a document in the online data room misstating potential environmental liabilities, making inaccurate statements regarding the unionization of employees, and not disclosing a threatened $40 million lawsuit. RAA allegedly terminated the parties' negotiations as a result of its discovery of the inaccuracy of the misrepresentations and subsequently sued Savage to recover its costs. The Delaware Supreme Court dismissed RAA's claim on the grounds that the parties' nondisclosure agreement ("NDA") included an acknowledgement by RAA that Savage was not making any representation or warranty as to the due diligence materials provided by Savage and an agreement that Savage would not have any liability resulting from the use of such materials except as provided in a definitive purchase and sale agreement.

RAA argued that this provision applied only to negligent or unintentional misrepresentations and not to the kind of "willful falsehoods" allegedly made by Savage. The Delaware Supreme Court disagreed, noting that the "buyer beware" language of the provision did not distinguish between information that was negligently inaccurate and information that was intentionally inaccurate. Thus, the court held, in the absence of an express carveout for intentional or fraudulent misrepresentations, a broad non-reliance provision encompasses all information (or lack thereof) provided by a seller.

The court was especially reluctant to interpret the NDA language more restrictively than provided on its face because the parties were sophisticated negotiators with comparable bargaining power. In such cases, the non-reliance provision is considered to be a fully bargained-for allocation of risk.

Finally, the court held that waivers of fraud are not against public policy. RAA argued that even if the non-reliance provision was by its terms all-encompassing, it was ineffective as a matter of public policy because it would allow a party to shield itself from liability for its own dishonesty. The court rejected this argument, ruling that a public policy in favor of truthfulness would lead to the opposite conclusion. In other words, that allowing a buyer to disavow a broad non-reliance provision it had agreed to would sanction the buyer's own misconduct.

Despite the result in the RAA case, fraud remains a powerful claim. The prospective buyer may have been more successful if the target's allegedly fraudulent misstatements had been expressly included as a representation in the same agreement under which the prospective buyer waived the target's liability for fraud, on the grounds that such misstatement fraudulently induced the waiver. Likewise, some courts have held that waivers of fraud are not enforceable if the fraud claim is brought under federal securities law. However, as a negotiating matter, both buyers and sellers should assume in negotiating acquisition and sale agreements that waivers of claims and limitations of remedies apply even where allegations of fraud can be made, and to agree to, or resist, inclusions or exclusions of fraud accordingly. ■

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underlying a UK agreement, particularly in the context of an auction, are different from those under a U.S. contract. Critically for sellers, a typical UK agreement assumes that, even where there is a gap between signing and closing, deal certainty is required from signing and from that point risk passes to the buyer. That, combined with the fact that post-closing redress (*e.g.,* for breach of warranty) is less likely to be pursued and harder to achieve in the UK than in the U.S., makes selecting UK law a compelling strategic choice for the seller.

While, as always, there are many exceptions to the general UK approach, it is interesting that even in a deteriorating deal market, where a shift of negotiating power from sellers to purchasers might be expected, there have not been material changes in the UK approach. Under similar circumstances in the U.S., there have been some meaningful seller-friendly market changes, particularly as to remedies for buyers breach, but the U.S. approach remains markedly less friendly for sellers.

The balance of this piece discusses a number of key differences between UK and U.S. practice in greater detail.

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Deal Certainty

Conditions: Typically UK agreements contain only conditions required by law or regulation, *e.g.*, anti-trust clearances or other regulatory approvals. These are generally specified together with detailed provisions on timings for filings and consequences based upon the response from the relevant regulatory body. In contrast, U.S. deals are somewhat more likely to have greater conditionality and certainly more likely to provide for a meaningful period of time before closing, known in the U.S. as the Marketing Period, for the buyer to have a fair shot at placing its financing.

Material Adverse Change: It is unusual for UK deals to be subject to a Material Adverse Change condition. Even if a MAC condition is included, it is likely to be relevant only if an "armageddon" event occurs which is not the result of macro-economic factors. For instance, MAC clauses often now specifically exclude any direct or indirect consequences of a breakup of the Euro zone. By contrast, MAC clauses are far more common in the U.S., although they are also interpreted very narrowly.

Financing: UK deals are usually done on a "certain funds" basis with no financing condition or financing out. Some strategic and private equity deals in the U.S. contain financing conditions. If there is no financing condition, as is the case in virtually all large cap private equity deals, there will typically be a reverse termination fee which requires the buyer to pay a fixed amount if the financing is not available and the other closing conditions are met. This reverse termination fee is usually the seller's exclusive monetary remedy against the buyer.

Although reverse termination fees are seen in the UK they are relatively rare, certainly by comparison with U.S. practice.

Break Up Fees: In the U.S., a buyer with a definitive agreement to acquire a public company who subsequently gets trumped by a topping bid will be entitled to a breakup fee for its role as a stalking horse. In the UK, such break up fees on public bids are expressly prohibited without the consent of the UK Takeover Panel.

Pricing Mechanics

It is has been common for a number of years in UK-governed acquisition agreements, particularly in auctions, for the acquisition price to be structured on a "locked box" basis. That is, the price payable for the target company is agreed upon in advance of signing based on a balance sheet drawn up to an agreed locked box date. The purchaser then bears the risk and rewards of the target's performance from the locked box date through signing to closing. In return, the seller undertakes that there will be no "leakage" of value from the "locked box" to the sellers in that period in the form of dividends or otherwise. This is entirely in keeping with the philosophy that risk passes to the purchaser from signing, and

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the advantages for the seller in using a "locked box" include the ease with which bids can be compared, price certainty (as there is no post-closing adjustment) and control over the pricing process.

Although the use of locked boxes is increasing in the U.S., it is still common to have a purchase price adjustment based on the working capital or net worth of the company as of the closing date (which is typically estimated at closing and trued up post-closing), and the seller is generally free to make distributions out of the company during the interim period. Unlike the locked box mechanism, and depending on the precise formula utilized in any particular adjustment formula, the seller retains the commercial risk and reward until closing, the seller has less control over the final amount of the purchase price, and the price is likely to be subject to a post-closing adjustment and potential dispute based on the closing accounts.

Seller Liability

Scope of Representations and Warranties: There is an expectation in English law-governed deals that sellers will provide less extensive warranty coverage than in the U.S. The style of the representations and warranties also tends to be more general in nature and not as comprehensive as in U.S. deals.

Bring Down of Representations: In the UK, it is unusual for representations to be repeated (or "brought down") at closing, although, as a compromise, sellers may agree that a small number of fundamental representations, such as with respect to title and legal capacity, are brought down to closing. In the U.S., the practice is generally to require representations and warranties to be accurate as of closing as a condition to the deal, subject to MAE and materiality qualifications.

Disclosure: The style and substance of the disclosure process differs between UK and U.S. documents. Under a UK acquisition agreement, the seller's disclosure against representations is typically contained in a separate disclosure letter, rather than the schedules to the sale agreement itself, which is often the case in the U.S. A UK disclosure letter will contain a mix of general and specific disclosures against the representations. Even the specific disclosures are normally deemed to qualify all representations and not just the specific representations to which they relate. More significantly, in auctions it would be usual for the entire contents of the data room and of any vendor due diligence reports to be deemed to be generally disclosed against the representations. In the U.S., the buyer will usually allow specific disclosures in respect only of each representations against which the disclosure is made and any other representations as to which it is readily apparent that such disclosure might relate. General disclosures or imputations to buyers of the entire contents of the data room, are far less common and not typically accepted by buyers.

Indemnities: In the U.S., in a transaction where the representations survive, the buyer would usually enjoy express contractual indemnification, for breach of warranties and representations. In most U.S. deals, where the seller is a private equity firm or collection of individuals, the buyer's exclusive source of recovery (if any) for such indemnification is recourse against an escrow funded with an amount equal to five to ten percent of the equity value absent unusual circumstances (and in some cases, where the seller is a private equity firm, there is no indemnification at all). The escrow is typically paid over to the seller once the representation and warranties expire, subject to reserved amounts for any pending claims. As a corollary, in the U.S., in these types of sell-side private equity deals, the seller's representations and warranties and other agreements can survive for as little as the first anniversary of the closing or alternatively, the completion of the first audit cycle under the buyer's ownership.

In the UK, such express contractual indemnification is much less common, other than in relation to tax or other specifically identified risks (*e.g.,* environmental exposure). The purchaser's remedy for breach of a warranty in a UK acquisition agreement would, therefore, usually be a contractual claim for damages with a duty to mitigate losses and a requirement for any damage to be reasonably foreseeable. Some U.S. deals actually end up with a similar result, notwithstanding the express contractual indemnification due to waivers by buyers of consequential damages and a contractually imposed duty to mitigate.

Specific Performance: Whilst, in broad terms, U.S. and UK courts apply the same standards when deciding whether to grant an order for specific performance, (*i.e.*, monetary damages would be an inadequate remedy), it is probably more difficult to obtain an order for specific performance in the UK than in the U.S. where it is typically an enforceable remedy on properly crafted deals. Since 2008, specific performance has become a fairly standard buyer remedy in private equity deals, though the scope of such specific performance rights can vary meaningfully deal by deal.

Limits on Liability: Financial thresholds, (*i.e.* caps and baskets) are common under both UK and U.S. acquisition agreements, though, in some circumstances, a UK agreement may contain more extensive general limitations

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on the seller's liability than in the U.S. It is also worth noting that private equity sellers in the UK rarely stand behind business warranties in an acquisition agreement. In those circumstances, a purchaser relies upon warranties received from management (up to negotiated caps and with thresholds) and, if it chooses to purchase it, insurance. Any management liability of this kind is extremely rare in the U.S., perhaps reflecting a calculation that a law suit against one's new management team (assuming a private equity buyer) is a not unattractive proposition and, therefore, not a meaningful remedy.

Other Differences

Closing deliverables are likely to be more extensive in the UK than in the U.S. Furthermore, the covenants to which the target business and seller are subject in the period between signing and closing are likely to be significantly more extensive in the UK than in the U.S., again reflecting the fundamental difference of when the risk of ownership transfers in the U.S. versus the UK.

Conclusion

These differences demonstrate why sellers should prefer that international deals are done under UK law. However, in making tactical decisions about the choice of law, sellers should be mindful of the likely pool of purchasers. If they are predominantly U.S.-based, sellers may find it difficult to insist on the use of UK-style stock purchase agreements for assets based outside of the UK. However, in transactions outside the UK where they are competing with European and UK bidders, U.S. private equity buyers should recognize that accepting UK-style approaches may be required in order to be competitive and should weigh the risks accordingly. ■

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Preliminary Creditors' Committee to comment regarding the court's appointment of the insolvency administrator, before the court makes its appointment. The committee can set out requirements or qualifications the insolvency administrator has to meet, or the committee can propose a specific individual for the position. If the committee makes a unanimous recommendation of an administrator, the court is bound to appoint that individual unless the candidate is not eligible for some extrinsic reason (*e.g.*, for conflict reasons or clearly insufficient experience).

This mechanism is in marked contrast to the prior law, in which a court had sole discretion to appoint a preliminary administrator and often did so from an unofficial or court-approved list without creditor input; with the possibility that the administrator would have little or no experience in the debtor's area of business. Although creditors had a chance to change the administrator at their creditors' meeting, this might occur several months after the initial appointment, when it would be too late to effectively change course and when critical decisions about the restructuring may already have been made.

Conclusion

The full impact of the new German insolvency law will not be known until the courts actually implement the new provisions. In principle, however, the new law presents very intriguing possibilities for distressed investors, because it allows for flexibility in designing a restructuring that can "cram down" existing equity by granting new equity to creditors or new-money investors without old equity's consent. The new law also appears to be a strong message to investors that the German insolvency regime will no longer favor liquidation, but rather will permit creditors a significant voice in a process that (albeit less flexibly than a U.S. Chapter 11) permits management to continue business operations while a restructuring plan is negotiated. ■

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