Debevoise & Plimpton
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Three's Company: An Evolving Market in Private Equity Add-On Transactions

Over the past ten years private equity firms have looked with increasing frequency to add-on acquisitions by their portfolio companies to drive growth. Add-ons allow sponsors to take advantage of operational and financial synergies that are not available to them upon the initial acquisition of a portfolio company, giving them an edge in auctions over other private equity firms and sometimes exclusive opportunities that are more typically the preserve of strategic buyers – all boosting returns on exit.

According to data from Preqin, the prevalence of add-on acquisitions has grown from 1/5 of all private equity transactions representing 2% of overall deal value in 2008 to nearly 1/3 of all private equity transactions and over 13% of overall deal value in 2013. This publication reported last year on the key issues in these add-on acquisitions (see: "Strategic Thinking: Special Considerations for Private Equity Sponsors Contemplating Add-on Acquisitions" in the Winter 2013 edition of the *Debevoise & Plimpton Private Equity Report*).

We have recently observed the development of two important variations on the traditional add-on transaction. At the bidding stage, we have seen an increase in "two for one" simultaneous acquisitions – eliminating the traditional timing gap between closing of the first portfolio company acquisition and closing of the

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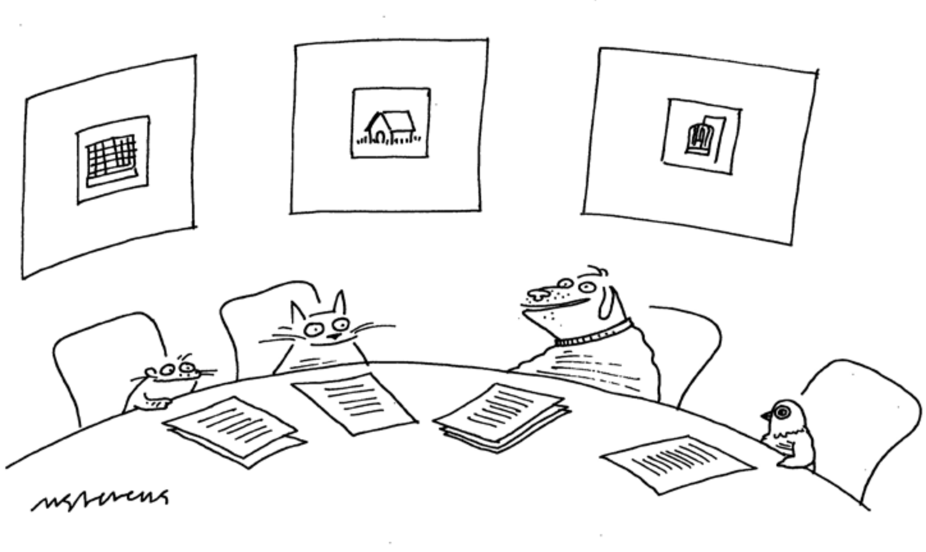

"It's agreed then: dogs, cats, gerbils and parakeets will merge, forming an entity which will be called Unipet."

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Private Equity Group members are based in New York unless otherwise indicated.

Please address inquiries regarding topics covered in this publication to the authors or any other member of the Practice Group.

The Inversion Craze: What You Need to Know

Much ink has been spilt in the U.S. press recently on the topic of "inversion" transactions – from Pfizer's failed pursuit of AstraZeneca, to the $48 billion Medtronic/Covidien deal, to the more recent and creative Cosmo Technologies/Salix Pharmaceuticals, Mylan/Abbott and Burger King/Tim Hortons transactions. Advocates of inversions claim the deals seek to create shareholder values. Detractors condemn them as unpatriotic and immoral. This article does not take sides in the debate but rather clarifies the basic elements of these transactions, which are sometimes misunderstood.

What Is an Inversion?

An inversion is the acquisition by a foreign corporation of a U.S. corporation (a U.S. Target). Although some reports describe inversion transactions as the takeover by a U.S. corporation of a foreign corporation, the opposite is actually the case as a technical matter. The confusion arises because the U.S. Target in an inversion transaction is often much larger than the foreign corporation, and other factors are present that suggest the U.S. Target is the acquirer. However, for the U.S. tax benefits from an inversion to be available, the foreign corporation must be the acquirer, even if it is the smaller company.

For an inversion transaction to "work" (that is, for the foreign acquiring corporation not to be taxed as a U.S. corporation), it is critical that the former shareholders of the U.S. Target own less than 80% of the shares of the foreign corporation following the transaction. Of course, the relevant rules are detailed and complex, and what is counted in the calculations can sometimes be counterintuitive, as described below.

Who Really Is Acquiring Whom?

From a purely commercial point of view, it is understandable to think of the U.S. Target as the acquirer. After all, the shareholders of the U.S. Target typically end up owning a significant majority of the equity of the combined company after the inversion. In most cases (though not all), the name of the combined entity will be the name of the U.S. Target. For instance, Medtronic plc will be the name of the parent entity created in the inversion transaction between the U.S. Target Medtronic and the foreign company Covidien plc. The operational headquarters of the combined businesses often remains in the United States, as is the case, for instance, in the AbbVie/Shire deal (Chicago) and the Cosmo Technologies/Salix Pharmaceuticals deal (Raleigh). The board of the combined company is usually composed mostly of members of the U.S. Target's board, with a few additions from the foreign company, and the management team of the U.S. Target typically dominates the executive suite after closing. Finally, the U.S. Target is often the party proposing the transaction in the first place, sometimes in an obviously unsolicited manner.

Why Would a U.S. Corporation Wish to Be Acquired by a Foreign Company?

There are many reasons that a U.S. Target may wish to enter into an inversion transaction. Some reasons have nothing to do with tax, such as achieving or expanding an international platform or more readily accessing the international capital markets or simply expanding in search of growth. However, it is fair to say that reducing the U.S. tax burden (and, relatedly, deploying cash "trapped" outside the United States) is often a major, if not the primary, reason for an inversion. Private equity sponsors that own U.S. portfolio companies may want to take advantage of these benefits if they can find the right foreign partner, as 3G Capital, the majority owner of Burger King, has done with Tim Hortons.

The United States, at 35%, has the highest corporate tax rate of any OECD country. In contrast, the Irish and U.K. corporate income tax rates are 12.5% and 21%, respectively. The United States is also one of the only industrialized countries to tax the worldwide earnings of its corporations, including upon repatriation. Other countries have a "territorial" system under which the repatriation of earnings from offshore subsidiaries to the parent is exempt from taxation (either entirely or to a large extent). Although the U.S. grants a credit for foreign taxes paid by offshore subsidiaries, the credit system results in incremental U.S. taxes to the extent the foreign tax rate is lower than the U.S. rate. (For example, upon the repatriation of foreign earnings taxed locally at 10%, the U.S. will collect a 25% federal tax – the excess of 35% over 10%.) Moreover, under the United State's extensive anti-deferral regimes, the U.S. often taxes foreign earnings

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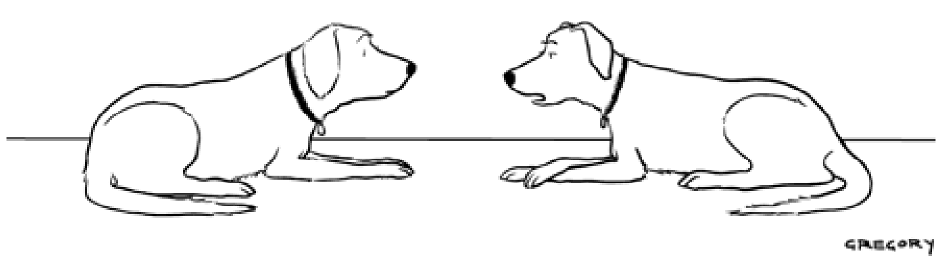

"I would not be opposed to a cat tax."

even before they are repatriated. Adding further salt to the wound is the fact that the U.S. tax compliance burden is very high due to the formidable reporting requirements that the U.S. imposes on its multinationals.

Many U.S. Companies Do Not Actually Pay the Full 35% Tax Rate, So Why Do They Still Wish to Invert?

It is correct that many U.S. multinationals do not have an effective tax rate anywhere near the nominal U.S. corporate rate due to a variety of tax planning strategies. For example, U.S. multinationals, particularly those in the pharma and technology areas, are often able to fund research and development from subsidiaries organized outside the United States. If the R&D leads to the creation of valuable intangibles, the foreign subsidiary that funded the research is entitled to reap some or all of the profits from the commercialization of the intangible. In this way, significant earnings may be kept offshore, and a lower effective U.S. tax rate may be achieved. (For example, Apple is reported to have a 7% global effective tax rate.) However, the benefit is merely one of deferral. If and when the U.S. parent wishes to access the earnings of its foreign subsidiaries (either by receiving a dividend of, or by borrowing, the foreign earnings), the U.S. parent must pay U.S. tax on the amount accessed.

"Advocates of inversions claim the deals seek to create shareholder value. Detractors condemn them as unpatriotic and immoral."

When a U.S. Corporation Inverts, Does It Avoid All U.S. Income Taxes?

One persistent misconception is that U.S. multinationals do not have to pay U.S. income taxes once they invert. The truth is that a U.S. multinational that inverts must still pay U.S. income tax on the earnings derived from its U.S. operations and from its foreign operations that continue to be owned by a U.S. company. However, it is also true that inversions provide an opportunity to diminish the U.S. tax base, as described below.

What are the Key U.S. Tax Benefits Derived From an Inversion?

There are two major U.S. tax benefits that can be achieved through an inversion. First, the U.S. Target can be leveraged with intercompany debt from the foreign acquirer in an inversion. The interest paid on the intercompany debt is generally deductible by the U.S. Target, which leads to a smaller U.S. tax base. Although the U.S. has "thin capitalization" rules, they are not very stringent and significant earnings can be stripped from the United States in this manner. Second, future non-U.S. business expansion that otherwise would have taken place under the U.S. Target can be undertaken by the foreign acquirer. In this way, the U.S. is not able to tax future earnings from international expansion.

Do U.S. Shareholders of the U.S. Target Have to Pay Tax When They Exchange Their U.S. Target Shares for Shares of the Foreign Acquirer?

Many share-for-share exchanges involving a U.S. target and a U.S. acquirer are structured to be tax-free to U.S. shareholders. In an inversion, however, the acquirer is foreign, so the normal share-for-share tax rules do not apply. Generally, inversion transactions are taxable to U.S. shareholders of the U.S. Target, unless the equity value of the U.S. Target is equal to or smaller than the equity value of the foreign acquirer. If the U.S. Target is the bigger of the two companies, U.S. shareholders will be taxed when they exchange their U.S. Target shares for shares of the foreign acquirer (to the extent of any gains based on the fair market value of the shares received). If the transaction is a pure share-for-share exchange, U.S. shareholders who recognize gain would have "phantom income" and must satisfy their U.S. tax liability by using other resources or selling some of the shares of the foreign acquirer that they receive.

Has the U.S. Congress Done Anything to Curtail Inversions?

The Shareholders of the U.S Target End Up Owning 80% or More of the Combined Company Post-Inversion. Congress enacted anti-inversion legislation in 2004. The legislation imposes a severe sanction in cases where the former shareholders of the U.S. Target end up owning 80% or more of the foreign acquirer as a result of the inversion. Specifically, the foreign acquirer is treated for U.S. tax purposes as if it were a U.S. corporation. If the foreign acquirer is treated as a U.S. corporation, none of the foregoing tax advantages can be achieved. Moreover, the foreign acquirer would become subject to U.S. corporate income tax on its worldwide earnings. The legislation unilaterally overrides all tax treaty obligations of the United States that would otherwise prohibit the U.S. Government from taxing the foreign acquirer. As a result, the 2004 legislation effectively shut down most inversion transactions where the 80% ownership threshold was reached or surpassed.

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Russian Sanctions: Six Things Private Equity Firms Should Know

Compliance with sanctions regimes has become a hot topic this year as the rapid expansion of sanctions against Russia, a country well integrated into the global economy, coincides with aggressive enforcement and the imposition of a record-setting penalty against BNP Paribas. Here, we provide a quick primer for private equity firms and their portfolio companies to help them understand key aspects of the new sanctions against Russia and the steps they can take to mitigate potential risks. More in-depth coverage of U.S. and E.U. sanctions on Russia can be found at The Sanctions Resource (www.debevoise.com/thesanctionsresource), a collection of Debevoise & Plimpton's sanctions-related Client Updates.

Sanctions Against Russia Are Complex and Expanding

Beginning in March 2014, the United States and the European Union have imposed progressively harsher sanctions on Russia in response to events in Ukraine. Both the United States and the European Union have attempted to tailor their sanctions regimes in a manner that recognizes Russia's interconnectedness with the global economy. This tailoring has created complexity, which presents its own set of compliance challenges for many firms.

Blocking Sanctions. The United States and European Union maintain "blocking" sanctions, which prohibit most business dealings by U.S. and E.U. companies and persons (including U.S. private equity firms and funds and their U.S. portfolio companies), and in some cases their affiliates, with a large number of Russian government officials, businessmen and companies.

Financing and Capital Markets Restrictions. The United States and European Union have also instituted so-called "sectoral" sanctions, targeting certain Russian financial, defense and energy companies. These sectoral sanctions restrict U.S. and E.U. companies and persons from providing long-term financing to, or dealing in new long-term debt instruments (including loans) of, designated companies and, in some cases, dealing in new equity of designated companies. For this purpose "long-term" debt is debt payable more than 30 days (or more than 90 days) in the future (depending on the company and the circumstances).

Oil-Related Restrictions. U.S. and E.U. companies and persons are also prohibited from providing many goods and services to support most Russian oil exploration or production projects.

U.S. Sanctions Can Apply to Non-U.S. Portfolio Companies

Private equity firms may not be aware that a non-U.S. portfolio company is also required to comply with U.S. sanctions if the private equity firm or fund is deemed to control the management of the portfolio company. In such cases, the private equity firm or fund could face liability for sanctions violations by the portfolio company. And while many U.S. private equity firms have in place sanctions compliance programs, their non-U.S. portfolio companies may not.

Risk Assessment Is Key

Private equity firms should monitor sanctions developments and conduct regular risk assessments with respect to their operations, both at the fund level and at their portfolio companies. Sanctions on Russia substantially increase compliance risks faced by U.S. and E.U. companies because, unlike many more "traditional" sanctions targets, Russian companies are frequent counterparties to U.S. and E.U. companies, both within Russia and in international financial markets.

Due Diligence Is More Important Than Ever

Private equity firms should conduct comprehensive sanctions-related due diligence when considering new investment opportunities or add-on acquisitions. Among other things, private equity firms should ensure that they understand the ownership structures of their counterparties. Under both U.S. and E.U. sanctions regimes, prohibitions and restrictions apply not only to listed Russian companies and persons but also, in many cases, to entities that may be owned or controlled by sanctioned persons. Know who you're dealing with!

Compliance Programs Mitigate Sanctions-Related Risks

In many cases, even an inadvertent violation of sanctions can result in significant penalties. However, regulators may give meaningful credit to firms that have in place good compliance programs, training and oversight. Firms should adopt risk-based sanctions compliance plans that provide appropriate controls for investor intake (*e.g.*, screening potential fund investors and co-investors against sanctions lists); encourage comprehensive sanctions-related due diligence on new investment opportunities pursued by the firm's funds; and require, where appropriate, portfolio companies to implement compliance programs as well.

Employees and Directors Can Be Liable

Employees and directors of private equity firms or their portfolio companies may be held liable in their personal capacities for their violations of sanctions laws. ■

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For e-mail updates on sanctions developments, please subscribe to the Debevoise & Plimpton LLP *Sanctions Alert*, a semi-monthly summary of developments in economic and trade sanctions. To subscribe, please e-mail sanctions@debevoise.com.

Alan V. Kartashkin
avkartashkin@debevoise.com

Matthew Howard Getz
mgetz@debevoise.com

Robert T. Dura
rdura@debevoise.com

The Shift in Litigation Risks When U.S. Companies Go Public

When a privately held company goes public, its litigation risks change dramatically. U.S. publicly traded companies face scrutiny from a broad audience – including state and federal regulators, shareholder advocates, the media, whistleblowers and plaintiffs' law firms – and with it, a risk of more frequent and potentially damaging litigation. And because the boards of public companies also face greater scrutiny and more substantial risk, they – and their audit committees in particular – are more likely to sponsor internal investigations or take other steps that, in turn, lead to even more regulatory scrutiny and/or litigation.

It's no surprise that the single biggest change in litigation risk in the transition from private to public is the potential exposure that comes with the company's new, and far more extensive, disclosure and compliance obligations. What may be less obvious is that the increased exposure can give rise to a broad range of additional types of litigation – not just disclosure-driven private securities fraud claims, but shareholder, derivative, employment, regulatory and even criminal claims, all based on essentially the same underlying facts, but posing different challenges for the company and its defense.

Litigation travels in packs, and a single securities class action suit may trigger not just a government inquiry, but a host of related suits, including claims naming senior executives and board members as defendants. In planning for the risks a company may face once public, its directors and management often find it useful to review a snapshot of the kinds of claims they could face, and anticipate how to respond if those claims arise.

Common Public Company Litigation Risks

In litigation arising from public company disclosures and decision-making, each set of plaintiffs has its own agenda, theories and constraints, but they almost always cluster around the same alleged misconduct and try to translate it into a viable theory of recovery within their particular context. Four kinds of actions are particularly likely to travel together: (1) private securities class actions; (2) government investigations or enforcement actions; (3) shareholder derivative actions; and (4) ERISA litigation. In all four, management's judgment and fiduciary duties on a material issue for the company are likely to be central to the action.

Private Securities Class Actions. The increased likelihood of private securities class action litigation arising from statements in the company's disclosures and SEC filings certainly remains the first source of additional risk, and a driver of much of the other litigation. The overwhelming majority of such actions allege fraud claims under Section 10(b) and Rule 10b-5 of the Securities Exchange Act, and virtually all of them include allegations of misrepresentations in financial documents. Complaints also frequently focus on forward-looking statements; accounting-related claims had for a period become less prevalent but have recently re-emerged and currently appear in about a fifth of the filed cases. Securities fraud claims arising under analogous state statutes – like New York's Martin Act – are also common. Although the number of securities class actions dipped below the historical average for a five-year stretch between 2008 and 2013 – due to a host of factors, including changes in the law – in recent years, litigation rates have been creeping back up toward their historical averages. Recent data and personal experience suggests that trend is likely to continue.

Government Investigations and Enforcement Actions. Government investigations and enforcement actions also are more common among publicly-traded companies – although as a general matter, litigation by private plaintiffs historically has far exceeded enforcement activity in this area. Not every securities class action is accompanied by an SEC investigation, but many are, and a subset of those may become the subject of a separately-filed SEC complaint. SEC actions commonly target the company, but the SEC recently has demonstrated a greater willingness to bring actions against senior executives and directors as well. The SEC's broad investigative and enforcement power, and its ability to coordinate with and call in other government agencies and enforcement officials (and in particular to coordinate with DOJ investigations), mean that every company must take an investigation seriously and respond with care. Enhanced judicial scrutiny of settlements with the SEC – both as to financial terms and as to admissions – has only served to raise the stakes. And, although the SEC may be the primary enforcer of the securities laws, the DOJ and other agencies may also initiate action, both civil and criminal.

Shareholder Derivative Litigation. Public companies frequently face shareholder derivative actions. Plaintiffs and their counsel often file multiple, competing derivative cases at or around the time of a securities class action filing – although they may not wait for a securities fraud claim to be filed, and may target business decisions that do not ultimately trigger fraud claims. Shareholder derivative claims focus on alleged breaches of common law duties and obligations by the company's managers and directors and are unique in this group because they must be brought on behalf of the company and seek to recover for its benefit – not on behalf or for the direct benefit of the individual shareholders. Derivative actions frequently

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trigger the creation of a committee of independent board members to oversee an internal investigation of the allegations.

Companies may incorrectly assume that any derivative action will be brought in the state of incorporation, whose law governs and whose courts are most familiar with those laws. That was once the case, but the trend has shifted notably in the direction of "out-of-state" suits. A company may be sued in any one of a number of forums, including the jurisdiction in which its headquarters is located, and the jurisdiction where it principally does business, as well as the state where it is incorporated. Now, even Delaware corporations are frequently sued in other states, often in multiple states at once. As a result of this trend, companies have increasingly been forced to defend themselves in parallel actions in state courts that are less familiar with the law governing the claims and defenses.

ERISA Class Actions. ERISA class actions are quite common when a company's stock drops – there, the plaintiffs purport to act on behalf of company employees and focus on the impact of the stock drop, and the conduct alleged to have caused it, for employees and their retirement plans, rather than for public stockholders. ERISA plaintiffs may rely on many of the same facts as the securities plaintiffs, but their allegations are for breach of the duties that are imposed on fiduciaries of an employee retirement plan under the ERISA statute, rather than violations of the securities laws. Because the defendants in an ERISA action should be the alleged fiduciaries of the plan, they may include individuals or entities who are not named in the securities actions (and may exclude some who are); in addition, the allegations may focus on disclosures and communications to plan participants in addition to those made to the market more generally.

What to Do?

In the face of these risks, what's a company to do?

First, as noted, because so many of the litigation risks particular to public companies arise from and relate to SEC obligations, the steps that a company may take to ensure proper, fully compliant, carefully vetted filings and disclosures are the same steps that will help protect it against litigation down the road. Strong in-house securities and compliance teams can be among the first, and best, defense lawyers in these cases. Even so, plaintiffs – especially with the benefit of hindsight – may find fault and attempt to bring a claim.

If a company does face litigation or investigation arising from its disclosures, one of the best things it can do is view the actions holistically, and respond with a tightly coordinated global defense. While each line of attack – class action, derivative, ERISA and government – will involve its own set of issues and area of expertise, having a clear view of the entire chess board and understanding how the pieces move together, and in competition, can be invaluable.

A coordinated approach recognizes that although the substantive law and procedural posture of each action is different, they arise from the same core facts and have cross-cutting issues and implications. An effective defense holds in focus both the differences and the intersections, and approaches the actions in a coordinated way to minimize exposure across the entire portfolio of litigation. It also takes into account and balances the potentially different perspectives and interests of shareholders, management and the board in dealing with the issues giving rise to the litigation or investigation. That isn't easy. It requires attention to detail and breadth of knowledge across all of the implicated subspecialties, a coherent end-game and the ability to implement it. But, when it's effective, a global approach can drastically reduce the burden on the company – both in terms of defense costs and inconvenience, and ultimate liability and exposure. ■

Mark P. Goodman
mpgoodman@debevoise.com

Shannon R. Selden
srseldon@debevoise.com

"While each line of attack … will involve its own set of issues and area of expertise, having a clear view of the entire chess board and understanding how the pieces move together, and in competition, can be invaluable."

Differing Approaches to the Documentation Risk in European and U.S. Acquisition Financings

Buyers worldwide negotiating acquisition financing commitment letters seek to ensure that conditions to debt funding are not materially more expansive than the closing conditions in the related acquisition agreement. Stated otherwise, the goal of every financing lawyer is to ensure that there is no, or only a limited, gap in conditionality between the financing commitments supporting a given acquisition and the corresponding acquisition agreement. A potential gap in conditionality could result from the need to turn acquisition financing commitment letters into fully developed financing agreements. This gap is commonly referred to as the documentation risk. The documentation risk is addressed differently in acquisition financings in the United States and in Europe.

In U.S. acquisition financings, typically a negotiated term sheet is attached to a commitment letter when the acquisition agreement is signed, but definitive loan documents are only negotiated at a later stage. In European acquisition financings, by comparison, typically definitive loan documents (short or long form) are signed, or in an agreed form, at the commitment letter stage. The market is not yet settled, however, on which of these approaches to follow when a European acquisition is financed in the U.S. financing markets – particularly when a sponsor cannot walk away from the underlying M&A transaction by paying a reverse termination fee.

> **"In the United States… there is no analogous 'certain funds' concept to shape market participants' views of financing contingencies."**

Different Approaches to Financing Conditions

The European Approach. A bit of background is necessary to set the stage for this discussion. The European approach to acquisition financing commitments derives in part from the requirement of the English Takeover Code that a bidder have "certain funds" when it makes an offer for the shares of a public company or a company otherwise subject to the Takeover Code. Availability of "certain funds" generally means that the committed debt providers will be required to fund an acquisition unless a change of control or certain major defaults occur with respect to the acquisition vehicle(s) (but not with respect to the target or its subsidiaries) or it becomes illegal for such debt providers to fund. In England and in the rest of Europe, it also became customary for sellers of companies that are not subject to the Takeover Code to require that bidders demonstrate availability of certain funds.

The U.S. Approach. In the United States, however, there was no analogous "certain funds" concept to shape market participants' views of financing contingencies. Tender offers for public companies can be conditioned on the bidder's ability to obtain financing. Also, for many years prior to the financial crisis, private equity firms were able to include financing conditions in acquisition agreements for leveraged buy-outs of private companies. In the years just before 2008, as competition for deals reached a fever pitch, private equity firms agreed to eliminate the financing conditions in acquisition agreements but in exchange sought, and generally obtained, reverse termination fee provisions to limit their exposure. Some of these reverse termination fees were structured as a blanket right of the buyer to walk from a deal on payment of a fairly low fee (3-4% of equity value). However, after the financial crisis, sellers wanted greater certainty of closing and pushed for the right (1) to specifically enforce the buyer's obligation to draw the financing and close if in fact the financing was available and/or (2) to be paid a higher fee (or even full damages) in the event the financing would have been available and the buyer failed to close. While all these variants persist in the U.S. market, the absence of a financing condition in acquisition agreements and the ability of the seller to specifically enforce (if financing is available on the contemplated terms), coupled with a single tier reverse termination fee (if financing is not so available), seem to have become most prevalent.

Different Approaches to Addressing Documentation Risk

The European Approach. To achieve "certain funds," the practice under financing commitments governed by English law is to negotiate, and sometimes execute, at the commitment letter stage either a complete set of interim loan documents (short-term financing arrangements that, if drawn, would expose the borrower to a great deal of risk given their short-term nature) or full form loan documents, including the principal related transaction documents (such as the security and intercreditor arrangements, if applicable). (If interim loan documents are prepared, although the parties typically do not expect the interim financing to be funded, the banks are committed to do so if definitive documentation is not finalized by closing.) In either case, there is no risk that the financing would fail to close because the parties do not reach agreement on the terms of the financing documentation.

The U.S. Approach. In the Unites States, acquisition financing commitments typically

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Post-Crisis Restructurings and Regulation of E.U. Insurers and Banks Create Investment Opportunities for Private Equity Investors

At a roundtable hosted in late September in London by Debevoise & Plimpton, investment bankers, private equity deal professionals and representatives of other financial institutions assembled to discuss the investment opportunities resulting from the post-financial crisis restructuring of insurers and banks in the European Union. The principal speakers included: Jacques Aigrain, Chairman of LCH Group and Senior Adviser of Warburg Pincus; Eric Dinallo, Debevoise partner and former Superintendent of Insurance for the State of New York; Jeremy Hill, Debevoise partner and co-chair of the firm's Financial Institutions Group; Gregory Lyons, Debevoise partner and chair of the firm's Global M&A Banking Practice; and Richard Ward, Debevoise partner and chair of the firm's U.K. tax practice.

The roundtable participants first discussed the post-2008 investment opportunities for private equity and strategic acquirers; then turned to the specific regulatory and market issues driving these opportunities; and finally addressed the key structuring considerations for deal professionals considering a potential investment in an E.U. insurer or bank, or in its assets.

The Evolving Opportunity

The investment bankers and deal professionals participating in the Debevoise roundtable identified three phases of crisis/post-crisis financial institution M&A activity. Phase 1, largely at the outset of the financial crisis, was characterized by nationalizations and recapitalizations. Phase 2, in the early-to-mid post-crisis period, saw fire sales of distressed assets to enable institutions to weather the crisis. In Phase 3, which is now beginning in earnest, banks, insurers and other financial services players are evaluating the new regulatory landscape that is coming into focus and the associated costs; identifying their core and non-core activities based on a variety of criteria; and engaging in strategic sales and other transactions accordingly.

Private equity firms and other non-financial services players will have the opportunity to play a prominent role in Phase 3, whether acquiring divested assets; purchasing business lines that were de-emphasized or terminated by financial institutions as a result of prohibitions and costs imposed by new regulation or due to inadequate returns given the new constraints; or investing in or with strategic acquirers.

The financial services industry in the E.U., particularly in the Eurozone, is experiencing a major phase of transition and regulatory change. For example, from November 4, 2014, after the latest stress test results are released, the European Central Bank (the ECB) will be the regulator of the 120 largest banks in the Eurozone (and other member states that opt in), representing 85% of banking assets, and will be responsible for the Single Supervisory Mechanism (SSM) within the Eurozone. In addition to the SSM, the Single Resolution Mechanism (SRM) – a single set of rules across the Eurozone to allow for the timely and effective resolution of cross-border and domestic banks – is expected to be operational from January 1, 2016. Additional regulatory initiatives, such as the Solvency II framework for insurers, which is due to come into force in January 2016, and the Basel III framework for banks, which will continue to phase in through 2019 will increase investment opportunities for private equity firms and other less regulated entities.

The above and other factors driving restructurings of insurers and banks in the E.U. are discussed below. Notably, while insurers and banks have distinct regulatory and business concerns, in many regulatory areas (*e.g.*, new capital requirements and resolution planning) the rules, and the stresses they create, are or are anticipated to be similar for both. Experience and expertise with respect to both the banking and insurance regulatory frameworks will best position banks, insurers and private equity firm acquirers to succeed as Phase 3 plays out over the next several years.

Principal Drivers of E.U. Insurance Restructuring

Two key factors have driven restructuring in the insurance sector over the past several years, specifically: (1) state forced sales, some of which have taken the form of public share offerings (ING is a good example of this); and (2) the expected implementation of Solvency II in 2016, which will include more onerous capital, financial modelling and supervisory requirements.

In addition to these two factors, developing and increasingly onerous new global capital standards, along with coming resolution plans and other regulatory initiatives discussed below, are expected to drive additional restructurings. These new drivers provide substantial incentives for insurers to consider carefully which assets/business lines are strategic, and which they should dispose of to increase profitability and/or reduce capital and regulatory complexity.

Insurers in the E.U. are increasingly facing the question of whether to keep smaller subsidiaries burdened by significant regulatory requirements or to sell those

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follow the "SunGard" approach to conditionality, named by reference to the first transaction where it was used. In a SunGard-style financing commitment, it is neither typical nor customary to negotiate the documentation for the credit facilities at the commitment letter stage. Instead, the parties typically agree that the financing will be on the terms set forth in a detailed term sheet attached to the commitment letter and that gaps in the final documentation (*i.e.*, terms not set forth in the term sheet) will be filled by reference to an identified documentation precedent (typically the credit documentation for a recent similar transaction closed by the sponsor). While the execution and delivery of the documentation for the credit facility (consistent with the commitment letter) is a condition precedent, properly negotiated commitment letters do not require as a closing condition that the documentation for the credit facility be negotiated (or be in form and substance satisfactory to the lenders) and only require execution by the borrower so that lenders cannot argue that their own failure to execute the credit facility documentation amounts to the non-satisfaction of a closing condition.

An Open Question. Still, the question remains: When a European acquisition is financed under financing commitments governed by New York law, does the need before the closing to convert the term sheet into a full credit agreement create an unacceptable execution risk, given that the sponsor does not have the ability to walk away from the transaction by paying a reverse termination fee?

To answer this question, we will consider the enforceability of SunGard-style commitments and discuss whether the remedy of specific performance is more likely to be available under the "certain funds" approach than under the SunGard approach. Finally, we will discuss practical considerations that may well dictate where the market is likely to land.

Are SunGard-Style Commitments Enforceable?

SunGard commitment letters have been tested during the financial crisis, most notably in the *Clear Channel* litigation in 2008, a case brought by Bain Capital Partners, LLC and Thomas H. Lee Partners L.P. against various banks to enforce a $22 billion commitment letter governed by New York law. It is generally accepted that, short of a problem with the solvency of the target (which would typically result in the failure of a condition precedent to be satisfied) or the failure to satisfy other closing conditions, arrangers have not been able to walk away from SunGard-style commitment letters.

A 2010 decision from the Supreme Court of New York, *Amcan Holdings, Inc. v. Canadian Imperial Bank of Commerce*, created some tension in the marketplace. In that case, the Court ruled that an executed term sheet was not a binding agreement to provide financing. The Court, based on an analysis of the facts of the case, determined that the parties did not intend the term sheet at stake to be a binding agreement and the decision is generally viewed in the marketplace as simply stating that enforceability of a commitment to lend hinges upon the parties' intent.

While an agreement to agree is not enforceable under New York law, market consensus is that a properly drafted SunGard-style commitment letter is not merely an agreement to agree. Furthermore, since the 2008 market meltdown and the *Amcan* decision, SunGard commitment letters have evolved and typically (1) identify with specificity a documentation precedent and (2) include language to the effect that the commitment letter is a binding and enforceable agreement with respect to the subject matter contained therein (including an agreement to negotiate in good faith the facilities documentation in a manner consistent with the commitment letter). In the United States, this approach is generally viewed as providing sufficient certainty.

While reverse termination fees cap the financial sponsor's (private equity firm's) exposure, such fees are quite substantial, sponsors are understandably loath to pay them, and we do not believe that, in general, sponsors negotiate reverse termination fees believing that SunGard-style financing commitments may not be enforceable. Nor do sponsors feel that agreeing upon, or signing, an interim set of loan documents would provide needed additional comfort at the commitment letter stage.

Can Financing Commitments be Specifically Enforced?

In general, under New York law, specific performance is not available if money damages are an adequate remedy. The same principle also applies under English law.

There are two different specific performance issues in the context of acquisition financings. The first is the buyer's right to specifically enforce the commitments it obtained from the lenders to finance the acquisition. The second is the seller's right to specifically enforce the acquisition agreement by compelling the buyer to draw down the financing and consummate the acquisition. In the United States, a well-drafted acquisition agreement would normally give the seller a specific performance remedy vis-à-vis the buyer. The seller relies to a considerable extent upon that remedy, for situations in

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Private Equity in Africa: An Inside View

Africa is among the most talked about parts of the world for private equity firms looking to invest in emerging markets. Despite the challenges to investing in the various regions within Africa, many economic indicators are pointing in the right direction and some traditional market barriers are being broken down. The floodgates aren't fully open, perhaps, but they have certainly been opened more than a crack in some African countries.

Against this backdrop, Geoff Burgess and Ben Collins-Wood from Debevoise's London office spoke with a number of key market insiders, asking them their views on the private equity trends playing out on the continent. Our panel of experts, for whose input we are most grateful, consisted of:

- Mark Kenderdine-Davies, General Counsel and Company Secretary, and Jeremy Cleaver, Portfolio Director – Africa Funds, both of CDC Group (CDC).
- Michelle Kathryn Essomé, Chief Executive Officer, of the African Private Equity and Venture Capital Association (AVCA).
- J-P Fourie, Investment Relations – Lereko Metier Fund Managers (Metier).
- Theophilus I Emuwa, Partner, Nigerian law firm ÆLEX.
- Karim Anjarwalla, Managing Partner, and Rosa Nduati-Mutero, Partner, both of Kenyan law firm Anjarwalla & Khanna (A&K).

An edited Q&A with our panel of experts follows.

Question:

What are African private equity funds doing (or what must they do) to attract investors (LPs) from outside Africa?

Answers:

Mark Kenderdine-Davies and Jeremy Cleaver, CDC: "Local general partners need to continue to change the perception that investing in Africa involves a high degree of risk relative to other parts of the world. The reality is that there have been strong improvements in democracy and in the legal and regulatory environments across Africa, which, combined with a young and growing middle-class population and structural improvements in infrastructure and related industries, have created an 'enabling environment' with an attractive private equity profile."

Michelle Kathryn Essomé, AVCA: "Domestic private equity funds are increasingly attracting global LP investment. Optimism abounds for the asset class, due in part to Africa's resilience to the global economic growth slow-down, attractive demographics, and the many economic, political and social reforms that have taken place in a number of African nations in recent years. Interestingly, our most recent global LP survey, *The search for returns: Investor views on Private Equity in Africa*, showed that regional funds are the preferred route to accessing African private equity in the near-term, and that fund of funds are the preferred route of first-time investors in Africa. Development finance institutions (DFIs) continue to actively support domestic private equity funds that source local deals and promote real development impact."

Question:

What is the current dynamic between private equity firms and African pension plans and other African institutions (LPs) seeking to invest in private equity?

Answers:

J-P Fourie, Metier: "Given that listed equity markets in many regions in Africa have been buoyant, there is a heightened awareness of portfolio diversification. Local LPs are looking to further understand private equity as an asset class as the industry matures. Additionally, very often private equity investments offer environmental, societal and governmental (ESG) factors that are not easily accessible for investors via listed or other structures. I would argue the DFI involvement in African private equity as LPs and co-investors has driven ESG extensively, and Africa has the advantage that this is built into the way of doing business and not an additional item to comply with."

Theophilus I Emuwa, ÆLEX: "Many African pension plans are flush with capital to invest. Recently, governments have begun allowing a percentage of this capital to be invested in private equity. However, there are still significant barriers for private equity funds to be able to attract pension plan investors. First, many local pension fund administrators are new to the private equity industry and lack knowledge of private equity and relationships with those in private equity. Consequently, they have been shy in putting money in private equity. Those that have put their money into private equity have often chosen the wrong partners. Second, regulatory barriers still exist. For example, Nigerian pension funds can only invest with Nigerian general partners."

Question:

What are the main barriers to entry for international private equity looking to do deals in Africa?

Answers:

TE, ÆLEX: "It is important to find and foster relationships with the right local partners. Building relationships and developing trust with the right partners will open local doors into countries and industries."

MK-D and JC, CDC: "One of the biggest barriers to entry is finding the right

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subsidiaries. In the U.K., insurance business can be transferred as provided in Part VII of the Financial Services and Markets Act 2000; this is a Court-sanctioned transfer of the assets and liabilities of a particular book of business to a new owner. Similar arrangements exist in most other E.U. member states in respect of both insurance and banking business transfers.

New Global Capital and Regulatory Requirements – G-SII Designation. Potential additional drivers of restructurings include the Financial Stability Board's (the FSB's) designation of Globally Systemically Important Insurers (G-SIIs). In July 2013 the FSB designated nine insurers as G-SIIs, of which five were E.U. domiciled. G-SIIs (like the bank analogue, Globally Systemically Important Banks, or G-SIBs, first designated in 2011) are the insurers determined by the FSB to be the internationally active insurance groups (IAIGs) most critical to a healthy global economy. The FSB will conduct its first annual update of the G-SII list in November 2014, and may expand this list further to include several global re-insurers. As discussed below, designation as a G-SII involves the imposition of additional regulation, oversight and costs, which could lead those insurers to restructure.

New Global Capital and Regulatory Requirements – Basic Capital Framework. Many observers expect a new, consolidated capital framework (the Basic Capital Requirements) to be finalized for G-SIIs at the Brisbane Summit in November 2014, with capital surcharges (again, similar to G-SIBs) being imposed upon G-SIIs in 2015. Debevoise explained how detailed analysis it had performed of the Basic Capital Requirements shows that many elements of that framework are similar to the Basel III capital framework for banks. U.S. insurers designated as non-bank Systemically Important Financial Institutions (or SIFIs) (and thus potentially subject to the U.S. bank capital framework) have stated strongly that these bank like rules are not compatible with their industry.

New Global Capital and Regulatory Requirements – ComFrame. For large IAIGs not designated as G-SIIs, the International Association of Insurance Supervisors (IAIS), a multi-lateral regulatory body for the insurance industry, is expected to discuss at its late October 2014 meeting in Amsterdam, and to finalize in 2016, a common supervisory framework (ComFrame). While not as burdensome as the rules applicable to G-SIIs, ComFrame is nonetheless expected to have a significant impact on affected insurers.

Required Recovery and Resolution Plans. In addition to the capital and supervisory rules mentioned above, FSB standards contemplate that G-SIIs will complete recovery and resolution plans. Such plans would detail how G-SIIs should be wound up in times of severe stress so as to minimize damage to the economy. Debevoise participants in the roundtable discussed how they assisted a U.S. non-bank SIFI to complete its first recovery and resolution plan this year. The several thousand-page plan (also based in large part on banking law principles) involved significant fact finding, strategic thinking to reduce complexity and extensive discussions with regulators.

Resolution planning is on the agenda for the IAIS late October meetings in Amsterdam. Debevoise will be hosting a dinner there to discuss resolution planning with G-SII and IAIG representatives.

For both G-SIIs and IAIGs, all these developing and increasingly onerous global capital standards and the coming resolution plans and other regulatory initiatives are expected to drive additional E.U. restructurings of insurers, leading to increased investment opportunities for private equity and other non-financial services investors.

Principal Drivers of E.U. Bank Restructuring

Global banks have been seeking to adapt to increasing regulatory burdens for several years longer than their insurance counterparts, and thus the response of the banks provides a window not only onto the evolving banking landscape, but also useful insights for insurance dealmakers seeking to predict future trends. According to a 2013 survey of large banks conducted by Ernst & Young and the Institute of International Finance, 81% of bank respondents are evaluating their assets mix and 44% are considering exiting business lines. Subsequent surveys and studies suggest that this trend will continue. For example, a 2014 impact study by European banking regulators stated that the banking industry shortfall to Basel III capital ratio requirements could be as high as €36.3 billion. Similarly, liquidity rules could result in a shortfall of high-quality liquid assets for banks as high as €262 billion. According to 64% of large bank respondents to this 2014 survey, together these rules will have a "significant" effect on the cost of doing business.

Sixteen of the 29 G-SIBs have their primary banking operations in the E.U. Like G-SIIs, these banking institutions are subject to the most burdensome capital, liquidity and other regulatory burdens. As a result, these 16 E.U. banks are on track for €100 billion in asset sales this year, according to a report in the Financial Times, which also noted that €2.4 trillion of non-core assets remain on their balance sheets.

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Private Equity Investments in Mining: Drilling for Deal Opportunities

The speakers at a seminar hosted by Debevoise & Plimpton in New York this summer discussed both opportunities and challenges facing private equity firms considering investments in the mining sector. The seminar speakers included: Maurizio Levi-Minzi, a partner in Debevoise's Mining Group; Hugo Dryland, Executive Vice Chairman and Global Sector Head of Metals and Mining at N M Rothschild & Sons; Erica Berthou, a partner in Debevoise's Investment Management Group; and Stuart Hammer, a member of the firm's Environmental Practice Group.

The speakers agreed that the mining industry as a whole has weakened considerably, as operating costs have risen substantially and commodity prices have declined and are either entering or recovering from a cyclical trough. Rather than deploying capital, many mining companies are facing pressure to return capital to their shareholders, and a number of mining companies have been disposing of non-core assets. This market environment provides potential opportunities and challenges for private equity firms considering investing in the mining sector. More details of Mr. Dryland's presentation at the Debevoise seminar and the subsequent roundtable discussion are summarized below.

Opportunities in the Mining Sector

As a result of recent subpar investments by strategic investors and a corresponding reluctance among those investors to get involved in further M&A activity, private equity investors who can deal with the cyclical nature of these investments are presented with an opportunity to become engaged in the mining sector. Successful investments by private equity funds have generally fallen into one of three categories, representing options along the mining supply chain:

- Upstream investments in mining operations, which often focus on small and early stage ventures. These investments are subject to significant volatility in commodity prices.
- Downstream investments, such as smelters, refiners or specialty metals, which carry significantly less commodity price volatility than investments in mining operations.
- Structured investments, such as creative financing structures, often including royalties and streams as well as convertible debt and/or equity.

Mr. Dryland noted three key considerations for private equity investments in the mining sector: the commodity, the asset and the management team. With volatile and highly cyclical prices for commodities, timing of an investment is critical. In selecting an asset, it is essential for the investor to understand the risk (with substantially less risk in mines that are already in production as opposed to development projects), and to be conscious of social and political risks, which may be greater than in many other types of investments. Finally, a strong management team can extract value from a difficult mining operation.

Mr. Dryland also noted three models for future success by private equity firms seeking to invest in the mining sector:

- Providing capital for acquisitions (or development/expansion projects) for companies in need of financing. This requires clever structuring and possibly a willingness to stay invested for a longer time horizon than is customary for private equity investors.
- Supporting a management team to create a new mining company.
- Investing in special situations, such as loan to own, last money in, rescue financing and cost overrun funding, among others.

Ms. Berthou noted that the typical long-term investment horizon associated with mining could be particularly challenging for private equity investors, who look to operate a company's assets and exit in accordance with a predetermined fund term. The panelists commented that so long as the investment is made during a favorable period in the cycle, for many mining transactions investment early in a standard fund's ten year term leaves sufficient time to create value prior to exit.

Partnerships between private equity investors and strategic investors provide another opportunity for private equity involvement in the mining sector. A strategic investor will often combine financing from various sources, but will likely still face a gap in financing; a private equity investor can enter the transaction and structure an investment to fill that gap. These types of partnerships are not without issues, however. Strategic investors tend to be skeptical of private equity investors and may be unable to accommodate their higher return expectations or may prefer to incur a higher cost of capital rather than to share ownership of assets. For these partnerships to work, both sides will need to adjust their objectives and expectations.

Unique Challenges in the Mining Sector

The opportunities in the mining sector are not without challenges, and many are unique

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> "There are two principal difficulties inherent in the mining sector that private equity investors must contend with: cost of capital and volatility...."

Post-Crisis Restructurings and Regulation of E.U. Insurers (cont. from page 12)

Particularly given that ECB stress test results are due at the end of October 2014, and that the ECB has declared that it will enforce stricter prudential oversight, these banks can be expected to provide substantial deal opportunities. Rules still to come fully into force, such as the Net Stable Funding Ratio, the Volcker Rule and the regulations enacting the recommendations in the Liikanen and Vickers reports, in the E.U. and U.K., respectively, as well as pending resolution plans (which already have had an impact on U.S. banks), will further accelerate the necessary re-positioning of these banks. The roundtable participants discussed how private equity firms and other non-financial services sector investors, which are outside the scope of these regulations and additional burdens, can benefit substantially from these developments.

Acquisition Considerations

Finally the conversation turned to the best way to approach acquisitions of these assets and operations by private equity firms or other acquirers.

Non-Tax Structuring Considerations. A potential buyer of insurers or banks or their assets will have to ensure, among other things, that:

1. the relevant regulator is satisfied that policyholder/depositor interests will not be prejudiced as a result of the sale (for example, particularly in the case of private equity and other potential investment firms, the relevant regulator may require the structure of the target board to be altered to ensure that policyholder/depositor interests are adequately protected);
2. there is a regulated entity in a suitable jurisdiction that will take over the carrying on of the regulated activity in question (the establishment of a branch or a subsidiary and E.U. passporting rules will need to be considered); and
3. in the case of sales of state-owned assets, limitations on due diligence, representations, warranties and indemnities must be duly considered and reflected, as appropriate, in the price and deal documents.

A financial buyer should also be mindful of the requirements of the E.U. Acquisitions Directive, which applies to transactions involving banks and insurers whenever 10% or more of the shares or voting power of the regulated entity or its parent is proposed to be acquired. The Acquisitions Directive imposes extensive disclosure obligations on the potential acquirer, which include disclosure of the owners of the acquirer. In the private investment funds context, this may involve looking at the fund's general partner and anyone who exercises significant influence over the general partner, and even could involve limited partners. The buyer will also need to satisfy the relevant regulator that it is adequately capitalised to provide sufficient policyholder/depositor protection on an on-going basis.

Tax Structuring Considerations. Tax analysis should focus on tax optimisation for the acquisition itself, the taxation of the ongoing operations of the business to be acquired (including the distribution of profits) and the tax treatment of any exit (whether partial or complete). This analysis is complex and fact-specific in a cross-border context. In the E.U., dividends can flow up holding company structures without tax liabilities across multiple jurisdictions. Holding companies are conventionally incorporated in Luxembourg or Ireland although other jurisdictions (including the U.K.) are also being used, all of which have participation exemption regimes for dividends and capital gains (the U.K. is also unusual in having no withholding tax under domestic law for dividends). Luxembourg is still largely the preferred jurisdiction for incorporating holding companies, given its tax authorities' flexible approach to rulings.

From a tax perspective, it is often easier to control profits within a group via a subsidiary rather than a branch structure, which may be somewhat at odds with the regulatory preference for operations within the E.U. (although a branch structure may be less disadvantageous where the local businesses operate on a standalone basis). Transaction taxes in the context of insurance restructuring may focus on VAT issues, because the incidence of VAT on any business sale may give rise to significant tax leakage: this may force any restructuring to take the form of reinsurance (rather than an asset sale).

Conclusion

The roundtable discussion concluded with an interactive discussion between private equity firms, investment banks and the other participants about the foregoing and with the general consensus that this is a time of potentially significant opportunities for private equity and other investors in the insurance and banking sectors which merit careful analysis and evaluation. ■

Jeremy G. Hill
jhill@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

Edite Ligere
eligere@debevoise.com

GUEST COLUMN

New Legislation Modernizes the Law Governing Cayman Islands Funds

After much anticipation, The Exempted Limited Partnership Law, 2014 of the Cayman Islands (the New ELP Law) took effect in July 2014. Cayman Islands private equity funds are typically formed as exempted limited partnerships (ELPs) and, as such, are subject to the New ELP Law. The New ELP Law substantially modernizes the law applicable to ELPs and, importantly, substantially harmonizes Cayman Islands law with the current equivalent Delaware statute on which the previous ELP Law was originally based.

Among other things, the New ELP Law: provides greater protections for advisory committee members; clarifies that limited partners of an ELP owe no fiduciary duty to the other parties; permits the parties to modify the fiduciary duty of the general partner of an ELP; clarifies that forfeiture provisions with respect to the default of a limited partner are enforceable; limits the statutory right of the ELP to claw back distributions previously made to the limited partners; and simplifies signing and other mechanics for closing a Cayman fund and for maintaining its register.

The New ELP Law is the product of several years of consultation among practitioners in the Cayman Islands, the Cayman Islands Government and U.S. and other onshore practitioners. A key goal of the New ELP Law was to present the market with a cutting edge piece of legislation responsive to both current market needs and market practice. The key changes introduced by the New ELP Law are described below.

Extension of Limited Liability Safe Harbors

The New ELP Law extends the existing Cayman safe harbor provisions to confirm that acting as a member of an advisory committee will not compromise the limited liability of the appointing limited partner.

Advisory Committee Members

The New ELP Law clarifies that, subject to the provisions of the partnership agreement, advisory committee members do not owe fiduciary duties to the ELP or any partner.

In addition, the New ELP Law provides a statutory basis for advisory committee members to enforce any indemnification and exculpation provisions intended for their benefit in the partnership agreement for the ELP, even though they are not parties to the partnership agreement. This provision was intended to address the lack, until recently, of third-party beneficiary rights under Cayman Islands Law. It should be noted that the Contracts (Rights of Third Parties) Law, 2014 was enacted in the Cayman Islands in May 2014. This new third-party beneficiary legislation gives contracting parties that wish to opt in the ability to grant to persons who are not a party to a contract the ability to enforce rights that have been conferred on them under the terms of the contract.

The ability to confer third-party rights on members of advisory committees eliminates the need for separate indemnity agreements or deed polls. One less piece of paper to sign on closing is always embraced.

Fiduciary Duties of Limited Partners

The New ELP Law confirms that, subject to any express terms of an ELP's partnership agreement to the contrary, a limited partner does not owe any fiduciary duty to the ELP or any other partner.

General Partner's Fiduciary Duty

Previously, a general partner of a Cayman Islands private equity fund structured as an ELP had to act at all times in good faith in the interests of the ELP. Under the New ELP Law, in line with Delaware law, the general partner of an ELP may act in the interests of (or take into account the interests of) a party other than the ELP, including its own interests, provided that (1) the partnership agreement expressly permits the general partner to take into account such other interests and (2) the general partner acts in good faith. This provision reflects the reality that there will be circumstances, such as managing conflicts of interest, where it may be appropriate for a general partner to take into account interests other than those of the ELP.

Fund Financings

The New ELP Law simplifies borrowing at the fund level by, among other things, confirming that the property of an ELP includes the right to make capital calls and receive the proceeds thereof. In addition, the procedure to be followed by a secured creditor to establish the priority of its security interest when taking security over the interest of a limited partner in the ELP has been simplified. These changes should assist in the smooth execution of financing transactions for Cayman Islands private equity funds.

Statutory Clawback

Similar to the Delaware statute, the New ELP Law now includes an "actual knowledge" qualifier to the previous

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which financing on the contemplated terms is available, and relies upon the reverse termination fee as the sole remedy when financing on such terms is not available. That said, the enforceability of a remedy of specific performance against the buyer only gets the seller across the finish line if, in turn, the buyer is able to obtain the committed financing. Hence, the crux of the issue is the ability of the buyer to specifically enforce its loan commitments.

In the *Clear Channel* litigation, the argument was made that, under New York law, specific performance is not available as a matter of law for an agreement to lend money (with the exception of a line of cases relating to real estate purchases). The banks argued that alternative financing, albeit on more expensive terms, was available and, as a result, money damages were adequate compensation for the difference. The question was not ultimately resolved, because the *Clear Channel* case was settled – although not before the Supreme Court of New York dismissed a motion for summary judgment noting that the availability of specific performance raised triable issues.

Arguments similar to those made by the banks in the *Clear Channel* litigation could be made against the availability of specific performance as a remedy under English law, even if an interim loan agreement is signed.

On balance, we do not think that the ability to obtain specific performance to fund a committed financing – even one where loan documents have been drafted or even executed – would be very different under a New York law governed SunGard-style commitment letter and an English law interim loan agreement. However, as outlined below, there is a residual risk with the SunGard approach.

Practical Considerations

While market practice in the U.S. favors the SunGard approach and there is market consensus that this approach provides sufficient certainty with respect to the debt financing, turning a SunGard-style term sheet into a credit agreement can result in friction and tense negotiations. In the *Clear Channel* litigation, the banks argued that they could not be forced to fund because the parties has failed to reach agreement on approximately 40 open business issues on the credit agreement for the senior secured facilities (including, as an example, with respect to the ability to refinance senior notes coming due inside the maturity of the senior secured facilities and with respect to the cushion to the financial covenant) and approximately 25 open baskets, ratios or exceptions to important negative covenants. Whether the parties were engaged in tough negotiations or the banks were trying to run out the clock and cause the merger to collapse (as the private equity firms argued), *Clear Channel* illustrates the residual execution risk inherent in a SunGard-style commitment. At least from a practical perspective, failure to agree on definitive documentation could hold up, or complicate, the process.

While the European approach of negotiating an interim loan agreement and form of security documentation eliminates the execution risk discussed above, it also significantly increases costs at the bid stage for the buyer, and can be burdensome where the acquisition vehicles are organized in multiple jurisdictions. In contested auctions, the seller will likely dictate the process; and where other bidders are following (or expected to follow) the certain funds approach to the documentation process, a bidder may need to do the same in order for its financing not to be viewed as more conditional. That said, retaining SunGard-style documentary conditions could prove beneficial to both buyers and sellers: buyers could reduce costs and sellers could potentially attract more buyers in the sale process.

Conclusion

Where the market will land on the documentary condition when a European acquisition is financed in the U.S. loan market is likely to come down to a cost-benefit analysis. Are the additional expenses resulting from the preparation of an interim loan agreement (and the related documentation) outweighed by the benefit of eliminating the residual documentation risk inherent in the SunGard approach?

U.S. private equity firms working on transactions governed by New York law typically believe the answer is no (although unlike in European transactions, their exposure relating to a failure to close because of a failure to obtain financing is capped). Furthermore, in the United States sellers have not been in a position to drive the market towards the certain funds approach. In Europe, sellers have often required the buyer's financing sources to follow the certain funds approach, even for transactions expected to be financed in the U.S. loan market. As the number of European transactions financed with cross-border loans increases, it will be interesting to see if European sellers will become more open to accepting the SunGard approach. ■

Alan J. Davies
ajdavies@debevoise.com

Pierre Maugüé
pmaugue@debevoise.com

Delaware Provides Going Private Roadmap; Wrong Turns Still Possible

In March 2014, the Delaware Supreme Court affirmed a 2013 Court of Chancery decision holding that a going private merger with a controlling stockholder will be subject to the business judgment rule, rather than the far more stringent test of entire fairness, if the transaction is conditioned from its inception on (1) approval by an independent and fully empowered special committee of directors and (2) the uncoerced, informed vote of a majority of the shares held by persons unaffiliated with the controlling stockholder (a so-called majority-of-the-minority vote). The case, *In re MFW Shareholders Litigation*, represents an important development for private equity sponsors considering going private transactions with controlling stockholders.

The entire fairness test – the most rigorous test under Delaware law – is not only challenging to satisfy as a substantive matter, it is also highly fact intensive. This makes it very difficult to dispose of entire fairness litigation at a preliminary stage, which, in turn, means that entire fairness litigation can be expensive to resolve. Even though previous Delaware case law shifted the burden to the plaintiff to show that the merger was not entirely fair if one of the protective procedural steps described above was taken, the *MFW* case may be helpful (from the perspective of the private equity controlling stockholder) because, if the conditions the Court enumerated in its decision are met, the question of fairness need not be addressed at all by a reviewing Delaware court. The merger would instead be reviewed under the protection of the business judgment rule.

Entire Fairness vs. Business Judgment

Previously, the Delaware Supreme Court had consistently applied the entire fairness standard of review to all mergers where controlling stockholders were part of the acquiring group. The Court held in *Kahn v. Lynch* that where such a transaction was approved by *either* a special committee of independent directors or a majority-of-the-minority vote, the burden shifts to the plaintiff to show that the merger was not entirely fair. However, neither *Lynch* nor any of the cases following it, where a controlling stockholder stood on both sides of the transaction, involved a transaction that was conditioned on *both* special committee approval and a majority-of-the-minority vote ("procedural protections"). The Court called this a "vital distinction," and approached the *MFW* case as one of first impression.

The Court articulated the following four reasons for holding that business judgment, not entire fairness, is the appropriate standard of review where both procedural protections are implemented:

- Where the controlling stockholder "irrevocably and publicly disables itself from using its control to dictate the outcome," the controlling stockholder merger resembles a third-party, arm's-length merger, which is reviewed under the business judgment standard.
- Conditioning the transaction on both special committee approval and a majority-of-the-minority vote "optimally protects" the minority stockholders by providing "a potent tool to extract good value for the minority."
- Adopting the business judgment standard is consistent with Delaware law's tradition of deferring to the informed decisions of impartial directors, particularly where ratified by the approval of disinterested stockholders, and will encourage controlling stockholders to provide these protections to minority stockholders.
- The underlying purposes of entire fairness review and the dual protection structure – ensuring a fair price – are consistent.

Procedural Protections and Conditions

The Court emphasized that to be eligible for business judgment review, a controlling stockholder merger must satisfy each of the following conditions:

- the controlling stockholder from the beginning must condition the transaction on both special committee approval and a majority-of-the-minority vote;
- the special committee must be independent;
- the special committee must be empowered to select its own advisors and to say no to a proposed transaction definitively;
- the special committee must meet its duty of care in negotiating a fair price;
- the vote of the minority must be informed; and
- there must be no coercion of the minority.

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> **"[T]he *MFW* case may be helpful …because, if the conditions the Court enumerated in its decision are met, the questions of fairness need not be addressed at all by a reviewing Delaware court."**

first add-on acquisition.[1] We have also begun to see private equity funds in later stages of their investment periods or that are otherwise capital constrained bringing in another private equity firm to fund, alongside the first private equity firm's portfolio company, investments into add-on targets. This article will explore this second new add-on structure, which brings elements of traditional private equity club deals into the world of add-on transactions, and significantly increases the complexity of these transactions.

The appeal of the "New Club Deal," as we'll call these transactions, is significant. For the sponsor of the existing portfolio company, it is the opportunity to participate in an acquisition process and access investment returns that it otherwise could not. The original sponsor brings to the table the traditional advantages of a strategic buyer in terms of synergies and sector expertise, supported by a full management team able to assess and diligence a target. For the new sponsor, the New Club Deal provides an opportunity to leverage synergies and sector knowledge arising from the original sponsor's portfolio company, offer a more attractive price in an auction process and perhaps access an exclusive opportunity. But these deals require careful advance planning, creative negotiation and thoughtful process management in order to ensure smooth execution.

Two Diligence Exercises

The preparatory phase raises a number of unique challenges in a New Club Deal. As is typical in any club deal, the two sponsors will need to work out the terms of their joint approach to the target. But the stakes and issues are different from those in the typical club deal. In the case of a New Club Deal, the sponsor providing new equity must also use the preparatory phase to run a parallel diligence process with respect to the original sponsor's portfolio company. These processes can put significant stress on the portfolio company's management team. The management team will be called upon to gather information and answer questions to support the new investor's diligence, and simultaneously asked to conduct business diligence with respect to a significant acquisition – all at a time when some members of management may feel concerned about their own future employment prospects. Where a management team is lean, recruiting outside advisors to provide early support can be critical. Care must also be taken to ensure that the pacing of the buy-side diligence of the target and the sell-side diligence on the original portfolio company by the new sponsor do not get out of sync. The same is true of the negotiation of the transaction agreements.

"The appeal of the 'New Club Deal,' as we'll call these transactions, is significant."

New Money, Differing Interests

The outcome of those parallel diligence processes will be two inter-linking agreements: (1) an investment agreement between the new sponsor, the original sponsor and the existing portfolio company, and (2) an acquisition agreement between the existing portfolio company's acquisition vehicle and the sellers and/or the target company.

An investment agreement of this kind between an original and a newly investing sponsor is an unusual animal. It must contain the customary representations, warranties and potentially indemnities of a standard acquisition agreement in order to provide the new sponsor with support for its due diligence on the original portfolio company, as well as purchase price adjustments, closing conditions and the other usual features of an acquisition agreement. But these issues must be negotiated in the unique context of how the target company will perceive them. Buyer conditionality is anathema to sellers, so closing conditions are typically narrowly limited other than a requirement that the acquisition of target and the new sponsor's investment be consummated substantially simultaneously. For example, an original sponsor (and a savvy target) might ask that any materiality measure used to judge the accuracy of representations and warranties at closing be measured against the combined company rather than the existing portfolio company alone. To simplify the negotiations and diminish tensions between old and new sponsor, the parties may agree that the investment agreement will adopt the representations and warranties given by the target, either in whole or in part.

Because the sponsors are entering into a long-term partnership, the original sponsor may resist indemnities that could result in disputes after closing. The new sponsor, on the other hand, may seek such protections as compensation for limited closing conditionality. Where indemnities and purchase price adjustments are agreed, given cash constraints, an equity based adjustment mechanism (*i.e.*, altering each sponsor's ownership of the portfolio company) may be more appropriate than

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1 *Recent examples of simultaneous acquisitions include Clayton, Dubilier & Rice's acquisition of Brand Energy and Harsco Infrastructure and Apax Partners' acquisition of One Call Care Management and Align Networks.*

cash payments, requiring the parties to work through the inherent complexity of such mechanisms.

In addition, the investment agreement must address – or at least begin to address in the form of a well-developed term sheet – the many potentially complex intra-sponsor issues that will exist in the life of the joint venture through exit. Key points include structuring, governance (including allocation of board seats and any shareholder veto rights over key actions), executive management and management equity arrangements, transfer restrictions and other exit rights such as drag-along rights.

The negotiation of these issues raises challenges beyond those typically encountered in club deals. The sponsors are fundamentally aligned in their desire for the investment in the target to be successful, and as private equity investors will generally share similar investment approaches. However, the new sponsor and original sponsor are not identically situated. The original sponsor will be at a later stage in its investment with respect to the portfolio company and likely toward the end of its investment period. As a result, the parties may have differing tax structuring needs and will have different investment horizons. A new sponsor might, for example, resist a near-term drag right in favor of the original sponsor – possibly insisting on performance hurdle conditions in order to ensure that the original sponsor does not seek an exit before the full benefit of the transaction has been realized. Governance arrangements must also reflect the possibility that an indemnification claim backed by an equity-based remedy could upset initial expectations as to relative ownership. These issues may be addressed through step down thresholds for board seats and shareholder veto rights, and limitations on the potential shift in equity interests.

Keep it Simple from the Target's Perspective

The complexity of a New Club Deal is significant, but to succeed the sponsors must do their best to make that invisible to the target. This is particularly the case in a competitive auction context, where the target will resist risk to the availability of the new sponsor's equity financing or any debt financing that is tied to the performance of the original portfolio company. A variety of techniques may be used to limit that risk. As noted above, the new sponsor may agree to limited closing conditions for its equity investment. The lenders may be persuaded in some circumstances to make the closing of any financing contingent only on the performance of the target company and the fulfillment of conditions under the main acquisition agreement, and not to insert additional conditionality tied to the performance of the portfolio company. Sponsors may also offer a "reverse termination fee" remedy with customary triggers if the transaction is not consummated when required in accordance with the acquisition agreement, perhaps with responsibility for any fee allocated by the sponsors to the party who is deemed responsible for the failure to close. Finally, sponsors may provide equity commitment letters to the acquisition vehicle and limited guarantees similar to those seen in a more typical leveraged buyout structure.

Three's Not a Crowd

New Club Deals are an attractive solution for sponsors that cannot act on an attractive add-on investment opportunity due to lack of capital or a desire not to over-lever their portfolio company. Such deals also provide an opportunity for the incoming sponsor to find exclusive or semi-exclusive opportunities in which they may be able to reap the benefit of strategic-like synergies. While the old saying goes that two's company but three's a crowd, three is a very welcome number for New Club Deals. Given the number of sponsors managing late stage funds, we expect to see more New Club Deals in the future. ■

Jonathan E. Levitsky
jelevitsky@debevoise.com

Andrew C. Rearick
acrearick@debevoise.com

"The complexity of a New Club Deal is significant, but to succeed the sponsors must do their best to make that invisible to the target."

team. It is critical to have an investment team that has deep African expertise in the private equity space. These should be people from Africa or with significant long-term, on-the-ground experience in Africa so that they know and understand the local context and have strong deal sourcing networks across the continent. However, it is not always easy to find such professionals."

MKE, AVCA: "Perception generally plays an important role in generating interest and commitments. For example, the respondents to our recent global LP survey cited a perceived weak exit environment as a barrier to investing in Africa. This perception is something AVCA, together with Ernst & Young, has been trying to tackle with the launch of the second edition of our annual study of the exit environment for private equity in Africa. The 2014 study uncovered 207 exits during the period from 2007 to 2013, including 89 exits in 2013 alone. The exit market is alive and well."

Question:

With the increase of available capital and investment in many African countries, what are the best ways to attract and retain qualified managers and employees?

Answers:

Rosa Nduati-Mutero, A&K: "Human capital ranks extremely high, possibly immediately after raising capital, as a constraint when evaluating investment opportunities. While firms can grow talent organically by recruiting graduates fresh from university, it is fairly difficult to find good talent at higher levels of seniority. One source of top talent is African nationals living in the diaspora that are repatriating home in large numbers and are taking up senior positions in large corporations. African professionals who have lived and worked abroad bring home global standards and international expertise."

J-PF, Metier: "Increasingly there is a strategy/opportunity for intra-regional trade and partnering with local companies in the sub-continent to provide capital, industry expertise, customer relationships and management skills. We prefer to partner with entrepreneurs and management teams to do platform build ups and provide growth capital, often in the development and implementation of in-house investment theses prior to any investment. Skills and experience are key factors, and are integrally linked to the region's expansion opportunity. You have a completely different deal potential discussion with a management team when you bring to the discussion another team with skills, references, past experience, relationships and networks."

Question:

What is the deal environment for African private equity at the moment?

Answers:

Karim Anjarwalla, A&K: "We have generally seen foreign private equity investors widen the destination of their investments from the more 'safe' countries to include those previously shied away from. For example, Cote d'Ivoire appears to be emerging as a popular destination for private equity due to steady growth in the economy, better political stability and better infrastructure. Ethiopia is also generating high interest due to robust economic growth and the relaxing of strict rules of foreign ownership."

MK-D and JC, CDC: "We continue to believe that Africa offers an exciting opportunity for investors. Some of the countries that are attractive are Angola, Ethiopia, Ghana, Ivory Coast, Kenya, Senegal, Tanzania and Uganda. We believe that the large-cap space is quite competitive but that growth investments in the small and medium-size enterprises (SMEs)and in the mid-cap space are attractive across a variety of sectors."

J-PF, Metier: "Top-down investment strategies in Africa revolve around emerging middle-class and affordability imperatives driving consumer growth, infrastructure spending multiplier effects, population growth and urbanisation, and increasing intra-regional trade."

Question:

What are the top current challenges facing private equity in Africa?

Answers:

TE, ÆLEX: "(1) Private equity funds must have a different sense of time: projects may go slower, but will realize a high return for those willing to wait. (2) Additionally, the lack of fully-developed liquid lending and capital markets make exit windows less predictable."

MKE, AVCA: "(1) The limited number of established general partners with track records. (2) The perceived weak exit environment. (3) The perception that Africa has political risk in a greater magnitude than may be the reality. Despite these challenges, our recent global LP Survey found that African private equity is perceived to be more attractive than other emerging markets, and African private equity returns are generally expected to compare favorably to listed equity."

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Private Equity in Africa: An Inside View (cont. from page 20)

J-PF, Metier: "(1) Slow flow of non-DFI fundraising and too much focus on infrastructure. (2) Not many fund managers have gone full fund cycle and made cash-on-cash returns across vintages. (3) Very slow pace of venture capital and SME funding."

RN-M, A&K "(1) Because private equity is still in its nascent stages in Africa, entrepreneurs and businesses can often take a while to understand and appreciate the structure and requirements of private equity firms. (2) There is a limited pool of talent available in many African countries. (3) Political and economic volatility, along with a lack of liquidity of the target companies, can make planned exits difficult to execute on time."

MK-D and JC, CDC: "(1) African institutions and local businesses need better education about the advantages of investing in private equity and seeking investment from private equity funds. (2) International investors need to be better educated about investment opportunities across Africa and have perceptions and stereotypes about Africa dispelled. (3) Private equity funds should look outside the countries to which private equity capital has traditionally flowed (*e.g.*, Nigeria and South Africa) to African countries with interesting opportunities but less competition."

Conclusion

Our interviews elicited a variety of interesting perspectives, but perhaps the unifying theme is the dynamic nature of the African market. Optimism reigns, and, despite the challenges that remain, most expect the volume of private equity deals on the continent to increase. We can also expect the economic and regulatory backdrop in Africa to continue to evolve. For those looking to make the most of the opportunities in Africa, it will pay to bear these ongoing changes in mind. ■

Geoffrey P. Burgess
gpburgess@debevoise.com

Benjamin P. Collins-Wood
bpwoods@debevoise.com

Private Equity Investments in Mining: Drilling for Deal Opportunities (cont. from page 13)

to the sector. There are two principal difficulties inherent in the mining sector that private equity investors must contend with: cost of capital and volatility, both of which may be better handled by strategic investors. Historically at least, strategic investors have tended to have a lower cost of capital than private equity firms, which has allowed them to pay a higher price for assets with financing. Additionally, volatility, which is a hallmark of the mining industry, makes it challenging for private equity investors to obtain leverage at the levels customary in other private equity investments. Strategic investors, on the other hand, may be better suited to secure leverage by pledging other assets as security.

Mr. Hammer pointed to the environmental concerns that certain private equity investors face in connection with many investments in the mining industry. Traditional risks and liabilities, such as issues related to the cleanup of contamination, exist in mining investments, but the related costs can be more significant than in other sectors. Additionally, investments in the mining sector present risks that private equity investors may not be accustomed to, such as those associated with the displacement of indigenous populations. Environmental issues associated with mining operations may also result in unwanted media attention.

Conclusion

The challenges and opportunities facing private equity firms seeking to invest in the mining sector are significant. Deep sector expertise, careful investment selection and timing, creative deal structuring and counsel experienced in mining transactions are necessary to overcome these challenges for firms interested in drilling for deals in the mining sector. ■

Maurizio Levi-Minzi
mleviminzi@debevoise.com

Stuart Hammer
shammer@debevoise.com

Stephanie Margulies
smarguli@debevoise.com

The Shareholders of the U.S. Target End Up Owning at Least 60% But Less than 80% of the Combined Company Post-Inversion. The 2004 anti-inversion legislation also imposes two relatively mild sanctions in cases where the former shareholders of the U.S. Target end up owning at least 60% but less than 80% of the foreign acquirer as a result of the inversion.

First, in such a transaction, executive officers and directors of the U.S. Target are required to pay an excise tax on the value of their stock-based compensation, such as options and RSUs relating to shares of the U.S. Target. The theory is that the public shareholders are required to pay tax on their gains in an inversion deal where the 60% threshold is met, so insiders who orchestrate the inversion should not be allowed to escape tax on the value of their stock-based compensation that would otherwise roll over tax-free into equivalent interests in the foreign acquirer. There is an exception to the excise tax if the stock-based compensation is cashed out at or prior to the closing of the inversion. As a result, many inverting companies choose to accelerate vesting and then cash out stock-based compensation to protect employees and directors who would otherwise be subject to the excise tax. Other inverting companies often simply indemnify their employees and directors against the excise tax.

> **"[T]he Treasury Department recently announced that it would try to deter inversions by issuing tax regulations that… would apply to transactions that close on or after September 22, 2014."**

Second, in the "at least 60% but less than 80%" scenario, gains arising on the transfer by the inverting U.S. company to a related foreign company of appreciated property during the ten-year period following the inversion cannot be reduced by net operating losses or similar tax attributes. Congress's intention was to prevent a U.S. inverted company from transferring its appreciated foreign subsidiaries to its foreign parent without paying a current toll charge.

Only a Very Narrow Exception Applies. A narrow exception applies in the above scenarios (even in the case where the 80% threshold is met): no sanctions will apply if the foreign acquirer conducts significant business operations in its country of organization. However, Treasury Regulations define "significant business operations" in a way such that very few corporations will qualify for this exception to the sanctions outlined above.

The 2004 Legislation Does Not Effectively Prevent All Inversions. Why Does Congress or the U.S. Treasury Department Not Do More?

The Congress may consider additional actions to prevent inversions. Representative Sander Levin and Senator Carl Levin (the two are brothers) have introduced legislation that would curtail most inversions by, among other things, lowering the threshold for the severe sanction (treatment as a U.S. corporation) to "more than 50%" from 80%. The law would be retroactive to inversions occurring after May 8, 2014. However, the Levin bills have thus far not received wide endorsement. Some in Congress believe that inversions are a symptom of a broken corporate income tax system; they argue that the issue of inversions should be addressed through comprehensive corporate income tax reform such as shifting to a territorial system, the system used in most other developed countries. The Administration has taken the position that legislation should be enacted immediately to deter inversions while Congress works on comprehensive corporate income tax reform.

Congress's creativity in deterring inversion transactions is not limited to lowering the threshold ownership requirements. For instance, one recent bill threatens to prohibit the U.S. federal government from contracting with companies that have undergone inversions (as well as with other companies that have subcontracted business to the inverted companies). Another legislative proposal would strengthen the rules against earnings stripping and penalize the borrowing of funds by the parent of an inverted group from foreign subsidiaries of the U.S. Target.

Because Congress has thus far not enacted any of the recent proposals, the Treasury Department recently announced that it would try to deter inversions by issuing tax regulations that would make it costly for foreign acquirers in inversions to access the earnings that a U.S. Target holds offshore in foreign subsidiaries. The new regulations would apply to transactions that close on or after September 22, 2014.

Are There Traps for Private Equity in the Current Anti-Inversion Statute?

The 2004 anti-inversion statute and related regulations are written broadly and sweep in transactions that should never be thought of as inversions. For example, in

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The Inversion Craze: What You Need to Know (cont. from page 22)

one common fact pattern, a private equity fund that is acquiring a U.S. Target with international operations contributes cash to a newly-formed foreign acquisition vehicle, which then buys all of the shares of a U.S. Target for cash, other than shares held by management. Management of the U.S. Target is permitted to roll its shares into shares of the foreign holding company in exchange for, say, 5% of the shares of the foreign holding company. Under Treasury regulations issued in January of 2014, the 95% of the shares of the foreign holding company owned by the private equity fund are disregarded because they are issued in exchange for a cash contribution. (Don't ask.) For purposes of the anti-inversion statute, the only shares taken into account are management's shares. Because those shares constitute 100% of the only regarded shares, the 80% threshold is exceeded, and the foreign holding company is treated as a U.S. corporation subject to unlimited U.S. taxation on its worldwide income.

Do Inversions Present Special Opportunities for Private Equity?

A private equity fund that owns a foreign portfolio company of adequate size may hold the "ticket" for a U.S. Target to effect an inversion. If the deal is sensible from a commercial perspective and the foreign portfolio company is worth more than one-quarter of the value of the U.S. Target (measured by equity value), the foreign portfolio company can serve as the acquirer of the U.S. Target, provided that the shareholders of the foreign portfolio company end up with more than 20% of the shares of the combined company. Because the commercial and tax benefits of an inversion are generally significant, the owner of the foreign company can often extract a premium (in the form of a favorable exchange ratio) in exchange for its willingness to participate in the inversion.

There is no tax law requirement that the private equity fund remain invested in the combined company. For example, in a recent inversion transaction, the private equity investor sold its shares of the foreign portfolio company for cash in a pre-arranged private placement, which closed just prior to effecting the inversion transaction.

Conclusion

Many in Congress and the Administration would like to curtail inversions further. Retroactive legislation has been introduced and the Treasury Department has given notice of new anti-inversion regulations. Because predicting the outcome of government initiatives in an election year is always treacherous, it is clear that there will be a premium placed on creativity in structuring inversion deals going forward. ■

Gary M. Friedman
gmfriedman@debevoise.com

Andrew L. Bab
albab@debevoise.com

Kevin A. Rinker
karinker@debevoise.com

Delaware Provides Going Private Roadmap; Wrong Turns Still Possible (cont. from page 17)

How Useful is the Roadmap?

The Court provided a detailed roadmap. How often will it be followed? There are a few reasons for skepticism.

First, the extensive list of requirements to be satisfied may itself make it difficult to dispose of litigation at a preliminary stage. According to the Court, a plaintiff will survive a motion to dismiss and be entitled to discovery if it can plead a "reasonably conceivable" set of facts showing that a transaction fails to satisfy any of these conditions. Indeed, in a footnote the Court said that the *MFW* plaintiffs' complaint would have survived a motion to dismiss.

Moreover, if, after discovery, there remain triable issues of fact as to whether the conditions were satisfied, the case will proceed to trial under an entire fairness review. This apparently means that if the defendants do not succeed in obtaining summary judgment on the applicability of the business judgment standard, then even if they can show at trial that all conditions were actually met, they will not be entitled to review under the business judgment standard – although satisfaction of all of the conditions will be powerful evidence that the deal *was* entirely fair.

Finally, private equity sponsors involved in going private transactions with controlling stockholders will continue to face a difficult choice, because the requirement to condition the deal on approval by holders of a majority of the unaffiliated shares can impose a significant degree of transaction risk. As we saw in the Dell transaction, the existence of such a vote can invite gamesmanship by activists. Sponsors considering such transactions should review carefully the size and composition of the unaffiliated stockholder base before deciding whether to take the route prescribed in *MFW*.

William D. Regner
wdregner@debevoise.com

statutory clawback and makes other changes favorable to investors. Before the New ELP Law, for example, a limited partner was required to repay to the ELP amounts received from the ELP representing a return of any part of the limited partner's capital contributions within six months before an insolvency of the ELP.

Under the New ELP Law, by comparison, a limited partner must have actual knowledge that it received a distribution from an ELP when the ELP was insolvent (or that the distribution resulted in the ELP being insolvent) to be subject to the statutory clawback. In such a situation (and in certain other enumerated situations), the limited partner will, for a period of six months starting on the date of such distribution, be liable to return the payment to the extent necessary to discharge a debt or obligation of the ELP incurred during the period that the contribution was an asset of the ELP.

Defaulting Limited Partners

The enforceability of partnership agreement provisions providing that a limited partner may, among other consequences, forfeit all or a portion of its interest in an ELP if it is found to be in default under the ELP's partnership agreement (e.g., if the limited partner fails to make capital contributions) was a topic that caused much consternation after the 2008 financial crisis. The New ELP Law confirms that such provisions will not be treated as penalty provisions and will be enforceable.

The application of such default provisions by a general partner to a limited partner will remain subject to the general partner's fiduciary duty under the New ELP Law to act at all times in good faith and, subject to any express provisions to the contrary in the ELP's partnership agreement, in the interests of the ELP. Provided that a general partner adheres to its fiduciary duties, this confirmation of the enforceability of default provisions should reduce potential fiduciary and litigation risk for a general partner when applying the default provisions specified in an ELP's partnership agreement. The New ELP Law specifies that, provided that a general partner has complied with its fiduciary duties, a general partner shall not be liable for its decision to impose or for imposing any default remedies or consequences upon any partner (or indeed its decision not to do so).

"The new ELP Law clarifies that… advisory committee members do not owe fiduciary duties to the ELP or any partner."

Admission of Limited Partners

The New ELP Law clarifies the circumstances in which a limited partner will have been duly admitted as a partner. The motivation behind the change is to ensure that, provided the admission procedures in the applicable partnership agreement have been complied with, a person will be deemed to have adhered to and agreed to be bound by the partnership agreement, even if there is a technical defect in the manner in which admission has been effected. This change, which simplifies the formalities associated with the admission of limited partners, is retrospective.

Register of Limited Partnership Interests; Inspection Rights

Following the implementation of the New ELP Law, the register of limited partnership interests no longer needs to contain details of capital contributions, which must be maintained by the general partner as a separate record. The register of limited partnership interests may now contain less information: the name and address of each limited partner; the date on which a person became a limited partner; and the date on which they ceased to be a limited partner.

A general partner may now expressly exclude in the partnership agreement of an ELP the ability of limited partners to inspect the register of limited partnership interests. In addition, the record of contributions is only available for inspection by limited partners (and any other person) with the consent of the general partner.

The changes to the maintenance of an ELP's register of limited partnership interests have simplified prior requirements. Whilst the ability to prescribe the extent of rights of access to the register of partnership interests may be welcomed by general partners, implementing this change as a matter of practice may not be a commercial reality for established sponsors whose limited partner base has an expectation of such access rights based on existing investments.

Execution of Deeds

The English *Mercury* case *(R (on the application of (1) Mercury Tax Group Limited and (2) Darren Neil Masters) v HMRC and others [2008] EWHC 2721 (Admin))*, which stipulated strict requirements for the valid execution of

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deeds, was expressly disapplied in the Cayman Islands by amendments to the Companies Law (as amended) of the Cayman Islands in 2011 (the Companies Law Amendments). The ramifications of the *Mercury* case were not perceived as practical or reflective of market practice in an increasingly global corporate environment where virtual signings and closings are usually held. However, there were differing views among practitioners in the Cayman Islands as to whether the Companies Law Amendments extend to the execution of deeds on behalf of an ELP or in respect of an ELP (such as an ELP's partnership agreement).

The New ELP Law confirms the disapplication of the *Mercury* case to ELPs. As is the case under the Companies Law Amendments, the relevant provision has retrospective application. This important amendment removes the need for additional formalities from the signing and closing of Cayman Islands private equity funds, restoring "business as usual" and enabling a streamlined process with the signing and closing mechanics for Delaware vehicles.

Powers of Attorney

Prior to the implementation of the New ELP Law, the partnership agreement for an ELP was required to be executed as a deed where it contained a power of attorney. The New ELP Law provides that a power of attorney contained in the partnership agreement of an ELP will be valid even if the ELP's partnership agreement has not been validly executed as a deed in compliance with the usual formalities under Cayman Islands law to grant a power of attorney. This is significant because, prior to the implementation of the New ELP Law, there have been instances where a partnership agreement for an ELP that needed to be executed as a deed (owing to the inclusion of a power of attorney) was not validly executed as a deed, thereby calling into question the validity of the power of attorney granted under the partnership agreement. In essence, the partnership agreement containing the power of attorney will be deemed, regardless of how executed or adhered to, to have been validly executed as a deed for the purposes of the Powers of Attorney Law of the Cayman Islands. This provision has retrospective effect.

It should be noted that this amendment is not applicable to subscription agreements containing a power of attorney and executed by limited partners in respect of their investment in a Cayman Islands private equity fund. Accordingly, it is still essential to ensure that a subscription agreement containing a power of attorney has been validly executed as a deed. Furthermore, please note that as a matter of best practice, we recommend that a partnership agreement containing a power of attorney still be executed as a deed, notwithstanding the provisions of the New ELP Law.

Registration of Foreign Partnerships

A welcome change under the New ELP Law is the ability to register a foreign partnership, such as a Delaware limited partnership, to act as the sole general partner of an ELP. This is frequently desired from a structuring perspective. The new enabling provision has eliminated the need to appoint an additional general partner to meet specific legal requirements as to who may serve as a sole general partner of an ELP, where it is desirable that a foreign partnership act as sole general partner of an ELP.

Other Changes

In addition to the foregoing, the New ELP Law allows for an alternative simplified procedure for dissolving ELPs that have ceased to be active and adds a new mechanism to enable the transfer of an ELP from the Cayman Islands to Delaware or other jurisdictions.

Conclusion

The implementation of the changes outlined above will assist in making the formation and operation of Cayman Islands private equity funds more efficient and more consistent with market practice, and will facilitate the harmonizing of the partnership agreement for an ELP with the partnership agreement for any Delaware parallel or feeder fund. ■

Caroline Williams
Partner, Walkers

Recent and Upcoming Speaking Engagements

September 10
David H. Schnabel
"Nothing Is Certain but Regulation and Taxes"
Private Equity Growth Capital Council CFO Day
New York

September 11
Eric R. Dinallo, Thomas M. Kelly, Marilyn A. Lion, Maeve O'Connor
"Trending Topics in the New Culture of Enforcement"
Debevoise & Plimpton Seminar
New York

September 12, 16 and 17
Matthew Howard Getz, Satish M. Kini, Carl Micarelli, Michael B. Mukasey
"US and EU Sanctions Against Russia – Analysis and Business Implications"
Debevoise & Plimpton Seminar
New York, Moscow, London

September 12
Erica Berthou
"Fundraising: Mapping the Changing Scenario"
Latin Lawyer Private Equity Conference
New York

September 23
Geoffrey P. Burgess, Anthony McWhirter
"GP and LP Perspectives on Investment in the African Market"
African Private Equity and Venture Capital Association and Debevoise & Plimpton
London

September 24
Gregory J. Lyons
"Business Implications of the Volcker Rule and Other New Regulation"
ESec Securities Financing Conference
Boston

September 25
Eric R. Dinallo, David Innes, Jeremy G. Hill, Gregory J. Lyons, Richard Ward
"Opportunities in EU Financial Services Restructuring"
Debevoise & Plimpton Seminar
London

September 29
Klaudius Marius Heda, Thomas Schürrle, Philipp von Holst, Peter Wand, Daniel Wiedmann
"M&A Transactions: Process and Acquisition Agreement Provisions"
Summer School at the Institute for Law and Finance of Goethe University
Frankfurt

September 30
Lawrence K. Cagney
"Retailization of Private Equity"
Private Equity Growth Capital Council
CCO Working Group
New York

October 1
Jyotin Hamid, Shannon Rose Selden
"Hot Topics in Employment-Related Disputes with Highly Compensated Employees"
Hedge Fund General Counsel and CCO Summit
New York

October 7
Lee A. Schneider
"Casting a Shadow: Securities Financing Transactions"
SIFMA
New York

October 9
Matthew Howard Getz
"US and EU Sanctions Against Russia – Analysis and Business Implications"
Shorex Wealth Management Forum
London

October 9
E. Raman Bet-Mansour, Sally Gibson, David Innes
"Global Capital: Exits, Direct and Co-Investment, and Regulatory Developments"
BVCA Summit 2014
London

October 9
Lawrence K. Cagney
"Executive Compensation Developments"
Society of Corporate Secretaries
New York

October 9
David J. Schwartz
"Secondaries in 2014"
Private Equity International:
Secondaries Roundtable
San Francisco

October 14
Geoffrey P. Burgess
"Regional Roundup: Where Are the Hot Opportunities?"
EMPEA Private Equity in Emerging Markets Conference
London

October 15
Nicholas F. Potter
"The Cutting Edge of Deals: PE Movement into Insurance and Other Regulated Industries"
Private Equity Growth Capital Council GC Summit
New York

October 16
Geoffrey Kittredge, Matthew D. Saronson
"Protecting GP Interests and Maintaining Competitive and Marketable Positioning for LPs"
EMPEA Fundraising Masterclass
London

October 16, November 5 and December 4
David H. Schnabel
"Planning for Private Equity and Hedge Fund Investments"
Practicing Law Institute Strategies 2014
New York, Chicago, Los Angeles

October 16
Alexander R. Cochran, Jeremy G. Hill, John M. Vasily, Peter Wand
"PE and Strategic Investment Opportunities in the German Life Insurance Sector"
Debevoise & Plimpton LLP
Munich

October 16-17
Jordan C. Murray
"Co-Investment Structures"
American College of Investment Counsel
Fall Meeting
New York

October 20
Satish M. Kini
"Anti-Money Laundering Compliance Challenges"
National Society of Compliance Professionals
National Conference
Washington, D.C.

October 20 and November 17
David H. Schnabel
"Tax Issues in Private Equity Transactions"
NYU School of Continuing and Professional Studies
73rd Institute of Federal Taxation Conference
New York, California

October 20
Katherine Ashton
"Start-Ups and Capital Markets: 'JOBS Acts' Around the World – Stimulating Growth or Blowing a Bubble?"
International Bar Association Annual Conference
Tokyo

October 23
Peter F.G. Schuur
"Tax Issues in Private Equity Transactions"
Tulane University Law School's
63rd Annual Tax Institute
New Orleans

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Recent and Upcoming Speaking Engagements (cont. from page 26)

October 23
Michael P. Harrell
"The SEC's Evolving Critique of GPs' Valuation Processes and Best-in-Class Responses"
KPMG Alternative Investment Valuation Conference
New York

October 30
Lord Goldsmith QC, Jeremy G. Hill, Edite Ligere, John M. Vasily
"Recent Trends in Regulatory Enforcement on Financial Institutions in Europe and Beyond"
Debevoise & Plimpton Seminar
London

November 5
Katherine Ashton
"The Drivers of the Secondary Market"
BVCA Breakfast Seminar
London

November 6
Andy Y. Soh
"From Start to Finish: How to Implement an Internal Investigation"
FinanceAsia 3rd Annual Compliance Summit
Hong Kong

November 6-7
Helen V. Cantwell
"Anti-Bribery Compliance: Through the Line of Fire"
NWAL 10th Annual General Counsel Institute Seminar
New York

November 11
David Grosgold, Maurizio Levi-Minzi
"Investment in and Regulation of Insurance Businesses"
Posse, Herrera and Ruiz
Bogota

November 12
Cécile Beurrier, Matthew D. Saronson
"FATCA Issues Facing Private Equity Firms"
BVCA Tax, Legal & Regulatory Conference
London

November 13 and 19 and January 22
Jonathan Adler, Gavin Anderson, Erica Berthou, Peter A. Furci, Geoffrey Kittredge, Jordan C. Murray, Andrew M. Ostrognai
"Emerging Markets: Issues and Opportunities in Private Fund Formation"
Debevoise & Plimpton Seminar
New York, London, Hong Kong

November 17
Peter A. Furci
"How Are Latin American Countries Easing the Way for Private Equity Investment?"
BVCA International Series
London

November 20
Paul D. Brusiloff, Alan J. Davies, Pierre Maugüé
"Private Debt Fund Strategies"
Legal 500 Debt Funds Roundtable
London

December 1-2
E. Drew Dutton, Stuart J. Valentine
"How Can Multinationals Win in Asia?"
IBC InsuranceCom Asia 2014
Hong Kong

December 8-9
Peter A. Furci, Michael J. Gillespie, Gregory V. Gooding
"Legal Issues in Brazil Fund Formation and Investment"
Latin Markets Private Equity Brazil Forum
Sao Paulo, Brazil

February 12
Alan J. Davies, Pierre Maugüé
"Private Debt Funds Strategies"
BVCA Debt Funds Forum
London

March 3
David Innes
"Critical Warranties and Indemnities in M&A Deals"
BVCA Legal Agreements Course
London

Have Questions About Topics Covered in the Private Equity Report?

Partners in the Private Equity Group are available to our Clients to discuss these issues and answer questions in depth.

Contact Howard Rosenberg in New York at +1 212 909 1983 or hrosenberg@debevoise.com, or Peter Ferenz in London at +44 20 7786 5452 or pferenz@debevoise.com, to arrange a PER follow-up call or e-mail.

Recent Client Alerts and Publications

Listed below are Debevoise & Plimpton Client Alerts and publications issued since our last issue of this publication that are most relevant to the private equity industry. They can be found at www.debevoise.com.

Health Care Mergers and Acquisitions Answer Book 2014 (PLI), edited by Andrew L. Bab and Kevin A. Rinker.

Delaware Court Affirms Refusal to Extend WARN Act Liability to Private Equity Sponsor
October 7, 2014

Be Timely or Else: SEC Imposes Sanctions Against Both Insiders and Issuers for Beneficial Ownership Reporting Failures
October 2, 2014

Russia Limits Foreign Ownership in Mass Media to 20% in 2016
October 1, 2014

Expense Allocation: The SEC Brings Down the Hammer
September 26, 2014

U.S. Treasury Department Tries to Curtail Inversion Transactions
September 23, 2014

Provocative DOJ Proposal Aims to Hold Financial Services Executives Criminally Liable, Even Absent Criminal Intent
September 22, 2014

Some Preliminary Observations: Impact of the Referendum on Scottish Independence on Private Equity and Other Alternative Asset Managers
September 17, 2014

U.K. Takeover Regulator Consults on Rule Changes Prompted by the Pfizer/Astrazeneca Bid Approach
September 16, 2014

U.S. Expands Sectoral Sanctions Against Russia, Blocks New Defense Companies
September 15, 2014

E.U. Expands Sector-Wide Sanctions on Russia, Imposes Sanctions on New Individuals and Entities
September 15, 2014

CFTC Opens Door for Use of Jobs Act General Solicitations
September 12, 2014

Businesses Wary of Impact of Ukrainian Sanctions
September 2, 2014

Long-Awaited Chinese Fundraising Rules Take Effect
August 25, 2014

Second Circuit Holds Whistleblower Anti-Retaliation Provision Does Not Apply Extraterritorially
August 19, 2014

OFAC Revises and Clarifies "50% Rule," Combines Ownership Interests of Different Blocked Persons
August 18, 2014

Russia Imposes Restrictions on Agricultural Imports from the U.S., E.U., Canada, Australia and Norway
August 8, 2014

E.U. Imposes Sector-Wide Sanctions on Russia, Imposes Sanctions on New Individuals and Entities
July 31, 2014

Treatment of SPVs and M&A Escrow Accounts under the Advisers Act Custody Rule
July 11, 2014

SEC Settles First "Pay-to-Play" Enforcement Action
July 2, 2014

German Insurers and Pension Funds May Effectively Be Banned from Investing in Non-EEA Private Funds
June 24, 2014

SEC Brings First Anti-Retaliation Enforcement Action Under Dodd-Frank
June 19, 2014

Second Circuit Defers to SEC in Overturning District Court's Rejection of Settlement with "Neither Admit or Deny" Language
June 5, 2014

SEC Warns Against Interference with Potential Whistleblowers
May 6, 2014

Foreign Bank Investments in Parallel Fund Structures Under The Volcker Rule
May 1, 2014

SEC Releases Cybersecurity Examination Roadmap
April 22, 2014

Looking for a past article?

A complete article index, along with all past issues of the *Debevoise & Plimpton Private Equity Report*, is available in the "News, Events and Publications" section of the firm's website, www.debevoise.com.