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Private Equity

In this issue

p1 Estate Planning Opportunities with Interests in Private Equity Funds

p3 Conflicts in Private Equity: Respecting the Rights of Limited Partners of Private Equity Funds and Shareholders of Portfolio Companies

p5 Fair Value Reporting for Illiquid Investments: Ready or Not (Here It Comes)

p9 Antitrust Considerations in Sector-Focused Investment

p10 UK "Anti-LBO" Laws to be Revoked

Dechert LLP

Estate Planning Opportunities with Interests in Private Equity Funds

By **Lee D. Caney** and **Amy S. Ufberg**

Typically, the sponsors of private equity funds are consumed with the fundraising process and the initial launch of the fund, and little attention is devoted to the estate planning opportunities that may be best exploited at the beginning of the life of the fund. Interests in private equity funds, especially the carried interest, are particularly good assets to transfer for estate planning purposes because of their significant potential for appreciation.

The Gift and Estate Taxes

Every person may gift up to $1,000,000 ($2,000,000 for married couples) during his or her lifetime, free from federal gift tax. In addition, every person can bequeath at his or her death $2,000,000 ($4,000,000 for married couples), reduced by the amount gifted during lifetime. Any amounts gifted or bequeathed in excess of these exemptions are taxed at a maximum rate of 45% (plus any state estate or inheritance tax).

Therefore, it is a good idea for individuals with substantial wealth to begin transferring assets to children or grandchildren so that the assets—and the increase in value on those assets—are not part of their taxable estate. The best assets to gift to maximize the use of the lifetime exemption are those that have the most potential for appreciation.

Transfer of Carried Interests and Capital Interests

A carried interest in a private equity fund is a logical choice to transfer during one's lifetime because of its low value at the formation of the fund and its significant potential for appreciation. A capital interest in the fund does not have quite the same promise for appreciation, but may still have a significant ability to increase in value. The transfer of carried interests and capital interests involves complex estate and gift tax rules, but if done correctly (and, of course, the fund is successful), it can produce tremendous results.

Techniques

There are various techniques that can be used to transfer these interests. Because of certain gift tax rules, in certain circumstances an individual may be required to transfer an equal percentage of both

his or her capital interest and carried interest—what we will refer to as a "vertical slice"—when making any transfer. Consideration must also be given to appraisal costs and risks and vesting issues. Finally, most of the techniques involve the use of trusts where the original owner of the assets continues to pay income tax on the assets transferred; therefore, it is important to consider the proposed legislation that may alter the income taxation of the carried interest.

The following is a very brief summary of four techniques that may be used.

Direct Gift

A simple technique is to transfer a portion of an interest in the fund to a trust for family members (referred to as a "family trust"). This technique may require gifting a "vertical slice" of carried and capital interests. The value of the gift would be determined by an appraiser, and the donor's lifetime gift tax exemption would be reduced by the value of the interest transferred. The trustee of the family trust would determine when and how much of the assets of the family trust to distribute to family members. At the time of death of the donor, the assets in the family trust, including any increase in value from the date of the gift (which could be significant if the fund is successful), would not be subject to estate tax.

Sale of Interest

A second option is to sell to a family trust (that has been funded with a certain amount of property) a "vertical slice" of carried and capital interest in exchange for a promissory note. The benefit of the sale transaction is that any increase in value in excess of the interest rate on the note will be retained by the family trust free from estate and gift tax.

Grantor Retained Annuity Trust ("GRAT")

A GRAT is a trust to which an individual contributes property and retains the right to receive a fixed annuity payment for a specified term of years. The retained annuity is large enough so that the value of the gift to the GRAT is zero. Any appreciation in the value of the assets contributed to the GRAT above the government's interest rate is transferred to the family trust at the end of the term of the GRAT. In order to use the GRAT technique, often a transfer of a "vertical slice" of capital and carried interest is required.

The most attractive features of the GRAT are:

- that no lifetime gift exemption is used to create the GRAT, as the value of the gift is zero, and
- there are no valuation risks.

Cash-Settled Option

The cash-settled option technique allows the transfer of the economics of the carried interest (as opposed to the actual carried interest) without transferring the capital interest, and without having to wait for the carry to vest. An individual would sell an option to the family trust that would allow the family trust to purchase the economics related to a portion of the individual's carried interest.

This technique is particularly effective. However, as with all of the techniques, there are important tax risks to consider.

Please note that this is a brief summary of potential techniques that may be used to transfer interests in private equity funds, but in no way is it a complete summary of the requirements or risks of any technique described.

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Conflicts in Private Equity: Respecting the Rights of Limited Partners of Private Equity Funds and Shareholders of Portfolio Companies

By **Robert M. Friedman**

Private equity fund governing documents generally permit a manager to commence investing a new fund ("Fund B") at the time an existing fund ("Fund A") has invested or used to pay expenses an agreed upon percentage of its committed capital (on average, approximately 75%). After providing for future management fees, Fund A should have capital available for follow-on investments and possibly for additional new portfolio investments as well. Therefore, in assessing an investment opportunity in a new portfolio company or a follow-on investment to an existing portfolio company of Fund A, the manager must determine how to allocate the investment as between Fund A and Fund B.

There is often general language committing the manager of a fund to offer to the fund all new investments meeting the investment parameters of the fund. In such a case, the investment must be offered to Fund A. Sometimes, however, the documents provide that Fund A be given priority as between Fund A and the manager in the allocation of investment opportunities. If the manager of Fund A has an economic interest in Fund B (which presumably the manager does through its carried interest), then the allocation of the investment opportunity to Fund B is indirectly placing the manager's interest ahead of the partners' of Fund A.

In order to avoid the allocation conflict, some funds provide for the allocation between an earlier and later fund to be made based on committed or available capital of the two funds. The difference between these formulations may be significant. Assuming Fund A and Fund B each has $500 million of initial commitments, but Fund A has only $100 million of commitments remaining uncalled, while Fund B has $400 million of commitments remaining uncalled, then, if a new investment is allocated based on committed capital, each fund will take half the transaction. However, if the allocation is based on available capital, then Fund B would take 80% of the opportunity and Fund A would take 20% of the opportunity.

Another way to avoid the conflict is to close the investment period for new investments of Fund A when Fund B commences. Note that although this avoids the conflict on allocation of new investment opportunities, by closing the investment period of Fund A, the management fee calculation may then be made based on the reduced amount of invested capital under management rather than committed capital.

Follow-on investments present additional potential conflicts. As to allocation of the opportunity, one might provide that all follow-on opportunities for investment in portfolio companies of Fund A must be offered to Fund A. If Fund A did not have capital available to make the investment or to fund the entire amount, then Fund B could be offered the opportunity to invest. When Fund B makes

an investment in a portfolio company in which Fund A previously has made an investment, there is the sensitive issue of placing "good money after bad." Some funds either flatly prohibit follow-on investments in portfolio companies of an earlier fund, or restrict these investments in circumstances in which the earlier fund owns a material percentage or otherwise controls the portfolio company.

Often funds do not prohibit such follow-on investments, but place safeguards to protect fund investors. For example, a follow-on investment in a portfolio company of an earlier fund might require an independent valuation (either by an outside expert or by the market check of a co-investor taking a significant percentage of the investment), and/or the review and approval of the advisory boards of the funds involved.

In each of these potential conflict situations, the manager is called upon to use judgment not only as to a fair price, but also as to the allocation of the investment opportunity based on the status of each fund. What factors should the manager consider in making this determination? What covenants might the manager have agreed to with the limited partners of Fund A that govern? For example, although Fund A has capital remaining available, the manager must determine how much of that capital it would be prudent to retain for anticipated expenses (including management fees) and other possible follow-on investments. The time horizon for expected realization must be assessed.

While it is true that investors in Fund A do not want to pass up a possibly lucrative investment opportunity, they also do not want to extend the term of their fund beyond its expected life. The manager must be sensitive both to managing investor expectations as to timing of realizations as well as to the effect on the fund's IRR of extending the term. In fact, some funds limit further follow-ons to a period of two or three years following expiration of the initial commitment period for this reason. The manager also must consider concentration issues based on the total amount of capital being invested in the portfolio company or in the industry of the portfolio company.

Separate from the potential conflicts in allocating an investment opportunity between managed funds, there also are issues to consider relative to a portfolio company of Fund A if the new investment opportunity is potentially a natural acquisition for that portfolio company. Assuming the manager has a representative on the board of directors of the portfolio company, then the director may have a fiduciary duty to provide the corporate opportunity to the portfolio company. This presumes, however, that the portfolio company is financially able to exploit the opportunity. Assuming the manager brings the investment opportunity to Fund B which makes the investment, then the manager may have competing companies in the same industry, raising significant issues of how to manage the business of those companies. For example, in any determination of the portfolio companies to pursue the same subsequent opportunity, the director representative of the manager would have conflicting duties to each of the portfolio companies. If, subsequently, the two portfolio companies sought to combine, the manager would have a conflict as it would be on both sides of the transaction.

Many of these conflict issues can be addressed in fund documentation pursuant to which limited partners acknowledge potential conflicts and waive them in advance, or agree upon objective parameters to be met before an investment presenting a conflict may be made. Similarly, corporations in Delaware may waive by charter provision or vote of its board of directors any interest or expectancy in, or being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities. Transactions between multiple portfolio companies in which the manager has an interest can be accomplished so long as the conflict is disclosed and the transaction is approved by disinterested directors or shareholders of each portfolio company, or the transaction is fair as to each portfolio company.

It would be prudent for fund managers to protect themselves by incorporating provisions in their fund documents and in documents of portfolio companies that would allow them to maintain flexibility in allocating investment opportunities, while at the same time complying with their fiduciary obligations to their managed funds, and for portfolio companies to follow proper legal procedures in approving transactions in which they are conflicted.

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Fair Value Reporting for Illiquid Investments: Ready or Not (Here It Comes)

By **Roger Mulvihill**

For many years, private equity funds (both venture and buy out) carried illiquid portfolio companies at cost for at least a year or more unless a subsequent financial transaction supported a different valuation. In some cases, cost basis valuations continued until liquidity. This approach, often justified as conservative, tended to understate the actual performance of privately held portfolio companies in strong markets and overstate performance in weak markets. In the most extreme example, it took some years for the full impact of the internet bubble collapse to flow through to the financial statements of some limited partners.

Although generally accepted accounting principles require that investments be valued at "fair value," and most general partners are required to furnish GAAP financials to their limited partners, private equity funds and their auditors could plausibly argue for many years that cost approximated fair value for many private companies, partly because there was little guidance from the Financial Accounting Standards Board. In September 2006, the FASB issued FAS #157, which outlined specific methodologies for valuing illiquid investments and the accompanying required disclosures. Compliance with FAS #157, which is generally effective for financial statements issued for fiscal years beginning after November 2007 and interim periods within those years, could lead to much greater volatility in reported results of private equity funds and, at a minimum, will require significantly more attention to valuations by general partners.

Background

For some time, the private equity industry has struggled with the appropriate valuation of private companies in private equity fund portfolios. While general partners were obligated to report to their limited partners on the valuation of the fund holdings on at least an annual basis, and usually more frequently, there was a wide divergence in the application of valuation methodologies, even in funds that were contractually obligated to report on a fair value basis. As a result, the performance of similar funds (in style or vintage) was often difficult to compare. It was not unheard of for limited partners to receive different valuations from several funds that held similar interests in the same portfolio company.

Many general partners preferred relatively conservative valuation techniques, content to ride with the principle of "under promising and over delivering." Others wished to avoid the volatility in reported performance which a more comprehensive fair value reporting approach might encourage. As a result, a common conservative practice was to carry investments at cost for at least a year, unless an unrelated third-party financing clearly demonstrated a higher (or lower) value.

Partly in response to concerns by limited partners over the delays in writing down investments in the wake of the internet bubble, a volunteer group of industry-wide representatives (including general partners, limited partners, and service providers in the private equity industry in the

U.S. and abroad) organized the Private Equity Industry Guidelines Group ("PEIGG") in 2002. PEIGG sought to develop greater reporting consistency and transparency in portfolio valuations through the development of Guidelines for valuing investments in portfolio companies at fair value based on a more comprehensive approach to valuation. Although not binding on private equity funds, the PEIGG Guidelines were supported (but not endorsed) by the National Venture Capital Association, and endorsed by the Institutional Limited Partners Association.

While recognizing the role of the managers' "best judgment" in determining value, the Guidelines emphasized the importance of considering other methodologies, such as comparable company transactions and performance multiples, particularly when recent third party financings were nonexistent or stale. The Guidelines also endorsed the formation of Valuation Committees in private equity funds to review (but not determine) valuation methodologies and reported values. In 2003, the American Institute of Certified Public Accountants urged auditors to take a rigorous approach to ensuring client use of fair value in valuing illiquid assets.

The PEIGG Guidelines were not greeted with unrestrained enthusiasm. According to a 2005 survey of 102 private equity funds by the Tuck School of Business at Dartmouth College, only 19% of respondents formally adopted the Guidelines. A significant number of respondents who did not adopt the Guidelines cited their preference for write ups only if a new round of financing had occurred, an implicit recognition of the potential volatility and other drawbacks of the fair value approach. The study also found that, although all of the respondents prepared audited fund financial statements for 2004, fewer than 1% had been issued a qualified opinion for not using fair value methodologies, and only 1% had been warned to expect a qualification going forward if fair value standards were not explicitly adopted. Interestingly, nearly 70% of the respondents said that they would write up their portfolios by some percentage if they were to apply fair value principles.

In September 2006, the Financial Accounting Standards Board adopted FAS #157 ("Fair Value Measurements") for all fiscal years beginning after November 2007 (although earlier application was encouraged). FAS #157, which requires investments to be reported at fair value, set up a comprehensive three level scheme for determining fair value, and PEIGG in March 2007 issued its own report, which is intended to assist managers of private equity funds in applying FAS #157 to their specific circumstances.

In general, FAS #157 and the Updated PEIGG Guidelines seek to have all portfolio investments reported at fair value on a consistent, transparent, and prudent basis. Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The objective is to estimate the price at which a hypothetical willing marketplace participant would agree to transact in the principal market or, lacking a principal market, the most advantageous market.

At each valuation date, including periodic reporting dates within the fiscal year, the managers must make a determination of fair value for each investment that takes into consideration all relevant factors (i.e., all reasonably available information about the business and all assumptions that market participants would normally use in their estimates of value). Accordingly, the managers cannot simply rely on cost or the value of the latest round of financing as an approximation of fair value without taking into consideration other facts and circumstances.

Other Measures of Value

Both FAS #157 and the Updated PEIGG Guidelines recognize that cost or latest round financing will still be useful benchmarks, and in some instances, such as early stage venture companies whose promise is still largely unfulfilled, may be determinative. In other situations, where such measures of value become less reliable as an approximation of fair value over time, the Updated Guidelines require a careful consideration of other factors.

Where more reliable indicators of value are not available, the Updated PEIGG Guidelines encourage managers to look at third party investments in equity securities of comparable companies, adjusted for any control premiums or unique synergistic benefits or detriments. However, the Updated Guidelines recognize that comparable companies may be difficult to identify until the portfolio company has achieved marketplace acceptance for its products or services.

Under such circumstances, the Updated PEIGG Guidelines encourage the use of a performance multiple methodology to derive the value of the portfolio company. An "appropriate and reasonable" multiple is obtained from reference to market based conditions of quoted companies or recent private transactions, and adjusted to reflect differences in growth prospects and risk attributes.

The Updated PEIGG Guidelines note that the appropriate multiple would be one of the following:

- current average comparable company multiples;
- current average multiples for recent private transactions in similar companies; or
- the original acquisition multiple.

The appropriate multiples, adjusted if necessary, will then be applied to the relevant operating performance data.

If performance multiples cannot reliably be used to measure fair value, the manager should consider other valuation methodologies, such as discounted cash flow where estimates and forward looking information are reliable; net asset valuations when value relates primarily to tangible assets rather than performance; or industry specific benchmarks that are customarily and routinely used in specific industries (e.g., price per subscriber).

In the end, the estimate of fair value under FAS #157 would require the managers to consider all reasonably available information about the business of the illiquid portfolio company and to utilize assumptions that market participants would normally use in their estimate of value.

Observations

- If nothing else, the implementation of the new rules on the valuation process for audited financials is likely to be far more demanding than in the past. One prominent industry participant noted that a process which typically took two hours recently extended over three or four weeks—virtually a full audit of valuations. Limited partners have also requested additional portfolio company documentation from private equity firms to support their own valuation audits using fair value accounting.
- Could private equity firms avoid fair value treatment altogether? The Updated PEIGG Guidelines note that the provisions of the partnership agreement govern, and in theory the general and limited partners could agree on a different basis of valuation. The valuations, however, may not be GAAP-compliant, so that limited partners who themselves need audited financials may not concur in a different approach to valuation. In partnership agreements with valuation provisions that are inconsistent with FAS #157 and whose limited partners require GAAP statements for their own purposes, the Updated Guidelines suggest that the managers furnish two sets of statements or amend their partnership agreements to comply with GAAP valuations.
- If general partners of private equity firms fail to adopt FAS #157, or are slow to transition to fair value to the satisfaction of their auditors, it could produce significant problems for some limited partners, such as public pension systems that are legally required to produce annual GAAP-compliant financials. Limited partners are not well positioned to systematically and independently value numerous underlying portfolio companies. The Updated Guidelines do not address limited partner or fund of fund valuation issues.
- Fair value reporting would be used for both annual and quarterly statements as well as in private placement memoranda and other marketing materials. Although both FAS #157 and the Updated PEIGG Guidelines note that only a reasonable effort is required by managers without incurring undue cost or expense, frequent application of the fair value methodologies is not an insignificant undertaking. While less effort might be reasonable in interim reports than in the annual valuations, inconsistencies between the two resulting from more limited reviews in interim periods

could be embarrassing or worse, particularly if these inconsistencies were reflected in fund raising documents. Some have speculated that the pendency of fair value accounting might encourage fund sponsors to accelerate the fund raising cycle in order to operate under the existing valuation approaches before fair value reporting has firmly taken root. However, fund raising decisions are driven by many other variables that are more significant (i.e., market conditions, track record, remaining capital), and, in any event, all private equity funds subject to GAAP reporting will sooner rather than later be required to conform to the new requirements.

- Although neither FAS #157 nor the Updated PEIGG Guidelines requires managers to obtain independent valuations, it would be desirable to form a Valuation Policy Committee consisting of a subset of the fund's investor representatives. (Many private equity funds already have Advisory Boards which could serve similar functions). The Valuation Policy Committee would establish written valuation parameters and would periodically review the level of the manager's adherence to the policy parameters, although it should be clear that private equity fund managers are solely responsible for establishing and documenting valuation policies, practices, and procedures, and for valuing investments.

- While in theory there should be no bias toward either increasing or decreasing carrying values to reflect fair value, a decrease in value may be more easily identified than an increase in value. The Updated PEIGG Guidelines note the difficulty in building sustainable long-term value in private equity and urge caution in recording write ups, particularly for early stage venture companies.

- Values associated with preferred stock should reflect the relative economic and control rights of holders as provided in the constituent agreements. However, since liquidation preferences are often renegotiated or not fully enforced, managers are encouraged to reflect such adjustments in determining the value of securities with liquidation preferences.

- FAS #157 and the Updated Guidelines will conflict with the common practice (particularly among venture funds) of valuing investments using the last round of financing. How much time can reasonably pass before such valuations are considered stale? There is no "hard and fast" rule, but an arbitrary time frame will not be consistent with GAAP. The Updated Guidelines recommend evaluating the investment at least as of each reporting date by considering such factors as the portfolio companies' progress against milestones, performance against budgets, and market or economic conditions.

- Some common valuation practices will be modified by the new fair value rules. Typically, a subsequent equity financing that included substantially the same group of investors was not a basis for revaluing the investment. Under the new fair value approach, it generally would be considered. In that same vein, a subsequent third party financing at a substantial increase to the last round was often discounted, whereas there would be no basis for a discount under fair value reporting, unless the third parties paid more than fair value or the rights of the securities were substantially different. Under fair value accounting, transaction costs (on the way in or expected on the way out) are not included in the determination of fair value. Finally, the Updated PEIGG Guidelines recommend an adjustment at the measuring date for the carrying value of interest bearing securities as a result of changes in interest rates, a reversal of the 1989 Guidelines of the National Venture Capital Association.

- One unforeseen effect of fair value accounting may be the impact on provisions of many partnership agreements that permit a pay out of carry to the general partners only after the value of the portfolio reaches a percentage of invested capital (i.e., 120% or 130%). While the precise language of the reserve provision will control, the application of fair value accounting could permit higher valuations than under the more conservative approach and release of carry before the limited partners expect.

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Antitrust Considerations in Sector-Focused Investment

By **Paul T. Denis** and **Jeffrey W. Brennan**

Sector-focused private equity investments, particularly those involving portfolio companies that compete, can offer sponsors the opportunity to realize significant synergies, thereby driving the kind of returns their investors have come to expect. In the wake of the FTC investigation into Carlyle Group's investment in Kinder Morgan, much has been made of antitrust as a possible impediment to private equity investments. But while antitrust laws certainly do apply to mergers and even partial acquisitions, they are hardly an impediment to most private equity sponsors. To the contrary, the evolution of antitrust merger analysis and merger remedies has created opportunities for deals that previously could not be done.

Principal one: Numbers do not matter like they used to. Compared to prior periods, the Federal Trade Commission (FTC) and Antitrust Division of the Department of Justice (DOJ)—the federal agencies responsible for U.S. antitrust law enforcement—today place decidedly less importance on market concentration and market share levels. The agencies instead focus primarily on how competition actually occurs among merging companies and their rivals, and how the merger is likely to affect that competition.

An important consequence of this "competitive effects-based" merger analysis is that the agencies are more apt to clear many deals that, due to high market shares and concentration levels, almost certainly would have been off-limits in the past. This is not because government scrutiny of mergers is less rigorous than before—it isn't. Rather, it is because smart merging parties apply experience, economic learning, and modern statistical tools to develop and interpret concrete evidence on how the affected markets work and why this particular transaction will not adversely affect that competition. Then they effectively present this evidence to agency staff reviewing the deal. This is how deals like *Whirlpool-Maytag* (DOJ cleared, despite 70% share in washers and dryers) and *Federated-May* (FTC cleared, despite 90% share in traditional department stores in some cities) got through.

In general, a merger might be anticompetitive for two reasons. First, it may enable the remaining firms in the market to raise price, either by coordinating their actions or by coordinating more effectively than before. The government would have to show that the merger substantially weakens constraints on coordination that existed before the merger. Second, the deal may enable the merged firm unilaterally to raise prices, without regard to how rivals respond. Such an effect often depends on a particular closeness in rivalry between the merging companies in terms of their location, product characteristics, bid history, or customer preference. Absent evidence that it is likely to have a negative effect on the competitive status quo in one of these two ways, a merger is unlikely to meet government resistance merely due to "high numbers."

Principal two: Merger remedies usually are not "all or nothing." For transactions that present competition concerns, the agencies show greater flexibility in accepting remedies that allow the deal to close with divestitures or other forms of relief. The government usually prefers divestiture, but may sometimes agree to limit the assets to be divested—such as by product line or geographic area. Depending on the circumstances, the government may be open to limiting the remedy primarily to licenses of key intellectual property, or, in some cases, to restrictions on future conduct. This is how competitive concerns were resolved in deals like *Monsanto/Delta & Pine Land* (DOJ consented to a remedy that included transfer of certain intellectual property and license to other intellectual property), *Procter & Gamble/Gillette* (one FTC-mandated divestiture was accomplished without the sale of any hard assets), and *Carlyle Group/Kinder Morgan* (FTC cleared upon Carlyle's agreement to end its board representation in the rival, cede control of the rival, and refrain from influencing the rival's management).

The number of potential antitrust questions that may arise in any transaction involving direct competitors, and the market factors that may be relevant to answering those questions, are of course too numerous to identify here. But applying these two principles should afford sector-focused private equity investors opportunities to do deals previously thought to be beyond their reach.

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UK "Anti-LBO" Laws to be Revoked

By **Adam Levin**

English law has given much to worldwide jurisprudence and legal theory. One of its most notable theories has been the common law created by the courts on the maintenance of capital. Essentially, this means that a company cannot deal with its capital, except in a manner approved by the law.

So, for example, when the shareholders of a company want the company to make some sort of capital transaction, such as granting security over its assets so that its shareholders can keep the acquisition finance costs down, the common law steps in and prohibits the transaction unless all the legal rules are met. These rules might be contained in the articles of association of the company, or in the governing company's legislation.

This has always been quite an unusual doctrine of law that developed, at its heart, as an all-encompassing prohibition, rather than what you might be accustomed to from English law—namely the permission to do anything, except specific issues that are deemed worthy of protection for society's sake. Compare, for example, the development of the law of negligence, where the courts found and developed a duty of care to protect people from the behavior of others which fell below the expected standards—the courts didn't develop a law of permitted behavior ruling everything else as impermissible.

After the courts set this precedent, the British Parliament picked up on it and, in response to the demands of an increasingly sophisticated business environment and international developments, created a number of exceptions to the prohibition to facilitate the functioning of companies. This created an unusual situation for the UK's lawmakers—instead of doing what they usually do quite well in the sense of identifying behavior that they did not like and outlawing it, they had to try to make sense out of a prohibition that the courts had handed them and make it workable.

You might think that they could have foreseen the folly in all this (one member of a U.S. private equity fund deal team expressed his frustration to me about these laws by calling them "anti-LBO" laws) and would simply have reversed the prohibition, but they didn't. So there is a hodgepodge of band-aid exceptions that we've had to grapple with over the years. There are exceptions for dividends, court approved capital reductions, buy-backs of shares if you follow the statutory formula, and the so-called "whitewash" procedure, which permits the giving of financial assistance if you comply with the requirements laid down in the UK companies legislation.

The "whitewash" was estimated by the UK's Company Law Review Steering Group to cost the economy about £20 million in 1999. With the explosion of leveraged buyout activity since then, the costs are now likely to be much higher. To meet the requirements for the "whitewash," the directors have to make a statutory declaration about the company's continuing solvency for one year ahead, and the auditors have to report (which usually takes about a month to prepare) that the directors' statement is reasonable.

In leveraged buyouts, typically warranties about the robustness of the target's business plan and its likelihood of success are either struck out by the seller's lawyers at the first instance and never argued for again, or they're never requested in the first place as the buyer's lawyers will confidently confirm that no properly advised seller would be likely to give the warranty, particularly in a competitive market where sellers have the edge. Yet, to achieve the lowest cost financing structure by having the banks' security placed directly on the assets, the law asks the company's directors after the acquisition (often none of whom have been directors of the company beforehand) and the company's auditors to make exactly the same type of statement, backed up by criminal penalties if the statement has not been made on reasonable grounds.

Additionally, the EU has made it compulsory for EU countries to adopt laws preventing a public company from giving financial assistance, and it's a condition of EU membership for new countries that they introduce such laws for public companies incorporated in their countries. How-

ever, countries often introduced the financial assistance prohibition concept without limiting their application to public companies or a clear description of the boundaries of the requirement, which means that, if you're trying to obtain a clean legal opinion on whether the leveraged financing structure you are proposing complies with these laws, you can forget it—anyone who knows anything about the laws won't give you a clean opinion. In England and Wales, we have an independent expert bar consisting of barristers who are prepared to express their opinions on a particular structure. That's often good enough for solicitors and clients (whether sponsors or banks) alike. No other country around Europe has a similar system.

However, the tide is turning and lawmakers are now realizing that they have sufficiently tough laws in place to do away with the financial assistance prohibition laws. What's changed? I think that people have just realized that the laws don't actually serve to protect any particular constituency not already covered more than adequately by other laws. Shareholders are frustrated because it's their money that they can't deal with as they want, and creditors are amply protected by insolvency type laws.

The UK has already abolished the prohibition with effect on October 2008 for private companies, and would like to have abolished it for public companies as well, except that EU laws (which ironically were heavily influenced by British laws in the first place) prevent it. However, even at the EU level, ideas are changing. There are now proposals to partially relax the prohibition for public companies providing financial assistance in some circumstances. The amount of the financial assistance must not exceed the level of the company's distributable reserves, and certain other requirements must also be met, but at least the possibility of a relaxation of the laws is now being discussed.

What will happen when the laws are abolished? There is some speculation by commentators that banks will require companies going through a leveraged buyout to comply with a similarly cumbersome and expensive procedure as applies now.

Personally, I think that such thoughts are fanciful musings from a group that is wondering what to do about the loss of fees caused by the absence of the "whitewash" procedure. Banks don't require that sort of process for any other type of loan and, even if they'd like to have it, the market is awash with money, so the thought of one bank making it a requirement would be akin to a modern-day King Canute ordering the tide to stop advancing—the bank would lose all its business and credibility.

So what will happen in the UK after the change in the law? There will be no free-for-all on companies' assets. Rather, we'll see advice on insolvency laws coming to the forefront—directors will need to make sure that they aren't unduly stressing a company's finances; otherwise they could suffer heavy personal penalties or imprisonment. Also, directors' attentions will be drawn to their fiduciary positions, so that the penalties of making improper payments (for example, payments that benefit them personally) will be in the forefront of their minds.

And, for private companies at least, we'll be back in the position that UK lawmakers are rather more used to handling—namely identifying improper conduct and outlawing it.

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