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In this issue

Loan-to-Own Strategies and the Private Equity Investor

by **Craig L. Godshall** and **H. Jeffrey Schwartz**

The U.S. economy is currently in a severe credit crunch as a result of the sub-prime mortgage crisis. While the downward trend of the credit markets poses a serious threat to the U.S. economy and existing investors in troubled companies, substantial opportunity exists for investors to acquire good businesses with bad balance sheets at distressed prices by executing a loan-to-own strategy.

The Dechert team routinely advises its clients with respect to loan-to-own transactions. Generally, loan-to-own transactions involve one or more of the following:

- the purchase or provision of prepetition secured debt;
- the provision of debtor-in-possession financing;
- rights offerings or plan funding agreements; or
- the purchase of the fulcrum security.

In the past, investors specifically targeting distressed debt have been the most active in utilizing these strategies. With the dearth of financing for traditional private equity investments, and the possibility in bankruptcy that some of the bankruptcy constituencies will be forced to take notes for their claims (and effectively provide financing to the buyer), private equity firms have taken a new look at these loan-to-own strategies. While the basics of loan-to-own are as true for private equity investors as the more traditional distressed debt investors, there may be some important issues in execution that are more critical to a private equity investor.

Here's an overview of loan-to-own:

Executing a Loan-to-Own Strategy

Secured Debt

The first strategy that a distressed investor can use to acquire a troubled business is by providing senior secured debt or by purchasing the company's senior secured debt. By holding a first lien position, the distressed investor will have powerful leverage to influence a restructuring. If the company commences a chapter 11 case, a secured creditor can participate in an auction of the company's assets by credit bidding the full face value of its allowed secured claim as opposed to the discounted purchase amount of the claim.[1] In addition, the secured creditor will have a leg up over other potential bidders for a company's assets because it will have superior information about the company and its assets by its position as a secured creditor.

The secured creditor will have significant leverage with respect to the ultimate formulation of the debtor's chapter 11 plan. The secured creditor will either be able to control the reorganization or receive payment for the full amount of the allowed claim. Specifically, to cram-down a plan on an objecting secured creditor, the company will be required to make deferred payments under its plan of reorganization whose face value equals the amount

[1] *See Cohen v. KB Mezzanine Fund II, LP v. Cohen (In re Submicron Sys. Corp)*, 432 F.3d 448, 459-60 (2d Cir. 2006).

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of the allowed claim and whose present value equals the value of the collateral.

In *In re Granite Broadcasting Corp.*,[2] the court was faced with two competing distressed investors at different levels of the capital structure. One investor was a secured creditor of the company and the other was a preferred stockholder of the company. The company proposed a chapter 11 plan that provided the secured creditor with an 85% recovery including most of the new equity of the company. The preferred stockholders offered an alternative package that would have given the secured lender a 100% recovery in debt and cash and provided the new equity to the preferred stockholders.

In support of the alternative plan, the preferred stockholders argued that because the secured lender preferred an 85% package including the new equity to a 100% package of cash and debt, the secured lender could not possibly believe the valuation proffered by its expert. The court rejected this argument because the issue is not whether the secured lender believes that there may be upside to its investment in the debtor but whether the plan gives the secured creditors value that is more than 100% of their debt. Accordingly, the court confirmed the plan proposed by the company and in favor of the secured lender.

The *Granite* decision demonstrates, among other things, that a distressed investor using a secured debt strategy has a leg-up on other constituencies at lower levels of the capital structure.

DIP Financing

A distressed investor can provide debtor in possession financing ("DIP financing") to the company once it commences a chapter 11 case. While the Bankruptcy Code provides that a new lender can prime a prepetition secured lender, i.e., by taking a security interest in collateral ahead of the security interest of the prepetition secured lender, priming can only be accomplished if the debtor is able to provide the prepetition secured lender with adequate protection for the diminution of value of its collateral as a result of the priming loan. Accordingly, in most situations, the prepetition secured lender provides the DIP financing. As a result, if a distressed investor desires to provide DIP financing, holding a position in the prepetition secured debt will make it more likely that the DIP financing is approved by the bankruptcy court because the DIP lender can consent to the priming of its prepetition liens.

There are several advantages to providing DIP financing for the distressed investor. The DIP financing will be subject to approval by the bankruptcy court. Once the DIP financing is approved by final order, the DIP lender will have super-priority claims and liens that are not subject to challenge. The ability to obtain a court order and certainty of legal rights in the DIP financing should provide a distressed investor with substantially more comfort than if it was providing a secured bridge loan before the commencement of a bankruptcy case.

A distressed investor also can use DIP financing to take control of the negotiations concerning the company's chapter 11 plan or to control the sale of assets to the DIP lender. In *Official Committee of Unsecured Creditors v. New World Pasta*,[3] both the district court and bankruptcy court held that a DIP financing agreement may provide that any chapter 11 plan of reorganization must be satisfactory to the DIP lender. In addition, bankruptcy courts have repeatedly approved DIP financing agreements providing that the terms of an asset sale under section 363 of the Bankruptcy Code must be satisfactory to the DIP lender.[4]

Fulcrum Security

The second strategy for a distressed investor is to determine which layer of a company's capital structure is the "fulcrum security." The fulcrum security is the security that is most likely to receive equity in the reorganized company after confirmation of a chapter 11 plan. Whether a particular security will be entitled to equity will be determined by the enterprise value of the company. For example, if a company has an enterprise value of $150 million, $100 million in secured debt, and $100 million in unsecured bond debt, the holders of the secured debt will be paid in full, and the holders of the bond debt will receive equity in the reorganized company. Existing equity will be cancelled. In this example, the bond debt is the fulcrum security.

If the fulcrum security is an unsecured obligation of the company, the distressed investor can band with other similarly situated investors to form an ad hoc committee and pursue restructuring negotiations with the company. In addition, the distressed investor also may be able to serve on an official creditors committee once the company commences a chapter 11 case. By serving on either an ad hoc or official committee, the distressed investor will be able to obtain material non-public information from the company. However, by receiving such information, the distressed investor's ability to trade its securities in the company may be significantly limited.

[2] 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

[3] 322 B.R. 560 (M.D. Pa. 2005).

[4] *See*, for example, the court-approved DIP agreement in *In re Phoenix Information Systems Corp.*, Case No. 97-02498 (Bankr. D. Del.).

Rights Offerings and Plan Funding Agreements

To increase its holdings in the new equity of a reorganized company, a distressed investor may participate in a rights offering to purchase the new equity either as part of the chapter 11 process or before the commencement of a chapter 11 case in the context of a prepackaged bankruptcy. For example, in *Curative Health Services, Inc.*,[5] the company permitted certain large bondholders to participate in a rights offering for additional equity in the reorganized company in connection with the formulation of its prepackaged chapter 11 plan. By participating in the rights offering, large bondholders were able to obtain additional equity in the reorganized company at a discount in exchange for making the cash available to the company during the chapter 11 case.

Similarly, a distressed investor can choose to be a plan sponsor. In this capacity, the distressed investor agrees to contribute liquidity to enable the company to make distributions under its chapter 11 plan. In the *Loral Space* bankruptcy,[6] for example, MHR Fund Management supported a plan of reorganization that rendered MHR the reorganized debtor's controlling stockholder by, among other things, backstopping a substantial rights offering of senior secured notes by a Loral subsidiary.

Flexible Approach

Distressed investors can invest in various parts of a company's capital structure. For example, a distressed investor can have both debt and equity positions in a company. In this instance, the distressed investor must be careful to distinguish between its role as equity holder and its role as debt holder. This means not only executing separate documents respecting debt and equity investments but also acting like a debt holder when the investor monitors the loan and responds to a default. In addition, if the distressed investor has representatives on the company's board of directors, those directors should avoid any conflicts of interest that may arise if the investor enters into negotiations with the company to refinance its debt obligations.

Win Board Support

To maximize a loan-to-own strategy, the distressed investor should work with the company's board of directors. This emphasis on a cooperative approach with the board is consistent with the general approach of most private equity investors in transactions.

A company's board of directors has significant flexibility in choosing the course of a restructuring or a preferred bidder for the company's assets whether or not the company commences a chapter 11 case. In *North American Catholic Educational Programming, Inc. v. Gheewalla*,[7] Delaware's highest court held that (a) a creditor cannot assert a direct claim for breach of fiduciary duty against the directors of a solvent or insolvent company, and (b) a creditor cannot assert a derivative claim for breach of fiduciary duty against the directors of a solvent company. It remains unclear whether a creditor can assert a derivative claim for breach of fiduciary duty against the directors of a company in the zone of insolvency.

Traditionally, private equity investors have relied on a cooperative approach to maximize the information they get from the target company. This is true as well in a distressed or bankruptcy context, although a bankruptcy court will typically try to create a process that aims to give all interested parties access to a common set of information.

The inability of a creditor to pursue a direct claim against the company's board of directors for breach of fiduciary duty when the company is insolvent (and potentially a derivative claim when the company is in the zone of insolvency) provides directors with a basis to resist activist distressed investors.

Role of Management

The most significant set of issues that are specific to a private equity investor involve the role of management. Private equity investors traditionally hold tightly to three ground rules for their investments: (a) they are friendly with and aligned with management, (b) management invests a significant amount of their personal net worth in the transaction to focus their attention, and (c) an equity plan is set up to give management a significant stake in the upside of the target, assuming the target hits its objectives.

Of these three fundamentals, only the third carries over easily into the bankruptcy context. (A bankruptcy court in approving a reorganization plan will typically permit option, restricted stock and other equity plans as an incentive for management post-bankruptcy). The other two fundamentals, however, can be more problematic. For the first—collaboration and alignment with management—the position of the private equity investor depends greatly on the point in the process in which they invest. If they are investing at a time when the incumbent management team that presided over the deterioration of the business is still

[5] *In re Curative Health Servs., Inc.*, Case No. 06-10552 (Bankr. S.D.N.Y.).

[6] *In re Loral Space & Commc'ns Ltd.*, Case No. 03-41710 (Bankr. S.D.N.Y.).

[7] 930 A.2d 92 (Del. 2007).

running the business, there could be some real issues. The new private equity investor, for example, might be supportive of the incumbent management. It would not be uncommon and, in fact would be very common, for disgruntled creditors to be very unhappy with management. The management team the private equity investor invests with may or may not be the management team that survives the bankruptcy. A separate issue arises if the private equity investor invests when there is a restructuring team in place—a team brought in to replace the incumbents to try to fix the problems or at least halt the deterioration. Putting aside the turnaround specialists who only expect to work during the restructuring itself, it is not necessarily clear that a team whose strengths are cost-control, cost-cutting, and capital preservation is the same team that would be ideal for growth and development in a post bankruptcy environment.

Finally, it will often be the case that management in a distressed entity will simply not have the financial wherewithal to make a significant investment. If the target is currently owned by a private equity sponsor, chances are the management has lost their investment that they made with that private equity sponsor. If the target is a public company, chances are that the significant portion of their compensation tied up in options and restricted stock grants is now worthless. While some managers in a distressed scenario might indeed have the liquidity to make a significant investment, this will often not be the case.

Most private equity firms see their most critical role as evaluating management talent; in a distressed setting, this role is more critical than ever. Private equity firms take great pride in their ability to evaluate talent. The dynamics of loan-to-own investing truly puts this skill to the test.

Risks of a Loan-to-Own Strategy

Risks of Liquidation

While most high-profile bankruptcies often result in a reorganized company staying in business post-bankruptcy, the overwhelming majority of Chapter 11 filings result in liquidation. There is nothing magical about a bankruptcy filing; while it gives the company room by staying claims of pre-bankruptcy creditors, the poor financial performance that precedes the bankruptcy filing is often predictive of poor financial performance post-filing. When combined with the extraordinarily high cost of operating in bankruptcy the result is often liquidation.

This risk is present in almost every distressed company. In evaluating the right loan-to-own strategy to employ, the private equity investor will need to carefully evaluate the downside of the different strategies. A plan funding agreement is obviously the safest—if there is no reorganization, there is no funding (subject to the litigation risks described below). Providing the DIP financing also tends to leave the investor in a much better position in liquidation. In choosing its investment strategy, the private equity investor will need to make a careful analysis with its bankruptcy advisors of the right place in the capital structure to effect a loan-to-own strategy. The rules can be quite complex and the outcomes not always intuitive.

Litigation Risk

Distressed investors may face litigation from other constituencies seeking control or greater recoveries from a bankrupt company. Some of the claims that can be asserted against a distressed investor include:

- aiding and abetting breach of fiduciary duty;
- equitable subordination of the investors' claims;
- recharacterization of the investor's claims; and
- preference or fraudulent transfer claims.

However, a well-advised investor can structure the investment and related course of conduct to minimize the risk of such litigation.

In *Official Committee of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.),*[8] a distressed investor successfully thwarted claims asserting recharacterization, equitable subordination, and aiding and abetting breach of fiduciary duty with respect to secured loans made to the company before the commencement of its bankruptcy case. The *Radnor* decision provides some guiding principles:

- It is reasonable for a lender to provide additional credit to a distressed borrower before the commencement of a bankruptcy to protect its existing loans;
- An investor is not an insider even if the investor controls some, but not all, of a company's board seats, has the right to acquire additional board seats, and has access to non-public information; and
- A board of a highly distressed company may incur additional debt in an effort to rehabilitate the business.

Competing Investors

To ensure the success of a loan-to-own strategy, the distressed investor should be prepared to offer a superior

[8] 353 B.R. 820 (Bankr. D. Del. 2006).

apples-to-apples offer when confronted with competing investors at different levels of the capital structure. For example, if a secured lender attempts to control the restructuring process, distressed investors at lower levels of the capital structure can attempt to work with management and present a competing bid. The ensuing competition, and any associated legal fight, may produce a variety of benefits: (a) the competing bid may prevail, (b) the secured lender may make a significantly better offer that provides more value to distressed investors at lower levels of the capital structure, and (c) the value of the securities at different levels of the capital structure may temporarily spike because of perceived upside.

Conclusion

The current credit markets have created a wealth of opportunity for distressed investors to obtain strong returns by purchasing good businesses with bad balance sheets at distressed prices. Before making a loan-to-own play, the distressed investor should carefully determine which strategy to implement, determine the value of the company, properly document the transaction, and act in good faith.

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Private Investments in Public Equity


by **Brian D. Short** and **James A. Lebovitz**

In the past, when private equity investors invested in a public company, they were typically taking the company private. Recently, private equity sponsors have been investing more frequently as minority holders in public companies through PIPE (private investments in public equity) transactions. Private equity sponsors have been reluctant to make these "passive" investments. However, with the current disruption in the credit markets and the record amounts of capital in private equity funds, PIPE investments have become a more attractive means for private equity sponsors to deploy their capital.

The Changing PIPE Market

PIPE transactions have traditionally been used as financing vehicles for public companies wishing to avoid the time and expense of an underwritten offering. The sale of securities to an investor is done as a private placement to sophisticated investors without any general solicitation or marketing efforts by the issuer or its placement agent. The securities are subsequently registered with the Securities and Exchange Commission by the issuer for resale by the investors.

The companies tapping the PIPE market have traditionally been smaller and in industries that require frequent funding (e.g., biotechnology companies). In the current market, more and larger companies across different industries have entered the PIPE market. Some recent PIPE transactions involve Legg Mason, Lenovo, Sun Microsystems, and Palm Inc. According to industry sources, the total value of closed deals more than doubled from approximately $39 billion in 2006 to approximately $84 billion in 2007.

Many of these recent larger deals have been so-called "Sponsored PIPEs"—i.e., one investor takes all or substantially all of the securities sold in the placement. Sponsored PIPEs are attractive to private equity sponsors because purchasing the entire investment permits the investor to exert more influence on the structure and investment terms of the purchased securities.

Transaction Process and Structure

The transaction process in a PIPE transaction is streamlined. Due diligence is typically expedited because the issuer is a public company with publicly available information. The negotiation of the security and the transaction documents is also expedited due to the speed of the due diligence and the desire of the parties to keep the transaction confidential. The closing is usually a T+3 closing, as most transactions are structured so that stockholder and other third party approvals are not required.

Many traditional PIPE transactions are structured as a sale of common stock. In these transactions, the securities are usually offered at a discount to the current trading price. The issuer may also issue warrants as a "sweetener" in these transactions. Under the listing rules of the New York Stock Exchange and the NASDAQ Stock Market, stockholder approval is generally required for sales of 20% or more of the issuer's outstanding common or voting stock when the securities are issued at a discount to the trading price. Most deals are structured to avoid crossing this threshold, as closing speed and certainty are crucial advantages of a PIPE transaction to an investor and an issuer.

Most investments by private equity sponsors are structured as convertible preferred stock or convertible debt. These structures provide some downside protection to the investor and may also provide some control features. Due to the convertible nature of the securities, the underlying common or voting stock in many instances can be deemed to be issued at or above the trading price. This allows issuers to sell more securities in these transactions without the need for stockholder approval.

Unique Concerns of Private Equity Sponsors

Control

Unlike private equity sponsors' typical investments, PIPE investors will not control the board or the liquidity events of the company. In some cases, an investor may be able to negotiate for the right to designate a director or directors to the board and even some limited blocking rights. However, these provisions are far short of the control to which private equity sponsors are accustomed.

Liquidity

In most instances, PIPE investments offer short-term liquidity through the resale registration process. However, in some Sponsored PIPE transactions the issuer has required that the investor be restricted from selling for a specified period of time.

Transaction Fee

Infrequently, transaction fees are paid to the investor from the proceeds of the financing. Based on a review of PIPE transactions completed in the last two years involving private equity sponsors (and with proceeds greater than $25 million), we found only three transactions that included transaction fees to be paid to the investor. In each case, the fee was 1% of the gross proceeds.

Conclusion

As the PIPE market continues to grow, there are increasing opportunities for private equity sponsors to invest in a broad range of companies. PIPE investments offer many advantages to investors. Private equity sponsors should also be aware of the issues presented by these investments, as the issues are in many cases significantly different from those dealt with by private equity sponsors on their typical investments.

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LBOs: A Simpler System with Greater Influence

by **Graham Defries**

As UK law becomes more liberal, Germany and France may grow restless. Leveraged buy-outs (LBOs) with UK target companies will soon be easier to complete. Forthcoming changes to UK company law affecting LBOs, which the Companies Act 2006 brings in, will permit a company or its subsidiary to give financial assistance to acquire the company's shares or to reduce or discharge a liability incurred for that purpose. The new law differs from the German and French position on the acquisition of a target company incorporated in either of those jurisdictions.

Whitewashing

In October 2008 the Companies Act's rules on financial assistance will take effect. The law on financial assistance currently prohibits assistance being given for the proscribed purposes for both public and private companies, subject to a variety of exceptions (some of which are broadly considered unreliable in practice). It grants an exemption for private companies in certain circumstances. This is called the whitewash procedure. Public to private deals have been able to be completed by employing a whitewash before giving security to a lending bank after the public target has been reregistered as a private company. The lender's ability to perfect its security over the target's assets is delayed. This prohibition has become a

problem for LBOs because it creates extra cost, complexity and delays. The Law Commission estimated that the whitewash procedure cost the UK economy £20 million ($39.45 million) in 2000; and with the explosion in leveraged buyout activity since then, that sum must now be much higher.

A whitewash cleanses what would otherwise constitute the giving of unlawful financial assistance by a private company. In the whitewash procedure, before the assistance is given, the directors satisfy themselves that the company giving the assistance is solvent. They swear a statutory declaration, backed up by an auditors' report, confirming that the company will be able to pay its debts for at least 12 months after providing the assistance. These requirements cost money. And if it emerges that the statutory declaration was not based on a reasonable belief held at the time it was given, the directors are exposed to personal liability. The risk of personal liability can cause nervousness among management buyout teams, which may not be intimately involved in the structuring of the loan—the incident that will need to be whitewashed.

A whitewash cleanses what would otherwise constitute the giving of unlawful financial assistance by a private company.

Fewer Restrictions

The new law will now allow UK companies to give financial assistance, removing the need for the whitewash procedure. But it will still not be possible for a private company to grant financial assistance for the proscribed purposes in an acquisition of shares in its public holding company, or for a public company to grant financial assistance for the proscribed purposes relating to an acquisition of shares in its private holding company. The prohibition on the giving of financial assistance by public companies remains in place. It is likely that this would have been removed as well, had it not been that EU law—ironically heavily influenced by UK company law—prevents its removal. At the EU level, proposals now exist to relax the prohibition on public companies when the amount of financial assistance does not exceed the company's distributable reserves, and when certain other requirements are also met.

Three aspects of a typical deal reveal the practical impact of this legislation for leveraged buyouts. First, regarding the target company's granting of security over its assets to secure the bank loan that makes an LBO possible, the new legislation will remove the restriction preventing a private company from giving financial assistance, in many circumstances, from October 2008. Thus, it removes the need for the whitewash procedure.

This development has advantages in the context of LBOs. It eliminates the need for the complex structures that have been employed to avoid problems relating to financial assistance. It also reduces the legal and audit fees associated with the whitewash procedure and compliance with the legislation. Some commentators have speculated that banks will ask companies engaged in a leveraged buyout to go through a process as cumbersome and expensive as the whitewash, even without the formal need to do so. But banks do not require such procedures for other loans, and it seems unlikely that they would require it for a leveraged buyout in the absence of the legal requirement.

Second, the issue of what amount (if any) might not be considered material for the purposes of the statutory prohibition as a proportion of a private target company's net assets, and therefore might be paid towards the LBO team's professional fees without whitewash, no longer exists. Last, the lifting of the restrictions on financial assistance for private companies will solve the often highly contentious issue of the directors' declarations that have been required under the whitewash procedure.

And on the Continent

The new UK law is much more liberal than German and French legislation. Some similarities exist between legislation for German limited liability companies (GmbHs) and limited companies in the UK. But in the past the UK need for the whitewash procedure made its laws more cumbersome than those of Germany. Under German law the key factor is the maintenance of equity capital (non-freely available equity of the company). This is reflected

in the requirement that the assets of a GmbH cannot be reduced by the grant of financial assistance to below the level of free equity capital. The definition of financial assistance under German law includes the grant of security over the company's assets for the liability of shareholders to a third party. Following the implementation of the new law in the UK, the German stance will seem much more restrictive. For German public companies (AGs) the prohibition covers all the company's assets. As with UK laws on public companies, it is possible that the German public companies position will be amended as a result of any change in European legislation.

French legislation states that a company may not advance funds, grant loans or give guarantees in view of the subscription or the acquisition of its own shares by a third party. This general prohibition applies to French *sociétés anonymes* (SA), *sociétés en commandite par actions* (SCA) and *sociétés par actions simplifiées* (SAS). The prohibition

Following the implementation of the new law in the UK, the German stance will seem much more restrictive.

on financial assistance applies to all schemes that could be directly or indirectly considered as granting a loan or giving guarantees by the company for the purpose of the subscription or the acquisition of its own shares. Some legal exceptions to this prohibition exist, and there are practical ways of dealing with it, subject to certain conditions. But unlike the UK, France does not have the equivalent of the whitewash procedure, making the French position more restrictive. As with Germany, the UK's new stance on giving financial assistance will be substantially more liberal than that in France.

The impact of the removal of the prohibition of financial assistance by private companies will be positive for the LBO industry in the UK, reducing the costs and complexity of leveraged buyouts. It remains to be seen whether the increased permissiveness of UK law will result in calls to reform the laws in Germany or France, to bring them in line with the UK position.

A version of this article authored by Graham Defries, Olivia Gueguen and Kristina Karbach appeared in the January 2008 edition of the International Finance Law Review (IFLR) Private Equity and Venture Capital Review *supplement*.

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"Big Boy" Letters Do Not Always Insulate Traders from Liability


by **Glenn E. Siegel** and **Davin J. Hall**

Holders who receive confidential information but still want to buy or sell the related debt sometimes use "big boy" letters to complete a trade. These letters, which are only entered into between sophisticated investors (i.e., "big boys"), are effectively a waiver of rights by the party to the trade who does not possess the confidential information when, notwithstanding this inequality in information, this party is still willing to make the trade.[1] The industry believes that such a letter adequately protects the party with superior information because the other "big boy" has waived its claim.[2]

Nonetheless, these letters cannot offer complete protection because they are not binding on the SEC or the company providing such confidential information. In particular, a big boy letter does not insulate the trader from liability under Exchange Act Rule 10b-5(2), which provides that the duty of trust or confidence forming a predicate for insider trading liability under the "misappropriation" theory exists whenever a person *agrees* to maintain information in confidence.[3]

R² Investments v. Salomon Smith Barney and Jefferies

The issues related to the use of "big boy" letters came to a head in a lawsuit recently brought by the Texas-based hedge fund R² Investments. In *R² Invest. LDC v. Salomon Smith Barney Inc.*,[4] R² Investments sued Salomon Smith Barney ("SSB") and Jefferies for violations of federal securities law and common law fraud in connection with its purchase of certain unsecured notes of World Access. R²'s complaint alleged that SSB owned $31 million in ap-

1 Anderson, Jenny, *Buyer-Seller Agreements Not to Sue Raise Issues About Inside Information, New York Times* at C1 (May 22, 2007).

2 *See, e.g.,* Drain and Schwartz, *Are Bankruptcy Claims Subject To The Federal Securities Laws?*, 10 AMBKRILR 569, n.105 (Winter, 2002).

3 *See, e.g.*, McTague, Rachel, *In Insider Case, Big Boy Letter Signatory Need Not Have Been Deceived, Official Says*, 39 SRLR 1893 (Dec. 10, 2007).

4 Case No. 01-03598 (S.D.N.Y. 2001).

proximate face value of World Access notes as of October 2000.

Under the notes' indenture, World Access was required to make a tender offer upon consummation of a certain asset sale; however, it was dealing with various liquidity and cash flow issues, so a protective group of the largest noteholders (including SSB) was formed to discuss a restructuring. As a member of this protective group, SSB was required to ratify an agreement to keep confidential certain non-public information. It was alleged that this information included the fact that World Access was only prepared to make a tender offer for less than half of the debt that the public thought was going to be tendered and that it was considering filing for bankruptcy.

SSB then sold these notes to Jefferies pursuant to a big boy letter under which Jefferies acknowledged that SSB (as seller) was in possession of material, non-public information, but also under which such information was not to be disclosed to Jefferies (as buyer). At SSB's request, Jefferies sold the notes to a third party, which in turn sold the notes to R2. After the transaction, the reduced scope of the tender offer was made public with predictable results in the marketplace for the World Access debt. The repercussions in the marketplace of this announcement were so severe that World Access filed for bankruptcy.

As a result, on April 27, 2001, R² sued SSB and Jefferies, arguing that both had committed securities and common law fraud and, in particular, that Jefferies had a duty to disclose that it was a party to a big boy letter and was trading with inside information. In its motion for judgment on the pleadings, Jefferies argued that its knowledge that SSB was in possession of non-public information was too general to be material for purposes of disclosure under the securities laws.[5]

Moreover, as Jefferies argued, disclosure was not warranted since R² must have known that the ultimate seller of the notes sat on the protective committee (since there was no other noteholder that held so large an interest that was not also on that committee), and in any event, the public knew that World Access was not doing well financially and that the tender offer was not a closed deal. Furthermore, even if the underlying information was material, Jefferies argued that the very existence of the big boy letter meant that SSB's possession of material, non-public information (as opposed to the actual nature of the information) was not subject to a duty of confidentiality between SSB and World Access. Jefferies argued that R² could not recover because it did not show that the fact that SSB had material, non-public information (as opposed to the actual undisclosed information) would have affected its decision to purchase the debt.

The focus of SSB's motion to dismiss was on R²'s securities fraud allegations. Among other things, SSB interpreted R²'s complaint as making two types of insider trading claims—one based on a classical theory of insider trading and the other based on a misappropriation theory.[6]

Essentially, SSB argued, for it to have incurred liability under a classical theory, it would had to have been an insider of World Access, which it argued it was not, since merely possessing non-public, material information did not give rise to insider status.[7] Jefferies argued that it had no duty to R², because it was trading in debt securities and was not the direct seller of the securities that R² purchased. SSB also argued that it was not liable under a misappropriation theory, because only the issuer of the ultimate securities (World Access) had standing to assert such claims. In addition, SSB asserted it owed no duty of confidentiality to World Access because its mere possession of certain material, non-public information (even if that were true) did not give rise to a confidential relationship of trust.[8]

5 Jefferies argued that its acknowledgement under the big boy letter was more akin to mere rumor, as opposed to actual knowledge of insider facts, which would have triggered securities law disclosure requirements.

6 SSB interpreted liability under the classical theory as a breach of a fiduciary relationship, and liability under the misappropriation theory as a breach of a duty of confidentiality in a self-serving manner.

7 SSB argued that because a corporation generally does not owe fiduciary duties to its creditors (their relationship is simply contractual in nature), SSB could not have owed duties to a thrice-removed buyer of debt securities.

8 Interestingly, at a later hearing on summary judgment (following years of motion practice), the court suggested to counsel for SSB that a jury could interpret the existence of

In response to the arguments that neither SSB nor Jefferies breached fiduciary duties, R² argued that because SSB had superior, material, and non-public knowledge, it was a temporary insider, and because World Access was operating in a zone of insolvency, fiduciary duties were indeed owed to holders of debt claims, meaning that SSB could be liable for classical insider trading. Moreover, because, as R² alleged, SSB learned about non-public information pursuant to a restriction agreement, it owed World Access a duty of confidentiality, and it misappropriated this information by making trades. These duties were imputed to Jefferies as SSB's "tippee," which meant that Jefferies had a duty to disclose that SSB was in possession of material, non-public information or abstain from trading.[9]

By January 2005, the district court held a hearing on the defendants' motions for summary judgment. The court found that the big boy letter did not insulate SSB from liability as a matter of law and that it did not provide a defense to the claims of the plaintiff under the misappropriation theory. Indeed, the court suggested that the letter might even be evidence of trading with misappropriated information.

These issues, however, were not ultimately adjudicated. Following years of motion practice and discovery, the parties entered into a settlement agreement in July 2007, the terms of which are (not surprisingly) confidential.

Barclays Bank

On May 30, 2007, the SEC announced it had filed suit against Barclays Bank and Steven Landzberg and that the defendants had agreed to final judgments against them granting both permanent injunctions and imposing almost $11 million in compensatory damages and penalties.[10]

From July 2000 through June 2006, Landzberg was the head proprietary trader for Barclays' U.S. Distressed Debt Desk. He was responsible for supervising Barclays' analysts and other staff who worked on the Desk. As alleged in the complaint, in 2002 and 2003, the defendants joined at least six bankruptcy creditors committees, three of which were official unsecured creditors committees, and the other three were ad hoc committees. In five cases, defendants signed confidentiality agreements (and in one case endorsed committee by-laws providing for confidentiality) through which they received material, non-public information.

In particular, it was alleged that, over a period of 18 months, the defendants purchased and sold millions of dollars of securities while aware of material, non-public information received through the six committees—all in breach of fiduciary and similar duties of trust or confidence. Moreover, it was alleged that the defendants failed to disclose their illicit trading activities to the sources of the information (the creditors committees and issuers), the U.S. Trustee, the federal bankruptcy courts, or trading counterparties. The SEC also alleged that Barclays and Landzberg *misappropriated* material, non-public information obtained by virtue of their positions on the committees. In connection with the three official unsecured creditors committees, Barclays and Landzberg owed fiduciary duties to all of the bondholders. The Commission was unimpressed with Barclays' use of big boy letters to advise its bond trading counterparties that it may have possessed material, non-public information, since in no instance did it disclose the information it had received (which, of course, it could not do without violating the confidentiality agreements).

According to the SEC, Landzberg was behind this activity and Barclays failed, through its senior management and Compliance Department, to adequately supervise his course of conduct. In particular, the complaint suggests that Barclays had internal safeguard procedures in place but ignored them when it came to Landzberg's trades.

These allegations led Barclays to agree to pay approximately $11 million in disgorgement, penalties, and interest, while Landzberg consented to an order to pay a $750,000 penalty and agreed to an injunction precluding him from ever participating on a creditors committee in the future.

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the big boy letter as an admission that SSB had a relationship of trust with World Access.

9 R² further argued that the existence of the big boy letter was a material fact that needed to be disclosed.

10 SEC Lit. Rel. 20132, *SEC v. Barclays Bank PLC and Steven J. Landzberg*, 07-CV-04427 (S.D.N.Y.), Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information, May 30, 2007.

NID and NIDCo's: the Belgian Corporate Tax Deduction for Risk Capital – Belgium's Position as a Top European Location for Foreign Investors Not Jeopardized

by **Eric Deltour, Richard J. Temko, and Jean-Yves Steyt**

On February 26, 2008, the Belgian Prime Minister Guy Verhofstadt and Belgian Minister of Finance Didier Reynders confirmed that the Notional Interest Deduction ("NID"), a major stimulus to recent foreign investment in Belgium, would not be withdrawn as some had feared. Their statements finally lifted the political controversy of the last few months as to whether to maintain, amend or even cancel this unique tax investment stimulus which was drawing significant capital funds into the country, and thereby put an end to the legal insecurity resulting therefrom.

Background

The NID, introduced at the initiative of the Belgian government in 2005, reinforced Belgium's position as an attractive location for international investors lured by the European market. The main objective of this unique feature in international tax law[1] was (i) to attract international investors, (ii) to encourage capital intensive investments in Belgium, (iii) to strengthen the financial position of companies by stimulating equity financing, and (iv) to simultaneously lower the effective corporate tax rate for all companies subject to Belgian corporate tax.

NID was introduced by the Belgian Law of June 22, 2005,[2] and entered into effect in 2006.[3] The timing of this new legislation must be viewed in the context of the legal debate a few years ago questioning the conformity with EU Law of the Belgian coordination centre regime ("BCC") which had been introduced in 1983 and whose main feature was not to tax interest earned from intra-group financing activities at the level of the coordination center. In 2003 the European Commission decided that the BCC regime constituted a prohibited state aid under EU law, a conclusion which was largely confirmed by the Court of Justice of the European Communities. Although Belgium was nevertheless allowed to apply a transitional phase-out period for this tax regime,[4] the government immediately sought ways to set off the resulting cutback in tax competitiveness in order to maintain and even improve the country's position as a top European location attractive to foreign investors. It is in this context that NID was conceived. Contrary to the BCC regime, NID is not susceptible to being challenged as a prohibited EU State Aid since it applies to both Belgian and foreign companies with a taxable presence in Belgium.

What is NID?

The underlying idea of NID is to provide for a similar tax treatment whether company's activities are funded by shareholder equity or by debt (loans and bonds). Stated otherwise, NID aims at narrowing or bridging the gap between the formerly existing "discrimination" between companies that on the one hand use their own capital to invest (which is remunerated through dividend payments which are not tax deductible), and on the other hand companies funding their activities through debt (which is remunerated through tax-deductible interest).

This has practically been implemented through a unique tax provision allowing Belgian companies and Belgian branches of foreign companies to deduct a fictitious or deemed ("notional") interest charge from their annual taxable income. It is a fictitious interest charge because the company does not actually incur any interest expense with respect to its own share capital. The amount of the deduction is calculated on the basis of the company's equity (the company's "risk capital"), subject however to a number of adjustments (excluded items) in order to avoid double use of tax deductions and/or abuses. The equity to be considered is the company's equity under Belgian GAAP in the opening balance sheet of the taxable period and includes the share capital, share premiums, profits carried-forward and other reserves (legal reserve, non-distributable reserve, tax-exempt reserves and distributable reserves). Changes during the financial year, such as capital increases or redemptions, are taken into account. A specific rate is then applied to the company's adjusted

1 Although a few other countries apply similar systems, none do on the same scale as the Belgian NID.

2 Belgian Official Gazette of June 30, 2005.

3 Thus as of January 1, 2006, for companies keeping their books on a calendar year basis.

4 Existing BCCs may continue to benefit from the scheme but until December 31, 2010, at the latest.




risk capital. Such rate is based on the average annual interest rate on Belgian 10-year government bonds, and is subject to an annual review by the Belgian government. For the tax year 2009 (i.e., accounting year 2008 for calendar-year taxpayers) the NID rate is 4.307%.[5] In other words, the formula is currently:

NID = (equity – excluded items) x 4.307%

A brief example for demonstration purposes: Company A has an adjusted share capital of 100,000 euros and a profit before tax of 50,000. *Without* the *NID* the corporate tax of 33.99% would be applied on 50,000; *with* the NID, the corporate tax is only applied on 50,000 – (100,000 x 4.307%) = 45,693. Subject to the specific circumstances of each case, NID can therefore constitute a substantial structural reduction to the effective tax rate, proportionate to the invested equity.

The adjusted equity corresponds to the equity minus a number of items, mainly (i) the net fiscal value of shareholdings recorded as financial fixed assets[6] (depending on each specific case, this can substantially or entirely reduce the NID base), (ii) the net fiscal value of the shares the company holds in its own share capital, (iii) the net fiscal value of shares in collective investment companies the dividends of which qualify for the dividends-received deduction, (iv) the net assets of foreign permanent establishments located in countries with which a double taxation treaty has been concluded, (v) the net accounting value of foreign real property located in countries with which a double taxation treaty has been entered into, (vi) subsidies, tangible fixed assets whose attendant costs are unreasonably high, and (vii) other investments that are not acquired in order to produce a regular income for the company.

NID is recurrent in the sense that the notional interest is deducted every year again on the company's adjusted equity. Furthermore, the portion of the NID amount which cannot be (fully) deducted from the company's taxable base in a given taxable period (referred to as excess or unused NID) can be carried forward for seven years.[7] Note however that NID cannot be carried forward in the event of a change of control of the company if the change of control does not respond to legitimate financial or economic needs in the sense of article 344 § 1 of the Belgian Income Tax Code. Furthermore, NID is subject to a number of restrictions, such as the unavailability of this regime for certain companies (such as BCCs) and the fact that the NID amount cannot be immediately distributed to the shareholders but must remain in the company for at least three years.

Why are NIDCo's attractive vehicles for foreign investors focusing on the EU?

NID interacts with several other business-friendly tax measures which attracted many foreign investors using Belgium as their European hub. Special reference can be made to the EU Parent-Subsidiary Directive, pursuant to which dividends paid to a parent company in another EU Member State are exempt from withholding tax in the source state and exempt from further taxation in the state of receipt—subject to conditions such as a minimum holding percentage of 15% (10% as of January 1, 2009) and a minimum holding period requirement of twelve months—as well as to the Belgian Royal Decree of December 21, 2006, which extends the benefit of the Belgian witholding tax exemption under the EU Parent-Subsidiary Directive to dividends paid to companies established in countries that have entered into a double taxation treaty with Belgium.

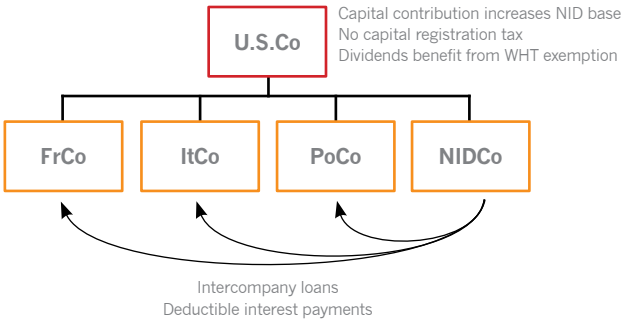
Because of such interaction, operating in Europe through a Belgian NIDCo vehicle offers attractive tax planning op-

5 The general NID rate is to be increased by 0.5% for small companies in the sense of article 15 § 1 of the Belgian Company Code (4.807% for tax year 2009). The NID rate for tax year 2008 was 3.781% (4.281% for small companies).

6 Without this exclusion the NID deduction could be applied several times on the same capital. Take for example the case where a shareholder contributes capital of 100 in company A, which holds a participation of 100 in company B which holds a participation of 50 in company C: The same contributed capital would then be taken into account several times for NID purposes.

7 Losses on the other hand are recoverable without limitation in time.

portunities to international investors operating in the European Union. Another brief example: a parent company (U.S.Co) contributes capital to its wholly owned Belgian subsidiary (NIDCo). No capital registration tax is due any longer on such a contribution. The contributed capital will increase the NID base of NIDCo, which uses the capital to provide inter-company loans to other subsidiaries wholly owned by the U.S.Co in France (FrCo), Italy (ItCo) and Portugal (PoCo). The interest paid by the latter subsidiaries to NIDCo is deductible from their taxable bases. The dividends paid by NIDCo to U.S.Co would benefit from withholding tax (WHT) exemption under the U.S./Belgian income tax treaty. If NIDCo were held by U.S.Co through an EU parent company located in another EU Member State, the European participation exemption would be available (subject to the relevant conditions) for the dividends received by the latter from its Belgian subsidiary.



Recent Developments

Since its introduction, this tax measure appears to have proven to be successful in accomplishing the stated objectives. It is considered that NID has attracted many foreign investors and generated substantial new jobs in Belgium. It also appears that Belgian companies, in order to maximize their NID benefits, performed capital increases for an overall amount of 48.7 billion Euro in 2006 as compared to 5 billion Euro back in 2005.[8]

It is worthwhile noting that at the end of 2006 a proposal was made to the Parliament of the Grand Duchy of Luxembourg to introduce a NID system in that country's corporate tax regime. The proposal was, however, finally rejected in 2008 for technical reasons.

In Belgium, especially during the last several months, in the context of the formation of a new Belgian government, certain politicians have expressed concerns with regard to the budgetary impact of NID for the Belgian

treasury. The importance for Belgium of maintaining NID is crucial and has therefore been supported by most business organizations. Many of the latter even strongly advocate a further reduction of the current corporate tax rate set currently at 33.99%.

Conclusion

The main feature of NID is that it interacts with several other attractive tax measures available in Belgium, such as but not limited to (always subject to the relevant conditions) the 95% intercorporate dividends-received deduction, the full exemption for capital gains on share participations, the extension of the full exemption from Belgian withholding tax on outgoing dividends paid to substantial shareholders located in other EU countries to payment to substantial shareholders in countries with which Belgium has signed a double taxation treaty, the recent patent royalties deduction,[9] the prior loss deduction, the investment deduction, the broad system of advance tax rulings (binding upon the tax authorities) and Belgian's extensive tax treaty network. It is the combination of such competitive tax measures which makes Belgium a choice location for foreign investors. And NID is now playing a key role in this overall Belgian tax environment to attract additional foreign investors.

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[8] Electrabel, a Belgian energy company, implemented a capital increase that enabled it to save 30.2 million Euro of corporate income tax in 2006.

[9] Introduced in Belgium by the Law of April 27, 2007.

New Accounting Rules Affect M&A Transactions


by **Scott M. Zimmerman** and **Evan D. Michalovsky**

The Financial Accounting Standards Board issued two new accounting standards in December 2007: FAS 141R, *Business Combinations* and FAS 160, *Accounting for Noncontrolling Interests*, dealing with the accounting and reporting of M&A transactions. Generally, the new rules require the immediate expensing of transaction costs and expand the use of fair value accounting. Both rules will be in effect for acquisitions that close in fiscal years that start after December 15, 2008.

One of the most significant changes is the requirement that transaction costs related to an acquisition, including fees for attorneys, investment bankers, and accountants, be expensed as incurred rather than capitalized over time. As a result, transaction costs will be reported in earnings in the periods in which those costs are incurred, which would typically precede the closing, and may also precede the announcement, of any such acquisition.

Another significant change relates to the way companies account for earn-out arrangements. Under the current accounting rules, earn-outs are recorded when the contingency is resolved, and the earn-outs are considered part of the cost of the acquisition. Under the new accounting rules, earn-outs and other forms of contingent consideration will be recorded at fair value on the acquisition date regardless of the likelihood of payment. In each reporting period during the earn-out arrangement, the fair value of the obligation will be adjusted through earnings until the contingency is settled. However, if the contingent consideration is classified as equity, an acquirer will not be required to revalue the contingent consideration in subsequent accounting periods.

These changes will have many practical implications. The expanded use of fair value accounting will necessarily create valuation complexities resulting in increased costs. These changes also have the potential to generate greater earnings volatility in the periods before and after an acquisition. As a result, companies will need to evaluate the impact of such earnings volatility on their existing financial covenants. As companies negotiate new financial covenants, they should seek to eliminate the impact such earnings volatility will have on their financial covenants.

Other key features of the new standards include:

- Certain acquired contingent assets and liabilities (e.g., litigation and environmental issues) will be recorded at fair value as of the acquisition date. Adjustments to the fair value of the assets and liabilities will be recorded in each reporting period thereafter as new information becomes available.
- Acquirers will generally be precluded from recording a liability related to a planned restructuring of a target company's operations. Instead, these restructuring costs will be charged to earnings in the post-acquisition period in which such costs are incurred.
- In an acquisition of less than all of a target company, but where control is obtained, the acquiring company will recognize at fair value 100% of the assets and liabilities, including goodwill, as if the entire target company had been acquired.
- Gains or losses on the sale of shares of a subsidiary when control is retained will no longer be recognized.
- In-process research and development will no longer be written off when acquired but will be capitalized over time on the balance sheet.

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News from the Group

New Additions to Dechert's Global Private Equity Team

- In January 2008, Dechert LLP announced the opening of its Hong Kong office and formal association with Hwang & Co. **Basil Hwang**, who was elected a partner of Dechert LLP and is managing partner of Hwang & Co, is qualified to practice law in Hong Kong, England, and Singapore. He advises private equity, venture capital, investment funds, and hedge funds investing in China and issuers and underwriters in securities offerings.
- In January 2008, **Drake Tempest** joined Dechert's New York office as a corporate and securities partner. Mr. Tempest represents buyers, sellers, financial advisors, and special committees of boards of directors in complex public and private acquisitions; sponsors and investors in private equity funds; lenders and borrowers in secured and unsecured credit facilities; and issuers and underwriters in public and private offerings of debt and equity securities. Mr. Tempest was executive vice president and general counsel of Qwest Communications International Inc. in 1998–2002 and was also its chief administrative officer in 2000–2002.
- In February 2008, **Kristopher D. Brown** joined Dechert's New York office as a corporate and securities partner who focuses his practice on private equity and venture capital financing transactions and the representation of numerous financial and corporate strategic investors as well as several emerging growth companies in the healthcare, life sciences, information technology, software, consumer electronics, and telecommunications industries.
- In March 2008, **Kevin P. Scanlan** also joined the firm's New York office as a partner in the financial services group. Mr. Scanlan focuses his practice on the structuring and formation of and investment in international and domestic private investment funds, particularly hedge funds, private equity funds, real estate funds, venture capital funds, and fund-of-funds. He also advises these funds in connection with their subsequent investment activities.
- In May 2008, **Corinna Mitchell** joined Dechert's London office as a partner specializing in transactional banking work with special expertise in cross-border acquisition finance and project finance, loan and credit facilities. She has extensive experience advising sponsors, lenders, and borrowers on complex leveraged transactions.

Upcoming Speaking Engagements

Convergence 2008 – M&A Summit in the Hamptons
June 16–17, 2008
The Southampton Cultural Center
Southampton, New York

Thomas Friedmann will be moderating the "SPAC Attack: Blank Checks Make a Comeback" panel. To register, please visit: www.themaforum.org/html/hampton_event_registration.html.

Business Law Asia 2008 Conference
June 18–19, 2008
Hilton Singapore
Singapore

Basil Hwang will be speaking on private equity and venture capital investing in Asia. To register, please visit: www.asianlegalbusinessevents.com/register.cfm.

Private Equity Tax Practices 2008 Conference
June 23–25, 2008
Hilton Boston Back Bay
Boston, Massachusetts

Kathleen Ziga and Susan Camillo will be speaking on the "Fund Structure and Administration – ERISA: Moving Forward, What You Need to Know Now" panel. To register and access Dechert's 20% discount, please visit: www.iirusa.com/petax and type "XU2072KZ" as the speaking code.

5th Annual PEI Strategic Financial Management Conference
July 16–17, 2008
New York Marriott Downtown
New York City

Dechert will be sponsoring this event. Daniel Dunn will be participating as a speaker on the "Proactive Tax Planning in Fund Formation" panel, and James Nix will be speaking on the "Management Fee Waivers" panel—both of which are taking place on July 17. To register and access Dechert's speaker discount, please visit: www.peimedia.com/Product.aspx?cID=5496&pID=174342&contType=6 and type "SPSFMNY08" as the promotion code.

For more information about these conferences or to obtain a copy of the related presentation materials, please contact Michelle Lappen at +1 212 649 8753 or michelle.lappen@dechert.com

About Dechert LLP

With more than 1,000 lawyers in the United States, Europe and Asia, Dechert LLP is an international law firm focused on corporate and securities, business restructuring and reorganization, complex litigation and international arbitration, real estate finance, financial services and asset management, intellectual property, labor and employment, and tax law.

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