DechertOnPoint

Summer 2008

Editor: Roger Mulvihill

Private Equity

In this issue

p1 Transaction and Monitoring Fees: What Is Now Market?

p4 Renminbi-Denominated Funds: An Emerging Platform for Private Equity Investment in China?

p7 Preserving Interest Deductions: IRS Temporarily Grants Relief for Interest Deductions on Certain High Yield Debt Instruments

p8 Giving Seller Notes a Makeover

p9 Going Public

p11 Current Trends in Islamic Private Equity

p12 To Disclose or Not to Disclose

p16 Rights Offerings: The Time is Right for Private Equity Sponsors

p19 News from the Group

Dechert LLP

Transaction and Monitoring Fees: What Is Now Market?

By **R. Jeffrey Legath**, **Derek M. Winokur**, and **Michael T. Fischette**

Given the major developments in the private equity arena over the last several years, we have prepared a survey of transaction and monitoring fees based on a random sample of publicly reported acquisitions by private equity buyout funds. This study presents the data from the survey in abstracted form. We hope that this survey will serve as a benchmark to private equity investors and their advisors and give an understanding of how the market for transaction and monitoring fees has evolved over the last decade.

Type of Transactions

This survey covers 60 leveraged control acquisitions by 40 different lead investors, all of which are prominent private equity firms.[1] As in our original survey conducted in 2003 (January 2003 *DechertOnPoint,* "Transactional Monitoring Fees: Does Anything Go?"), the transactions were selected on a random basis, and the data was extracted from filings of the target companies with the Securities and Exchange Commission. In some cases, we also obtained and reviewed the agreements that set forth the transaction and monitoring fees.

Our sample ranges across deal sizes, industries, and investors. Unlike in 2003, our current sample does include a small number of transactions by private equity investors affiliated with financial services firms. In 2003, we observed that these investors frequently abstained from charging customary deal or monitoring fees, and we did not want to distort the survey. In our current study, we did not observe any such pattern or any statistically significant variance in the size of fees charged by private equity firms affiliated with financial services firms.

We reviewed acquisitions consummated during the previous five years. The 60 transactions covered by the study were completed in the years shown in Table 1 below.

Table 1: Deal Years

Year	2003	2004	2005	2006	2007
Number of Deals	6	12	12	16	14

As was the case in our 2003 study, all transactions employed a high degree of leverage and a majority of them were mergers or recapitalizations in which certain selling shareholders reinvested a portion of their equity. Deal sizes in the current survey ranged from $155 million to $5.5 billion, compared to deal sizes of $163 million to $2 billion in our 2003 survey. The deal size is the reported enterprise value for each deal, being the sum of (i) the aggregate equity value established in the transaction (including any rollover) and (ii) the aggregate principal amount of new and assumed debt. The breakdown by deal size is shown in Table 2 below.

Table 2: Deal Years

Deal Size	Number	Mean (Millions)	Median (Millions)
Less than $500 million	14	$342.8	$358.2
$500 million to $1 billion	19	$711.7	$650.0
More than $1 billion	27	$2,403.9	$1,800.0
All transactions	60	$1,387.1	$872.1

[1] These firms include some clients of Dechert, however none of the data presented herein was derived from transactions on which we worked.

Although, as would be expected, deal sizes have increased since our 2003 study, this survey includes a similar range and sample of deal sizes as were used in our 2003 study. The mean deal size for all transactions in this survey increased to $1.38 billion from $858 million in our 2003 study, while the median deal sizes remained closer together ($872 million in this survey compared to $762 million in our 2003 study).

Transaction Fees

Transaction (or deal or success) fees are the fees charged by the private equity firm in connection with the completion of the acquisition for typically unspecified advisory services. In each transaction covered by the study, the private equity firms collected such one-time fees in cash. Table 3 below shows the range, mean, and median of these transaction fees by deal size:

Table 3: Transaction Fees (One-Time Fee in Millions of Dollars)

Deal Size	Minimum	Maximum	Mean	Median
Less than $500 million	$0.5	$7.5	$4.5	$4.1
$500 million to $1 billion	$2.0	$13.0	$8.3	$10.0
More than $1 billion	$0.6	$75.0	$24.4	$20.0
All transactions	$0.5	$75.0	$14.6	$10.0

As expected, the dollar size of transaction fees continues to be strongly correlated to deal size. Table 4 below expresses transaction fees as a percentage of deal size:

Table 4: Transaction Fees/Deal Size (One-Time Fee as Percentage of Deal Sizes)

Deal Size	Minimum	Maximum	Mean	Median
Less than $500 million	0.23%	2.96%	1.35%	1.23%
$500 million to $1 billion	0.28%	2.00%	1.16%	1.26%
More than $1 billion	0.03%	2.89%	1.01%	1.02%
All transactions	0.03%	2.96%	1.14%	1.07%

The percentages are fairly consistent across deal sizes, with a small but meaningful decrease in percentage size found as deal size increases. In particular, deals of more than $1 billion averaged almost exactly a 1% transaction fee, whereas middle and smaller market deals were typically closer to 1.25%. Despite the wide overall range (0.03%–2.96%), a significant majority of deals fell within a much smaller range. In 45 of the 60 acquisitions (75% of the deal sample), the transaction fee was within the range of 0.65% to 1.65%, i.e., within .5% of the mean for all deals. Only in 9 out of the 60 deals (15% of the deal sample) was the transaction fee above 1.5%. The standard deviation for the entire sample is 0.54%.

A few interesting trends are discernable in these results compared to our 2003 study.

- First, percentage transaction fees on smaller deals appear to have fallen and are now closer to the average percentage transaction fees across all deal sizes. In our 2003 study, the mean percentage transaction fee for deals under $500 million was 1.76%, compared to only 1.11% for deals between $500 million and $1 billion and the overall average of 1.35% for all deals in our 2003 study.
- Second, transaction fees are becoming more standardized with less overall variance. The standard deviation in our 2003 study was 0.64%, and only 19 of 32 acquisitions (59%) were within .5% of the overall mean (compared to 75% in our current study).
- Third, as deals have continued to become larger, it appears that percentage transaction fees on the largest deals are decreasing slightly compared to all other deals. In our 2003 survey, the largest deals (more than $1 billion) showed no decrease in percentage transaction fees compared to the overall averages, and in fact were higher on a percentage basis than mid-size deals (1.35% to 1.11%). Our current survey shows a decline in percentage transaction fees for the largest deals compared to all other deals (1.01% vs. 1.24%).

The deal fees reflected in Tables 3 and 4 do not include advisory fees for post-closing transactions. Consistent with

our 2003 study, large buyout firms frequently charge deal fees (or at least have the contractual right to do so) for significant post-closing transactions such as add-on acquisitions or debt refinancings. We did not compile data on the amount of these fees. However, we did observe that the right to charge post-closing deal fees is frequently locked in contractually at the time of the acquisition in the management/transaction services agreement. Usually, the fee is specified in advance as a percentage of the future deal or financing size, often being 1% or a percentage consistent with the initial transaction fee percentage. In some cases, the amount of the fee is not specified and the agreement provides for "reasonable compensation" as determined by the parties.

Monitoring Fees

Monitoring (or management) fees are the fees charged by the private equity firm to its portfolio company after the acquisition for ongoing advisory and management services. Expenses are typically reimbursed separately. In each transaction covered by this survey, the controlling stockholder charged an annual monitoring fee in cash under an agreement entered into at the time of the acquisition. Monitoring (or management) fees are the fees charged by the private equity firm to its portfolio company after the acquisition for ongoing advisory and management services. Expenses are typically reimbursed separately. In each transaction covered by this survey, the controlling stockholder charged an annual monitoring fee in cash under an agreement entered into at the time of the acquisition. The nature of the advisory and management services is typically described in detail, but with no specific level or amount of services being required to earn the monitoring fee.

Table 5 shows the range, mean, and median of these monitoring fees in nominal dollars, and Table 6 calculates monitoring fees as a percentage of EBITDA of the portfolio company. We relied on the portfolio company's publicly reported figure, in most cases in the form of Adjusted EBITDA, which eliminates transaction expenses and similar extraordinary or one-time items. Just as we did in our 2003 study, we used (in order of availability) EBITDA for the fiscal year following the acquisition, the fiscal year of the acquisition, or the fiscal year preceding the acquisition.

Table 5: Monitoring Fees
(Annual Fee in Millions of Dollars)

Deal Size	Minimum	Maximum	Mean	Median
Less than $500 million	$0.10	$3.05	$1.33	$1.05
$500 million to $1 billion	$0.25	$3.0	$1.39	$1.25
More than $1 billion	$1.0	$10.0	$3.74	$2.5
All transactions	$0.10	$10.0	$2.44	$2.0

Table 6: Monitoring Fee/EBITDA
(Annual Fee as Percentage of EBITDA)

Deal Size	Minimum	Maximum	Mean	Median
Less than $500 million	0.93%	5.19%	2.41%	2.00%
$500 million to $1 billion	0.19%	4.05%	1.59%	1.40%
More than $1 billion	0.46%	3.52%	1.48%	1.08%
All transactions	0.19%	5.19%	1.73%	1.40%

In contrast to transaction fees, overall monitoring fees are closer in dollar amount across deal sizes, with declining fees as a percentage of EBITDA as deal size increases. Most monitoring fees fall within a commonly accepted dollar range regardless of deal size or EBITDA. In 41 of 60 transactions (68%), the annual monitoring fee was within the range of $1 million to $3 million, with outliers often being the very smallest and largest deals in the survey. The standard deviation from the average fee is $2.4 million, but we believe a few outliers cause this calculation to overstate the actual variance in the data. If we remove the four highest and lowest figures from the sample, the standard deviation on the remaining 52-deal sample is $1.3 million. The standard deviation from the average percentage of EBITDA is 1.10%.

There are again some interesting trends compared to our 2003 study. First, monitoring fees have increased only modestly in dollar amount in smaller deals and are flat in mid-size deals (mean annual fee of: $1.33 million in this survey vs. $1.06 million in our 2003 survey for deals less than $500 million; $1.39 million in this survey vs. $1.38 million in our 2003 survey for deals between $500 million and $1 billion). In the largest deals, however, monitoring fees have increased appreciably, both on an absolute

basis (mean annual fee of $3.74 million in this survey vs. $1.42 million in our 2003 survey) and on a percentage of EBITDA basis (mean annual fee 1.48% in this survey vs. 0.81% in our 2003 survey).

Second, management fees on a percentage of EBITDA basis, while still exhibiting a declining slope as deal size increases, are also showing less variance. The mean percentages in our current study ranged from 2.41% for the smallest deals to 1.48% for the largest deals, while in our 2003 study percentage fees ranged from 2.63% for the smallest deals to 0.65% for the largest deals.

A few additional observations:

- In some cases, the management agreement provided for the management fee to be calculated as a percentage of actual or budgeted EBITDA. However, in these cases, the fee provision always included a floor (e.g., "the greater of $1 million or 2% of EBITDA"). Interestingly, unlike our 2003 study, none of the fees calculated in this manner contained a cap or collar—thus allowing for much greater potential fees as EBITDA rises (subject to any restrictions on payment set forth in the portfolio company's credit facilities).
- Management agreements typically continue until the expiration of a term (regularly 5–10 years) or until the buyout firm ceases to hold a specified level of equity ownership. The initial public offering is usually not a termination event, but in some cases the buyout investor terminated the agreement in connection with the offering for a significant one-time fee. This is consistent with our 2003 study.
- At least one buyout firm covered by our survey requires its portfolio companies to prepay the monitoring fee at the time of the acquisition for all or a significant portion of the term of the management agreement. More typical payment schedules are either annually or quarterly, payable in advance or in arrears.

Conclusion

Is there a market rate for transaction (or deal) fees and monitoring (or management) fees collected by private equity investors? We believe there is at least a market range, and we note that the fee ranges have grown narrower over the last decade. In our current study, transaction fees tend to converge around an average of 1.25% of deal size for deals under $1 billion, and 1% for deals over $1 billion. While monitoring fees show more variance on a percentage basis than transaction fees, overall they tend to be flat, i.e., less related to the size of the deal or the portfolio company. This tendency holds particularly true for the range of deal sizes at or below $1 billion, while we observed a more noticeable increase in the absolute dollar value of monitoring fees in deals above $1 billion in size. Overall monitoring fees averaged $2.4 million per year, with the average being closer to $1.3 million per year if deals in excess of $1 billion are removed from the sample.

The authors would like to thank Steve Lee for his assistance with this article.

R. Jeffrey Legath
+1 215 994 2365
jeffrey.legath@dechert.com

Derek M. Winokur
+1 212 698 3860
derek.winokur@dechert.com

Michael T. Fischette
+1 215 994 2985
michael.fischette@dechert.com

Renminbi-Denominated Funds: An Emerging Platform for Private Equity Investment in China?

By **Basil H. Hwang**

Southeast Asia's largest property developer, Singapore-based CapitaLand, announced on June 23, 2008, that it had established the first Chinese currency- (Renminbi or RMB) denominated real estate private equity fund together with CITIC Trust, China's largest trust company and a member of the state-owned CITIC financial and investment group. The new fund, named the CITIC CapitaLand Business Park Fund, closed its RMB500 million (approximately US$73 million) fundraising on June 6, 2008, with CapitaLand holding a 50% sponsor stake and local Chinese corporate and individual investors holding the rest through a trust plan.

Similarly, U.S.-based IDG Technology Ventures, which has had a remarkably successful track record with China venture capital investments and exits during the last half-dozen years, also reportedly established a RMB500 million fund in January 2008.

Other than the two examples above, both notably taking place within the first six months of this year, other RMB-denominated funds established to date have either had significant local government involvement or have been driven by local PRC investment institutions.

RMB investment funds have sporadically caught the attention of the international investment community since 2003, when the necessary rules were first issued, but what are they, and have they finally come of age?

Types of RMB-Denominated Funds

RMB-denominated funds fall into two categories: (i) domestic RMB funds; and (ii) foreign-invested RMB funds. Domestic RMB funds are raised from Chinese investors and governed by Chinese laws relating to domestic commerce. Foreign-invested RMB funds are either fully or partially foreign-owned and therefore are subject to Chinese laws governing foreign investments in China. This article primarily discusses foreign-invested RMB funds.

Establishing Foreign-Invested RMB Funds

Under current laws (see below for imminent developments), a foreign-invested RMB fund has to be established under the Rules on Administration of Foreign-Invested Venture Capital Enterprises (the "FIVCE Rules"). The FIVCE Rules were promulgated in 2003 by five central government agencies, including the Ministry of Commerce ("MOFCOM").

The FIVCE Rules allow a foreign invested fund to be structured in one of two ways:

- as a legal person in the form of a limited liability company or wholly foreign-owned entity (an "Incorporated FIVCE"); or
- as a non-legal person entity in the form of a Sino-foreign cooperative joint venture (an "Unincorporated FIVCE")—this is the closest analogy under these rules to a Western-style limited partnership.

An Incorporated FIVCE vs. an Unincorporated FIVCE

The liability of an investor in an Incorporated FIVCE is limited to its original investment in the fund. In contrast, the investment and management agreement for an Unincorporated FIVCE usually provides for several investors with limited liability, *whilst* there will be one party that agrees to be an "indispensable investor"—with obvious parallels to the general partner in a traditional private equity fund—that will bear unlimited liability

for the fund. The indispensable investor must have the requisite previous fund capital, management, and staffing experience, and it is required (for investor protection reasons) to follow strict regulatory rules imposed by the PRC Government if it wishes to extract itself from the Unincorporated FIVCE fund.

Private equity investors in FIVCE RMB funds have tended to opt for the Unincorporated FIVCE model over the Incorporated FIVCE model given the near equivalence of the Unincorporated FIVCE model to the traditional private equity fund structure.

An Overview of the FIVCE Requirements

The FIVCE Rules require that a foreign-invested RMB fund must have a minimum registered capital of US$5 million for an Incorporated FIVCE, or US$10 million for an Unincorporated FIVCE. The registered capital for either model must be invested within five years of establishment of the FIVCE fund. Any foreign-invested RMB fund established under the FIVCE Rules must also be approved by the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC," which is now part of the MOFCOM).

A significant advantage that FIVCE RMB funds have over offshore funds is that the FIVCE does not have to grapple with the complex foreign exchange issues that frequently confound offshore funds when they attempt to make investments in China. Investments by a FIVCE are made in RMB and the FIVCE Rules allow foreign investors to invest and withdraw capital invested as well as any capital gains made on exit from a portfolio company, e.g., following an IPO.

In the absence of a foreign investment partnership law, the key features of a RMB fund partnership must be set out expressly in the fund agreements. Issues that must be specified in the agreements include fiduciary duties,

inter-party liability, default of a partner, assignment and transfer of limited partner interests, and bankruptcy, among others, which would naturally require specialists' legal advice.

It should be noted that under the FIVCE Rules, an "indispensable investor" (in effect, the general partner) in an Unincorporated FIVCE is required to contribute 1% of the registered fund capital and is liable for the fund's debts. The indispensable investor/GP can be an offshore entity provided that it or its affiliate satisfies certain statutory requirements, including that:

- venture capital investing should be its principal business;
- it has at least US$100 million under management in the three years preceding the application to register as a FIVCE, of which at least US$50 million was used for venture capital investing; alternatively, an onshore indispensable partner/GP's total investment capital must be at least RMB 100 million, of which at least RMB 50 million has been used for venture capital investing; and
- it has at least three professionals who have practical experience in venture capital management for more than three years.

In practice, if an offshore GP is used, for tax reasons it should be carefully structured to ensure the passive status of the GP so that it is not brought onshore for PRC taxation purposes.

Until the Amended Enterprise Tax Law came into effect on January 1, 2008, a foreign investor was exempt from withholding tax in respect of dividends received from companies deemed to have a permanent establishment in China. From January 1, 2008, it is possible that a 20% withholding tax may be charged, so careful tax planning advice on offshore investment structures may be necessary to preserve tax efficiency.

Foreign investors should be aware that although the FIVCE Rules state that the liability of a limited partner is capped to its capital contribution, this has not been tested in a Chinese court, which may ignore such a cap. This could mean that foreign investors should invest ideally through offshore feeder funds or special purpose corporate vehicles.

It should also be noted that under the FIVCE Rules, capital calls can be made on a committed basis. New limited partners ("LPs") can be introduced, and assignment or transfer of fund interests to third party can be made, without needing additional government approvals (provided that the original approved fund agreement provides for these).

A Comparison of Selected Taxation Consequences

China normally considers each investor in a Chinese cooperative joint venture to have a permanent establishment in China by virtue of that joint venture. Any income, gain, loss, and deduction attributable to the joint venture would be subject to enterprise income tax ("EIT").

In the past, a non-legal person joint venture, such as an Unincorporated FIVCE, could be subject to a different tax basis. If structured properly (for example, so that all of its investment management functions were outsourced to an independent manager), an Unincorporated FIVCE would be deemed as a foreign entity without a permanent establishment in China and would thus be able to enjoy pass-through tax treatment. The result would be that the Unincorporated FIVCE itself is not subject to EIT, and distributions to the investors would be subject to a 10% withholding tax rate (or less, depending on the tax domicile of the investor and applicable double-tax agreements), reduced by any more preferential tax treaty benefits that may be available to individual investors. Moreover, there would be no EIT against the investor's share of items of income, gain, loss, or deduction of the fund. In this respect, an Unincorporated FIVCE was more tax efficient than an Incorporated FIVCE.

This tax advantage, however, may now be lost under the Amended Enterprise Income Tax Law and its Implementing Rules, both of which came into force on January 1, 2008. Under the Implementing Rules, a fund that has an agent (an investment manager) who conducts investment activity in China on its behalf would be deemed to be a permanent establishment in the PRC and would also be subject to EIT. The tax authorities have not yet made a definitive ruling on how they intend to interpret or enforce this rule.

Under a Circular promulgated by the State Administration of Taxation on February 7, 2007, an incorporated FIVCE registered as a professional start-up investment company may, in certain circumstances, be entitled to an Enterprise Income Tax deduction of up to 70% of its total investment in prescribed small or medium-sized high technology companies.

Alternative Foreign-Invested Partnership Rules on the Horizon

In addition to the FIVCE Rules, foreign investors may soon have an alternative means to establish RMB funds by the

Preserving Interest Deductions: IRS Temporarily Grants Relief for Interest Deductions on Certain High Yield Debt Instruments

By **Daniel M. Dunn**, **Richard P. Wild**, and **Michiel Muizelaar**

Interest expense deductions on acquisition indebtedness are an important component in projecting the rate of return earned by private equity funds on their investments in portfolio companies. However, recent difficulties in credit markets may result in financings for which interest deductions could be deferred or denied. Delay or loss of these deductions could result in a significant drag on the performance of private equity fund investments.

On August 8, 2008, the IRS issued Revenue Procedure 2008-51, which offers temporary relief from the so-called "AHYDO" rules that restrict interest deductions for original issue discount ("OID") accrued on certain debt instruments. The temporary modification of these rules may help private equity portfolio companies preserve their anticipated returns.

Under U.S. tax law, an issuer of a debt instrument with more than *de minimis* OID is generally permitted to take a deduction for a ratable portion of the OID as it accrues over the term of the debt even though no interest is actually paid. However, if the debt is an "applicable high yield debt obligation" ("AHYDO"), deductions for OID are suspended until paid in cash; further, no deduction is permitted for the "disqualified portion" of OID if the yield to maturity exceeds the applicable federal rate for the calendar month in which the debt instrument is issued plus 600 basis points. OID may result when debt is considered to have been issued at a discount from face or when debt is issued with pay-in-kind interest or other interest not required to be paid in cash at least annually.

An unforeseen AHYDO problem may arise when debt is treated as having an issue price lower than the cash proceeds of the loan received by the borrower. This can occur when the original lender is considered to be a broker, placement agent, or underwriter, and the debt is resold to purchasers at a discount. Debt may also be treated as reissued at a discount when the terms of the debt undergo significant modification.

In response to current market conditions, Revenue Procedure 2008-51 suspends the application of the AHYDO rules for three types of financings obtained by corporate borrowers before January 1, 2009. Accordingly, if the debt of a corporate taxpayer falls within one of the three enumerated circumstances, deductions for OID will not be deferred or denied under the AHYDO rules. Generally, the revenue procedure calls off the application of the AHYDO rules on (i) debt issued for money if the debt would not have been subject to the AHYDO rules assuming its issue price was equal to the loan proceeds received by the borrower ("Safe Debt"); (ii) Safe Debt exchanged for new debt ("Revised Safe Debt"); and (iii) Revised Safe Debt exchanged for new debt. In situations (ii) and (iii), the new debt instrument must be issued within 15 months after issuance of the original debt, the maturity must not be extended by more than one year, and the redemption price at maturity must not be increased (although the maturity and redemption price requirements are waived if the original debt was issued before August 8, 2008). The likely beneficiaries of the revenue procedure are corporate taxpayers who convert bridge financing into debt that trades at an unanticipated discount or debt that is sold by the original lender, if considered to be a broker, placement agent, or underwriter, at a discount from face. For example, if a private equity sponsor funded the acquisition of a portfolio company with a bridge loan and, in accordance with the bridge loan terms, subsequently the bridge loan is refinanced, the revenue procedure may operate to call off the application of AHYDO rules provided that all conditions of the revenue procedure are otherwise satisfied.

The AHYDO rules and other rules affecting debt issuance, exchanges, or modifications are highly technical. Tax review is strongly advised before considering such transactions.

For a more detailed description of Revenue Procedure 2008-51, please see our August 2008 *DechertOnPoint,* "IRS Temporarily Suspends AHYDO Rules in Certain Financing Transactions."

Daniel M. Dunn
+1 212 698 3857
daniel.dunn@dechert.com

Richard P. Wild
+1 215 994 2670
richard.wild@dechert.com

Michiel Muizelaar
+1 215 994 2424
michiel.muizelaar@dechert.com

Amended Partnership Enterprise Law (the "Amended Partnership Law") that came into effect on June 1, 2007, and the draft Foreign Investment Partnership Regulations (the "FIPR") that is expected to be promulgated soon.

Compared with the original Partnership Enterprise Law promulgated on February 23, 1997, the Amended Partnership Law is a major breakthrough. The most significant change is the provision for limited liability partnerships as a business vehicle.

Although the Amended Partnership Law contemplates foreign partnerships, on its face it only applies to domestic partnerships. To extend its regulatory scope to foreign investors, MOFCOM drafted the FIPR and circulated it to other governmental agencies for comments on January 25, 2007. The FIPR is currently still in draft form, but there is widespread anticipation that it will be promulgated soon.

To foreign investors, the current draft of the FIPR may raise more questions than it answers regarding the feasibility and viability of establishing foreign-invested RMB funds. Some of its requirements seem to evidence an incomplete understanding of how venture capital fundraising operates globally. For example, the FIPR requires the foreign limited partners to fund all of their capital commitments within 90 days of approval of the establishment of the partnership. It is also not clear how MOFCOM, by proposing the FIPR, envisages a foreign-invested partnership to operate as an investment vehicle, and whether extra MOFCOM approvals would be required for particular investments. It is possible, however, that these concerns will be addressed when the final regulations are published.

Offshore/Onshore Parallel Structures as an Alternative

Another emerging structure to bear in mind is an offshore/onshore parallel fund structure that has been adopted successfully in at least one example. The Infinity-CSVC Fund and, subsequent to the success of that first fund, the US$350 million Infinity I-China Fund, are parallel funds structured with an offshore entity in Israel and a limited partnership in China, developed by Infinity Equity, an Israeli manager, and Suzhou Venture Group, the venture capital arm of state-owned Suzhou Industrial Park. The Infinity-CSVC Fund boasts of being the first limited partnership fund structure ever approved in China.

Basil H. Hwang
+852 3518 4788
basil.hwang@dechert.com

Giving Seller Notes a Makeover

By **Jeffrey M. Katz** and **Scott M. Zimmerman**

Given the current decline in asset prices and the decreased amount of institutional debt financing available for leveraged acquisitions, seller paper has become an increasingly important piece of the financing puzzle. It can bridge both valuation and financing gaps between buyers and sellers.

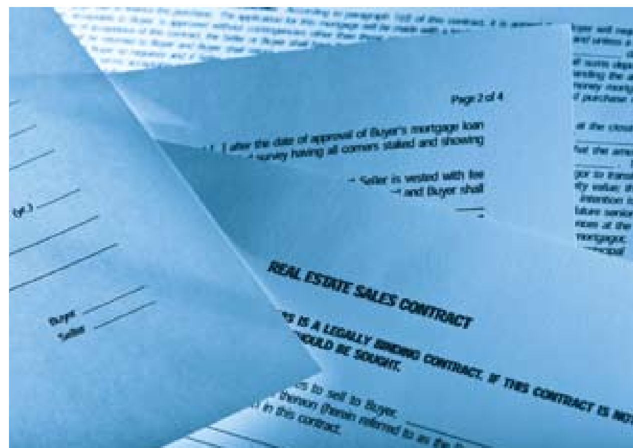
Sellers are often reluctant to take back substantial debt in the business they've just sold, especially because such debt typically is required to be deeply subordinated to the institutional (often bank and mezzanine) debt that financed the buyout. This article suggests certain potential "enhancements" to the debt taken back by sellers that could potentially make it more attractive to them.

Put Right

Grant the sellers a put right—the right to sell their notes to either the private equity sponsor or another entity outside of the bank group on a pre-determined date or upon the occurrence of certain events. This gives the seller some insurance (subject to counterparty risk in respect of the grantor of the put right) against company default on the notes and also provides some flexibility in terms of expected repayment dates.

Credit Support

Alternatively, the sellers may receive credit support from outside the bank group in the form of a limited recourse



guaranty, structured letter of credit, or other collateral support. As with the put option, credit support provides the seller an additional source of recovery in the event of the company's default, thereby adding value to the seller paper.

Rate Increases/Conversion Feature/Sale Rights

Seller paper may also contain features that provide for an increase in the interest rate (one-time or periodic), convertibility into increasing amounts of equity, or other value transfer mechanisms if note payments are not made as required. These features are designed to increasingly eat away at the sponsor's ownership in the company. In addition to the foregoing provisions that are intended to economically incentivize the equity sponsor to solve the credit problem, the holders of the seller paper may negotiate for a right to cause a sale of the company upon the failure of payment for a specified period of time.

Adding Collateral Security

Seller paper may also appear more attractive by giving it the benefit of collateral security. If the seller debt is issued by an intermediate holding company (rather than by one of the banks' loan parties), then a grant of collateral securing the seller paper may be achieved without affecting the bank lenders' blanket first lien on company assets (which typically would include a pledge of the equity of the operating entities).

Seller notes and bank debt are usually both issued by the company, and the seller notes are contractually subordinated to the bank debt, leaving the seller with junior unsecured notes. By instead having the seller paper issued by a holding company (without a subsidiary guaranty), the need for contractual subordination is eliminated, as the seller notes are now structurally subordinated to the bank debt. Moreover, the seller debt may be secured by the equity of the subsidiary directly owned by the issuer of the seller note, without in any way affecting the seniority of the bank debt. The seller would then hold a "senior secured note." Although, effectively, the two are not very different, a "senior secured note" may be more appealing.

Participation as Tranche of Bank Debt

Another alternative is to have the seller debt participate as a tranche of either the first- or second-lien bank debt. While the seller's tranche presumably would still be paid last in relation to the other tranches, the seller debt would be secured by the company's assets like the bank debt.

In these ways, the appeal of seller paper may be enhanced. In certain transactions, if creatively utilized, they could potentially make the difference.

Jeffrey M. Katz
+1 212 698 3665
jeffrey.katz@dechert.com

Scott M. Zimmerman
+1 212 698 3613
scott.zimmerman@dechert.com

Going Public

By **Adam Levin** and **Claudine Ang**

Partial Exits Can Benefit PE Firms, as a £3.5 Billion Czech IPO Shows

In May 2008, the shares of New World Resources NV (NWR), a Dutch-incorporated company (formerly a wholly-owned subsidiary of RPG Industries SE) with mining operations in the Czech Republic, were admitted to trading on the London, Prague, and Warsaw stock exchanges. The offering, after exercise of the greenshoe option, was approximately £1.3 billion resulting in a market capitalization of about £3.5 billion, the largest European IPO to date in 2008. Post-IPO, RPG Industries holds approximately 63.8% of the shares in NWR.

RPG Industries is a Cypriot-incorporated company with diversified investments including real estate, transportation, and mine and landfill gas extraction. Its majority shareholders are two leading private equity players in Europe, Crossroads Capital Investments Inc and Zdenek Bakala (a Czech financier). Its minority shareholders are American Metals & Coal, Inc and First Reserve Corporation, both major international private equity investors. The IPO represents a significant partial exit for all these investors. This article examines the corporate restructure leading up to the IPO, including the use of tracking stock, a tool sometimes used in company restructurings, which tracks a division of a company's business.

PE Firms Bring Focus

The company undertook a major restructuring and recapitalization before the IPO. OKD a.s. (NWR's key operating subsidiary) was previously listed on the Prague Stock Exchange. Its then-majority investor acquired the Czech National Property Fund's significant minority stake, following which RPG Industries acquired that majority investor (in 2004) and took OKD private (in 2005), after a squeeze-out of minority interests. It was one of the largest leveraged finance transactions in Central Europe at that time.

The restructuring that followed shows the focus that private equity houses can bring to a business. This included: the consolidation of the mining businesses within one entity, OKD, rather than the five entities within which the assets had been partially held, and the demerger or sale of the company's non-mining businesses; initially demerging OKD's non-mining property portfolio and placing it under the direct ownership of RPG Industries; separating real estate used by the company in its mining activities from the company's mining operations (thus creating two separate divisions and the tracking stock concept); extracting the company's railway assets into a separate legal entity and placing them under direct ownership of RPG Industries; and transferring NWR's mine and landfill gas extraction business into a separate company wholly owned by RPG Industries, known as Green Gas International BV. The recapitalization included a €1.1 billion senior facility and €300 million high yield bond.

Tracking Stock

Tracking stock is a security issued by a company to track the performance of a division of its business or a subsidiary. It is used in corporate restructurings to track separate businesses of a company which are not, or cannot be, separated. As part of its policy of managing its real estate business independently from its mining business, RPG Industries wanted to transfer NWR's property portfolio to a separate legal entity, which it achieved with respect to the non-mining real estate.

However, mining regulations in the Czech Republic would not permit land used in mining to be removed before the cessation of mining activities. The mining assets and NWR's real estate portfolio were partitioned into separate divisions—the Mining Division and the Real Estate Division—and operated separately for accounting and reporting purposes. To reflect this division, the company's share capital was reorganized into two separate classes of shares, or tracking stock—the A Shares track the performance of the Mining Division and the B Shares track the performance of the Real Estate Division—and have no financial rights or entitlements over the Mining Division or its assets. The IPO was only with respect to the A Shares. RPG Industries has retained the B Shares.

Corporate Governance

To allay potential concerns about the relationship between the two classes of shares and the operation of the separate businesses, the company adopted divisional policy statements to ensure that the Mining Division has unrestricted access to the Real Estate Division's property, and that the Mining Division and Real Estate Division are managed in the best interests of NWR as a whole.

All dealings between the two divisions are to occur on arms' length terms as if they are separate companies. To ensure proper corporate governance procedures are in place, a real estate committee comprised of NWR's independent directors has been established. The committee oversees the assets and liabilities of the Real Estate Division, manages the interaction between the divisions in connection with the Real Estate Division assets, and reports to, and advises, the Board regarding the Real Estate Division.

Good for Investors

The tracking stock strategy has benefits and disadvantages. The benefits include: investors can track the performance of a specific part of a company's business; different investor groups can participate in separate lines of the company's business; and shared overheads.

The disadvantages include: no legal separation between the divisions so that each can suffer from unrelated liabilities in the other; potential corporate governance conflicts; and potential competition between shareholder groups.

The concept of tracking stock is useful for diversified companies, or large corporations such as NWR that have significant non-core assets. It is an effective means by which private equity and other investors can optimize exits from their investments.

A version of this article authored by Adam Levin and Claudine Ang appeared in the June 2008 edition of the International Finance Law Review (IFLR) Private Equity and Venture Capital Review Supplement.

Adam Levin
+44 20 7184 7564
adam.levin@dechert.com

Claudine Ang
+44 20 7184 7580
claudine.ang@dechert.com

Dechert Represented NWR in Its Recent IPO

About NWR

- A pure play hard-coal-mining and coke production company through its A Shares.
- A leading supplier of hard coal in the fastest growing region in Europe.
- Owns five established mines and two coking facilities in northeast Czech Republic. It is pursuing opportunities in Poland and elsewhere.
- One of the largest industrial groups in the Czech Republic in terms of assets and revenues.
- Second-largest private employer in the country with approximately 18,341 employees and 3,563 contractors.

IPO Information

- Offer priced at top of the price range: £13.25.
- Total offer valued at £1.3 billion, resulting in a market capitalization of about £3.5 billion.
- Offer over-subscribed at about 7.3 times at the top of the price range, amounting to about £9.2 billion.
- Strong institutional demand from all regions in which the shares were offered.
- Morgan Stanley, Goldman Sachs, JPMorgan Cazenove as joint sponsors, global coordinators, and bookrunners.

Current Trends in Islamic Private Equity

By **Andreas Junius**

The current market for private equity is characterized by a general lack of funding from existing sources due to the liquidity crunch triggered by the sub-prime crisis. Oil and gas exploration at record capacity in the Gulf and elsewhere, and an oil price of well over US$100 have generated an abundance of liquidity in the MENA region that is seeking investment opportunities around the world. An ever-growing portion of that liquidity is Islamic. In order to access this investor base, private equity funds need to be Shari'ah-compliant, both in terms of the assets they target as well as the way they are structured. Available Shari'ah-compliant acquisition finance structures widen the scope of available investments. Shari'ah-compliant private equity funds are also attractive to conventional investors. As Shari'ah screens exclude highly leveraged targets as well as those that engage in forbidden activities, conventional investors are attracted to Shari'ah-compliant funds because they engage in activities that are comparable to socially responsible investment objectives. In addition, notorious corporate failures such as WorldCom and Tyco were eliminated as appropriate investments by Shari'ah screens way before investors lost their money.

The Current Market

The credit crunch and liquidity constraints brought about as a consequence of the subprime crisis in the U.S. have severely restrained private equity activity. Investors seem to be reluctant to start investing their own funds again, afraid of putting a significant amount of their own investment funds at risk. Due to this liquidity shortage there is also a shortage of conventional leveraged buy-out (LBO) acquisition financing. However, this has not been accompanied by a decrease of available investment options. In fact, there are numerous buying opportunities for investors because of the attractive valuations in this recessionary environment. An obvious way of dealing with the lack of funding for the private equity market under current conditions is to create an environment that facilitates access to private equity transactions for a broader investor base.

Whereas the Western finance world is busy with write-offs and restructuring due to the subprime crisis, there are seemingly abundant funds in the Middle East region and other Muslim countries, resulting from oil and gas

production at high capacity and historically high prices for these commodities. Part of these petro-dollars is reinvested in the local infrastructure, stimulating commercial activity, and thereby raising even more demand for private equity investment. In addition, portfolio diversification driven by both commercial and regulatory requirements induces investments outside the Gulf region in a variety of asset classes and target industries. Shari'ah-compliant private equity investments and (acquisition) finance products present an opportunity to tap the vast Islamic market.

Demand for Shari'ah-Compliant Investments

Demand for Shari'ah-compliant investment opportunities and products is primarily fueled by a growing population that feels strongly about adherence to religious Islamic principles. But also less religiously-minded Muslims are likely to prefer a Shari'ah-compliant product over a conventional one if it offers comparable returns and risk profiles. Furthermore, non-Muslims are increasingly attracted to Shari'ah-compliant investments from an ecological or socially responsible investment perspective.

To illustrate the potential of Islamic funds, one only has to look at the growth rates of Islamic finance. Among investment activity in and from the Gulf region, the Islamic finance sector is growing exponentially with Islamic assets increasing 20% annually worldwide, reaching US$900 billion in 2007.[1] Historically, those funds have been invested primarily on a straight equity basis, which—as a matter of course—had a limiting effect on deal size and the ability to obtain controlling interests in targets. The following is a review of select Islamic finance issues in the traditional private equity arena and of Shari'ah-compliant acquisition finance structures that have appeared in the market in the recent past. They provide leverage and, thus, an opportunity for larger investment sizes and, potentially, enhanced investor returns.

1 Daniel Bases, "US Islamic finance market underserved" (February 8, 2008), *Reuters*, available at www.reuters.com/article/reutersEdge/idUSN0843029520080208 (accessed April 9, 2008).

To Disclose or Not to Disclose

By **Jay R. Alicandri** and **Scott M. Zimmerman**

All credit agreements contain affirmative covenants requiring prompt disclosure to the administrative agent and/or the lender(s) of the occurrence of certain specified events, such as a default or event of default, commencement of material litigation, and specified ERISA events. The notice covenant serves as an early warning sign to lenders of the potential impairment of the credit and encourages borrowers to promptly disclose material information that they may not otherwise have reason, and may in fact prefer not, to disclose. The analysis of whether disclosure of a specified event is required is typically two-pronged: first, the event must have occurred or must be reasonably likely to occur; second, the event must meet the quantitative (a dollar test) and/or qualitative (materiality) criteria for disclosure. The borrower's ability to comply with this covenant with respect to specified events or monetary thresholds is reasonably straightforward. The analysis as to whether a particular event is "material" or "has had or is reasonably likely to have a material adverse effect" is subjective and is much more difficult to navigate.

The definition of "material adverse effect" usually includes not only a direct effect on the assets, properties, financial condition, and prospects of the borrower, but also a material adverse effect on the ability of the borrower to perform its obligations under the credit agreement (including, without limitation, the obligation to comply with financial covenants). There are any number of events extrinsic to the day-to-day operations of the borrower that may have a material adverse effect on the ability of the borrower to perform its obligations under the credit agreement and, as a result, potentially trigger the disclosure covenant. For example, credit problems affecting key customers or suppliers, legislative/regulatory developments, macroeconomic events affecting the borrower's markets, raw material and/or labor shortages, and dramatic climatic events could all have a material adverse effect on the borrower's financial performance, potentially resulting in a failure of the borrower to comply with its financial covenants. As difficult as it may be to determine whether one of these types of events is likely to occur, it is even more difficult to gauge the impact on the borrower's ability to perform its obligations under the credit agreement as a result of the occurrence of any such event. The determination for the borrower as to whether an event has triggered the notice covenant can be a "lose-lose" proposition. Failure of a borrower to comply with the notice covenant is

General Shari'ah Issues in Private Equity Transactions

The investment itself needs to be Shari'ah-compliant. This requirement applies to the structure of the investment as well as to the business and operations of the target. This is one of the reasons why a major part of Islamic money is invested through Shari'ah-compliant private equity funds. The fund management, with the guidance of the manager's Shari'ah advisory board, can assure compliance of multiple investments for a larger number of individual investors. The fund itself needs to be structured in a Shari'ah-compliant fashion, providing for equitable and Quran-conforming relationships, and profit and loss sharing among the sponsor, the management, and the fund-holders. Proper guidance and periodic review by an acceptable Shari'ah advisory board must be assured.

Each investment must be Shari'ah-compliant. This involves thorough due diligence and screening of the potential targets. Such screening must address mainly two areas: the business of the target in general; and how it conducts its operations. The latter concerns primarily extensive leveraging and revenues from credit or credit-like operations. In essence, the Shari'ah prohibits investments in companies that pay or receive (an excessive amount of) interest. A decision needs to be made on a case-by-case basis and with the guidance of the Shari'ah advisory board. A practical indicator as to what is acceptable Islamically is the screening criteria developed by the Dow Jones Islamic Market Index.[2] The acceptable limits are borrowings of up to 33% of market capitalization and deriving not more than 33% of income from interest. These limits exclude most non-Islamic banks. In this context, non-bank companies whose trade receivables exceed 45% of their market capitalization are not acceptable either, as receivables financing contains an interest-based lending element.[3]

2 Guide to the Dow Jones Islamic Market Indexes (2007), Dow Jones Indexes at [5-7] www.djindexes.com/mdsidx/downloads/imi_rulebook.pdf (accessed April 18, 2008).

3 Tying the permissible ratios to market capitalization has the obvious disadvantage of being susceptible to large fluctuations depending on daily share prices. Initiatives are underway to develop some other, less volatile measure or ratio.

typically an automatic event of default (no grace period and no ability to cure), and disclosing a potential covenant default, particularly an inability to meet financial covenants, may result in the borrower losing the right to request revolving advances (potentially causing liquidity issues for the borrower) or, in the case of public company borrowers, dealing with the impact of public disclosure of a potential default. This leaves management of the borrower with the daunting task of balancing the borrower's contractual obligations (which, as noted previously, are often not black or white) against the potential substantial and adverse consequences of informing the bank group that a default has occurred.

In the end, maintaining a good working relationship with lenders is in the borrower's best interest, and erring on the side of caution in disclosure of potential credit issues supports that objective. Of course, depending on the nature and extent of the events and/or developments that are triggering the disclosure analysis, the actual disclosure of that information can be packaged in a manner that softens its impact, is not an admission of an event of default, and discusses other potentially mitigating facts.

Jay R. Alicandri
+1 212 698 3800
jay.alicandri@dechert.com

Scott M. Zimmerman
+1 212 698 3613
scott.zimmerman@dechert.com

The general business of the target must of course comply with Shari'ah principles. The production and distribution of weapons, alcoholic beverages, and pork products are unacceptable as are morally offensive activities or materials, including gambling and pornography, but also certain fashion elements. Gray areas are businesses who derive revenue only indirectly or not primarily from forbidden activities or products. Examples here are real estate companies whose tenants include conventional banks, bars, and restaurants, etc., retail chains who also sell alcohol, and hotels with gambling operations. In each case, due diligence has to produce the relevant facts, which then have to be discussed with the Shari'ah Board, who may or may not accept the target or only with certain conditions, such as requiring a phase-out of the objectionable revenue source over time and/or donating a share of the profits that reflects the forbidden activity to charity.

Shari'ah-Compliant Acquisition Financing

At first glance, Shari'ah compliance and leveraging an acquisition appears to be a contradiction in terms. Indeed, Islamic investors have historically shied away from private equity investments that are leveraged, be it in the customary 80/20 debt-to-equity ratio range or even well below those levels. This has caused a significant amount of frustration, not only because the lack of leverage generally means much lower returns on equity, but an equity-only investment, obviously, would put limits on the deal sizes and the universe of possible targets. In the recent past, however, one can see a definite change in the marketplace. A number of Islamic investors, with the approval of their Shari'ah advisors, have started to look at leveraging their investments.

The key for a Shari'ah-compliant acquisition finance structure is that the financing arrangements between the Islamic investor, directly or through the target, are in themselves Shari'ah-compliant. The ultimate funding source may, but need not, be Shari'ah-compliant. Ultimately, funding may come from the capital markets or from a single financier or a syndicated group of lenders. A common feature of these structures is that a special purpose vehicle (SPV) is established, which enters into the Shari'ah-compliant financing arrangement, while the SPV may refinance itself Islamically or conventionally. Another common feature is that (in light of the requirement that Shari'ah-compliant financing be asset-based) the financing relationship is with the target and its assets, although in certain structures (see below) the new shareholders in the financing participate directly or indirectly.

Properly structured, in a share deal, such asset-based financing affords two possible advantages that are unrelated to Shari'ah. There are, of course, benefits in bringing in the financing on the level of the target because: (a) the tax burden on operating profits generated at the target level can be reduced by the cost of financing; and (b) corporate law limitations on the use of target assets for the acquisition of shares, prevalent in particular in civil law countries, can be bifurcated. If the acquiring shareholder takes out a Shari'ah-compliant facility or capital market financing, acquires the target shares and repays the financing out of the expected dividend stream, the operating profits are fully taxed on the target level and, depending on the acquirer's tax regime, the financing costs may or may not reduce the tax burden on dividends from the target. Also, under certain corporate legal regimes, the investor may not use the target's assets as collateral, but is limited to the acquired shares.[4]

In contrast, if it is the target that takes the financing, the financing costs reduce operating profit and resulting taxes

[4] These limitations apply to share acquisitions as opposed to asset acquisitions.

at the target level. In addition, the target's assets can serve as collateral.

In an asset deal, the acquisition structure is relatively simple: the buyer sets up an acquisition entity that buys the target's assets (and liabilities) and uses such assets to finance their acquisition. In a share deal, the structure is somewhat more elaborate: the target company obtains the financing and uses the proceeds to redeem the portion of the seller shares that is commensurate with the debt-financed portion of the acquisition. From the financing proceeds the compensation payment for the redeemed shares is made. The remaining shares can then be acquired in a regular share transfer to the purchasing shareholders and paid with equity.

As noted above, depending on the ultimate source of financing, the target will deal either directly with the Islamic financier or, as is more customary, with an SPV that in turn obtains the third-party financing. Because they allow access to conventional funding sources and thereby to a much larger universe of potential lenders, the structures involving an SPV are the most prevalent.

The centerpiece of the Shari'ah-compliant acquisition facility, therefore, is an SPV (in U.S. acquisitions, typically a Delaware corporation) which, however, may not be owned by or be affiliated with the Islamic investor. Rather, the investor will contract with a service company that establishes and manages such an "orphan" SPV for a fee. The SPV then takes out the conventional acquisition financing and passes it on to the target (who applies the financing to the redemption of a portion of the seller's shares) by way of (for example) an Ijarah arrangement (Ijarah wa-Iktinah).

Ijarah is very similar to a conventional sale and lease-back in that the SPV acquires all, or a portion, of the assets of the target and immediately leases them back. The acquisition price equals the financing portion of the overall acquisition and the lease rentals paid by target to the SPV match the debt service the SPV owes to its financier(s).The Ijarah will be accompanied by put and call options with respect to the target's assets between the target and the SPV in order to address early prepayment or default scenarios under the Ijarah.There is typically also a guarantee, by the acquiring Islamic shareholders vis-à-vis the SPV, to cover for any shortfalls in the target's operating profits that would prevent the target from meeting its rental obligations to the SPV and the SPV from satisfying its own debt service obligations. The Ijarah and accompanying agreements put the SPV in a position to grant a customary collateral package (pledge of assets, lease rentals, and investor guarantee) to its conventional lenders. In addition, there will be a tax matters agreement between the SPV and the target that secures that both entities take similar tax positions with respect to the leased assets. Also, the acquiring investors will be granted a purchase option for the service company's shares in the SPV to allow them to collapse the structure at the end of the financing.

The Ijarah-based Islamic financing structure is probably the most suitable of scenarios, where a stable flow of cash can be expected from the target's operations and where the regulatory or tax regime of the relevant jurisdiction provides no impediment to sale and lease-back arrangements. As an alternative to a conventional funding source for the SPV, it may issue Sukuk and, thus, refinance itself in the capital markets. The underlying assets for the Sukuk may, again, be brought about by way of Ijarah.

Alternatively, a Sukuk al Musharakah may be established, whereby the SPV, refinanced by proceeds from the issuance of Sukuk certificates, enters into a partnership-like arrangement with the acquiring Islamic investor under which the latter brings in and manages the business of the target and the SPV contributes the financing. The revenue from the target's operations is shared in such a way that the Sukuk financing is serviced and repaid over time. Because the payments of the Sukuk-holders under a Sukuk al Musharakah are based on the target's profits, this structure allows for structural subordination of the Sukuk-financing to other parallel financing arrangements, for instance under the straight Ijarah set forth above.

To the extent the target has operating financing in place, this must be replaced with Shari'ah-compliant financing structures. Depending on the target's business, this can be achieved by way of forward sale arrangements (Bai Salam) with respect to the company's production output. General funding of the target's operations, especially on a revolving basis, is frequently structured by way of metals-based Murabahahs or Tawwarukh. In these structures, the target buys certain allowed commodities (copper, platinum, etc.) for which there is a liquid market from the financing bank on a deferred payment basis. It then immediately resells the commodity on a spot basis to the bank or sells it on to a third party. This structure in effect generates cash for the target at the time the Murabahah or Tawwarukh is entered into.[5]

[5] At present, some of these structures have come under increased scrutiny and criticism from Shari'ah scholars, especially where the buying and selling broker at the relevant commodities exchanges were identical and/or no actual metal trades were made but simply book entries took place.

Conclusion and Outlook

The foregoing is meant to provide a very basic and rudimentary overview of current trends in acquisition finance in the mergers and acquisitions and private equity arenas as they relate to Islamic investments. Islamic banking and finance as an industry is in a constant state of flux and development. Innovative structures as well as those that attempt to make conventional financing Shari'ah-compliant are being developed, documented, and implemented. Islamic finance offers interesting alternatives to all sides of the market:

- in the current environment of tight lending conditions and liquidity constraints, buyers, borrowers, and other parties in need of financing may want to look at Shari'ah-compliant investment sources;
- Islamic investors have the opportunity to look at bigger transactions and a larger spectrum of available targets and investments; and
- not only Islamic but also conventional investors have an incentive to look at Islamic investment structures because these structures are becoming more and more prevalent and offer competitive terms and returns. More importantly, they offer a defined investment spectrum attractive to investors from a socially responsible investment perspective, as the Shari'ah disallows investments in industries that a socially responsible investor would seek to avoid.

Regulatory and tax issues have traditionally been an impediment to Islamic finance structures in Western jurisdictions. However, there is a notable change in attitude toward this market sector. The UK has seen the licensing of Islamic commercial (First Islamic Bank of Bahrain in 2005) and investment banks (European Islamic Investment Bank in 2007), both of which are listed in the AIM section of the London Stock Exchange. Others have followed suit. The British Government has recently removed double stamp duties on the transfer of certain assets, which had been an impediment to Sukuk issues. On the Continent, Germany, for instance, has recognized the importance of Islamic finance for the German financial markets, as evidenced by a recent speech by a member of the Executive Board of the Deutsche Bundesbank.[6]

[6] Boehmler, speech held at the 2nd Islamic Financial Services Forum in Frankfurt on December 5, 2007, available at www.bundesbank.de/download/presse/reden/2007/20071205_boehmler.pdf.

This article was first published in the Islamic Finance Review (May 2008).

Andreas Junius
+1 212 698 3578
andreas.junius@dechert.com

Rights Offerings: The Time is Right for Private Equity Sponsors

By **Bonnie A. Barsamian** and **William Tuttle**

Due to the recent turmoil in the capital markets, an increasing number of U.S. companies are seeking alternative means of raising capital. While rights offerings represent an important and relatively common capital-raising strategy among European issuers, due in part to the existence of statutory preemptive rights in favor of shareholders, rights offerings for U.S. companies other than closed-end funds have generally been viewed as a less favorable alternative to a capital raise from new investors through an underwritten public offering. Recently, share sales to sovereign wealth funds at substantial discounts to market value have attracted controversy, causing high-profile financial institutions to reconsider the use of rights offerings to raise needed capital without upsetting existing shareholders.

Rights offerings offer private equity sponsors alternative means of raising capital for publicly owned portfolio companies, particularly in constrained equity and debt capital markets, at a potentially attractive cost of capital and in a manner that reduces potential conflict with the public shareholders of those portfolio companies with regards to pricing. In addition, depending upon its structure, a rights offering can afford a private equity sponsor the opportunity to make a significant investment in a public company through a back-stop commitment.

Structure of Rights Offerings

Rights offerings typically provide an issuer's existing shareholders the opportunity to purchase a pro rata portion of additional shares at a specific price per share, often at a discount to the current market price. Because a rights offering is extended to all existing shareholders on a pro rata basis, there is minimal dilutive effect to

shareholders who exercise the rights issued to them. Any dilution to exercising shareholders results from the discount in price, if any. In addition, shareholders who exercise their rights may be entitled to subscribe, subject to certain limitations and to allotment, for shares that remain unsubscribed.

Shareholders typically have 15 to 20 days from the designated record date in which to exercise their rights and forward payment to an escrow agent. If the rights are made transferable, they will typically be traded on the same securities exchange on which the issuer's common stock is listed. Shareholders not exercising their rights are able to mitigate the dilutive effect in a transferable rights offering by selling such rights on the open market.

Rights offerings may also be structured to include a "backstop," or a standby commitment by a third party to purchase on the same terms any shares that are not subscribed for by existing shareholders (or their transferees) upon exercise of the rights. Although back-stop commitments typically have been provided by investment banks or affiliates, a back-stop commitment can also be provided by, and be attractive to, a private equity sponsor. A backstop commitment from a private equity sponsor, for example, might be combined with a commitment from the issuer to grant the backstopping entity a guaranteed minimum ownership interest in the issuer after giving effect to the offering. The backstop provider may also secure an agreement from the issuer to grant it certain governance rights, such as board representation and voting rights. Careful attention in structuring, however, is necessary in order to avoid inadvertently triggering Revlon duties, change of control provisions under the issuer's debt instruments, or interested stockholder provisions under applicable state corporate law. A rights offering that provides a minimum ownership commitment and governance features can offer a private equity sponsor an effective and potentially lucrative means of deploying capital.

Advantages of Rights Offerings

Rights offerings offer several potential advantages to issuers over follow-on offerings of common stock. Some issuers appreciate the egalitarian method of offering all existing shareholders the opportunity to purchase shares. Rights offerings that are backstopped provide an issuer with certainty of execution. In addition, rights offerings are exempt from the shareholder voting requirements imposed by the national securities exchanges in connection with issuances of common stock representing 20% or more of the voting power outstanding before issuance because they are deemed to constitute "public offerings for cash."[1] Conversely, certain private investment in public equity (PIPE) transactions and large private issuances typically do require shareholder approval, the receipt of which is not a certainty and may involve significant delay. For example, in connection with its recent $7 billion capital infusion, Washington Mutual, Inc. issued convertible Series T preferred stock, which cannot be converted until receipt of shareholder approval since such stock, on an as-converted basis, will represent greater than 20% of Washington Mutual's voting power. A rights offering, however, would not require such approval.

Many rights offerings feature a dealer manager to coordinate the rights offering and assist the issuer in garnering interest in the rights. Sales commissions associated with this role are typically lower than underwriting discounts for follow-on offerings. This is particularly true for European issues. In addition, because rights offerings are targeted at existing shareholders, roadshow expenses are generally lower than those associated with a follow-on offering

[1] If the offering is backstopped, the NYSE will generally view the issuance to the standby purchaser pursuant to a standby purchase agreement to be part of a public offering for cash if the backstop is on the same items as the rights offering and therefore exempt from the applicable NYSE shareholder approval requirements. However, if the standby purchaser is a current shareholder of the company, the NYSE takes the position that the standby purchaser may not participate in the rights offering unless there is an oversubscription privilege, in which case such shareholder/standby purchaser would be permitted to participate in the rights offering but not in the oversubscription.

of common stock. Alternatively, a rights offering, often distributing non-transferable rights, may be completed without the assistance of a dealer manager, thereby eliminating sales commissions and maximizing proceeds to the issuer.

Recent Rights Offerings

Several prominent European financial institutions have recently completed rights offerings in part to maintain sufficient regulatory capital and also to allay market concerns regarding their exposure to mortgage-backed securities. Royal Bank of Scotland Group plc and UBS AG, for example, have raised approximately $24 billion and $14.5 billion, respectively, through fully underwritten rights offerings being conducted at steep discounts to trading prices in the secondary market. These offerings have been managed by the European affiliates of several major U.S. investment banks including Goldman Sachs, Merrill Lynch, and Morgan Stanley.

In the U.S. domestic market, several closed-end funds, including Ares Capital Corp., Kohlberg Capital Corp., MCG Capital Corp. and TICC Capital Corp., and KKR Financial Holdings LLC, a specialty finance company, have completed rights offerings in the past several months, and two high-profile issuers, MBIA Inc. and Blockbuster Inc., have announced proposed rights offerings over the past year. Commercial bond insurer MBIA entered into an agreement with Warburg Pincus in December 2007 pursuant to which Warburg Pincus agreed to invest $1 billion in MBIA through a direct purchase of common stock and to backstop a subsequent rights offering. The backstop arrangements in the initial agreement were modified in February 2008 and expired unused following the completion of a $1 billion offering of common stock.

Shortly thereafter, in April 2008, Blockbuster, in connection with its $1.35 billion all-cash offer to acquire Circuit City Stores, Inc., announced it would potentially undertake a rights offering, possibly backstopped by affiliates of Carl Icahn, to finance the transaction rather than seeking extensive debt financing. Due to the size of the pending transaction compared to Blockbuster's market capitalization, both a PIPE transaction and primary common stock issuance would likely trigger contractual change-of-control provisions in Blockbuster's debt instruments and potentially Revlon duties under Delaware law. Also, a PIPE transaction would require shareholder approval. Instead, the proposed rights offering would allow Blockbuster to avoid triggering change-of-control provisions and shareholder vote requirements while still raising the necessary capital to finance the proposed transaction. Although the proposed rights offering by MBIA was abandoned and the Blockbuster offering appears to be on hold pending the possible consummation of its acquisition of Circuit City, these contemplated offerings helped to raise the profile of the rights offering as a respectable and viable capital-raising technique.

More recently, in August 2008, Griffon Corporation announced a rights offering to be backstopped by GS Direct, L.L.C., an affiliate of Goldman, Sachs & Co. As part of the proposed transaction, GS Direct has provided a 100% backstop, agreeing to purchase all shares that are not subscribed for by existing shareholders, thereby guaranteeing Griffon gross proceeds of approximately $170 million. Griffon, in turn, has guaranteed GS Direct the ability to purchase $85 million of shares even if the rights offering is fully subscribed, so that Goldman's minimum investment in Griffon is assured and Griffon has the potential to receive additional funds. Griffon has also agreed to provide GS Direct with certain governance rights, including representation on Griffon's board of directors, as well as certain registration rights. To avoid potential change of control issues, GS Direct has agreed to certain standstill and voting arrangements and to certain limitations on Board representation in order to assure Griffon's continuing independence. In the ten trading days following the announcement of the rights offering, Griffon's stock price increased by approximately 24% with a significant increase in average daily trading volume.

By offering the issuer an effective way to strengthen its balance sheet in constrained debt and equity capital markets, mitigating the execution and pricing uncertainties inherent in a public offering, offering an issuer's existing shareholders the opportunity to invest alongside a strong private equity sponsor, and offering a private equity sponsor an effective means of deploying capital, a rights offering can be a win-win for all involved.

The time is right for private equity sponsors to consider the rights offering as an attractive way to raise capital and/or make a private equity investment.

The authors would like to thank Martin Nussbaum for his assistance with this article.

Bonnie A. Barsamian
+1 212 698 3520
bonnie.barsamian@dechert.com

William Tuttle
+1 202 261 3352
william.tuttle@dechert.com

Upcoming Speaking Engagements

Strategics vs. Financials: Doing Deals in a New Economy
September 17, 2008 – 2:00 PM (EDT)
Complimentary Webinar

Martin Nussbaum will participate as a speaker on a webinar that is being hosted by *The Deal* titled "Strategics vs. Financials: Doing Deals in a New Economy." The panel will explore topics such as: the state of the M&A market in an evolving market; who has the edge—strategics, private equity, or hedge funds; and lessons learned in diligence and execution. To register for this complimentary webinar, please visit: www.thedeal.com/marketing/webinar/stratvfin.

2008 In-House Congress Hong Kong
September 30, 2008
JW Marriott Hotel Hong Kong
Hong Kong

Basil H. Hwang will lead a panel titled "Asian Private Equity Deal Terms" at the 2008 In-House Congress Hong Kong conference. The panel will address issues and challenges in private equity across Asia. To register, please visit: newsletter.pbpress.com/v071/index.php?page=public_form&event_id=b43ad471dadf91a5ee0667150302f913.

Financial Research Associates' Private Equity Financial Management Summit
December 9–10, 2008
The Flatotel
New York

Daniel M. Dunn will participate in a panel discussion titled "Investments in Tax Transparent Entities: Innovative Techniques to Minimize Tax Burdens and Maximize Returns." To register, please visit: www.frallc.com/conference.aspx?ccode=B671.

For more information about these conferences or to obtain a copy of the related presentation materials, please contact Michelle Lappen at + 1 212 698 8753 or michelle.lappen@dechert.com.

New Additions to Dechert's Private Equity Team

In September 2008, **Henry Wang** joined Dechert's newly licensed Beijing office as a corporate and securities partner. Mr. Wang has extensive experience representing private investors, financial institutions, and global corporations in connection with corporate matters involving China. He frequently counsels Chinese companies seeking to establish or expand their global footprint outside of China.

In June 2008, **Shmuel Vasser** joined Dechert's New York office and has experience in all aspects of bankruptcy, workouts, and distressed situations. He has represented various hedge funds and private equity firms, acquirers of distressed assets and securities, debtors, creditors, Chapter 11 and Chapter 7 trustees, creditors' committees, and institutional lenders. Mr. Vasser routinely advises on the structuring of innovative transactions and new financial instruments.

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.

Dechert
LLP

www.dechert.com

© 2008 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions, and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

The United States Treasury Department issues Circular 230, which governs all practitioners before the Internal Revenue Service. Circular 230 was amended to require a legend to be placed on certain written communications that are not otherwise comprehensive tax opinions. To ensure compliance with Treasury Department Circular 230, we are required to inform you that this letter is not intended or written to be used, and cannot be used, by you for the purpose of avoiding penalties that the Internal Revenue Service might seek to impose on you.

U.S. Austin • Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels London • Luxembourg • Munich • Paris • **ASIA** Beijing • Hong Kong